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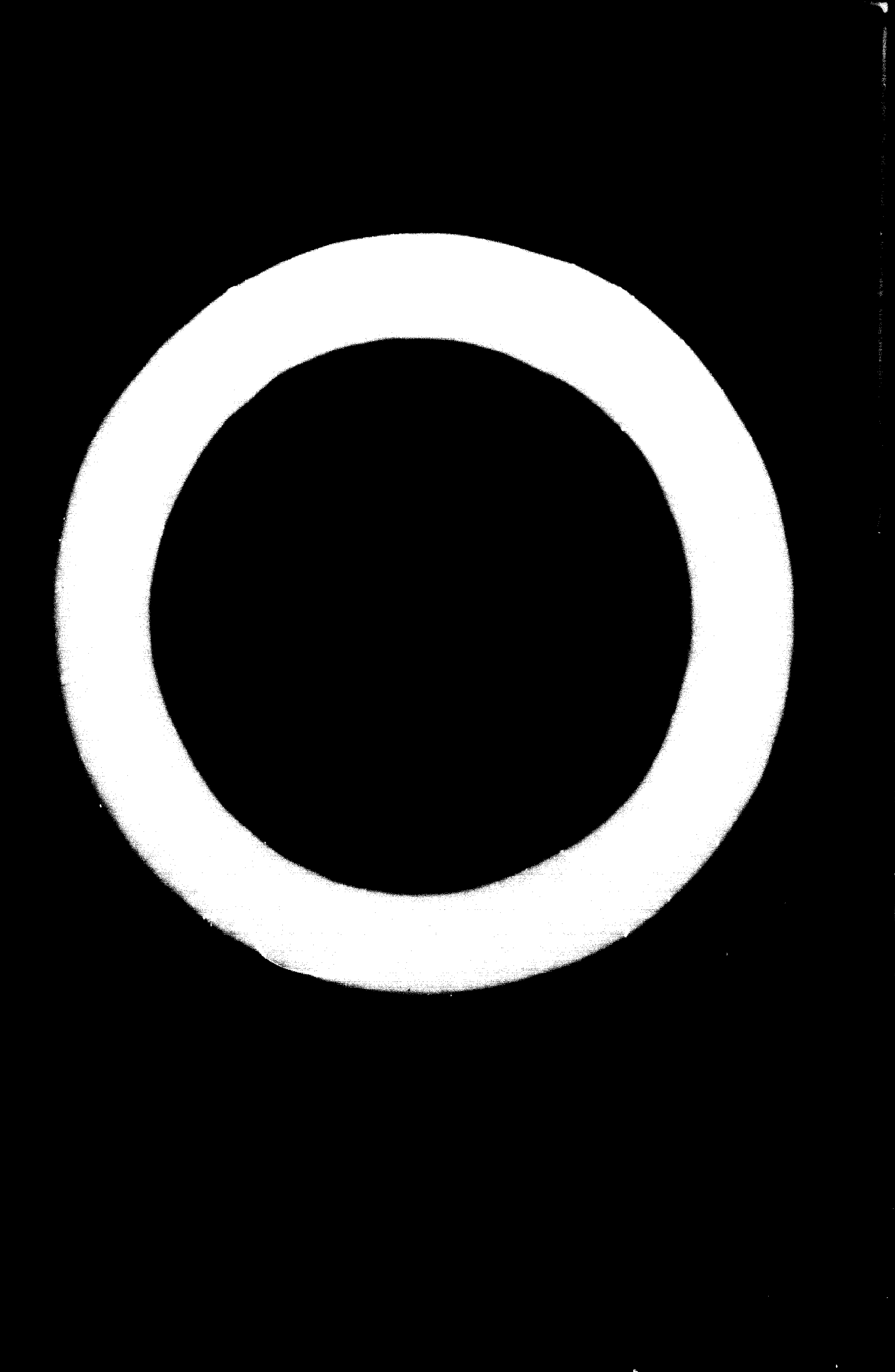
UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION

INDUSTRIAL REORGANIZATION AND MERGERS

Report
of an Expert Group Meeting
Vienna
7–10 November 1972

CONTENTS



INTRODUCTION

As part of the activities of the United Nations Industrial Development Organization (UNIDO) designed to develop a better understanding of industrial policies, an Expert Group Meeting was arranged to consider the subject of industrial reorganization and mergers. The Meeting was held at Vienna from 7 to 10 November 1972.

Five experts were asked to review the experience of their countries and to consider what lessons that experience provided for other countries, including countries at an earlier stage of industrialization. They were Hilton Liviero Pezzoni (Brazil), Jean-Jacques Bonnaud (France), R. V. Subrahmanian (India), Takeshi Isayama (Japan) and Nicholas A. H. Stacey (United Kingdom of Great Britain and Northern Ireland). The experts were acting in their personal capacity and not as representatives of their Governments.

This report draws on the experience of the five countries specifically to explore the reasons for increased industrial reorganization activity in recent years (chapter I), to consider why Governments have found it desirable and sometimes necessary to intervene to promote such reorganisation (chapter II), and to examine the types of policies and institutions that can be used to implement this intervention (chapter III).

The extent to which this experience can be transferred to other countries, including countries at an earlier stage of industrialisation, is considered in chapter V. Ways are suggested in which UNIDO can help to make this transfer of experience both effective and useful.

The Expert Group found that industrial reorganization was becoming an international as well as a national concern (chapter IV). The future development of industries in industrialised and developing countries should follow a mutually advantageous pattern. Developing countries should become increasingly important exporters of those manufactured products and parts that they can produce more cheaply, and developed countries should take this into account in their policies for industrial reorganisation.

In this and the following chapters the views expressed are those of the experts.

I. REASONS FOR INCREASED ACTIVITY IN INDUSTRIAL REORGANIZATION

Industrial reorganization has become an important area of industrial policy in most industrialized countries in the last 10 years. The tempo of industrial reorganization increased in the 1960s as domestic competition intensified, the pace of technological change accelerated, and competition from international sources became steadily more important. The substantial reduction in trade barriers between industrialized countries achieved in the last 15 years, fast-growing markets and larger economic groupings have all helped to produce a marked trend towards larger units. In these circumstances, Governments have accepted the need for the concentration of industry into a smaller number of larger units and, in some sectors of industry, they have found it necessary positively to promote such a change. Instead of focusing exclusively on fostering competition among domestic enterprises by outlawing monopolies and cartels, industrial policy has become more flexible in order to respond better to the growing force of competition from international rather than domestic sources.

Most developing countries have remained largely isolated from these changes, because they have continued to protect their industries from external competition with substantial tariffs or control of imports. However, the adverse effect of high-cost (heavily protected) industries both on domestic consumers and on export prospects is now more widely recognized than it was in the 1960s. Many developing countries urgently need to increase their exports of manufactures to keep their international payments in balance in the 1970s. To raise levels of efficiency and to help achieve their export targets, specific measures to facilitate and promote industrial reorganization have been introduced by Governments in a few of the more industrialized developing countries. Although this is a very recent occurrence, other developing countries are likely to follow this practice in the 1970s.

The aim of Governments in promoting the reorganization of industry has varied from country to country; policy has changed within one country; and the reorganization of different branches of industry has been approached in different ways. However, in practice it is usually possible to classify the motive for reorganization either as defensive (when management needs to be improved to deal with adverse circumstances) or as aggressive (when management needs to be strengthened or expanded to take advantage of particularly favourable opportunities). The textile, shipbuilding and coal-mining industries are examples of industries that have been reorganized in a defensive manner in some industrialized countries, in order to deal with a declining demand for the industry's products. The computer industry, electronics and some branches of the electrical and machine-tool industries are examples of industries in which some aggressive reorganization has been required as a basis for further expansion to meet growing demand at home and abroad.

In most cases, the need for reorganization has arisen because the existing structure of the industry, requiring the division of responsibility for management, was found inadequate to cope with the changed circumstances faced by the industry. Some industries were fragmented into too many independently managed units, making it difficult for each unit to rationalize production and to adopt improved technology as it became available. Others have experienced major shifts in demand for their products or have suffered from greatly increased competition from both domestic and foreign sources. Still others have been affected by growing foreign competition, which has been facilitated by a substantial reduction in the tariff and other barriers to trade between industrialized countries over the last 15 years. Whatever the cause, a larger management unit has been required to improve the competitive position of the industry and help it to maintain its status as an important supplier to the market, in addition to providing the special skills necessary when the operation of several units has needed to be rationalized or contracted.

In many cases, the need to reorganize an industry to take advantage of expanding demand has also derived from the fragmented structure of the industry. The expansion of firms that have required either new capital investment in large quantities or a sustained high level of expenditure on research and product development has been found desirable from the national point of view, yet it has been beyond the resources of existing firms acting independently. A trend towards more efficient and sometimes larger management units has been noted in industries with continuous production processes (for example, chemicals and petrochemicals) and in industries where a rapid pace of technological advance has been achieved by massive expenditures on research and product development (for example, electronics, aerospace, pharmaceuticals and specialized machine tools).

The scale on which industrial reorganization has been carried out in developing countries has been much smaller, but the pattern so far seems to have been much the same. Examples are found of both types of reorganization in India (for example, jute, textiles, steel and machine tools) and in Brazil (for example, textiles and steel). In developing countries, the need to consider a large-scale reorganization of industry is usually less urgent and subject to more constraints. Limitations of domestic demand tend to impose a constraint on the size of the plant to be installed, except in areas where exports are possible. Even where, because of growing domestic demand, export prospects or the need to update technology, the reorganization of industrial units is considered necessary, developing countries do not view such problems from the same angle as they are viewed in industrialized economies. Reorganization of industries, whether through mergers or other means, generally involves substantial changes in ownership and control of the means of production, and it may bring in its wake sensitive social problems. The important question that these countries have to face is how to benefit from modern, efficient large-scale industrial and business enterprise without injury to broader social objectives and interests. Each country has to find an appropriate answer with due regard to its tradition, experience and social and economic systems. A degree of State participation is often found necessary in actual practice in such reorganization schemes to secure a balance between economic and social considerations.

In both industrialized and the larger developing countries, then, government intervention to promote industrial reorganization has tended to concentrate on industries that are of strategic importance to the future growth of the industrial sector and the economy as a whole. Strategic importance appears to have been defined not only in terms of ensuring that the industry should be capable of meeting growing external competition but also that it should make full utilization of the country's natural resources (agriculture, minerals etc.), that it should have a major impact on further industrialization potential (machine tools and steel), that it should be subject to national control when it is a key industry for technological advancement (computers), and that it should develop adequate national sources of supply for materials and products which the country would need in the event of an emergency.

II. GOVERNMENT INTERVENTION TO PROMOTE INDUSTRIAL REORGANIZATION

The main purpose of industrial reorganization is to combine management responsibility for and the resources of two or more units so that their efficiency in the invention, manufacture and distribution of products or services may be improved in current operations and for future development. A more efficient or larger management unit may be needed: to reduce the number of manufacturing units, to improve the allocation of production to each unit (to overcome bottle-necks), to increase the length of production runs, to rationalize the system of distribution, to avoid duplication in research and product development, and to economize on management personnel etc.

These objectives are the same whether the firm represents public, private or a mixed pattern of ownership. The role that government intervention plays, however, will usually vary according to the type of ownership prevailing in the industry. Where the Government has a direct or indirect share in the ownership of a majority of the firms comprising an industry (as is often the case in a developing country where government-owned financing institutions are usually a major source of industrial financing), the Government itself may have some financial interest in the benefits of reorganization.

The need for a Government to take specific action to initiate reorganization at the level of a sector of industry depends on the influence that the Government can exert over the firms in the sector concerned. In most countries, the machinery established for joint government-industry consultation provides an opportunity for the Government to exert some degree of influence over the evolving structure of at least the more important sectors of industry. The most meticulous forms of consultation between industry and Government is found in Japan, but Brazil, France and the United Kingdom of Great Britain and Northern Ireland have also developed channels of communication. India for many years has had a system of licensing all major new investments in the industrial sector. Consultation over the form of new investment has not, however, obviated the necessity to reorganize a sector of industry when circumstances have changed at a later date.

The need for subsequent reorganization has often been identified by government studies made for indicative planning purposes. These have revealed weaknesses caused by the fragmented structure of a sector of industry and the need to change the structure. However, such studies have been made of only a few sectors of industry in most countries, since a very extensive and repeating range of studies would be needed to obtain a detailed picture of the constantly changing anatomy of the industrial sector as a whole.

In practice, therefore, extensive industrial reorganization has taken place on the initiative of the firms themselves without government intervention. In France, Japan, and the United Kingdom the contribution that such mergers have made to industrial reorganization has been substantial and is of growing importance. In recent years, the number of mergers has exceeded 4,000 a year in the United States of America and 1,000 a year in France, Japan and the United Kingdom. In Brazil and India the number of mergers has been relatively small.

Industrial reorganization through mergers takes various forms. If one firm absorbs another, thereby maintaining management responsibility for the enlarged enterprise, the merger may be called an "acquisition". If both enterprises (or in some cases more than two enterprises) lose their legal identity and together assume a new identity, the merger may be called an "amalgamation" or "fusion" of the enterprises involved; but in practice, there have been very few true mergers in this sense. Another form is the agreed sale of a manufacturing or trading unit by one enterprise to another, which may be called a "divestment", "de-merger" or "scission". The essential feature of each form is that the number of units managed by one management group is changed in a manner that permits improved co-ordination of their operations and future development. All of the above forms of industrial reorganization have been used to a greater or lesser degree in the five countries represented at the Meeting.

Obstacles to the implementation of mergers have been largely removed in countries where mergers have become an established or increasingly important part of the pattern of industrial life. The legal system of these countries facilitates a fusion of two or more industrial enterprises, and a substantial increase in the number of mergers has been made possible as the capital market has grown in flexibility and sophistication. The flexibility of the capital market can be measured by the proportion of companies quoted on the stock exchange to private family-owned enterprises; the ratio is highest in the United Kingdom and the United States and lowest in most developing countries. The sophistication of the capital market is reinforced by the defined responsibility of companies to report to their shareholders and to have their accounts independently audited. The amount of information legally required to be provided to shareholders was found to be highest in the United Kingdom and the United States and higher in Japan than in France. In developing countries shareholders are becoming increasingly conscious of the need for more information.

In addition to these institutional factors, the system of taxation may act as an obstacle to mergers. Where annual profits are the main basis for the taxation of companies (as in India, the United Kingdom and the United States), the taxation system may pose problems for mergers but not disadvantages. But in countries where the level of taxation is seriously affected by a revaluation of the assets (made necessary by inflation, for instance, in certain countries), the revaluation made at the time of the merger may increase the tax burden and thus discourage the merger. The Expert Group noted that the Governments of Brazil and France had introduced special laws to lessen or remove the impact of such obstacles posed by the tax system in their countries. India had exempted gains accruing from a merger from the capital gains tax.

Practical experience in industrialized countries has demonstrated that the relationship between the persons who own or hold senior management posts in the firms concerned may well decide whether or not a proposal for a merger is sympathetically considered, examined and finally implemented. Hence, even when two companies quoted on the stock exchange are involved, the personal element may act as a real obstacle to a planned merger. The extent to which government persuasion (either direct or indirect) has been used to overcome such obstacles appears to have been limited.

Thus in countries where both the existing traditions and the sophistication of business organization facilitate mergers, much of the necessary industrial reorganization may be achieved without government intervention, or intervention may be confined to the Government's indicating what changes it feels are desirable. In other countries, more direct forms of intervention may be needed as well as the more general measures described above to improve the circumstances under which firms can merge on their own initiative.

III. POLICIES AND INSTITUTIONS USED BY THE GOVERNMENT TO IMPLEMENT INDUSTRIAL REORGANIZATION

The Expert Group noted that government policies designed to influence the evolving structure in various industrial sectors initially had mainly the regulatory function of ensuring that the concentration of industry should not create a monopoly situation that was potentially dangerous to the interest of consumers. Acceptance of the view that such concentration may be desirable in the national interest is a relatively new aspect of industrial policy; it is based on the realization that international competition may exert sufficient control over a monopoly supplier even if national competition does not.

The change in policy has usually been gradual and pragmatic. Surveillance over potential abuses of a monopoly supply position has been maintained or intensified. In France and Japan most mergers have required the approval of a government agency. In the United Kingdom, the Government has reserved the right to investigate mergers where a monopoly situation or other circumstances unfavourable to the consumers' interest might be created.

In the industrialised countries, in appropriate cases, the Government now puts greater emphasis in its appraisal on the need for a national industry to be powerful and competitive enough to meet international competition than on avoiding the concentration of a dominant part of the country's sources of supply in one firm. Governments have shown an increasing willingness to accept the emergence of one or two leading firms that are capable of planning and implementing the further development of a particular industrial sector. As investment capital has become more readily available, policy has favoured the expansion by acquisition or merger of firms that have demonstrated their capacity for entrepreneurship, technical innovation and developing the skilled manpower on which further progress depends.

In Brazil and India, government policy recognizes the need for mergers when these can be shown to be in the national interest. But since they are both very large countries, a clear distinction is made between large-scale and small- or medium-scale manufacturing units. In Brazil, the Government actively supports the merger of two firms where this can be shown to result in increased competitiveness and lower costs. In India, the policy follows the same criteria, but it takes into account the Government's regional and social objectives. In addition, the large well-established firms are encouraged to use their resources of management and finance to develop industries requiring heavy investments and technology new to India, so that the development of other industries, where entry is easier, is left open to a new generation of Indian entrepreneurs.

Apart from official government persuasion, the principal means used to promote industrial reorganization has been financial incentives. Where reorganisation has meant a rationalization of production requiring substantial investment in new equipment, financial incentives in the form of tax concessions or investment grants have been provided. Where reorganization has been intended to facilitate expansion, the provision of financing, sometimes at a favourable rate of interest, has been the favoured means.

The experience of using a new institution to promote industrial reorganisation is found in the United Kingdom, where the Industrial Reorganisation Corporation (IRC) operated from 1966 to 1972, and in France where the Institut de développement industriel (IDI) (Institute for Industrial Development) has been in operation since 1969. In Brazil, the Fundo de Modernizacão e Reorganizaçao Industrial (Fund for Industrial Modernization and Reorganization), together with other government-sponsored sources of financing, has supported the reorganization of industrial sectors and specific mergers. In India and Japan, existing financing institutions have been used.

The functions of the IRC were defined in very broad terms: it was asked to promote or assist the reorganization or development of <u>any industry</u>, and, if requested by the Government, to establish or promote the establishment or development of <u>any industrial enterprise</u>. In determining how to exercise these functions, IRC was left considerable independence: it was "the duty of the Corporation to consider which industries it would be expedient to reorganize or develop". The IDI has been entrusted with a specific task, namely, to "examine the over all situation in certain sectors (designated by the Government as priority sectors, mainly on the basis of recommendations in the national plan) in order to bring out their weaknesses and potential for expansion, with the possibility that this examination will lead it (the IDI) to suggest various measures for promoting the development of a sector as a whole or of certain enterprises".

The Expert Group felt that when establishing new institutional machinery for promoting and implementing industrial reorganization, the Government should ensure that its functions should be clearly defined at the outset. The way in which government policy on industrial reorganization was formulated and implemented should be clearly defined, careful account being taken of the extent to which industrial reorganization was already being promoted by other government agencies and by private institutions.

When determining the functions of such a government agency, it is advisable to distinguish between inquiry and research, which have the aim of identifying the need for reorganization, and the provision of finance which may help to ensure that such a reorganization shall be implemented. While there are some administrative advantages in combining these two functions, there is a danger that a single state organization having the powers both to recommend and to implement industrial reorganization by mergers or de-mergers would not be subject to the checks and balances that would exist if the decision to finance reorganization were carried out by a separate agency. For this reason, some participants felt that the two functions should be separated, and, if necessary, two separate institutions should be established.

If this approach were adopted, one institution would have the power to initiate inquiries into sectors of industry with a view to examining whether or not concentration in any given field would be desirable; and having agreed to initiate an inquiry, it would then have the facilities to carry out research into its chosen field to ascertain if a proposed concentration would be commercially or industrially advantageous and economically feasible. Thus, this government agency would have facilities to carry out research into corporate mergers and their effects on the concentration of industry, as well as to undertake studies aimed at divestment and diversification of companies. The provision of finance would be entrusted to another governmental or quasi-governmental agency, which would be versed in the problems of the structure of industry and of the provision of finance for its expansion or diversification. Such an institution would provide a second opinion on and independent evaluation of whether the provision of such funds would be desirable. If this were found to be appropriate, the funds would be provided by the Government, if need be, under favourable conditions.

IV. INTERNATIONAL ASPECTS OF INDUSTRIAL REORGANIZATION

Although the Expert Group was primarily concerned with policy at a national level, it noted that the reorganization of industry could also be considered at the international level. The industrial policies of industrialized and developing countries were interdependent; the type of reorganization policy that industrialised countries adopted could affect the export prospects for the manufactured products, sub-assemblies or components that developing countries could manufacture at lower cost. If the policy of industrialised countries were adapted further to accommodate a sizable expansion of the production and export of such manufactured goods from developing countries, the mutual benefits of a more efficient international pattern of location and organization of industry could be realised.

There are signs that such a gradual change is already taking place, largely on the initiative of individual firms, but aided in a few cases by support from government policy. In the last 20 years, many firms have become international in their operations. Although the efforts of many firms concentrated initially on the industrialized countries, many now include developing countries (particularly the more industrialised countries) in their global production and marketing strategy. A growing number of firms have already allocated part of the production of their products and components for world markets to developing countries, which offer available skilled manpower and other economic advantages. More recently, in a few cases, an entire plant, which had become too costly to operate in an industrialized country, has been moved to a developing country where, with the readily available manpower, it could be operated profitably to supply both the domestic and export markets.

Other forms of international industrial co-operation are also emerging among industries of private, public or mixed ownership, which permit a realistic and workable division of production, not only between industrialized and developing countries but also between countries of the West and the East and between developing countries themselves. The Expert Group felt that all possible forms of such co-operation should be considered more actively if the present gradual pace of change were to accelerate in the years ahead to the mutual benefit of both industrialized and developing countries.

UNIDO is well placed to help countries develop a better understanding of the issues involved. The Expert Group felt that it should give further attention to this subject through consultations with the Governments of industrialized and developing countries and individual firms located in these countries, and that it should make use of the experience thus gained in conducting its promotional activities.

V. TRANSFER OF EXPERIENCE TO OTHER COUNTRIES

Although the Expert Group did not feel that it could recommend a uniform policy on industrial reorganization that would be generally applicable, it thought that the experience of selected countries with a declared policy would be of considerable interest to other countries. Furthermore, the Group believed that industrial reorganization activity was bound to increase in the future for the countries and the industries concerned.

The Expert Group felt that both developing countries and industrialized countries should have access to the growing volume of experience now being generated in different countries. The publication of the studies of the experience of the five countries represented at the Meeting, including the case studies of particular reorganisation schemes, would be a useful first step. Some further reference material describing the evolution of policy in selected countries might be collected in the future. The collection of additional case studies of the reorganisation of an industrial sector and of specific mergers and de-mergers implemented at the firm level would also be useful. Case studies of unsuccessful schemes, which explained the reason for their lack of success, would be as interesting as studies of successful schemes. In each case study, an attempt should be made to relate the approach adopted to the economic objectives of the country at that particular stage of its development. However, the best source of detailed, as opposed to general, advice on this subject would be likely to be people who have had first-hand pragmatic experience in the reorganisation of industrial sectors and of mergers between firms.

The Expert Group therefore recommended that UNIDO concentrate its activities in this limited and rather specialised field:

(a) By collecting reference material on the experience of individual countries on industrial reorganisation at the level of an industrial sector and individual firms. Both developing and industrialized countries who might use such reference material should be made aware of its availability;

(b) By maintaining a roster of experts with specialized pragmatic experience in this field who could fulfil requests for advisory assistance.

The Expert Group suggested that the initiative taken by UNIDO in organizing this Meeting could serve to make it a focal point for an international discussion in this area of industrial policy (industrial reorganization, mergers, acquisitions and divestments), if ways and means to develop further this initial exchange of views could be found.

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