Minority Shareholdings in Competitors

GCLC Lunch Talk

16 March 2012

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Overview

1. The Residual Shareholding Problem
2. Theories of Harm
    - Unilateral Effects
    - Coordinated Effects

Residual Shareholding

Issue: What happens to the shares that the Buyer has bought if the European Commission blocks the merger?

Article 8(4) of the EU Merger Regulation:

"4. Where the Commission finds that a concentration:

(a) has already been implemented and that concentration has been declared incompatible with the common market, …

the Commission may:

- -- require the undertaking concerned to dissolve the concentration, in particular though the dissolution of the merger or the disposal of all the shares or assets acquired, so as to restore the situation prevailing prior to the implementation of the concentration … ."

Residual Shareholding

The "Ryanair" Scenario: Buyer launches bid and acquires minority interest, but not control. Commission blocks merger.

- Commission does not have jurisdiction to require Buyer to sell down its stake because the concentration was never "implemented." See *Aer Lingus v Commission,* Case T-411/07.
- Commission does not have jurisdiction over non-controlling stakes, so why should it acquire jurisdiction simply because the stake was acquired in the context of a public bid?

Residual Shareholding

The "Tetra Laval / Schneider" Scenario: Buyer launches bid and acquires control. Commission blocks merger.

- Commission has jurisdiction to require Buyer to sell down minority stake because concentration is "implemented."
- Open question: how far down can the Commission require the parties to sell? Beyond a controlling stake?
- In *Tetra Laval* and *Schneider,* Commission required disposal above and beyond a controlling stake. Both companies contested this position on appeal, but General Court decided cases on other grounds.

Theories of Harm: Unilateral Effects

(1) Buyer may have less incentive to compete with Target.

- If Buyer raises price, it may lose sales to Target, but effect of loss will be diluted because it benefits through increase in dividends or share value.
- If Buyer lowers price, Target may lose sales to the Buyer, but the Buyer will share a proportion of the losses inflicted on the Target.
- Buyer may choose to avoid competing with Target in certain geographic or product markets

Theories of Harm: Unilateral Effects

Key factors affecting the magnitude of these potential unilateral effects:

- Size of minority interest
- Structure of market
- Degree of substitutability between the companies' products
- Diversion ratio (the amount of sales that will be diverted to the Target in the event of a price increase by Buyer)
- Barriers to entry

Theories of Harm: Unilateral Effects

(2) Buyer may use its stake to cause the Target not to compete as vigorously

- May cause Target to raise prices
- May cause Target to differentiate its product
- May use its influence to weaken the Target
- May prevent the Target from competing in certain geographic or product markets
- BUT: Does Buyer have ability to influence Target and, if it does, what is extent of its influence? Other shareholders will have incentive to thwart any attempt by Buyer to degrade Target's offering

Theories of Harm: Unilateral Effects

(3) Minority stake may discourage potential suitors

- Acquisition may make Target more competitive
- If discipline resulting from possible acquisition is removed, Target's management could become complacent and Target would become less competitive

Theories of Harm: Unilateral Effects

How much of a problem?

- Diversion ratio will be diluted by shareholding
- Buyer may not want Target to have more profits, which could be invested in making the Target a stronger competitor
- Buyer may not have ability to influence strategy of Target -- are typical minority blocking rights sufficient to give rise to problems?
- Buyer may not want to degrade Target's competitive offering as value of its stake will decrease

Theories of Harm: Coordinated Effects

Explicit

Buyer has more information on Target and more opportunity for Buyer and Target to exchange confidential information and collude.

- Extent of information obtained by Buyer depends on extent of its minority rights.
- Information flow more likely to be one-way
- Legal restrictions on exchange of information.

Theories of Harm: Coordinated Effects

Tacit

Buyer and Target could collude to set higher price. Buyer has less incentive to cheat because Target's profits will go down.

But collusion unlikely to cause harm unless

- the Buyer is a maverick, or
- there are widespread links in the industry.

Main Challenge in Assessing Minority Shareholdings

There is the theory…

COMPETITIVE EFFECTS OF PARTIAL OWNERSHIP: FINANCIAL INTEREST AND CORPORATE CONTROL

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I. INTRODUCTION

The competitive analysis of horizontal mergers in the United States follows a well-established and widely accepted economic framework.[1] A merger allows previously independent competitors to coordinate their price and output decisions to maximize joint profits. To the extent that the merging firms otherwise would compete with each other and are not sufficiently constrained by competition from other rivals, the combined firm has an incentive to raise prices and thereby reduce competition. This concern that prices may rise may be mitigated, for example, if rival firms are intensely competitive with the merged firm, if entry or expansion by small rivals in response to a price increase is easy, or if the merger significantly reduces costs or leads to superior products.

A. Numerical Example of the Price Effects of Merger and Partial Ownership

This Appendix develops a complete numerical example to show why a silent partial ownership interest has a smaller effect on the price set by the acquiring firm than would a complete merger. In fact, for the special case of the linear demand, used in this example considered here, a partial ownership interest of x% yields a direct effect on the acquiring firm's price of x% of the effect caused by a complete merger.

We assume that two firms, labeled 1 and 2, sell differentiated products in competition with one another. The demand for firm-1's product is

$$D_1(P_1,P_2) = 56 - .8P_1 + .4P_2 .$$

Firm-2's demand has the same cross effect as that for firm-1, i.e., a \$10 increase in the price of good 2 increases the demand for good 1 by 4 units (and vice versa). Prior to merging, firm-1 maximizes its profits $\pi_1 = (P_1 - c_1)D_1(P_1,P_2)$. The first-order condition for project-maximization is

$$D_1 + (P_1 - c_1)\frac{\partial D_1}{\partial P_1} = 0. \tag{A1}$$

Multiplying by P_1/D_1 and solving for P_1 yields

$$P_1 = \frac{e_{11}}{e_{11} - 1}\, c_1 \tag{A2}$$

where e_{11} is the absolute value of the own elasticity of demand for product 1, $e_{11} = -(\partial D_1/\partial P_1)P_1/D_1 = .8P_1/(56 - .8P_1 + .4P_2)$. Suppose that $c_1 = 80$ and $P_2 = 100$. Substituting these values along with the expression for e_{11} into equation (A2) and solving yields a premerger price of $P_1 = 100$.

Now suppose that firm-1 merges with firm-2. The merged firm chooses P_1 to maximize the joint profits $\pi^M{}_1 = (P_1 - c_1)D_1(P_1,P_2) + (P_2 - c_2)D_2(P_1,P_2)$. The first order condition now is

$$D_1 + (P_1 - c_1)\frac{\partial D_1}{\partial P_1} + m_2\frac{\partial D_2}{\partial P_1} = 0 \tag{A3}$$

…and there is the reality

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