

CHAPTER 8

Conclusions

The merger situation

8.1. Under the terms of reference we are required to investigate and report whether arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a merger situation qualifying for investigation as defined in section 64(8) of the Fair Trading Act 1973 (the Act), in that:

- (a) enterprises carried on by or under the control of Allied-Lyons PLC (a body corporate incorporated in the United Kingdom) will cease to be distinct from enterprises carried on by or under the control of Elders IXL Ltd; and
- (b) the value of the assets which will be taken over exceeds £30 million.

8.2. On 5 September 1985 Elders announced that it intended to lead a consortium to make an offer for Allied-Lyons. In the event the offer for Allied-Lyons' shares announced on 21 October was in the name of Elders alone and the formal offer document issued on 18 November by Hill Samuel was made on behalf of IXL, an English company incorporated for the purpose with unlimited liability and indirectly owned as to 49 per cent by Elders and 51 per cent by its associate Goodmayes (see paragraph 5.9). This offer lapsed on reference being made to the Commission. On 12 March 1986 Elders sold its holdings in Allied-Lyons (see paragraph 5.4), but assured us that it still contemplated the acquisition of the company.

8.3. The assets of Allied-Lyons exceed £30 million (see Table 2.3) and the conditions set out in section 64(1)(b) of the Act is therefore satisfied.

8.4. We conclude that arrangements are in contemplation by Elders for the acquisition of Allied-Lyons which if carried into effect will result in the creation of a merger situation qualifying for investigation.

The public interest

Competition

8.5. The reference of this proposed merger is unusual in that its consummation would not appear to represent any material reduction in competition in the markets in which the two companies currently operate. Elders does not compete with Allied-Lyons in the United Kingdom in either the food and drink industry or in the ownership of tied houses and off-licence outlets. It is true that the present arrangements are that Watneys brews and distributes Elders' Foster's Lager in the United Kingdom, while Allied-Lyons performs a similar service for Castlemaine XXXX. It is unlikely that the parties concerned would wish to continue on these lines after the merger, but there is no reason to suppose that some new arrangement to ensure the continued marketing of both brands could not be arrived at.

8.6. Potential competition issues could, however, arise from Elders' declared intention to dispose of the food division of Allied-Lyons. One immediate effect of this sale would be to reduce the overall size of Allied-Lyons with, at least initially, possible detriment to any economies of scale within the remaining divisions, and to any benefits obtained from internal cross-trading and cross-financing.

8.7. Elders' original intention was to dispose of the food division intact to one major company, but when it became apparent that this would be impracticable it was decided that the division should be broken up and sold to as many as ten different purchasers. Depending on who the buyers of parts of the division may be the disposals could alter the existing relationship between the food processors and wholesalers on the one hand and the retailers, including the large supermarket chains, on the other. A number of companies, both British and foreign, were said to have expressed an interest, but Elders told us that it did not contemplate selling to companies who were already major operators in this field in the United Kingdom. Elders assured us that it wanted to sell to those who would preserve the businesses as going concerns.¹

8.8. The intended disposal of Allied-Lyons' food division would represent the dissolution of a large and now successful business, and the removal from that market of one powerful competitor to the remaining contenders. Nevertheless it is at present impossible to foresee what effect this fragmentation might have on competition. That effect can only be judged when the prospective purchasers are known, at which time the acquisitions would be liable to the normal review procedures of the Director General of Fair Trading and thus to a possible reference for investigation.²

8.9. In respect of the Allied-Lyons Beer and Wines and Spirits divisions, fears were expressed that, because of Elders' lack of experience in the United Kingdom and its comparatively recent entry into the Australian brewing industry, its management might not be able to maintain the vigour of Allied-Lyons' competition. Elders struck us as a company which would apply demanding performance standards and would make use of the experience of the United Kingdom market to be found in the existing management of Allied-Lyons. This would accord with the way in which it has employed the considerable brewing expertise that it acquired with CUB. This expertise may itself represent a new competitive element in the United Kingdom market—one which could only be introduced by way of an acquisition, as a 'greenfield' entry is economically impracticable. Thus competition in both the home and the export markets from the divisions of Allied-Lyons retained by Elders should not be weakened, and indeed might well be strengthened.

Employment

8.10. It was put to us that, despite Elders' assurances, the financial pressures upon it in the aftermath of a successful bid could force the sale of parts of the food division to buyers seeking to eliminate competition, with harmful effects upon employment. If there were such pressures and if they had such

¹ Similar assurances are recorded in the transcript given us by Elders of a meeting between it and the TGWU on 20 November 1985.

² Elders told us that it intended to consult the OFT before finalising the sale of any of the United Kingdom businesses in the food division.

consequences, these effects would be taken into account when it was decided whether the disposals should be referred under the Fair Trading Act; a point which would no doubt be in the minds of potential purchasers.

8.11. If the disposals did not represent any increase in concentration—being for example sales to small companies, to newcomers or to large companies seeking to diversify into food—then they might be less likely to be referred under the Act; but equally there should be less likelihood of the businesses being shut down by their new owners. Allied-Lyons told us there was no significant over-production in any of the relevant food sectors. Elders said that many of the companies which had expressed interest were seeking to establish or enlarge their place in the United Kingdom market.

8.12. In the case of the Allied-Lyons Beer and Wines and Spirits divisions there is no evident reason why Elders' plans—as they see them—to invigorate the tied estate and to increase exports should have any adverse effect on employment overall.

Pensions

8.13. Representatives of some of the unions involved told us of their concern that in the post-merger situation Elders might 'raid the surplus' in the Allied-Lyons pension fund, or reduce or temporarily withhold their contributions. We received Elders' assurance that it would not 'tamper with the pension fund or strip it of any surplus benefits'; nor would it suspend company contributions.¹

Reciprocity

8.14. Many of those who submitted evidence to us were strongly of the opinion that Elders should not be allowed to take over Allied-Lyons because, they said, the reverse situation would not be permitted in Australia. Allied-Lyons told us that the Australian Foreign Investment Review Board had effectively prevented it from buying over 49 per cent of Castlemaine Tooheys.

8.15. In fact, as we have described in Appendix 6.1, the relevant practice in Australia was not so clear cut as alleged by some, and it has changed to some extent since that evidence was submitted (see paragraph 8.17). Nevertheless it must be recognised that Elders occupies a position of major importance in the Australian economy. Taken together with links which Elders has forged with BHP and other large Australian enterprises, the implications for the Australian public interest of a takeover bid for Elders by a foreign company would no doubt loom large in the minds of the Australian authorities. The implications for the United Kingdom are that a merged Elders/Allied-Lyons might to an extent be shielded from market forces from outside Australia, because an acquisition of the combined group as a whole by a non-Australian company could be blocked by Australian domestic considerations. Although Allied-Lyons considered this a matter of public interest for the United Kingdom, it did not see it as a ground on which Elders' bid should be disallowed.

¹ The Finance Act 1986 contains provisions whereby if a pension fund's assets exceed its liabilities by more than a prescribed maximum, it may be necessary to reduce or eliminate that excess. The ways in which this may be done include a refund to the employer, a suspension of contributions and an improvement in benefits.

8.16. It is also possible that the merged group itself might wish or need to dispose of businesses or assets—such as the food business of Allied-Lyons—to a foreign buyer. (We discuss below whether the merger is in fact likely to affect the viability of the merged group.) Even assuming the powers of the Foreign Investment Review Board to extend to transactions of this sort, it seems to us most unlikely that the powers would be used to prevent the group making such a disposition to its best advantage. If this is the case it then follows that United Kingdom buyers would have the opportunity of acquiring these businesses if the situation arose.

8.17. We have considered whether we should make any general observations on the question of reciprocity, about which some concern has been felt. We note that the Australian authorities announced on 28 July a major relaxation of foreign investment policy, to make it easier for foreign investors—both in partnership with Australian firms and on their own account—to engage in direct investment, especially in the manufacturing field. The existing requirements, including the Australian equity test, are being suspended and proposals will be automatically approved unless judged to be against the national interest. It may be that the Australian authorities, following their new policy, will exercise their powers in a way which will effectively remove any imbalance in the operation of the laws of the respective countries. It is also to be noted that in the United Kingdom the Secretary of State has powers under the Industry Act 1975, Sections 11 to 13, to prohibit transfer of control to non-residents of ‘an important manufacturing undertaking’, although we understand that this power has never been used.

The Allied-Lyons tied estate

8.18. There is no doubt that Elders’ announcement of its intention to introduce a version of its Australian pub-sharing scheme into the Allied-Lyons tied estate has aroused suspicion. Tenants are said to be uncertain of the effects of any such scheme on their security and profitability; doubts have been expressed as to whether tenants could afford to take the required stake in their pubs, and as to what would happen to those who were unable or unwilling to comply. Any consequent breach by Elders of the Code of Practice governing relations between brewers and tenants would, it was feared, undermine the efficacy of the voluntary regulation of the industry.

8.19. Elders was not in a position to allay the fears that it had aroused, in part because it was not yet able to settle the details of its scheme for the United Kingdom. Elders, however, assured us that the scheme would not have any effect on tenants’ security under the Code of Practice, and that any tenant who did not participate would suffer ‘neither detriment nor penalty’. Further consideration by those concerned must, we suggest, await detailed proposals which will have to be sufficiently attractive to tenants if the scheme is to have widespread acceptance.

Non-financial issues

8.20. After careful consideration of these issues it does not seem to us that, either separately or taken together, they provide grounds for thinking that the proposed merger may be expected to operate against the public interest.

Financial aspects of the merger

8.21. We next consider whether the financial aspects of this merger could have implications for the public interest. These might arise in two ways: because of their effect on the future viability of the merged group; and because of the wider implications of the financial arrangements used to bring the merger about.

8.22. As to the first point, there is a view that even if the merged group were to be so extended financially that it collapsed, the normal operation of market forces would ensure the most effective reallocation of resources. Buyers would come forward for the businesses that were viable, and other suppliers would step in to meet the demand for the goods and services previously supplied by those that were not. Natural selection would have ensured the survival of the fittest.

8.23. We recognise that this argument might be applicable in some cases, although there is inevitably a cost involved in both financial and human terms that may be considerable and ought not to be ignored. However, when dealing with a company of the size and importance of Allied-Lyons, account must be taken of the possible detrimental effects on the public interest if the company were to become financially over-extended. In this case these might include the weakening of a major competitor in the national brewing industry, which could lead to damage to its suppliers and customers, to substantial disruption to trade and industry, job losses on a serious scale, and the possible loss to the United Kingdom of markets—including the home market—to overseas suppliers.

8.24. We therefore consider that Elders' financial arrangements for the acquisition of Allied-Lyons could raise questions of public interest if they were such as to appear to threaten the future of the merged group. We look first at this issue and return later in this chapter to the question of the wider implications (see paragraph 8.50).

8.25. Most of the comment we received on Elders' financial arrangements for the bid was hostile, or at best sceptical. Because of the secrecy with which Elders surrounded some of its plans the majority of those who offered evidence in this area were not privy to the details (see paragraph 7.2). This may have been responsible for much of the speculation about their supposed ill effects. Nearly all the comment was received before Elders' transactions with BHP took place.

8.26. The general thrust of the criticism from those opposed to the merger was that the relative sizes of Elders and Allied-Lyons and the volume of borrowing needed to finance the merger provided an extreme example of a leveraged takeover, with the resultant risk of damage to the acquired company if unexpected adverse developments caused subsequent earnings to be lower than expected, so that fresh borrowings were needed to finance repayments.¹ Any pre-emption of cash flow to servicing its debt might mean forced sales of assets, less funds for future investment and a reduced ability to borrow or to raise new equity. This would endanger job prospects and harm competitiveness.

8.27. As has been explained (see paragraph 5.14 *et seq*), Elders recast its original financial arrangements and submitted fresh proposals to us in mid-May. Details of these were revealed to a limited number of persons at Allied-Lyons and

¹ Shortly after Elders' bid was announced there were references in the press to 'junk bonds'. We understand this to be an American term for high yielding debt securities which are rated by the major credit agencies as below investment grade. No such securities appear to be involved in Elders' proposed financial arrangements for the bid.

their advisers, and to the Bank of England and the arrangements have been described in outline in Chapter 5. For convenience they may be summarised here as follows:

	<i>£ million</i>
Estimated cost of bid assuming a price of £2.85 per ordinary share ¹	2,060
<i>Source of finance</i>	
Permanent capital:	
Ordinary share issue, say	300
Subordinated convertible loan stock issue, say	300
	600
Existing cash resources ²	214
Drawings on £1,300 million syndicated loan facility	1,246
	2,060

8.28. These arrangements are based on a bid price of £2.85 per ordinary share. Allied-Lyons' share price on 30 July 1986 was £3.25. We cannot forecast what it will be at the time of any renewed bid by Elders, but it seems likely that a bid in the near future would have to be at a price in excess of that assumed in the arrangements described above.

8.29. Accordingly it is impossible to calculate the size of the refinancing task that would face Elders after the merger, nor has it decided exactly how it will go about tackling it. In its original proposals (since withdrawn) it described its plans for refinancing the syndicated loan facility. In view of what it sees as its strengthened position arising from its cross-shareholdings with BHP, Elders is now keeping its options open and proposes to take whichever seem most appropriate from a number of refinancing courses open to it (see paragraphs 6.48 to 6.51).

8.30. All the evidence given to us by Elders, including its original proposals, indicates a pattern likely to involve high borrowings and gearing, low interest cover and the inclusion of quasi-equity in its capital base. Some such pattern may be inevitable given the disparity in size between the two companies (a disparity that would be compounded if Allied-Lyons' purchase of Hiram Walker were completed) and Elders' stated preference for obtaining the greater part of its finance requirements by borrowings rather than by equity. However, the issue of new equity is now likely to be more attractive to Elders given the rise in its share price since the offer was made and its understanding that BHP will continue to convert its investment so as to maintain a holding of just below 20 per cent of Elders' equity.

Capital gearing and interest cover ratios

8.31. The note in Appendix 6.2 on the use of capital gearing and interest cover ratios shows that the calculation and interpretation of these figures involves difficulties and uncertainties. There is no general agreement for example about the way in which some kinds of redeemable preference shares and long-term convertible subordinated loan stock should be treated for the purpose of the distinction between capital base and debt. It seems to us, indeed, that there can

¹ See footnote to paragraph 5.20.

² See footnote 1 to paragraph 5.19.

be no general rule, because the proper treatment in a particular case depends upon the nature of the company's business, the terms governing the rights and obligations of the holders of the particular stocks, and the prospects of repayment or conversion.

8.32. This does not mean that these ratios can be ignored. The market attaches importance to them, and departures from what it perceives to be normal levels may cause doubts to arise about the strength of a company's position and its prospects. Taken by themselves, however, gearing and interest cover are neither absolute nor reliable indicators of a company's condition. It is also necessary to look at such factors as cash flows, the purpose and terms of the company's borrowing, the nature of any assets acquired by use of the borrowed funds and the time within which the level of gearing is likely to be brought down. A company which has borrowed heavily in order to finance an advantageous takeover, and is in a position to reduce that borrowing within a reasonable time, may be in quite a different position from a company forced to borrow heavily because of poor trading results and facing the prospect of a mounting burden of debt. In some cases increased gearing, if it is based on good commercial judgment, may even indicate more effective use of available equity funds.

8.33. We therefore have to assess what Elders' capital gearing and interest cover would be following the merger and whether, in Elders' circumstances, they would be such as to indicate a degree of financial vulnerability which might lead, at worst, to the possibility of complete collapse. Even if that did not come about there might be such financial stringency that the Allied-Lyons businesses retained by Elders would be denied adequate funds for capital expenditure, placed under pressure to give priority to short-term considerations so as to generate funds to reduce borrowings, or be forced to implement drastic measures of rationalisation leading to substantial job losses.

8.34. To assist us in making these assessments we prepared, using data supplied by Elders and additional data from Allied-Lyons, various forecasts of the merged group's likely capital gearing and interest cover based on a number of different assumptions. These forecasts, which are set out in Appendix 8.1, include the effect of Elders' proposed acquisition of Allied-Lyons and the borrowings used to finance that acquisition, which Elders told us would now be treated as 'on balance sheet' items in its next published accounts.¹ Although Elders and Allied-Lyons have each expressed to us certain reservations with regard to these forecasts, we believe nevertheless that they offer a useful guide to what the position might be.

Capital gearing

8.35. We have accepted Elders' general projections of the profits and cash flows of Elders and Allied-Lyons until 1 January 1987, the date on which, for the purposes of the forecasts in Appendix 8.1, Table 1, the merger is assumed to take place. Basis 1 of that table shows that at a bid price of £2.85 per share the merged group's capital gearing immediately following the merger would be 114 per cent.²

¹ They do not, however, incorporate the borrowings of Elders' finance subsidiaries which, Elders told us, had separate and distinct financing structures and operations which justified the consolidation of their net assets only in Elders' published accounts. This accords with the treatment adopted by some other leading industrial and retailing groups with finance subsidiaries.

² For a note on the exchange rate used see the footnote to paragraph 2.1. The effect on the gearing of subsequent movements in the rate is not material.

Elders estimates that this would fall to 79 per cent a year later. For the purpose of Basis 2 of that table we have assumed a bid price of £3.85 per share, and that the additional £1 per share would be financed as to one half by the issue of further share capital and one half by further borrowing. We have also assumed that this increase would not give rise to any further revaluation of Allied-Lyons' assets. On the basis of these assumptions, the merged group would have a capital gearing immediately following the merger of 161 per cent, which Elders estimates would fall to 114 per cent a year later. Elders told us that it had to limit the level of its gearing to 175 per cent, because of the terms of its covenants with its lending banks. If it were to bid a price higher than £3.85 per share, the increased price would have to be financed by equity to the extent necessary to keep within that limit.

8.36. Allied-Lyons, apart from emphasising that it was in no position to verify the general profits and cash flow projections which Elders had made, adopted different approaches in a number of respects. These are detailed in Appendix 8.1, paragraph 3. Allowing for these differences, the immediate post-merger capital gearing at a bid price of £2.85 per share would be 130 per cent, falling to 89 per cent a year later; and at a bid price of £3.85 would be 191 per cent falling to 133 per cent a year later (see Appendix 8.1, Table 2, Bases 1 and 2). Allied-Lyons also pointed out that the forecasts made no allowance for its planned acquisition of Hiram Walker Spirits. The effect of this might be to increase the merged group's capital gearing (using the same assumptions in other respects) at a bid price of £2.85 per share to 317 per cent immediately after the merger, falling to 230 per cent a year later. At a bid price of £3.85 the gearing might increase to 521 per cent immediately, falling to 361 per cent a year later (see Appendix 8.1, Table 3, Bases 1 and 2).¹ However, Elders told us that this acquisition, if it took place, would make no difference to its plans, because Elders proposed to resell Hiram Walker Spirits to its present owners and was confident of being able to do this without loss.

8.37. We discussed with Elders the question whether its redeemable preference shares and the proposed convertible subordinated loan stock ought to be reckoned as equity (as Elders has done) in the calculation of its future capital gearing. Elders argued that the redeemable preference shares, most of which are held by BHP, would be converted into equity quite shortly; the loan stock would be long dated, and would almost certainly be converted into equity before maturity. These arguments were strongly contested by Allied-Lyons.

8.38. Even if the redeemable preference shares and the loan stock are both reckoned as part of the capital base and Elders' forecasts are accepted in other respects, the projected capital gearing of the merged group a year after a merger at a price of £3.85 would still be 114 per cent. This is substantially higher than the gearing of any of the companies, except one, listed in Appendix 6.2, Table 1; and it has to be compared with the level regarded by the Bank of England as generally acceptable, which is 50 per cent.

8.39. Elders' reply when we put these points to it was that its long-term objective was a capital gearing of 40 debt to 60 equity (ie about 65 per cent), but

¹ This forecast includes Hiram Walker Spirits' net assets at their present book values. The Chairman of Allied-Lyons in his letter to shareholders of 10 May 1986 said, 'These net assets will be brought into the Allied-Lyons consolidated balance sheet at current values which are expected to be significantly higher'.

it would not be worried by gearing considerably higher than this for a short period provided that immediate and realistic ways could be seen to bring it down to 100 per cent in a relatively short period of time. 100 per cent was higher than was normal in Britain, but not in other parts of the world, nor even in Britain would it be out of the way for the more aggressive companies. Elders did not think anything could go radically wrong with its plans, since it was proposing to invest in a stable industry with a steady cash flow. If any emergency were to arise Elders had investments which could be sold at short notice, including its marketable holding of nearly 20 per cent of BHP, which was worth about £900 million.

Interest cover

8.40. Again assuming a bid price of £3.85 per share, Appendix 8.1, Table 4, Basis D, shows that Elders' interest cover ratio in 1987, the year following the expected merger, might be 2.1:1, which is below all but one of the 1985 ratios of the companies listed in Appendix 6.2, Table 2; and well below the ratio of 4:1, which the Bank of England regards as a generally acceptable norm.

Conclusions on financial aspects of the merger

8.41. It is clear that Elders would by normal standards have high gearing and low interest cover in the period following the acquisition of Allied-Lyons. As we have already said (paragraph 8.32), this does not necessarily mean that the company would face financial difficulty. It is necessary to look more closely at the circumstances.

8.42. As regards the actual calculation of the gearing ratio, there are a number of factors which tend to justify Elders in including both the redeemable preference shares and the proposed convertible subordinated loan stock in capital. The preference shares do at present form part of the capital. The question arises in relation to them only because they are redeemable. They are mostly held by BHP, and we accept Elders' view that there is a strong probability that BHP will exercise the conversion rights attached to the shares. BHP has in fact already begun to do so by its exercise of options in July 1986. The loan stock, which would be subordinated to other debt, is intended to be long dated, so would naturally rank at least as long-term borrowing. Elders has told us, however, that it will be issued on terms which will make conversion very attractive to holders. It is also significant that the Bank of England (albeit in relation to banks and subject in their case to limits) is prepared to regard such stock as capital.

8.43. When one considers the significance of the gearing and interest cover for the merged group's financial future, the first circumstance to be noted is that the borrowed funds are to be used to finance the acquisition of a mature company with a stable cash flow. Furthermore, for commercial reasons, Elders intends to sell the food division of Allied-Lyons. The marketability and the value of the food division are substantially confirmed by Allied-Lyons. This sale offers an immediate prospect of reducing the capital gearing.

8.44. It is also relevant that Elders is not a weak or insignificant company. Its annual turnover of A\$7,000 million is the second largest in Australia. It employs capital of A\$1,470 million, has net assets of A\$700 million, and in 1985 earned profits of A\$134 million. Its management appeared to us to be efficient and responsible.

8.45. These arguments are reinforced by the association now formed between Elders and BHP. BHP is the largest company in Australia. It now owns practically 20 per cent of the ordinary shares in Elders, and we were told that each company proposes to appoint two directors to the other's Board. While there may be new developments in Australia, this association has increased the strength of Elders, and has given BHP an interest in maintaining Elders' prosperity.

8.46. It is also necessary to bear in mind Elders' history. Since 1981 the group has expanded greatly. Much of the expansion has been by acquisition, and throughout the expansion Elders has maintained its stability and its prosperity. The acquisition of Carlton United Breweries in December 1983 actually raised Elders' gearing ratio to no less than 530 per cent, but CUB was successfully integrated into the Elders group and by June 1985 the gearing ratio had been reduced to 110 per cent.

8.47. For these reasons, in spite of the high capital gearing and low interest cover which Elders would carry immediately after the merger, we do not think the merger would result in the merged group suffering such financial stringency as would prejudice the development of the businesses of Allied-Lyons. We find confirmation of this view in the attitude of the banks which are prepared to provide Elders with a syndicated loan facility of £1,300 million. While these banks would be primarily concerned with the prospect of repayment, the lead bank of the consortium told us that they would not have been willing to finance the bid if they had not been fully satisfied that the merged group would in all respects be financially viable. It is also noteworthy that other banks were prepared to support Elders in its recent transactions with BHP. Citibank, HongkongBank and Banque Paribas all expressed to us their confidence in Elders' management.

8.48. In stating these views about the likely financial consequences of the merger, we do not overlook the facts, stated in paragraphs 8.28 and 8.29, that it is not possible at present to know at what price a new bid would be made, or what would be the size of the consequent refinancing task facing Elders. However, what we have said in paragraphs 8.43 to 8.47 itself limits this uncertainty. We do not think Elders would make an imprudent bid at a price so high as to expose the merged group to the likelihood of financial difficulty. We think further that the interest of BHP and the reluctance of the Citibank-led consortium to finance a bid without being fully satisfied as to the financial prospects of the merged group would tend to support Elders' management in this attitude. Moreover, if the acquisition of Allied-Lyons were to take the form—as Elders has told us is now its intention—of an 'on balance sheet' transaction, there would be an additional constraint on Elders by virtue of the nature of its covenants with its lending banks, which at present require that its capital gearing should not exceed 175 per cent.

8.49. Elders' financial arrangements continually evolved in the course of our inquiry and, in particular, they appeared to be strengthened by the purchase by BHP of shares in Elders. Our conclusion is based upon the facts, proposals and circumstances as they are known to us at the date of our report. We conclude that the financial aspects of the proposed merger, as we have described them, would not affect the future viability of the merged group in a way that would be against the public interest.

The wider implications

8.50. In reaching this conclusion on the financial arrangements for the merger we have not overlooked the second aspect mentioned in paragraph 8.20; the public interest in the wider implications.¹ Some of those who gave evidence during our inquiry suggested that we should take account of the precedent that a highly leveraged bid by Elders might set for the United Kingdom market; leading perhaps to a long-term shift to debt financing at the expense of equity as, the Bank of England told us, has been taking place in the United States. If Elders' bid succeeded, other highly leveraged bids would be encouraged, which would both be disruptive and have implications for the assets of the banks involved and thus for the health of the financial system. Acquisitions where the buyer could borrow more than his worth—providing only that the lender felt confident that the quantum of his loan was ultimately secured by the assets of the target company, with no consideration given to broader issues—were condemned by some as likely to divert management attention from long-term growth strategy to short-term defensive tactics, shortening horizons at the expense of innovation and long-term investment.

8.51. We have stated our conclusion that the financial aspects of the proposed merger referred to us would not operate so as to affect the public interest (paragraph 8.49). In the face of this, it is impossible for us to allow any anxiety about the wider implications of these arrangements to influence our decision on this reference, since the Fair Trading Act requires us to concentrate on the particular effects adverse to the public interest resulting from the specific merger situation (section 72(2)). Nevertheless, in view of the importance of the issue and the concerns expressed to us, particularly those of the Bank of England, we think it right to add something about these wider implications.

8.52. We have set out (paragraphs 8.42 to 8.46) the features of this particular case which have led us to the conclusion that the proposed financial arrangements would not prejudice the public interest. It is easy, however, to imagine highly leveraged bids being made in circumstances widely different from those of the present case. In such circumstances there might be good cause for public concern about the likely results of exceptional levels of capital gearing and interest cover. It would be possible to deal with such cases by referring them individually to this Commission as they arose, but it may be thought preferable to introduce appropriate measures of supervision or control before the cases begin to occur.

8.53. We do not think we should suggest guidelines for general use, indicating what might be considered prudent levels of capital gearing or interest cover, nor do we think we should suggest means by which control might be exercised over highly leveraged bids if it were thought desirable to do so. Almost all the submissions made to us have related only to one proposed merger, the principal effect of which would be upon only one industry. This is not an adequate basis for suggesting important changes of general application in commercial practice, or even in the law.

8.54. We therefore suggest that the Bank of England and the Stock Exchange, which appear to us to be the authorities primarily concerned, should consider whether the appearance of highly leveraged bids in the London market makes

¹ See also the press release referred to in paragraph 1.2.

desirable the introduction of any new powers of control; and if so, whether effective control could be exercised by reference to levels of capital gearing or interest cover. We also suggest that the Department of Trade and Industry and the appropriate City regulatory authorities might consider whether any change is desirable in the rules in order to require the consent at a General Meeting of the shareholders of the bidding company before a bid may be completed.

Summary

8.55. As we have pointed out, this reference is unusual in that the merger in contemplation does not appear to involve any material reduction of competition. Potential competition issues may arise from Elders' intention to sell off the food division of Allied-Lyons, but such issues can only be considered when the prospective purchasers and their probable intentions are known.

8.56. We have considered the likely effect of the proposed merger on the future of the Beer and Wines and Spirits divisions of Allied-Lyons, upon employment and pensions and upon Allied-Lyons' tied estate. We do not find that in any of these respects the proposed merger may be expected to operate against the public interest.

8.57. Our attention was particularly directed to the financial arrangements proposed by Elders for this merger. It is clear that immediately after the merger the capital gearing of the merged group would be considerably higher, and its interest cover considerably lower, than is normal in this country. The precise levels cannot be estimated, because we do not know at what price per share a renewed bid would be made. However, because of the particular circumstances of this merger described in paragraphs 8.42 to 8.48, we do not consider that the financial arrangements would operate in such a way as to affect the public interest.

8.58. Two other aspects of Elders' bid for Allied-Lyons were put to us as being matters of public interest: the question of reciprocity, and the danger of a precedent being created for further highly leveraged bids. We have considered both matters and we understand the concern expressed. On the question of reciprocity we have concluded that in this particular case it appears unlikely that any imbalance between Australian and British law would operate against the public interest. We have noted the recent announcement of a relaxation in Australian practice and it remains to be seen whether the imbalance will any longer be a matter of concern. On the question of highly leveraged bids, we were not able to make a general pronouncement on the basis of this particular case, but we have suggested that the matter should be examined; and we also suggest that consideration be given to the rules governing consent to bids by the shareholders of a bidding company.

Conclusion

8.59. We conclude that the merger situation which will be created if arrangements in contemplation by Elders IXL Ltd for the acquisition of Allied-Lyons PLC are carried into effect may be expected not to operate against the public interest.

J G LE QUESNE (*Chairman*)

ROBERT CLAYTON

D G GOYDER

M S LIPWORTH

S McDOWALL

D P THOMSON

S N BURBRIDGE (*Secretary*)

30 July 1986

