Increasing UK productivity through takeover reform

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Executive summary

The UK has been in the grip of a productivity growth slow down for over ten years. Growth has been almost zero during this period.

The UK economy is currently suffering due to COVID-19 and the Withdrawal Agreement with the EU is due to expire at the end of 2020.

It is therefore imperative that the UK's businesses are able to invest for the long-term in order to boost productivity growth and stay competitive in the world economy.

Current UK takeover rules make it difficult for company boards to invest for the long-term benefit of their company. This may explain why the UK struggles to match comparable nations in terms of R&D spending, which is linked to greater productivity growth.

Internationally, commonly used models of regulation risk either entrenching bad management or inducing low levels of investment. This research analyses the problems using behavioural economics and proposes a solution that allows firms to invest efficiently, without entrenching bad management.

Context

Since 2008 the UK has suffered stagnated productivity growth. Productivity growth is linked to long term increases in wages and higher material standards of living. Parliament recognises that this is a key issue for the UK economy. This drop is mainly attributed to a lack of productivity growth in larger companies. Since productivity is often linked to trade volumes, with the Brexit Withdrawal Agreement due to expire at the end of this year it is crucial that the UK ensures that its economy is as productive as possible to compete effectively in global markets.

The disruption caused by COVID-19 and the subsequent change in working patterns and demand patterns for products and services makes it imperative for UK businesses to invest and adapt to the new markets that are developing.

Productivity growth tends to be associated with higher levels of spending on research and development. This is much lower in the UK than comparative nations. Part of this could be because the UK prohibits takeover defences. This means that if a company attempts to take over a public UK company, the target company cannot stop the takeover from happening. The constant threat of a takeover means that the board's jobs are at risk if dividends or share prices drop, since a takeover is likely to result in the board being replaced. Therefore, it disincentivises long-term investment in research and development, as such investment diverts funds away from dividends and lower dividends mean lower share prices and greater likelihood of a takeover. This disincentive needs to be removed.

Research aims

My research examines the impact of the regulatory framework underlying takeover defences, first, from a standard economic viewpoint and then through behavioural economics. It identifies how investor biases can lead to sub-optimal decisions, which feed into the decisions made by company boards. It then proposes a solution.

The main question concerns whether to allow the boards of companies to prevent a takeover that does not have their approval (i.e. whether to permit takeover defences). To date, the following trade-offs have been identified:

- if takeover defences are allowed, inefficient and ineffective boards may entrench themselves leading to sub-optimal economic outcomes (inefficient companies);
- if takeover defences are prohibited (as they currently are) boards may return too much capital to shareholders to protect their position, again leading to sub-optimal economic outcomes (under investment in the company's long-term opportunities).

Research findings

Applying behavioural economic theory my solution is as follows:

- Reform takeover regulation so companies may use takeover defences, however:
- These defences must be time limited for a specific number of years ('the defence period'). This ensures that if management fails to deliver, once the period has expired, they can be removed and replaced by more efficient managers. This prevents entrenchment.
- The defence period must be approved by shareholders. This ensures that boards are not able to use defences just to protect their position so that they can pursue 'the quiet life'.
- The defence period must be for the purpose of delivering some sort of investment (e.g. capital investment in new plant equipment that is expensive, but after the machinery is installed will yield higher productivity).

Policy implications/proposals

Takeovers are currently regulated by the Takeover Panel, via the Takeover Code, which is given power through the Companies Act 2006. The law can and should be reformed, ideally by the Panel itself reforming the Code or, if necessary, by direct reform of the Act to:

- Allow time limited takeover defences to be 'pitched' to investors who can chose to grant the company a period of time, free from the threat of hostile takeovers, to invest capital in specific projects (e.g. R&D, product development, new market penetration)
- Require 'pitches' to be scrutinised by independent third parties such as a merchant bank so that they can report to investors whether the projections and figures provided are reasonable and realistic

This should increase the opportunity for business investment while preventing the entrenchment of inefficient management, boosting UK productivity growth.