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# Agenda

## Advancing economics in business

# Who calls the shots? Minority shareholdings in merger control

**Competition authorities across the world are increasingly presented with cases involving partial acquisitions and minority shareholdings. Some jurisdictions, including the UK and Germany, can already address these under their merger rules, but the European Commission cannot, and it is consulting on closing this potential 'enforcement gap'. What are the differences between minority shareholdings and full mergers from a competition perspective? Is *Ryanair/Aer Lingus* a typical case?**

The EU Merger Regulation (EUMR) is currently limited to the assessment of transactions that grant the acquirer *de facto* control ('decisive influence') over the acquired firm (the 'target firm'). The European Commission is seeking to close the perceived enforcement gap by exploring ways in which the scope of the EUMR can be extended to non-controlling minority shareholdings.[1] A major recent case of minority shareholdings is *Ryanair/Aer Lingus*, which in March 2014 saw the UK Competition Appeal Tribunal (CAT) uphold the UK Competition Commission's (CC, which from April 2014 will be merged with the Office of Fair Trading into the Competition and Markets Authority) earlier ruling that most of the shareholdings should be sold off.[2]

Economic theory suggests that even the acquisition of minority shareholdings that do not lead to full control over the target firm may affect competition, by granting a certain (limited) degree of influence to the acquirer (e.g. through voting or veto rights), and/or through the incentives that the financial entitlements create for the acquirer. In practice, even a purely financial, non-controlling interest may reduce the acquiring firm's incentive to compete. Even so, the effects of minority shareholdings tend to be more pronounced the greater the corporate control. Since there is generally no clear one-to-one relationship between the size of the financial stake and the degree of control conferred by it, the analysis of the latter is often an important element in the assessment of minority shareholdings.[3]

### Horizontal minority shareholdings

When a firm acquires a financial stake in a competitor, this usually brings with it an incentive for the acquiring firm to raise its price (or, more generally, to compete less aggressively).[4] In doing so, the acquiring firm is likely to lose some of its customers, but at the same time increase its margin on the remaining ones. Some of the lost customers will switch to the target firm provided that the two firms are sufficiently close competitors. This increases the target firm's sales and profits and, as a result, the value of the acquirer's financial stake. Minority shareholdings therefore tend to increase the acquiring firm's incentive to unilaterally raise its price (irrespective of the degree of control over the target firm).

In practice, the acquiring firm may not always benefit from an increase in the target firm's profits. For example, the target firm may decide to invest any additional profits in the quality of its products or in additional production capacity, rather than paying dividends to shareholders. In this case, competition between the acquirer and the target firm would be likely to become more intense, and the acquirer would be worse off. Unilateral effects are unlikely in this type of scenario.

If a minority shareholding confers on the acquirer a significant degree of corporate control, the acquirer may be able to induce the target firm to increase its price or affect the target firm's commercial decisions in some other way in order to weaken it as a competitor. This effect tends to further increase the impact of the minority shareholding on competition. However, even in this case a minority shareholding would be expected to have a significantly smaller impact on competition than a full horizontal merger.

### Vertical minority shareholdings

Like vertical mergers, vertical minority shareholdings frequently give rise to efficiencies, and benefit consumers in most cases. However, as in the case of vertical mergers,

there are situations in which vertical minority shareholdings could give rise to concerns about foreclosure of competitors. What is the potential impact on incentives to foreclose if a supplier holds a minority share in one of its buyers (forward shareholding)?[5]

A forward shareholding may provide the supplier with a financial incentive to sell its product exclusively to the target firm, thereby foreclosing other potential buyers (input foreclosure). In doing so, the supplier strengthens the target firm's position in the downstream market, which tends to increases the value of its financial stake. At the same time, the supplier is likely to sell fewer units overall. The second effect is generally stronger than the first, since the financial stake entitles the supplier to only a *fraction* of the target firm's additional profits. The supplier's incentive to engage in this type of foreclosure is therefore often limited.

On the other hand, forward shareholdings may sometimes give rise to significant concerns about customer foreclosure (i.e. foreclosure of access to the target firm by rival suppliers), provided that the shareholdings confer a sufficient degree of corporate control on the supplier. In this case, the supplier may have the ability and incentive to strengthen its position in the upstream market by preventing the target firm from buying its inputs from competing suppliers.

## Efficiencies

As in the case of full mergers, it is necessary to assess the potential efficiencies of minority shareholdings, since these may offset some or all of their potential negative effects on competition and lead to overall consumer benefit.

While horizontal minority shareholdings are generally unlikely to lead to significant efficiencies, there are ways in which efficiencies can potentially arise—for example, through the diversion of funds from less efficient firms to their more efficient competitors.

Vertical minority shareholdings, on the other hand, may give rise to significant efficiencies, for example by providing firms with incentives to set lower prices along the supply chain.[6] In general, if a firm increases its price, it is likely to harm vertically related firms due to the increase in their input costs and the potential reduction in their sales to the next layer of the supply chain (to the extent that higher input costs are passed on). In the absence of minority shareholdings (or other types of vertical links), firms do not account for these negative effects when setting prices.[7] If, on the other hand, a firm has acquired a financial stake in another firm along the supply chain, it partly accounts for the impact of its pricing decision on this firm's profits and may therefore have an incentive to set a lower price. This increases the sales and profit margins of other firms along the supply chain and is likely to benefit consumers as the lower prices are passed on.

The following case study provides an example of how the CC has assessed some of the concepts discussed above. It also discusses a further aspect of minority shareholdings: the potential impact on entry.

## The *Ryanair/Aer Lingus* case

The *Ryanair/Aer Lingus* case is one of the most prominent and long-running European cases on minority shareholdings. Between 2006 and 2008, Ryanair gradually increased its share in Aer Lingus to its current level of 29.82%. The acquisitions were undertaken as part of Ryanair's attempt eventually to take over Aer Lingus entirely. In October 2010, following the European Commission's ruling that the minority shareholding did not constitute a concentration under the EUMR, and that it therefore did not have jurisdiction to examine the issue, the OFT initiated its own investigation into the minority shareholding. In 2010, the OFT referred this investigation to the CC due to concerns that the minority shareholding would enable Ryanair to weaken Aer Lingus as a competitor. In its final report published in August 2013,[8] the CC largely confirmed the OFT's position. It required Ryanair to sell its shares in Aer Lingus down to 5% and not to accept or seek any board representation in Aer Lingus or acquire further shares.

The CC was not very concerned about 'traditional' unilateral effects relating to potential price increases (as discussed above). There was no evidence that Ryanair's pricing had been affected by the shareholding, and the CC accepted evidence that strong competition remained between the two airlines in the period of Ryanair's shareholding (in fact, the evidence suggested that competition had intensified). Moreover, due to the absence of board representation from Ryanair, the CC did not expect that the shareholding would affect Aer Lingus's incentives to take into account the interests of Ryanair. As a result, the traditional concerns around unilateral effects were ruled out.

Instead, the CC's concerns focused mainly on potential ways in which Ryanair's minority shareholding could affect Aer Lingus's commercial policy and strategy, and thereby weaken Aer Lingus as a competitor. In particular, the CC was concerned that the shareholding would enable Ryanair to prevent Aer Lingus from combining with another airline (through a merger, acquisition or joint venture),[9] and it identified a number of mechanisms through which Ryanair could do this. In particular, it found that Ryanair's minority stake would provide it with sufficient votes to block special resolutions (which require approval by at least 75% of shareholders at a general meeting and are necessary for certain types of transactions). Moreover, the CC was concerned that having a competitor like Ryanair as a shareholder made Aer Lingus less attractive to potential acquirers.[10]

The CC was of the view that its concerns could be addressed only through a (partial) divestment of Ryanair's shares. In order to determine the size of the required divestment, the CC assessed Ryanair's effective voting power—i.e. the number of votes available to Ryanair relative to the total

number of votes actually submitted at a given shareholders' meeting. The CC identified a range of potential outcomes that could increase Ryanair's effective voting power:

- the Irish government—the other major shareholder in Aer Lingus, with a stake of 25.1%—abstaining from a shareholders' meeting;
- limited turnout by shareholders other than Ryanair and the Irish government;
- the Irish government selling its stake some time in the future, and its shares being dispersed to the general public (thereby potentially reducing the turnout for those shares);
- some shareholders ('allies') voting in line with Ryanair on a particular issue.

The CC's analysis is based on scenarios obtained by combining these outcomes in several ways, as set out in the first column of Table 1 below. The CC also took into account estimates of historical voter turnout at Aer Lingus's shareholders' meetings. While the analysis relies primarily on the average historical turnout estimate of 37.2%, it also considered other scenarios (as shown in Table 1).[11]

For each of the scenarios considered in its analysis, the CC calculated the minimum level of shareholding that would allow Ryanair to block special resolutions. As indicated above, special resolutions can be blocked by a shareholder or group of shareholders holding 25% of the votes actually cast. So if, for example, half the shareholders do not actually vote, a 12.5% stake would equate to 25% of the votes actually cast, which would be enough to block a special resolution. Table 1 shows these numbers for each of the CC's scenarios.

### Table 1 Ryanair shareholding corresponding to 25% effective voting power (%)

| | Turnout of shareholders other than Ryanair and the Irish government (%) | | | |
|---|---|---|---|---|
| | Historical low (23.4) | Historical average (37.2) | Historical high (41.4) | Full participation (100) |
| Ryanair without allies, Irish government votes | 13.2 | 15.7 | 16.4 | 25.0 |
| Ryanair with allies,* Irish government votes | 9.5 | 12.2 | 12.9 | 22.0 |
| Ryanair without allies, Irish government stake dispersed | 7.2 | 11.0 | 12.1 | 25.0 |
| Ryanair with allies,* Irish government stake dispersed | 3.5 | 7.5 | 8.6 | 22.0 |
| Ryanair without allies, Irish government abstains | 5.4 | 8.3 | 9.1 | 18.7 |
| Ryanair with allies,* Irish government abstains | 1.7 | 4.7 | 5.6 | 15.7 |

Note: * Assuming that 3% of total shareholders vote the same way as Ryanair.

Source: Competition Commission (2013), 'Ryanair Holdings plc and Aer Lingus Group plc. A report on the completed acquisition by Ryanair Holdings plc of a minority shareholding in Aer Lingus Group plc', 28 August. Rows and columns have been inverted for presentational reasons. The original CC table also shows an additional column for a shareholder turnout assumption of 60%.

The CC concluded that, in order to ensure that Ryanair would be unable to prevent Aer Lingus from participating in a combination with another airline in most of the scenarios shown in the table, Ryanair's shareholding would need to be reduced to 5%. The CC also found that a reduction to 5% would address most of its other concerns, such as the disincentive created for potential Aer Lingus partners.

Overall, the CC's economic analysis of the nature of Ryanair's influence on Aer Lingus provides a conceptual underpinning for its assessment of the minority shareholding. However, it is not clear whether the magnitude of the divestment remedy that the CC derives from this assessment is proportionate given the behavioural remedies offered by Ryanair (including a commitment not to block special resolutions). In other words, the CC drew the remedies line close to the final rows in the table, whereas there were also arguments to draw it further to the top.

Moreover, the CC's assessment appears to give little weight to several relevant factors in relation to potential future combinations. In particular, the European Commission's finding that merger efficiencies between Aer Lingus and Ryanair—which were considered to be each other's closest competitors—would be unlikely may suggest that similar findings could apply to a merger between Aer Lingus and another airline. In addition, there were only a few realistic takeover candidates, all of which had stated that they were not interested in a combination with Aer Lingus at that time.

The CC's concerns discussed above are not based directly on the 'typical' economic theories of harm in relation to minority shareholdings. Instead, the CC puts forward a more novel theory of harm which, if applied consistently, would prevent most minority shareholdings above 5–10% between competitors. The CC's approach may therefore send a negative message to companies looking to engage in partial acquisitions more generally.

## Should acquisitions of minority shareholdings be treated like full mergers?

Partial acquisitions (or pre-existing minority shareholdings) and full mergers generally create very similar incentives for firms, and should therefore be assessed based on the same economic principles.[12] It therefore appears reasonable to address partial acquisitions under the merger framework. This approach is already being followed by several EU member states, and is being considered by the European Commission.

Since the effects of minority shareholdings on competition are generally of a considerably lower magnitude than the effects of full mergers (particularly if they grant only limited control over the commercial decisions of the target firm), competition authorities can be expected to apply less restrictive intervention thresholds for minority shareholdings.

However, there are cases in which minority shareholdings could have an impact on competition, and in these cases a careful economic assessment of their likely effects is required. This assessment also needs to account for the fact that the offsetting effects arising from potential efficiencies are likely to be lower than those arising from full mergers.

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[1] The European Commission has published a consultation on this topic; see European Commission (2013), 'Towards more effective EU merger control', Commission Staff Working Document, June.

[2] *Ryanair Holdings plc v Competition Commission and Aer Lingus Group plc*, case number 1219/4/8/13, 7 March 2014. Oxera advised Ryanair in these proceedings. In August 2013, Ryanair appealed the CC's decision to the CAT. The CAT dismissed the appeal on 7 March 2014.

[3] In the UK, the Office of Fair Trading (OFT) and the CC have issued guidance on how to assess whether a minority stake grants its acquirer 'material influence' over the target firm. This includes analysis of the fragmentation of a company's shareholder base, voting and attendance patterns at shareholder meetings, and board representation. See Office of Fair Trading and Competition Commission (2010), 'Merger Assessment Guidelines', September.

[4] For more details on the assessment of unilateral effects in the context of non-controlling minority shareholdings, see Oxera (2012), 'Share and share alike? Unilateral effects analysis in minority shareholdings', *Agenda*, April.

[5] The economic effects of *backward* shareholdings are largely symmetric. For further details, see European Commission (2013), 'Economic Literature on Non-Controlling Minority Shareholdings ("Structural links")', Annex to the Commission Staff Working Document, June.

[6] Other possible efficiencies in the context of minority shareholdings include the strengthening of incentives to make beneficial relationship-specific investments.

[7] Since firms do not account for the negative consequences of their own pricing decisions on other firms in the supply chain ('pricing externality'), the resulting price level tends to be 'too high', in the sense that a reduction in prices would benefit firms and final consumers. This is frequently referred to as the 'double-marginalisation problem'.

[8] Competition Commission (2013), 'Ryanair Holdings plc and Aer Lingus Group plc. A report on the completed acquisition by Ryanair Holdings plc of a minority shareholding in Aer Lingus Group plc', 28 August.

[9] The CC was of the view that a combination could enable Aer Lingus to reduce its unit costs through economies of scale. The CC's concerns were reinforced by the recent trend towards consolidation in the airline industry.

[10] The CC also expressed several other concerns. For example, it was of the view that the minority shareholding would provide Ryanair with sufficient control to limit Aer Lingus's ability to effectively manage its portfolio of Heathrow slots.

[11] The CC considered the historical minimum turnout (23.4%), the maximum turnout (41.4%), and a 'full participation' scenario with 100% turnout.

[12] A range of quantitative tools have been developed to support this assessment—mostly based on existing merger assessment tools. See, for example, Oxera (2012), 'Share and share alike? Unilateral effects analysis in minority shareholdings', *Agenda*, April; or European Commission (2013), 'Economic Literature on Non-Controlling Minority Shareholdings ("Structural links")', Annex to the Commission Staff Working Document, June.