Kai Lucks (Ed.)

Transatlantic Mergers and Acquisitions

Opportunities and Pitfalls in German-American Partnerships

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1 Introduction

This book seeks to convey three messages: The importance of transatlantic mergers and acquisitions, their poor success rate on average to date and the outstanding results that top players achieve. The U.S. and Germany are each other's most important investors. Diligence, experience management and knowledge management can considerably improve the success rate of acquisition projects. They are thus key to tapping the tremendous potential for increasing value. The examples and articles in this book demonstrate how this can be achieved.

The economic role of TMA

Corporate mergers and acquisitions have become the hallmark of rapid economic change, particularly when it comes to the consolidation-based competition going on within Western industrialized countries. Companies seeking to establish themselves in mature markets cannot afford to engage in years of competition as a means of edging out their competitors. Instead, the acquisition of a national player has now become the method of choice for entering a market. Given the broadening scope of technological options and ever-shorter product lifecycles, acquisitions increasingly secure products and technologies that no single company would be able to develop on its own. These are the main factors driving transatlantic M&A activity today.

At \$57 billion, the gross product generated by German affiliates in the U.S. (2002) is roughly the same as the revenues generated by subsidiaries of U.S. companies in Germany (\$60 billion[1]). U.S.-German M&A projects are among the biggest deals worldwide (see the overview at the end of this book). At €65 billion, the volumes of U.S.-German M&A projects in both directions have been more or less equal over the last five years[2]. Most of the activity from Germany has been in the form of strategic engagements, with the volume showing a declining trend after the stock market hype in 2002. Americans are investing more and more in Germany, particularly equity investors.

[1] US Bureau of Economic Analysis: US-German linkages, gross product of majority-owned foreign affiliates

[2] According to Thomson Financials. Compare US Bureau of Economic Analysis: US Outflows to Germany 2000-2004 = \$30.6 billion, US Outflows from Germany 2000-2004 = \$63.5 billion

The markets

The structures of companies engaging in strategic acquisitions vary widely on the two sides of the Atlantic. German companies aiming to make the transatlantic leap generally already have a broad international presence in the European market. For them, entering the U.S. means tapping into the world's biggest single homogenous market. For budding transatlantic dealmakers from the U.S., on the other hand, the acquisition of a European company is aimed not only at achieving a leading position within the German market but also at establishing a broad presence in Western and Eastern Europe and developing a broad-based, multicultural management system to manage the diversity of markets and business entities there.

Given the dominance of the U.S. market and Germany's relative size within the European market, U.S.-German M&A activities are often among the most important strategic movements as the Western markets become more and more consolidated. Thus, the stakeholders on either side of the Atlantic often find themselves face to face with their strongest competitors. Once the M&A game has commenced in an industry, there is often a cascade of countermovements through M&A or organic defensive measures.

The limited number of candidates and the difficulties associated with trying to harmonize strategies and targets demands patience and endurance. It often takes years before a company's desired candidate becomes available, as was the case in the Siemens-Westinghouse example. And even then, the two companies may not always be a perfect match, as with Henkel and Dial. In such cases, buyers may have to settle for their second choice. If the necessary size increase is not achieved instantly, resources can be tied up for years, not only for integration but also for the subsequent organic development of the company's market presence. In many ways, Germany offers Americans the best platform for making a big entrance on the European markets. Germany is a leading location for industry and lies at the geographical center of Europe. It is home to strong players with holdings and relationships with low-cost suppliers in Eastern Europe, which is just a few hours' drive away.

Strategies

Until now, the markets for strategic investors (those seeking to achieve synergies) and financial investors (those primarily seeking to increase value through turnaround and by leveraging capital) have been largely separate. Increasingly, the massive financial resources available – particularly to U.S. funds – and the extensive portfolios managed by players like KKR are bringing the M&A markets together. Private equity firms are now also pursuing M&A strategies within their broad portfolios. Thus, they have also become serious competitors in the race for strategic targets and are now in a position to use their buying power to take on, take over and dissemble even large international players. Today, U.S. funds hold significant German assets that were previously in government hands.

For many companies, tapping into the huge market across the Atlantic is a top strategic and operative priority. A strong baseline position in the most important mature industrialized countries is often essential to developing the endurance needed for long drawn-out attempts to move into the new growth regions. New global players are rapidly emerging in the “BRIC” countries (Brazil-Russia-India-China). This makes transatlantic consolidation a must for companies that want to keep pace with the movement toward globalization in the decades ahead and to compete with newly emerging giants from the Far East.

What’s different in the U.S. and Germany?

The differences between Americans and Germans lie in the goals they set, their structures and their tolerance for risk. For Americans, M&A is the method of choice for entering markets and developing technologies quickly. They are more likely to shy away from the inherent risks of tying up resources for long periods for organic growth, particularly when it comes to R&D endeavors. Americans tend to view the risks associated with M&A as part of doing business (see article by Matthiessen/ Daniel, chapter 4.2.1). By contrast, Germans tend to focus more on endogenous growth through research and development and consider external growth to be riskier. Consequently, the M&A market is less developed in Germany. Higher levels of spending on R&D and on serving heterogeneous national markets keep profit margins down, making the cost of acquiring these German companies comparatively low, and thus an appealing prospect for U.S. companies.

Success and complexity

However, this appeal is muted somewhat by the M&A success rate, a mere 30% – 50% on the whole, based on the relative development of share prices following acquisitions. Transatlantic M&A deals fare even worse on average. Large-scale transatlantic M&A projects have a particularly low success rate, destroying vast assets within national economies in their wake. The commonly expressed optimism that Germans and Americans are particularly close because of the special relationship that evolved from the post-war era’s Marshall Plan, reconstruction and export ties – and that corporate mergers should therefore be easier – flies in the face of reality. According to analyses in several articles within this book, companies’ overestimation of their own capabilities and underestimation of the challenges involved (compare my article on management of complex M&A projects, chapter 4.1.2) are the real cause of M&A failures. Large M&A deals – and particularly in transatlantic business, this is generally the case – are often driven by management egos. However, once ego takes over, barriers go undetected, general due diligence takes a back seat and the projects end in disaster. Even authoritative writings on M&A often don't take these considerations seriously enough. Many authors content themselves with merely enumerating situational snapshots of individual deals rather than systematically examining management problems. The American “way of M&A” is characterized by pragmatism and confidence in general management abilities. However, studies show that the expertise and skills that are critical for M&A are quite different from those needed to ensure continuity in ongoing operations. Companies with better baseline performance do not necessarily have better chances of success with M&A. I had to learn from experience in numerous integration projects that M&A is always a balancing act. Too much pragmatism can easily result in chaos, while a rigid, systematic approach can generate complexities and create new problems instead of solving them. All the textbooks in the world can't replace experience, which is something that can only be acquired through painstaking, often frustrating practice.

TMA: Out of the comfort zone

Along with poor performance there are also cases of abuse in which financial investors looking to make short-term gains ignore the long-term consequences of a transaction. They leave in their wake companies overburdened with debt and they destroy jobs. These cases should be denounced. In the months just prior to the release of this book, such "black sheep" triggered a political debate in Germany that did little to help the situation. I spoke with numerous fund managers while preparing this book and am now more convinced than ever that professional and successful investors are in agreement that there is a correlation between the success and the sustainability of M&A investments.

The effects of the bubble economy and stock market hype in 2002 are still being felt today. The findings of fraud and misrepresentations resulted in a wave of new legislation like the Sarbanes-Oxley Act in the U.S., and new codes of conduct on both sides of the Atlantic. Making executives personally accountable for any information which might affect the stock price led to their becoming extremely cautious in any of their public statements. This, in turn, has caused today's 'legal advisory hype' – a phenomenon which also impacted this book. Half a dozen top executives from U.S. companies were highly motivated to tell their M&A stories and had committed early on to contributing them. Some of their texts had been ready for months. But when these were put through a series of legal reviews, the result was last minute withdrawals. I am grateful for offers by these executives to contribute to a possible second edition; their assumption is that, by that time, an open discussion about effectively managing M&A projects will be more commonplace. Their optimism that this book might be more than just a one-time event is heartening. However, due to this reticence on the part of senior U.S. managers to tell their stories at this time, most of the first-hand top management reports are from German companies, while the U.S. case studies are generally presented by consultants.

The subject of this book is anything but "comfortable." Transatlantic success cannot be achieved through simple formulas. Yet it is impossible to deny that mergers and acquisitions are a necessity. Anyone who avoids M&A due to fear or a lack of expertise is bound to lose out in today's consolidation-based competition and will be unable to achieve success in the growth regions.

The idea behind this book: Knowledge transfer

The idea for this book goes back to the first German-American Mergers & Acquisitions Day, which took place in New York on October 21, 2004, at the initiative of the German Federal M&A Association. Under the auspices of Jürgen Weber, the Federal

Commissioner for Foreign Investment in Germany, and together with the German-American Chamber of Commerce, we invited German and U.S. businesspeople and M&A specialists to Deutsche Bank's offices on Wall Street to share their experiences. The meeting was a success, not only in terms of the subject matter. Discussions among the participants were lively, continuing until the last of the attendees had to leave for the airport. M&A is a business that sparks emotion and always needs an "owner" who identifies with a project. But a case can only promise success if it is supported by technical expertise. The workshop's leaders agreed to undertake follow-up activities, of which this book is the first. It seeks to relay the knowledge and expertise to a broader audience, our readers.

Fundamentals of German-American M&A relationships

There is agreement among business people and experts that the success rate of M&A is largely determined by experience, knowledge transfer and technical diligence. Studies support this thesis. In this book, large companies that make frequent acquisitions and specialists who have established the necessary expertise management report on success stories. Among the most important rules for success are ensuring that the management has gained personal experience through the planning and implementation of comparable projects and ensuring that the disciplines needed for M&A are managed by proven experts.

It is along these lines that this book is structured. The first part provides information about the basics of German-American M&A relationships. Jürgen Weber illustrates the central role that Germany plays in the European strategies of U.S. companies. Daniel Hamilton and Joseph Quinlan outline the significance and structures of German-American shareholding relationships from a U.S. perspective. Thomas Schwingeler and Stefan Griesser document the transatlantic M&A market and its prospects for the future. Marcus Schenck, Frank Richter and Karoline Jung-Sennsfelder write about the capital market as a lever for transatlantic deals. And Fritz Kröger points out the direction that global consolidation is taking and analyzes the need for improvement.

Learning from M&A cases

In the second part of this book, representative examples illustrate what drives M&A in various industries and how success has been achieved in individual projects. The articles cover the major industries, different "classes" of companies (from large corporations to medium-sized enterprises to small, specialized operations) and a variety of case categories (from "strategic" projects involving special integration challenges to equity investors). The cases described here involve efforts to cross the Atlantic in both directions. A wide variety of business types are covered, from equipment manufacture to products and services to IT and asset acquisitions. Because of its heavier weighting in strategic investments, Germany is more prevalent here, while articles on private equity illustrate U.S. involvement in Germany. The selection of authors, many of whom are corporate executives like Rüdiger Grube (DaimlerChrysler), Lothar

Steinebach (Henkel), Hermann Thiele (Knorr), and Klaus Zumwinkel (Deutsche Post World Net), highlights the diversity of perspectives. With George Nolen (Siemens Corporation) and Randy Zwirn (Siemens-Westinghouse), we also hear from senior executives of German companies operating in the U.S. Smaller players from the new economy (Dirk Hoffmann: Jamba!) and the IT sector (Ingo Möller, Ingram Micro) also share their insights. Strategists like Axel Wiandt / Rafael Moral y Santiago of Deutsche Bank and Barbara Jeremia and Konrad von Sczcepanski of Alcoa write about movements in various industries. Jörg Sellmann and Oliver Maier of Degussa explain broadly based portfolio movements within corporations. We have also included joint presentations by companies and their consultants (in the case of Dräger Medical, presented by Wolfgang Reim and Carsten Kratz) and collaborations between strategic buyers and their equity partners (in the case of Zeiss-Sola aided by EQT, presented by Michael Kaschke and Udo Philipp). The private equity scene is represented by big specialists and small cap investors (Gernot Wunderle, Volker Schmidt). Helmut Uder's account of the Onex Food case from the human resources perspective serves as the segue to the specialized articles that make up part three of this book.

Leadership and strategies

The specialized articles in the third part of this book discuss the field of M&A specialists who should be involved, whether in-house experts or external consultants. The order of their appearance reflects the order of the project phases in which they are involved. We begin with strategic considerations, leadership concepts and corporate governance, offering various approaches to overarching perspectives. This includes a comparison of leadership behaviors by Joerg Matthiesen, Allison Bailey and Jeanie Daniel Duck as well as my own concept for managing complex transatlantic projects. Gerhard Plaschka, Rohit Verma and Douglas Squeo focus on customer reactions, a topic that has been sorely neglected in M&A on the whole. Their quantitative measurement methods are among the most innovative areas of M&A. Jens Schädler and Reto Isenegger cover the broader field of (non-equity) partnership between companies.

Transaction and cultural change

The next section covers transaction-oriented disciplines relating to stock markets, finance, controlling, measurement, due diligence, taxes and anti-trust law. Here too, we cannot limit ourselves to easy-to-digest, "simple fare." The articles in this section describe numerous important and innovative products. These in-depth explorations seek to illustrate the amount of specialist expertise and experience necessary for success. I ask for your understanding that I cannot name each and every one of the authors here. We then come to the more or less "soft" factors involved in integration projects. The segue here is provided by an article by Alexander Geiser and Nikolai Juchem, in which the authors seek to establish a link between capital market rules and communication. Patrick Schmidt sweeps away some preconceptions in this regard and leads us deep into the realm of linguistic messages while Bettina Palazzo, Craig

DeForest and Bernhard Pelzer round out the book with a fundamental discussion of U.S. pragmatism and “German thoroughness.”

Creating new enterprise organisms

Only a well-orchestrated ensemble can ensure success. Whether a selection of distinguished chamber orchestra musicians or a large marching band that can perform precision drills is needed depends on the case at hand. As we mentioned above, only experienced practitioners can determine which size of ensemble and which blend of (American) pragmatism and “German thoroughness” is needed. Americans and Germans can learn a great deal from each other, and a combination of the two cultures and approaches promises the greatest success. In a merger, the goal is not so much to equalize the existing cultures but rather to bring together the cultural and structural differences that are so critical to successful operation in different markets, and to thereby form a single organism.

Acknowledgements

I would like to express my deepest gratitude to all of the friends, authors, association colleagues and publishing house employees who have made this book possible. Although M&A is one of the toughest work environments, you have sacrificed your time to be a part of this endeavor. My special thanks go to the many teams of analysts, assistants and ghost writers, without whom these articles would never have been possible. To two of them I want to personally express my gratitude, namely to Andreas Richter who assisted me in organization and processing and to Gerhard Seitfudem for publishing of this book.

With the firm conviction that transatlantic alliances and mergers can regularly be brought to successful fruition, this book seeks to lend encouragement in undertaking the corporate mergers and acquisitions that are essential to the future of our nations – with competence, mutual understanding and enthusiasm for a new venture together.

Munich, October 2005
Kai Lucks

2 Markets and Structures

2.1 Going Where the Markets Are – M&A in Germany

Jürgen Weber

The enlargement of the European Union in May 2004 brought forth a single market of 454 million consumers offering major opportunities for overseas investors. Germany presents itself as a business location in the very heart of the union whose attraction has appreciated considerably recently thanks to the country's drive for greater global competitiveness.

The essential questions when looking at capital investment overseas are similar to those facing a person when buying a home: The three most important things to consider carefully are – location, location, location.

Despite the popular conception of the "rising" economies of Asia and their big emerging markets, Europe and America continue to be the most powerful commercial players. They have the world's strongest markets, they provide high-grade jobs and they are the basis for considerable revenues and profits due to the wealth of their peoples. Take the three German states of Bavaria, Baden-Württemberg and North Rhine-Westphalia, for example: they alone have a higher GDP than the four Asian tigers – South Korea, Taiwan, Singapore and Hong Kong – taken together.

Within the European Union, Germany's attraction as a business location has appreciated over the past three years – structurally because of a new drive for economic and social reforms and geographically because the country has become the center of the European Union following EU enlargement in 2004. Today, you could not be more centrally based in Europe than in this continental heartland neighboring nine countries. Germany is the natural linchpin between East and West, North and South and EU expansion has dramatically improved its competitiveness.

Why should foreign direct investment be encouraged, and why is the integration of our economies of both sides of the Atlantic so important? At one time, companies would primarily invest in overseas production and service bases in order to seize fresh market opportunities. But now that all types of hedging strategies are vital for healthy balance sheets, foreign direct investment has become a key factor in guarding a company against currency fluctuations and regulatory restrictions. This effect has become known as "natural hedging."

Related party trade – that is, trade between parent and affiliate companies – offers an explanation as to why U.S. imports from Europe remained strong and continued to grow in 2003 despite a 20 percent appreciation of the euro against the dollar. And that also partly explains why Germany remained the world's leading export nation even in 2004, despite a very strong euro. Had we not invested in each other's economies, things would look much darker today. Indeed, an integrated economy is less vulnerable.

The M&A business and private equity serve as a powerful engine in this integration process. Acting on behalf of their private and institutional investors, M&A consultancy firms are on the constant lookout for business enterprises to buy and develop further.

We at "Invest in Germany" – the agency I represent as Federal German Commissioner for Foreign Investment – recognize three main factors that attract foreign direct investment:

1. The chance to open up new markets and develop existing ones
2. A low-priced production base, which is a very popular reason for going abroad
3. Natural hedging.

I mentioned natural hedging already. So, let's concentrate on points one and two.

Access to markets is a classic reason for going abroad. Even the very best intentions will get you nowhere if you are not familiar with your market and its people. Being on the spot enables you to analyze situations quickly, take decisions that are geared to local conditions and traditions and deliver your goods or services fast. The famous saying "When in Rome, do as the Romans do" is as valid as ever. It pays to have the know-how.

Germany is the leading economy in Europe. Eighty-two million people live there – that is 22 percent of the EU population. They create 23 percent of the Union's gross domestic product. So anybody who wants to win a market share in Europe can't get around having a presence in Germany.

The expansion on May 1 from the so-called EU 15 to EU 25 countries has created a single open market of 454 million consumers. Germany enjoys a prime geographical situation in this enlarged union. Goods can be delivered to and carried from Prague, Warsaw and the Baltic states just as easily as – say – to and from Amsterdam, Brussels, Copenhagen, Paris or Vienna. Distances are short and air services, in particular, are frequent and quick, with flying times usually less than an hour-and-a-half. Germany's hub airports in Frankfurt and Munich are the most central of their kind in Europe.

Also, there is an excellent network of fast highways and railroads radiating from Germany. That is an advantage no major company can afford to ignore when seeking a location for its regional activities in Europe. Another interesting point: Central Europe has become the most important trading partner of the EU during the past ten years – more important than Asia or Latin America. Germany, Austria and Italy account for more than three-quarters of total trade flows between eastern and western Europe. It is lucrative to tap into these trade flows. All these features are compelling reasons for investing in or buying companies in Germany. FDI in both directions keeps the continents of America and Europe alert and competitive and ensures that innovation finds its way to the markets quickly.

My second point is **the cost of labor.** A low-priced production base is not the first thing that comes to mind when you think of Germany. Because people automatically relate low cost to cheap labor.

Cheap labor certainly is not what attracts U.S. companies to Germany first and foremost. In fact, the political debate in Germany has permanently been revolving round the question as to how to cut labor costs in order to secure global competitiveness. So there must be other, more compelling reasons for investing in Germany.

When you take a more comprehensive look, a low-priced production base turns out to be a rather mixed basket of comparatively low wages, highly qualified local staff and management, and stable labor relations.

Here Germany can score on the salient points. Each spring the American Chamber of Commerce in Germany publishes a survey of their 100 biggest member firms. They continue to regard Germany as an ideal location for U.S. companies, specifically for headquarters serving the European area.

AmCham members cite the quality of highly trained labor as the second strongest reason for operating in Germany after the strength of the market. It is the excellent productivity and the flexibility of the workforce that they are so happy with. Skilled labor – the famous German *Facharbeiter* – is very versatile. He can fix things for you, an AmCham member told me, for which you would require another specialist in an American company if you want to avoid a borderline dispute.

I will not gloss over the fact that the recent expansion of the European Union has been used by industry to shift some of their production eastwards where labor is extremely cheap. This has put pressure on management and unions in Germany to adapt to a new environment. And, indeed, Germany has made astonishing progress in this respect.

Wage freezes, a partial return to the 40-hour week, lower entry wages and shop contracts that allow more flexible working in line with market demand – all this is happening and reflects the new realities. Codetermination at the shop-floor level works. You will find readiness on the part of local shop committees to reach tailor-made agreements. That would have been unheard-of only a couple of years ago. Germany is definitely moving with the times! Executives of big U.S. companies in Germany with whom I have spoken are impressed by the flexibility of their labor force and shop committees.

R&D is another quality factor in Germany's favor. Sixty per cent of U.S. corporate research and development conducted outside the United States is based in Europe. The UK and Germany are the biggest labs for U.S. companies abroad. Germans continue to register the highest number of patents in Europe. Companies like Ford and BP have moved their European research centers from the UK to Germany for that very reason. So, the comparative advantage of a location is based on a number of different factors. And Germany has strong plus points speaking in its favor.

There is one other, very recent argument for giving preference to Germany over other business locations in Europe – and that is money. Germany's comparative advantages in the euro zone have grown remarkably. A survey published by the British magazine "The Economist" revealed that the euro area may have a single currency, but it still has many different real exchange rates. That is stunning news.

When the single currency was born, Germany's unit labor costs were the highest in the euro area. But since 1999 they have fallen by ten percent relative to the average. In contrast, relative unit labor costs have risen by nine percent in Italy, Spain and the Netherlands. Economists at ABN Amro were quoted as estimating that Germany's labor costs are now lower than Italy's. Ireland and Portugal have also lost competitiveness. In the past five years, Germany has boasted faster growth in labor productivity than the euro area average.

The same analysts conclude that Germany's real trade-weighted effective exchange rate against the dollar has risen only 4 percent since early 2002. By the same token, France's real exchange rate has gone up by 9 percent and that of Italy and Ireland by 17 percent. Germany also has the lowest inflation rate in the euro zone. The economists argue that Germany's modest rise in the real trade-weighted exchange rate explains the country's success as the world's leading exporter – a result of a remarkable improvement in the terms of trade.

Also, Goldman Sachs, the investment bankers, stated in a report that Germany's competitiveness has improved dramatically and was now on par with the rest of the Union. Germany, indeed, is good for many a pleasant surprise!

A final word on how M&A and private equity are being viewed in my country. In contrast to a more skeptical view several years ago, the private equity business has gained a lot of respect in recent years. This picture has hardly been marred by political criticism recently.

Private equity is seen by trade and industry as an alternative to classical forms of financing a company. Particularly small and medium-sized companies – the backbone of the German economy – are confronted with two major challenges: They find themselves facing global competitive pressure and want to expand. But the new Basle Two credit regulations make it difficult for them to obtain the necessary credit facilities.

Most of these small and medium-sized businesses suffer from a lack of capital resources. While it is common for U.S., French or Dutch companies to have an equity ratio of 30 per cent, they only possess seven-and-a-half percent on average. As a result, only a few can afford to invest in new products or technologies, although they are highly innovative as companies. There are dormant potentials which only a few of them can realize. Also, many of those firms that were established in the fifties and sixties, when Germany was recovering from World War II, are now in need of a successor to their present owners. Private equity can help to solve problems of succession.

Major German groups are interested in PE because the pressure is on for them to concentrate on core activities. Many diversified groups are thinking of spinning off activities that do not fit the portfolio anymore, even though they are profitable. So, at a time when the whole country is debating reform and adjusting to new global challenges, Germany has a lot of advantages to offer U.S. investors who are thinking of buying into local businesses.

By doing so, they will gain. They will obtain a footing in the EU or may help develop companies in their expansion drive. Whatever their objective may be, their activities will enhance transatlantic economic integration, produce results and secure jobs. A number of companies that are well known to German consumers have already become successful with the help of private equity: Gardena, the garden utensils manufacturer, for instance, or the Nordsee restaurant chain, the ATU auto repair chain, and Rodenstock glasses, to mention just a few.

Generally, the public is hardly aware of this fact. The lack of publicity is regrettable, but it could also be seen as a sign of normality in the transatlantic economy. And there are other, more spectacular cases, like that of the chemical giant Celanese or the purchase of Linde refrigeration engineering by United Technologies. A great number of M&A and private equity deals in Germany are real success stories. They bode well for a deepening of transatlantic economic relations.

Foreign direct investment in both directions will strengthen our respective position as global players. Let's always remain aware of that.

2.2 U.S.-German Relations: Will the Ties that Bind Grow Stronger or Weaker?

Daniel S. Hamilton and Joseph P. Quinlan

The economic interests and future prosperity of the United States and Germany have never been as interdependent as they are today. U.S.-German commercial interests are bound together by foreign investment – the deepest form of economic integration. The war in Iraq, and subsequent tensions between Washington and Berlin, served as a useful wake up call to policy makers on both sides of the Atlantic to the importance of the U.S.-German relationship. Now, however, the challenge for both parties is to renew their commitment to the relationship and forge ahead with new policies that will strengthen one of the most important bilateral relationships in the world.

With the end of the Cold War, and the receding threat of the Soviet Union, many parties on both sides of the Atlantic came to the conclusion that the United States and Europe were no longer strategic partners in need, that they were free to disengage from each other and free to pursue divergent interests. This view gained even more credence in the post-September 11th environment, when U.S. foreign policy shifted towards more pre-emptive strategies and unilateral initiatives, culminating in the U.S.-led war in Iraq.

The bitter division over the war in Iraq shook the transatlantic foundation to its core, notably the U.S.-German alliance. U.S. relations with one of its longest-standing European allies plunged to perhaps its lowest level since the creation of the Federal Republic of Germany. The war in Iraq fanned anti-Americanism across Germany, which, in turn, only served to stoke anti-European and German sentiment in the United States. Public opinion on both sides of the ocean turned decisively sour in 2003 and 2004. Against this backdrop, many observers began to think the unthinkable – the collapse of the transatlantic alliance in general, and downgrading of the U.S.-German partnership in particular, following decades of cooperation and prosperity.

Fortunately, the fashionable argument that the United States and Germany no longer need each other has begun to wane. In its place a new realism has emerged, one anchored in the belief that despite differences in other fields (security, climate change, Middle East policies), the economic interests and future prosperity of the United States and Germany have never been as interdependent and intertwined as they are today. U.S.-German commercial interests are bound together by foreign investment – the deepest form of economic integration – as opposed to trade – a well known yet rather shallow form of integration.

Interestingly, despite all the media hype about the emergence of China, the promise of India and the allure of the emerging markets, U.S.-German economic ties only grew stronger over the first half of this decade. However, the past is hardly prologue. Even a bilateral relationship rooted in foreign direct investment needs constant nourishment and reinforcing initiatives that deepen and strengthen the relationship. Today, U.S.-German linkages are among the strongest in the world. The question is whether or not the same will be true by the end of this decade and beyond.

U.S.-German commercial relations – the long view

In the aftermath of World War II, U.S.-German commercial relations were relatively shallow and underdeveloped. Given strong growth at home, U.S. firms were not aggressive foreign investors at the time, and what investment did take place abroad was directed at natural resources. Accordingly, mining and oil exploration were the principal sectors driving U.S. investment outflows; resource-rich Canada and Latin America accounted for roughly 70% of America's overseas investment position at the outset of the Cold War.

Europe's share of U.S. foreign investment was just 15% in 1950, with the United Kingdom accounting for nearly half of the European total. In the intervening decades, however, the motivations for investing overseas among U.S. firms shifted, as did the geographic composition of U.S. foreign investment. Access to markets, rather than raw materials, became the overriding determinant of U.S. firms' overseas expansion. As a result, Europe, which had lagged Canada and Latin America in the early 1950s, emerged as the most favored destination of U.S. firms in the ensuing decades, a ranking the region has never relinquished.

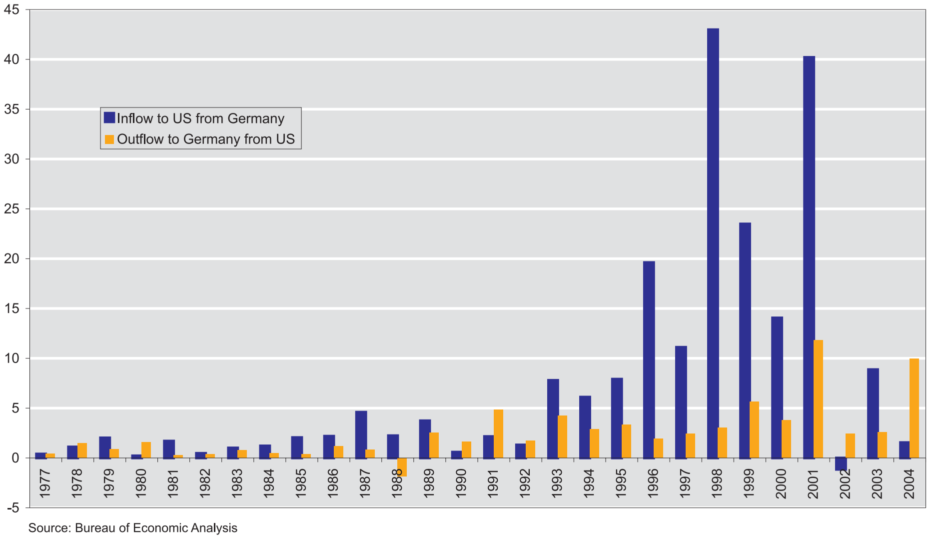

Figure 2.1 The Long View: U.S.-German FDI Flows (in US $ billions)

As Europe rebuilt and recovered from the ravages of war in the late 1950s, and moved toward the creation of a common market, U.S. firms were quick to seize the opportunities across the Atlantic. While U.S. foreign investment outflows to Europe averaged just $400 million (in nominal terms) annually in the 1950s, the annual average more than quadrupled in the 1960s, jumping to $1.7 billion. That represented nearly 40% of the U.S. global total, up from a 20% share in the 1950s. In the 1970s, Europe's share jumped to 47% of total U.S. FDI; in the 1980s, Europe easily accounted for more than half of total U.S. investment outflows.

U.S. foreign investment to Germany mirrored these general trends: over the 1950s, Germany attracted just $600 million of U.S. investment on a cumulative basis. Over the 1960s, as a European common market began to coalesce, and as Germany emerged as one of the most powerful economies in Europe and the world, U.S. foreign direct investment to Germany rose sharply. Indeed, over the 1960s, U.S. firms invested $3.4 billion on a cumulative basis in Germany, a near six-fold increase from the prior decade. In the 1970s, U.S. firms invested another $9.3 billion, more than two-and-a-half times the level of the prior decade. By the end of the 1970s, U.S. firms enjoyed a commanding position in Germany; U.S.-German investment flows were unbalanced by the end of the 1970s, with America's investment stakes in Germany, on a historic cost basis, roughly double ($15.4 billion) that of Germany's investment position in the United States ($7.6 billion).

The investment gap between the U.S. and Germany reflected the global economic conditions of the post-war era. Spared the destruction of war in their home markets, U.S. firms had the advantage of a healthy economy and the financial means to expand overseas. By contrast, the 1950s and 1960s were a period of rebuilding and reconstruction for most German companies. Before expanding abroad, many firms first had to resurrect their own facilities at home and reestablish their domestic market posi-

Table 2.1 FDI inflows

US foreign direct investment inflows from Germany (in US $ billions)

	US Inflows from Germany	US Inflows from Europe	Inflows from Germany as a % of Flow from Europe
1962-1969	0,5	3,3	14,9%
1970-1979	4,2	27,7	15,3%
1980-1989	19,4	216,3	9,0%
1990-1999	123,1	659,1	18,7%
2000-2004	63,5	502,4	12,6%

US foreign direct investment outflows to Germany (in US $ billions)

	US Outflows to Germany	US Outflows to Europe	Outflows to Germany as a % of Flow to Europe
1950-1959	0,6	4,2	13,3%
1960-1969	3,4	16,7	20,2%
1970-1979	9,3	57,9	16,1%
1980-1989	6,5	94,7	6,9%
1990-1999	31,8	465,3	6,8%
2000-2004	30,6	401,6	7,6%

Source: Bureau of Economic Analysis

tions. With the formation of the European Economic Community, German firms were initially venturing into neighboring nations rather than further abroad.

Over the 1970s, however, many German firms went on the offensive and made it a strategic priority to counteract corporate America's growing presence in Germany. Accordingly, after investing $4.2 billion in the United States over the 1970-79 time frame – up sharply from roughly $500 million over the prior decade – German firms dramatically increased their market presence in the United States over the 1980s. In fact, German firms invested nearly three times as much capital in the U.S. over the 1980s ($19.4 billion) as U.S. firms invested in Germany ($6.5 billion).

Over the 1980s, U.S. foreign direct investment overseas dropped sharply in part on account of the U.S. recession. Meanwhile, U.S. capital inflows from Germany and other nations soared, bolstered by a number of variables including favorable market attributes in the U.S., a wave of corporate restructuring that increased the number of domestic candidates for sale, and attractive incentives from many U.S. states and municipal governments. Shifts in U.S. tax laws related to accelerated depreciation schedules also lured record amounts of foreign investment. So did the dramatic depreciation of the U.S. dollar over the second half of the 1980s, with the weak dollar not only reducing the foreign currency cost of acquiring U.S. companies. The weak dollar also caused the dollar value of wages in other nations, notably Germany, to rise relative to U.S. wages, making it more difficult for German firms to export goods to the U.S. This made it all the more attractive for German firms to invest directly in the United States. And they did – by 1989, German investment in the United States, on a historic cost basis, was nearly 20% larger than corporate America's position in Germany, $28.4 billion versus $23.7 billion.

The 1990s and beyond – the bonds grow stronger, not weaker

When the economic history of the late 20th century is written, globalization will undoubtedly be invoked as the defining economic precept of the time. Like the initial period of globalization in the second half of the 19th century, the 1990s and beyond have been a time of robust and unfettered global capital flows, market liberalization measures and buoyant global trade. Global trade expanded by an average annual rate of 6.1% (in volume) over the 1990s, roughly double the rate of world GDP growth, and by a similar annual rate over the first half of this decade.

Global foreign direct investment (FDI) flows have expanded at an even faster pace, boosting the level of global inward FDI stock from $1.9 trillion in 1990, to $6.3 trillion in 2000, and to an estimated $8.2 trillion in 2003. At the start of the decade, there were over 60,000 transnationals with more than 820,000 affiliate spread around the world. From this global production base, the gross product of foreign affiliates totaled $3.7 trillion in 2003, with foreign affiliates employing over 54 million workers. Sales of foreign affiliates topped $17.6 trillion in 2003, versus $5.7 trillion in 1990, and were well above global exports of goods and services in 2003 – $9.2 billion.

Globalization's return has opened the untapped markets of central Europe, Latin America, and the Indian subcontinent. Free market reform has been the mantra of Poland, Brazil, India and a host of emerging markets for more than a decade, with these new markets providing new consumers, new resources to leverage and new opportunities to grow sales and revenues for the world's leading multinationals.

Yet despite all the hype associated with globalization, and notwithstanding all the excitement surrounding the emerging markets, notably China, one of the defining features of the global economic landscape over the past decade has been the increasing integration and cohesion of the transatlantic economy in general, and U.S.-German ties in particular.

American companies invested more capital overseas in the 1990s – in excess of $750 billion – than in the prior four decades combined. But the surge in U.S. foreign investment did not flow to the new and untapped markets of the developing nations. Rather, the majority of U.S. foreign direct investment in the 1990s, and the first half of this decade, has been directed at Europe. Of the top ten destinations of U.S. investments in the 1990s, five countries in Europe ranked in the top ten – the United Kingdom (ranked No. 1), the Netherlands (3), Switzerland (6), Germany (7) and France (8). Rounding out the top ten were Canada (2), Brazil (4), Mexico (5), Australia (9) and Japan (10).

In the first half of this decade (2000-04), six countries in Europe were among the top ten destinations of U.S. foreign investment. The United Kingdom, ranked first again, followed by Canada (2), the Netherlands (3), Switzerland (4), Mexico (5), Ireland (6), Germany (7), Singapore (8), Japan (9) and Italy (10). U.S. investment stakes in Europe have expanded sharply this decade, with Europe attracting nearly 56% of total U.S. foreign direct investment in the first half of the decade. The bias towards Europe runs counter to all the hype and angst associated with U.S. outsourcing to such low-cost locales like China and India, and the common belief that it is the low-cost destinations of East Asia that has attracted the bulk of U.S. investment.

To be sure, U.S. foreign direct investment to China and India has jumped dramatically this decade, notably U.S. investment to China. Total U.S. investment to China, for instance, surged to nearly $11 billion (on a cumulative basis) in the first half of this decade, nearly double U.S. investment flows to China of $5.9 billion over the second half of the 1990s. That represents a dramatic rise, although on comparative basis, U.S. investment in Germany over the same period ($30.6 billion) was nearly three times larger. By the same token, while U.S. foreign investment to India doubled in the first half of this decade, from just $1 billion over the 1995-99 period to $2.5 billion, U.S. investment in Germany was 12 times that level. In 2004, U.S. investment to Germany totaled nearly $10 billion, versus U.S. investment of $4.2 billion in China and just $1.2 billion in India.

Why such a disparity between U.S. investment in slow-growth Germany versus turbo-charged China and emergent India? At the end of the day, the motivations of multinationals to invest overseas are less about cheap labor and more about access to wealthy markets, to skilled labor and to the innovative capabilities of the host nation. The premium placed on these assets goes a long way in explaining why the U.S. and Germany are each other's most important foreign investors.

In addition, the size and the wealth of the U.S. economy has long been a key attraction for German firms, fueling a host of mega-acquisitions over the past decade. Chief among them were the Daimler-Chrysler deal and Deutsche Bank's purchase of Bankers Trust; the two deals helped to boost German inflows to a record $43 billion in 1998, equivalent to Germany's total investment in the United States over the 1980-94 period. German investment slipped to $23.5 in 1999, although the country still ranked second largest of foreign investors in the U.S. over the 1990s. Over the first half of this decade, FDI from Germany accounted for 9.4% of the U.S. total, making Germany the sixth largest investor in the United States.

Strong economic growth in the U.S. has been one propellant of rising capital inflows from Germany, with many German firms mindful of the fact that any truly global strategy dictates a presence in the U.S. This prompted both BMW and Mercedes-Benz to set up shop in the U.S. in the mid-1990s, bringing along many German suppliers as well. More recently, RWE, Henkel and Deutsche Post have all made significant acquisitions in the United States.

Other so-called push factors – created by local market and business conditions – have also been at work in promoting outward flows from Germany. These include high German wage costs, stifling corporate taxes, and inflexible employment practices, a lethal mix that has pushed many German firms abroad. The government has addressed some of these issues over the past few years, although change thus far has not be deep or radical enough to structurally change Gemany's low-growth-high unemployment environment.

Yet these issues aside, Germany remains an attractive market to U.S. firms. The allure of Germany lies with the nation's highly skilled labor force, research and development capabilities and first class infrastructure. The specialization and innovative capabilities of many small and medium-sized firms in Germany have also been notably attractive to U.S., particularly private equity groups. The latter, despite growing hostility in Germany, have been among the most active foreign investors in Germany lately, fueling greater cross-border M&A deals in Germany. Indeed, in the first half of 2005, Germany was among the most popular locations in the world for global M&A deals, with deals totaling $73 billion in the first half of this year, a 110% rise from the same period a year ago. Many of these deals have been initiated by U.S. firms.

The bottom line is that U.S. and German firms are stilled attracted to each other, and attracted to each other's home market, helping to sustain robust foreign direct investment flows in the first half of this decade – despite the transatlantic ill produced by the U.S.-led war in Iraq. In fact, over 2003 and 2004, German firms invested $10.4 billion in the United States, versus disinvestment of $1.1 billion in 2002. The latter was a result of the U.S. recession, which reduced affiliate profits and subdued new equity capital inflows from Germany. Over the same two-year period, U.S. firms sank $12.6 billion into Germany, up sharply from the $2.4 billion invested in 2002. In the end, while the politicians on both sides of the Atlantic were bickering over the war, is was largely "business as usual" regarding U.S.-German investment flows.

The eight ties that bind

The primacy of foreign direct investment in driving U.S.-German commerce is reflected in the robust infrastructure that links the United States and Germany. This

Table 2.2 U.S.-German linkages[1]

The Ties That Bind (US $ Billions, 2002)		
	U.S. Foreign Affiliates in Germany	German Affiliates in the U.S.
Gross Product of Affiliates	60,7	57,0
Overseas Assets of Foreign Affiliates	311,8	534,1
Affiliate Employment (thousands)	615,6	676,4
Manufacturing (thousands employees)	386,0	389,0
R&D of Affiliates	3,6	5,6
Foreign Affiliate Sales	205,7	290,4
Foreign Affiliate Income (Full Year 2004)	6,3	7,1

Source: Bureau of Economic Analysis

[1] Data from majority-owned foreign affiliates

commercial infrastructure has been under construction for over a half-century, but remains largely invisible to policy makers on both sides of the ocean. The following eight indices offer a clearer picture of the deep integrating force that makes the U.S.-German commercial link among the strongest in the world (Table 2.2).

Gross product of foreign affiliates

The total output of U.S. foreign affiliates in Germany ($60.7 billion in 2002) and of German affiliates in the United States ($57 billion) is rather sizable. Both figures, for instance, are equal or greater than the GDP of Bulgaria, Algeria, Peru, Morocco, New Zealand and many other nations. In Germany, U.S. foreign affiliates accounted for 3.1% of total German output in 2002, up from 2.7% in 1994. In the United States, the output of German affiliates has increased sharply over the past few years on account of rising German FDI in the U.S. In 1997, for instance, German-owned affiliate output in the U.S. totaled $37 billion, a figure that increased to $57 billion in 2002. Only British and Japanese affiliates in the U.S. produced more than German affiliates in 2002.

Overseas assets of foreign affiliates

America's overseas commercial presence, as measured by foreign assets of U.S. companies, is substantial, totaling over $6 trillion in 2002. The bulk of these assets, or 61%, are located in Europe, with the largest share in the United Kingdom ($1.5 trillion), the Netherlands ($508 billion) and Germany ($312 billion). While lagging the U.K. and the Netherlands, U.S. assets in Germany were greater than total U.S. assets in South America in 2002 ($117.8 billion), as well as many other developing regions, including Africa ($62 billion), the Middle East ($29 billion), Eastern Europe ($52 billion), and OPEC ($77.2 billion).

Total German assets in the U.S. – $534 billion – are among the largest of all foreign investors in the United States. Only the United Kingdom and Switzerland have a larger asset base in the U.S. than Germany. It is interesting to note that German assets in the U.S. are over 70% larger than U.S. assets in Germany, a factor related to the surge in German FDI in the United States over the past decade.

Affiliate employment

Thousands of workers in the United States and Germany are employed by foreign affiliates from each nation. Indeed, some 676,000 American workers were employed directly by German affiliates in 2002 – among the largest numbers of workers employed by foreign investors in the U.S. Only British firms employed more American workers in 2002. Roughly half of these U.S. workers were employed in manufacturing jobs, and concentrated in the Great Lakes region, as well as the southeast, where German affiliates are predominantly located. Although hard to quantify, many more American jobs are tied to U.S. exports to Germany.

In Germany, U.S. affiliates employed roughly 616,000 German workers in 2002, with nearly two-thirds of the total (386,000) consisting of manufacturing workers. So large was the manufacturing workforce of U.S. affiliates in Germany in 2002, that the number of manufacturing workers on the payrolls of U.S. foreign affiliates in Germany was 80% greater than the number of manufacturing workers employed by U.S.

affiliates in China in the same year. That said, however, U.S. foreign affiliate manufacturing employment in Germany is in decline, falling nearly 15% between 1990 and 2002. The job cuts reflect the migration of jobs to central Europe, where manufacturing employment of U.S. affiliates has soared over the past decade. Indeed, between 1994 and 2002, manufacturing employment of U.S. affiliates in the region rose from 63,000 workers to more than 190,000. The cut in manufacturing jobs in such high-cost places like Germany, however, has been offset rising employment among U.S service affiliates.

Research and development of affiliates

While R&D expenditures remain biased towards the home country, foreign affiliate R&D has become more prominent over the past decade as firms seek to share the costs of development, spread the risks and tap into the intellectual talent of other nations. Alliances, cross-licensing of intellectual property, and mergers and acquisitions – these and other forms of cooperation have become staples of the U.S.-German partnership.

Accordingly, of the $21.5 billion in R&D expenditures of U.S. foreign affiliates in 2002, roughly two-thirds was in the Europe, with the United Kingdom ($3.7 billion) and Germany ($3.6 billion) leading the way. Germany alone accounted for 17% of total global R&D of U.S. foreign affiliates in 2002, a reflection of Germany's skilled, innovative workforce and corporate America's penchant for leveraging skilled assets any place in the world. Conversely, America's highly skilled labor force, entrepreneurial culture and first-class universities have been key drivers attracting R&D capital from German firms. Indeed, in 2002, German affiliates in the United States invested more R&D capital ($5.7 billion) than another other foreign investor in the United States. German R&D expenditures in the U.S. accounted for 27% of the European total in the U.S. and just over one-fifth of the global total.

Intra-firm trade of foreign affiliates

Foreign affiliate sales are the primary means by which goods and services are delivered across the Atlantic. Trade is secondary, although the two modes of delivery should not be viewed independently of each other. They are more compliments than substitutes, since foreign investment and affiliate sales increasingly drive trade flows. Indeed, a substantial share of U.S.-German trade is considered intra-firm trade or related party trade, which is cross border trade that stays within the ambit of the company. It's BMW of Germany sending parts and components to BMW of South Carolina, for instance. Reflecting the tight linkages between German parent companies and their U.S. affiliates, roughly 62% of U.S. imports from Germany consisted of related party trade in 2004. Meanwhile, 32% of U.S. exports to Germany in 2004 represented related party trade.

Given the above, only after recognizing that almost two-thirds of U.S. imports from Germany are considered related party trade, can one begin to understand why U.S. imports from Germany have remained so strong over the past few years despite the sizable appreciation of the euro against the U.S. dollar since the beginning of 2002. Following such a large shift in prices or exchange rates, Economics 101 would have predicted or suggested a rebalancing of bi-lateral trade. Theory would have expected U.S. export growth to outstrip U.S. import growth, leading to an improvement in the overall trade balance. To the contrary, however, America's trade deficit with Germany actually widened in 2003, to $45 billion, and again last year, to $52 billion.

America's widening trade gap with Germany has confused many on both sides of the Atlantic. However, missing from most analysis is the simple fact that an unusually large percentage of U.S. imports from Germany are considered related party trade, and that parent-affiliate trade is less responsive to shifts in prices or exchange rates and more attuned to domestic demand. Accordingly, while a strong euro, in theory at least, would be associated with a decline in German competitiveness in the United States, the fact that many German multinationals produce, market and distribute goods on both sides of the ocean gives firms a high degree of immunity to a dramatic shift in exchange rates. Under this structure, trade flows are driven more by demand in the host nation. As such, with the U.S. economy among the most robust in the world, sales of German affiliates have remained strong over the past few years, which in turn, have generated more demand (a.k.a. imports) from the parent company for parts and components irrespective of exchange rate movements.

Foreign affiliate sales

Foreign affiliate sales are the primary means by which U.S. and German firms deliver goods and services to each other's respective markets. In 2002, for instance, U.S. foreign affiliate sales in Germany totaled $206 billion, well in excess of U.S. exports to Germany the same year, $42.2 billion. Similarly, German foreign affiliate sales in the United States totaled $290 billion in 2002 versus U.S. imports from Germany of $83.6 billion. In other words, foreign affiliate sales tell one story of U.S.-Germany ties, while trade tells another.

Based on U.S. exports, Germany ranked as the sixth largest market in the world for U.S. goods in 2004, well behind other nations like China, Canada, Mexico and the United Kingdom. From this vantage point, it's not hard to make the case that many emerging markets like China and Mexico are more important to U.S. commercial interests than Germany. That's not even half the story, however.

The story changes dramatically when considered foreign affiliates sales. Based on the latter, Germany ranks as one of the most important markets in the world for U.S. companies, with foreign affiliate sales of $206 billion in 2002 lagging only Canada ($336 billion) and the United Kingdom ($372 billion). In that a great deal of foreign affiliate sales in Canada represent exports to the U.S., Germany, for a practical purposes, is the second largest market in the world for U.S. companies. Relative to China, while U.S. exports and foreign affiliate sales to China have soared over the past decade, foreign affiliate sales of $42 billion in China were just one-fifth of U.S. affiliate sales in Germany in the same year. How important is Germany to corporate America? By the metric of affiliate sales, what U.S. foreign affiliates sold in Germany in 2002 exceeded the combined sales of affiliates in South America, Africa, the Middle East, and eastern Europe.

In the United States, it is a similar story: German affiliate sales in the U.S. in 2002 ($290 billion) were more than three times greater than U.S. imports from Germany – a striking statistic for Germany, a country commonly thought to be a classic "trading" nation.

Foreign affiliate income

In terms of profits, Europe easily remains the most important region in the world for corporate America. Over the first half of this decade, for instance, Europe's share of U.S. foreign affiliate income, a proxy for global earnings, actually rose to 54.6% versus a 53.1% share of the second half of the 1990s.

Germany's global share of U.S. foreign affiliate income fell from 4.8% over the 1995-99 time frame to 3.2% in the first half of this decade, a decline reflecting weak demand in Germany over most of this decade. However, thanks to the strong euro/weak U.S. dollar, U.S. foreign affiliates in Germany posted robust earnings in 2003 and 2004 – this despite the plunge in U.S.-German relations. U.S. affiliates tallied record profits in 2004, with affiliate income totaling $6.3 billion, more than double affiliate profits earned in China the same year.

Meanwhile, on account of strong U.S. demand, profits of German affiliates in the United States soared to a record $7.1 billion in 2004. For many German firms, strong demand in the United States has been a key offset to sluggish growth at home, helping to fuel earnings growth and solid gains in the stock market. In the end, Germany's prolonged economic slump has been quite painful for corporate Germany, although strong U.S. growth has been a critical offset.

Foreign affiliate sales of services

Following in the footsteps of manufacturers, service activities between the United States and Germany are becoming more intricate and complex. Indeed, foreign affiliate sales of services on both sides of the Atlantic have soared over the past decade, reflecting rising bi-lateral investments in such key service sectors as financial services, telecommunications, utilities, retail, insurance, advertising and computer services, to name a few.

In the 1970s and 1980s, firms delivered services primarily via trade. In the 1990s, however, foreign affiliate sales became the chief mode of delivery, helped by industry deregulation, falling communication costs, and the proliferation of the Internet. On account of these trends, sales of services by U.S. foreign affiliates in Europe soared from $85 billion in 1994 to roughly $212 billion in 2002. U.S. affiliate sales of services to Germany rose from $17.6 billion in 1995 to $24.5 billion in 2002, a near 40% increase. Over the same period, U.S. exports of services to Germany rose by nearly 26%. By 2002, U.S. affiliate sales of services were more than 50% larger than U.S. service exports.

Sales of services by German affiliates in the United States have also soared over the past decade. As Germany's investment position in services has expanded in the U.S., so have foreign affiliate sales of services in the U.S. The latter totaled $44.5 billion in 2002, representing a near four-fold increase from 1995, when affiliate sales of services amounted to just $11.9 billion. In 2002, German affiliate sales of services in the U.S. were nearly three times larger than service imports from Germany, highlighting the

Table 2.3 Sales of services

U.S. Sales of Services to Germany			German Sales of Services to the U.S.		
(US $ Billions)					
Year	U.S. Affiliate Sales of Services	U.S. Exports of Services to Germany	Year	German Affiliate Sales of Services in the U.S.	U.S. Imports of Services from Germany
1995	17,6	12,7	1995	11,9	7,5
1996	21,8	13,3	1996	17,0	7,9
1997	19,1	13,9	1997	22,2	8,2
1998	20,1	14,9	1998	27,4	9,5
1999	29,7	16,3	1999	29,5	10,5
2000	24,6	16,2	2000	42,0	12,6
2001	24,2	14,9	2001	42,2	12,8
2002	24,5	16,0	2002	44,5	15,6
2003	NA	17,5	2003	NA	16,4

Source: Bureau of Economic Analysis

role of foreign investment and affiliates as the primary means by which German and U.S. firms deliver services to each other.

In sum, these eight indices convey a more complete and complex picture of international economic flows than simple tallies of export and imports. Foreign direct investment represents the backbone of the U.S.-German partnership, with other variables like overseas assets, affiliate employment and sales, related party trade, services and others derived from the level and depth of investment linkages. That said, while U.S.-German commercial ties are deeply rooted, they are in need of a fresh impetus.

Wanted: a new impetus to deepen U.S.-German ties

U.S. and German commercial linkages are among the deepest in the world, with both parties benefiting greatly from over a half century of strong investment and trade ties. That said, however, the U.S.-German alliance needs a new catalyst to (1) prevent any erosion in the transatlantic partnership and (2) promote even thicker ties between the two parties.

The U.S.-led war in Iraq created a great deal of strain between both parties. More harmful to the relationship, however, is the increasing economic divergence of the United States on the one hand and Germany on the other. The embrace of free-market capitalism in the United States has never been stronger, helping to promote annual economic growth rates that have consistently outpaced growth in Germany. For its part, Germany not only remains an economic laggard of the developed nations, some elements of the German political spectrum have become more vocal in denouncing free-market capitalism. The backlash against private equity investment is the most recent evidence suggesting rising hostility toward what some call the "Anglo-Saxon" model of capitalism.

In general, the U.S. economy continues to outperform relative to its industrial peers like Germany, while Germany continues to underperform. The difference in economic paths could ultimately make it harder to build on the existing foundation of investment between the United States and Germany. Without policies designed to address labor rigidities, industry deregulation, and tax reform in Germany, U.S. multinationals might increasingly look elsewhere when it comes to investing in Europe and the surrounding region. How Germany handles its delicate immigration challenge, pursues environmental standards and reacts to its shifting demographics will also affect future U.S. investment flows.

In the United States, diverging regulations and technical standards, Sarbanes-Oxley legislation, and tightened security measures could act to halt or slow the pace of German investment in the United States. On both sides of the Atlantic, the potential for greater integration of various service activities is huge, although stiff regulations in both nations have prevented U.S.-German service activities from growing and becoming fully integrated.

In the end, the war in Iraq, and subsequent tensions between Washington and Berlin, served as a useful wake up call to policy makers on both sides of the Atlantic to the importance of the U.S.-German relationship. Now, however, the challenge for both parties is to renew their commitment to the relationship and forge ahead with new policies that will strengthen one of the most important bilateral relationships in the world.

2.3 Capital Market – Hurdle or Help in Transatlantic M&A

Marcus Schenck, Frank Richter, Karoline Jung-Senssfelder

According to a commonplace assumption, listed companies benefit greatly from having an acquisition currency in the form of their own shares. A secondary listing in the US is thus often seen as an important first step in preparing for external growth. While the financial advantages of such capital market based transactions in the context of transatlantic M&A are often pointed out, the associated disadvantages frequently go unnoticed. Specifically, the authors identify three factors, which may outweigh the potential benefits of a stock-for-stock transation across the Atlantic. First, shares originally paid as a purchase price tend to flow back into the home market, sometimes being the cause of substantial pressure on the acquirer's stock price. Second, different valuation levels and metrics may complicate negotiations and usually have an impact on how market

participants perceive the value of shares in the buyer. Third, additional transaction risk may arise due to the incompatibility of country-specific filing processes. Examining these issues in detail, the authors set out to determine under which circumstances transatlantic M&A is hindered rather than facilitated by capital markets.

Introduction

Exchange-listed companies are perceived to have a big advantage in managing mergers or acquisitions because they have an acquisition currency in the form of their own shares. These companies are not limited to financing acquisitions with cash, which to some extent may have to be raised in the markets. The purchase price for a company or asset will be paid by issuing new shares to the owners of the target company. The legal framework in Germany has been further developed to facilitate such transactions, e.g. by allowing the buyer to issue shares other than through a rights offering under certain circumstances. The result is similar in case of a merger between a company in Germany and another company in the US: If, for example, the shares of the US company are exchanged into the shares of the German company, the "selling" shareholders receive their proceeds in kind in the form of shares in the acquiring company (in our example the German company). Again, there is no need to raise money in the capital markets to finance such a transaction. Therefore, transactions using stock as an acquisition currency are perceived as fairly efficient, and the capital markets facilitate such transactions. As a consequence, it seems sensible to prepare companies that want to grow externally, e.g. by means of an exchange listing in the US in addition to a listing in their home markets. The company will thus get an acquisition currency, thereby increasing its strategic and transactional room for maneuver.

The benefits of such capital market based transactions are evident. However, they also have a cost. For example, if the selling shareholders are not interested or not allowed to hold the buyer's shares in their portfolio, a share-overhang will be created. In that case the shares received as a purchase price for the company or in exchange for other shares in a merger situation will most likely be sold in the home market of the buyer. This flow-back creates significant pressure on the buyer's share price and therefore has to be taken into consideration when planning such transactions.

Another important aspect is valuation. There are differences in market valuations in the US vs. Germany, e.g. in the utilities or the chemicals industries. The companies in the US trade at higher levels than the companies in Germany. In addition, the financial community uses different valuation metrics to assess valuation levels – e.g. P/E ratios in the US vs. EBITDA multiples in Europe. These differences often lead to complications in negotiations and may also influence the perceived value of the shares in the buyer. Managers who intend to engage in M&A discussions with their counterparts need to be aware of, and prepared to address, such valuation issues.

Finally, the legal requirements which define the process of stock offerings in the US are different from those in Germany or other European jurisdictions. The US requirements are more extensive and the processes take longer. This creates the need to manage the different time schedules according to local securities laws. Large timing gaps resulting from incompatible filing processes may lead to additional transaction risks.

These three aspects of capital market related M&A are discussed in more detail below. Many other aspects are relevant as well, e.g., corporate governance, taxation, and cultural issues. These aspects are dealt with in other parts of this book and are therefore not considered here.

Flow-back may lead to oversupply of shares in home markets

Can institutional investors be convinced to hold buyer's stock?

Certain institutional investors in the US invest only in US-listed companies. It is also possible that investors are not allowed to invest dedicated funds in stocks of non-US companies. The articles of incorporation of such funds define the investment strategies which the fund managers have to adhere to. Of course, larger investment management companies also have funds dedicated to international or European stocks. These companies are able to reallocate assets from a US-focused fund to an international fund. However, to do this the fund managers have to be convinced of the transaction and the overall equity story of the new entity. Experience shows that this is not always the case.

Additional issues arise if the buyer company is not included in stock market indices, either because they are not listed in the US or because of their size. Post transaction, the US target will no longer be listed and therefore eliminated from stock market indices which are tracked by institutional investors. In that case the question is whether the German company is included in any index of interest to the investors. The benchmark for inclusion in the S&P 500 is a market capitalization of $ 4 bn for US companies, whereby the definition of US companies used by the Index Committee depends on their legal and tax domicile, location of operations, corporate structure, accounting standards, and exchange listings. The benchmarks for other indices such as the Russell Index or the Wilshire Index are lower so that the listing requirement is the bigger hurdle.

The experiences of German companies with dual listings in Germany and in the US have not been very encouraging. The vast majority of trading volume still is generated in home markets, even for large companies like BASF, E.ON or Deutsche Telekom. Across a representative selection of companies, the median trading split is 93% domestic and only 7% US (Table 2.4).

Ways to mitigate the volume of flow-back

The trading split analysis shows that one cannot generally assume a strong interest of US institutional investors to keep the stock of German companies received in transatlantic transactions. The most important factors determining the level of flow-back, are the following:

- Strength of the equity story including the strategic rationale, expected synergy potential, and the anticipated impact on earnings per share
- Relative size of target versus acquirer

Table 2.4 Trading analysis of German US-listed stocks

Company	Trading Split[1]		Market Cap (€m)	US Exchange
	Germany	USA		
Qiagen	63%	37%	1,290	NASDAQ
SAP	79%	21%	40,562	NYSE
GPC Biotech[2]	86%	14%	317	NASDAQ
DaimlerChrysler	90%	10%	34,598	NYSE
Dialog Semiconductor	93%	7%	125	NASDAQ
Infineon	94%	6%	6,436	NYSE
Fresenius Medical Care	96%	4%	5,591	NYSE
Pfeiffer Vacuum	96%	4%	289	NYSE
Siemens	96%	4%	54,622	NYSE
Bayer	97%	3%	16,579	NYSE
Deutsche Telekom	97%	3%	64,016	NYSE
Schering	97%	3%	9,485	NYSE
Altana	98%	2%	6,599	NYSE
BASF	98%	2%	26,518	NYSE
Deutsche Bank	98%	2%	32,925	NYSE
SGL Carbon	98%	2%	540	NYSE
Allianz	99%	1%	32,778	NYSE
E.ON	99%	1%	43,271	NYSE
EPCOS	99%	1%	865	NYSE
Median	93%	7%		

Source: Bloomberg, Datastream, IFR

[1] Trading split adjusted for ADR gearing and based on US$-ADTVs over the last six months.

[2] Based on ADTVs since 1-Jul-04.

- Mix of consideration (cash vs. stock)
- Relative liquidity of both stocks
- Amount of index tracking money in acquirer's country and overall depth of domestic capital markets
- Acquirer's credibility and track record, including the support from target's management
- Place of incorporation

Clearly, it is of prime importance to the management of the acquiring company to convince investors abroad of the business prospects of the new entity created by the transaction. The flow-back will be reduced if investors "like the deal." To achieve this, concise communication and transparency are required. Also communication needs to be adapted to local standards and views. Size matters as well. Investors dislike relatively small companies with low levels of liquidity of their stock and limited research coverage. The credibility of the acquirer is also an important factor, which cannot easily be built-up just before a deal is considered.

Creating interest in and demand for the stock of the acquiring company in the US is important in limiting the amount of flow-back. Therefore, active marketing of the equity story even before any transaction and, clearly, at various steps of the transaction is important. Short-term oriented investors require tailored communication. Obviously, the buyer may also consider increasing the cash component of the consideration. (This is to say that capital markets may hinder rather than facilitate a transaction.) The buyer itself may absorb excess supply of its stock through a share buyback program. Under German law, this is possible for up to 10% of the share capital, subject to prior authorization by the shareholders' meeting. However, most of the larger German companies have this generic authorization in place anyhow. The company then can keep the stock and sell it in the markets afterwards over a longer period of time. The market may react cautiously to such a strategy, given the clear signal of a stock overhang and the expectation that the supply of stock will increase over time. The company may also consider reducing its capital by eliminating the shares it bought back. This, however, negatively impacts the capital structure and may not be desirable.

Challenges resulting from different valuation levels in the US and Germany

Differences in valuation levels as well as different perceptions of relevant multiples

Differences in relative valuations observed in capital markets are an additional source of challenges in transatlantic transactions. This is the case in particular if the underlying fundamentals in terms of expected growth and profitability do not differ too much. The phenomenon of different pricing levels despite similar performance characteristics can be observed in different industries such as utilities, chemicals, or automotive suppliers. Take, for example, the German OEM supplier Continental AG, which trades at Enterprise Value/EBITDA multiples of around 4.8x (based on 2005E EBITDA and July 2005 share price) and a P/E ratio of 10.9x. The median EBITDA multiples and P/E ratios of US automotive suppliers are 6.3x and 13.5x, respectively (Table 2.5). The question whether these companies are indeed comparable with each other, given their product mix etc., can be debated at length. However, one may as well take the view that the business and performance expectations for the German company are not worse than those for the average US supplier.

German buyers tend to focus more on "intrinsic" values, e.g., derived from Discounted Cash Flow valuation, rather than public market multiples. Their American

Table 2.5 Comparison of relative valuations in the automotive supplier industry

Company	**Closing Price 12-Jul-2005**	**% of 52 Week High**	**Enterprise Value (€m)[1]**	**EBITDA Multiple 2005**	**P/E Multiple 2005[2]5**	**5-Year EPS CAGR[2]**
US OEM Suppliers						
Dana	$16.60	85%	$4,380m	7.0x	13.8x	5.0%
Eaton	61.77	85	11,416	7.4	11.8	12.5
Goodyear Tire & Rubber	15.58	97	7,506	NA	14.6	3.0
Johnson Controls	58.83	92	13,631	6.6	12.6	13.0
Lear	41.10	67	4,756	6.0	21.4	11.0
Magna International	74.35	81	7,744	4.3	10.3	14.7
TRW Automotive	25.13	100	5,113	4.8	16.0	9.0
American Axle	26.40	74	1,920	6.3	18.9	10.0
ArvinMeritor	18.79	83	2,821	6.3	11.2	7.0
BorgWarner	57.43	99	4,192	6.9	13.2	14.0
Dura Automotive	$4.94	45	1,150	6.4	NM	8.0
Mean		83	5,875	6.2	14.4	9.7
Median		85%	$4,756m	6.3x	13.5x	10.0%
European OEM Suppliers						
Autoliv	€38.27	90%	€4,204m	6.1x	12.9x	15.0%
Continental	59.30	93	9,963	4.8	10.9	5.6
Faurecia	58.10	79	2,975	4.5	9.1	3.0
ThyssenKrupp	14.36	83	9,258	2.9	8.1	5.0
Valeo	€35.94	96	3,625	4.1	16.9	5.0
Mean		89	5,115	4.6	11.8	7.4
Median		91%	€3,914m	4.7x	11.9x	5.3%

[1] Source: Latest publicly available financial statements with sufficient detail. Equity Market Cap based on fully diluted shares outstanding. Enterprise Value calculated using latest reported net debt and adjusted for minority interests, preferred equity and pro forma adjusted for recent M&A transactions

[2] Source: LTM numbers are based upon the latest publicly available financial statements. All projected sales, EBITDA, EBIT, and EPS estimates have been calendarised. Projected sales, EBITDA, EBIT, and EPS source: IBES median estimates.

counterparts concentrate on the facts obtained from the information in the capital markets. Any transaction involving these companies will be challenged by their investors if market-based valuations are not taken into consideration. In addition to this fundamental question, there are often different views on the right indicator for assess-

Table 2.6 Comparison of relative valuations in the utilities industry

Company	Closing Price 12-Jul-2005	% of 52 Week High	Enterprise Value (€m)[1]	EBITDA Multiple 2005	P/E Multiple 2005[2]	5-Year EPS CAGR[2]
Large US Integrated						
American Electric Power	$38.99	100%	$26,019m	7.4x	16.0x	3.0%
Dominion Resources	75.91	99	43,466	8.7	15.0	5.0
Duke	30.05	100	46,705	8.5	19.4	5.0
Edison International	41.18	100	22,352	7.3	16.5	6.0
Entergy	76.94	100	24,411	8.2	16.6	7.0
Exelon	52.94	100	50,112	9.6	17.2	5.0
FirstEnergy	49.52	100	27,708	7.2	17.4	4.0
FPL Group Inc.	43.81	100	26,895	9.3	17.2	5.0
PG&E	37.72	99	23,580	6.7	16.8	5.0
Progress Energy	45.63	99	21,360	9.0	15.0	4.0
PSEG	63.05	100	28,577	10.7	19.1	3.5
Southern	35.66	99	41,779	10.2	17.0	5.0
TXU	83.27	96	33,380	8.9	13.1	6.5
Xcel Energy	$19.53	99	14,883	7.9	15.6	3.0
Mean		99	30,802	8.5	16.6	4.8
Median		100%	$27,302m	8.6x	16.7x	5.0%
Large European Integrated						
E.ON	€74.13	100%	€79,157m	7.5x	12.0x	3.1%
Endesa	18.44	95	41,863	7.9	13.4	6.0
Enel	7.09	92	67,469	7.2	16.5	4.5
RWE	54.55	100	67,887	8.0	13.5	9.2
Suez	€22.56	99	54,574	8.5	15.1	2.0
Mean		97	62,190	7.9	14.1	5.0
Median		99%	€67,469m	7.9x	13.5x	4.5%

[1] Source: Latest publicly available financial statements with sufficient detail. Equity Market Cap based on fully diluted shares outstanding. Enterprise Value calculated using latest reported net debt and adjusted for minority interests, preferred equity and pro forma adjusted for recent M&A transactions.

[2] Source: All projected sales, EBITDA, EBIT, and EPS estimates have been calendarised. Projected sales, EBITDA, EBIT, and EPS source: IBES median estimates.

Table 2.7 Comparison of relative valuations in the chemicals industry

Company	Closing Price 11-Jul-2005	% of 52 Week High	Enterprise Value (€m)[1]	EV/ EBITDA 2005	P/E Multi-ple 2005[2]	5-Year EPS CAGR[2]
US Specialty						
Air Products	$60.10	92%	$16,647m	9.2x	18.7x	10.0%
Albemarle	37.20	92	2,555	8.9	16.2	10.0
Arch Chemicals	26.17	86	846	8.0	21.5	NA
Cabot	33.64	83	2,523	7.2	16.0	15.0
Cabot Micro	32.65	80	650	9.0	22.3	14.5
Cytec	40.94	75	3,641	8.5	12.2	10.0
Du Pont	44.15	81	49,611	8.8	15.9	10.0
Eastman Chemical	56.84	93	5,890	5.3	9.6	5.3
Ecolab	32.23	91	9,173	10.7	24.2	12.0
Engelhard	28.99	89	4,054	8.8	14.5	10.0
HB Fuller	35.74	100	1,171	8.1	20.5	9.0
Hercules	14.59	96	2,801	7.8	13.3	7.0
Lubrizol	42.78	99	4,628	NA	14.8	7.5
Monsanto	63.38	93	19,508	13.2	28.7	12.0
Nalco	20.55	100	6,414	10.3	34.5	10.0
Polyone	7.05	71	1,313	7.0	11.7	8.0
PPG Industries	64.49	87	11,894	6.5	12.9	8.5
Praxair	48.50	99	19,811	10.3	19.8	10.0
Rohm and Haas	45.63	92	12,589	8.2	16.6	10.0
Sigma Aldrich	58.12	90	4,410	9.9	16.1	10.0
Valspar	49.59	98	3,341	9.9	17.7	11.5
Mean		90	8,737	8.8	18.0	10.0
Median		92%	$4,410m	8.8x	16.2x	10.0%
European Specialty						
Ciba Specialty Chemicals	€48.60	84%	€4,441m	6.8x	13.2x	6.6%
Clariant	11.35	83	3,512	5.8	11.5	8.0
Croda International	5.63	97	797	8.6	16.2	8.0
DSM	58.35	99	6,887	5.7	11.4	16.9