Whoa, Canada; More must be done to protect companies from foreign takeovers. The country's place in the world depends on it

By ROGER MARTIN AND GORDON NIXON
2 July 2007
The Globe and Mail

Canadians have been watching with increasing worry as large numbers of prominent Canadian-owned companies in historically important Canadian industries are acquired by foreign firms.

The acquisitions of Inco by Brazil's CVRD and Falconbridge by Switzerland's Xstrata were particularly troubling to many. Other great companies are gone from Canadian hands, too – graphic chip leader ATI Technologies, a world leader in door manufacturing Masonite, business forms giant Moore Corp., and luxury hotel giant Four Seasons. Virtually our whole steel industry has been acquired including the gem, Dofasco.

But a key question stands out: Is it a little or a lot?

By pretty much any valid standard, it's a lot. Over the past five years (2001-2006), 455 Canadian companies have been bought by foreign firms for a combined price of $137-billion (U.S.).

Adjusted for the size of our economy, the number of companies is the second-greatest total in the world after Australia, and the value paid is second highest after the United Kingdom. And since the beginning of 2006, the value of acquired Canadian companies leads all countries.

Of course, hollowing out is not a distinctly Canadian phenomenon. Virtually all industrialized countries are reacting to the trend of consolidation and globalization. But in the area of foreign takeovers, Canada may be heading toward leadership of the sort we don't want: since the beginning of last year, the value of public targets as a percentage of market capitalization has exceeded the U.K., U.S., Nordic countries and France combined.

So while we should not feel alone in experiencing global consolidation, the relative size, openness and make-up of our country has resulted in a more dramatic impact. And unlike many countries, we have not developed policies to encourage the development of Canadian champions or Canadian industries.

The Great Transformations

Brazil's CVRD bought Inco and India's Essar Global bought Algoma Steel. But the overwhelming majority of the 455 foreign acquisitions – in fact, substantially all – were made by firms from other highly developed countries in the Organization for Economic Co-operation and Development.

Yet these same OECD countries are all feeling hollowed out, and for the same reason: We are smack in the middle of a great global transformation, a transformation that bears eerie similarity to that of the Industrial Revolution.

During the 18th century, the relative place in the world for many countries depended on how they reacted during the transformational period. England drove the Industrial Revolution, which started roughly in 1780, and established its place as the world's economic superpower for a century or more. The newly independent United States embraced the Industrial Revolution with gusto and transformed its agricultural economy into a manufacturing economy at arguably a faster pace than any other country, enabling it to emerge as England's economic successor.

We believe that future historians will look back on the period 1980 to 2030 and say similar things: this was a period of fundamental transformation and what countries did or did not do during that period defined their place in the world for the next century – for better or for worse.

Two centuries later, we are in the middle of another great transformation, from the relatively flat world of 1980 to a much spikier world.

We read Thomas Friedman's book The World is Flat and think it makes a real contribution to the understanding of India and China's emergence in the global economy. However, the book leaves an unhelpful impression that the world is flattening in terms of economic activity – as if the economic activity of the world will be spread across the globe like butter.

We side with Michael Porter and Richard Florida in seeing a spiky world that is getting even spikier. In his landmark 1990 book The Competitive Advantage of Nations, Mr. Porter explained why entire global industries were often headquartered in a single country, if not a single region within a single country, like movies in Hollywood or printing presses in Heidelberg. A set of conditions in the local market creates a cluster of competitive companies that pressure each other to innovate and upgrade, teach local customers to be ever-more demanding, draw in and develop fabulous human resources, and attract co-location of helpful related and supporting industries. The result is a cluster that keeps getting better and better and, on the basis of that beneficial local competition, helps its members succeed internationally against competitors who don't have the power of a strong local cluster behind them. The Porter theory predicts a spiky world in which most of the successful competitors in a global industry come from very few places and export to the rest of the world.

In a 2005 Atlantic Monthly article titled The World is Spiky, Richard Florida countered Mr. Friedman's “flat world” hypothesis by showing that economic activity in the world is incredibly spiky as is innovation activity, measured by patents. Mr. Florida showed convincingly that talented people agglomerate in a limited number of regions in the world where they work for innovative organizations that dominate their industries.

We believe that since 1980, the world has gotten progressively spikier as the world's companies began globalizing at an unprecedented rate.

Increasingly favourable trade conditions and falling transportation and communications costs combined to make globalizing more of a reality as leading national firms found themselves pressured by capital markets to expand globally, rather than stay at home.

Research and development-intensive firms found that the only way they could afford to invest in competitive technological solutions was to utilize the scale economies of a global market.

We see the transformation proceeding in one direction only – to a spikier world in which all the globally competitive firms in all industries are headquartered in a limited number of locations. In some industries like golf clubs, cutlery, fax machines and movies, it will only be one location. In others, such as automobiles, computers, consumer electronics, it will be a few. But the days of being spread like butter across the world are quickly disappearing in this epochal transformation that we estimate to be about half over.

During this transformational period, we need to be building as many globally competitive firms and clusters as possible. We won't get a second chance – at least not for a century or so, if history is any guide.

As these industries get intensely spiky, a country is either a player or not; there is not an in-between. It has to be our No. 1 economic policy imperative to build globally competitive companies, and in the industries we now know exist, we believe that the game is going to be largely over in the next 20 years or so. Some games are over for Canada already. We aren't going to have a globally relevant consumer electronics company, automotive original equipment manufacturer, consumer packaged goods company or beer company.

Other games appear to be ending quickly. Steel is almost gone and much of mining appears headed that way. Those have become spiky already – with the spikes driven into foreign soil. We must have a sense of urgency because the looming downside is that we hit 2030 with few or no global leaders. If that were to be the case, we would be doomed to be an inconsequential country in the world; an outcome that is unacceptable for Canadians.

Where Canada Stands

There is good news and bad news in terms of how Canada has fared in the first half of the transformational period. It would be handy if it was an unambiguous picture, but it is not. However, on balance, we are more concerned than not, and believe we need to take action.

The good news is that in this transformation to a spiky world, Canada has managed to increase its numbers of global leaders. In 1985, Canada had only 14 world-scale global leaders, companies that are Canadian-owned, Canadian-headquartered, rank in the top five of their industry worldwide in revenue and have more than $1-billion (Canadian) in annual sales in that industry ($617-million in 1985 dollars). The 1985 list contained some great Canadian companies that remain global leaders – Bombardier, McCain Foods and Nortel, for instance – but it also contains names that have been snapped up by foreign firms, such as Seagram, Hiram Walker, and Moore Corp.

The current list includes 39 firms – almost three times as many as two decades ago. Great Canadian names such as Magna, Research In Motion, Husky Injection Molding, Couche-Tard and Manulife Financial have grown into world beaters. And even though they may not all be household names, the average revenues – adjusted for inflation – are about 50 per cent larger than for the 1985 firms.

Buttressing this good news is the fact that after having a net deficit of international investment for most of the 20th century, Canadian firms in the past 10 years have invested more abroad than foreign firms have invested in Canada.

So what's the bad news?

First, it appears that 2003 was the peak year for the number of globally competitive Canadian companies. Between 1985 and 2003, the number of such companies skyrocketed from 14 to 46. But since 2003, seven companies, a full 15 per cent of our precious stock of world leaders, ceased to be Canadian companies – and this trend may be accelerating. One company exited the list in a perfectly happy way: Placer Dome was acquired by Barrick, another Canadian company on the list. But six more were acquired by foreign firms, half of which (ATI, Domtar and Masonite) were firms that built a global position between 1985 and 2003.

Second, it is appearing as though absolute size is mattering more and more in the global consolidation game, and Canada is not doing well in keeping up with the size of others. For example, both Inco (nickel) and ATI (graphic chips) were clear No. 1 players globally in their respective industries. But they were acquired by considerably larger players in the broader industries in which they narrowly participated: CVRD in mining and Advanced Micro Devices in computer chips. Today, there are fewer Canadian firms in the global 500 rankings, with Royal Bank of Canada leading the way, but only at number 250.

What Must Be Done

Canadian policy is largely indifferent to – or ignores – this transformation. But there are many policy prescriptions that Canadian governments can and should pursue.

We will focus on the four most important:

1) Taxation of Business

Investment

The general view among Canadians is that we have a high tax environment. This is not true. If we take the broad comparator of the OECD, which includes the 30 most developed and high-income countries in the world, Canada's tax take as a share of the overall economy – 33.9 per cent – is 11th lowest and below the average of 35.8 per cent.

Among the narrower sample of the seven leading industrialized countries, we are third lowest.

So Canadians have little evidence to support the view that we are highly taxed. We aren't.

However, our corporations are. Among those 30 countries, Canada has the third-highest tax rate on business investment: 36.6 per cent versus the average of 20.6 per cent. (The U.S. is second highest at 38 per cent, a mere tenth of a per cent below Germany, the king of unhealthy corporate taxation.)

Sadly, Canada's tax system was designed well before the inception of this globalization era. If our overall taxation is below average and our corporate taxation is sky-high, then what must be low?

The answer is that our personal taxes and consumption taxes are comparatively low. That makes Canada attractive internationally from a tax standpoint, with an ability to attract immigrants and offer a fertile environment for consumer spending.

But the cost of that structure is that it is a crummy space for corporations to set up shop and for them to invest in machinery, equipment, software, hardware, branding and expansion.

There is no need to spur consumption by keeping the GST and other sales taxes well below OECD averages. What is desperately needed is for our corporations to invest as aggressively as they can to upgrade their productivity, innovate and expand globally.

Sadly for Canada, much of the rest of the industrialized world has figured this out and has tax structures tilted toward encouraging, rather than discouraging, corporate investment.

Even the socialist-leaning Scandinavian countries – despite an overall tax take that is way higher than Canada's (47.1 per cent versus 33.9 per cent) – offer a tax regime for business investment that is way, way superior (19.6 per cent versus our 36.6 per cent).

How ironic that the socialists are pragmatic rather than ideological about business taxation.

Canadian policy falls prey to an important and categorical fallacy in respect to corporate taxation. Our logic of fairness holds that poor people make little income and should pay little tax; middle-class people make moderate income and should pay moderate taxes; rich people earn lots of income and should pay high taxes; and corporations earn huge income and should pay very high taxes.

Yet corporations are not richer rich people. They are legal constructions whose purpose in the modern economy is to invest, innovate and create high-paying jobs.

Taxing them highly, as all the socialists have figured out, works against them investing, innovating and creating high-paying jobs.

As the socialists have figured out, the way to tax corporate activity is to tax at a personal level the earnings that rich people collect from the ownership of corporations.

In order for Canada to prosper in this transformational age, we need a fundamental rethink of our taxation philosophy. The question is not whether to lower taxation overall. The question is how to structure taxation so that corporations have the best chance of becoming global leaders and well-to-do Canadian individuals pay their fair share of the overall tax burden.

2) Screening of Foreign

Takeovers

In this transformational age, the ability of our global leaders to acquire foreign companies is critically important. Thus even though we may wish to prevent foreign takeovers of key companies, if we re-established a harsh Foreign Investment Review Act, we would jeopardize the ability of our leaders to expand and prosper abroad as other countries retaliate. Also, foreign investment in Canada has been a large contributor to our economic prosperity and should not be discouraged.

That having been said, governments around the world have a big incentive to help their global leaders and it would be foolish for Canada to be more accommodating to foreign investors than their home country governments are to our global leaders. It is not some sort of even-handed level playing field out there and as world economic power shifts, countries are playing an increasing role in global economic expansion. Governments are influencing foreign acquisitions at home and abroad. We need to ensure that Canada is giving its companies a fair platform for globalization rather than passively accepting aggressive policies that give an advantage to foreign firms.

On this front, the role and mandate of Investment Canada should be reviewed to make sure it has the ability to protect Canada's interest with respect to foreign acquisitions.

Investment Canada should be empowered to delay any acquisition of a Canadian firm by a foreign company if a foreign government is withholding or restricting approval of a related or opposing acquisition by the Canadian firm.

It also should work to extract more value from foreign acquisition of Canadian companies through commitments from an acquirer, such as maintenance of head-office location or research programs. Clearly, this is tricky territory. Overly aggressive negotiation by Investment Canada would be taken by the international community to be the moral equivalent of protectionism. However, there are recent examples of successful action by governments elsewhere. When U.K.-based Billiton and Australia-based BHP proposed merging in 2001, the Australian Foreign Investment Review Board provided the merger with expedited approval. And the Australian government made a number of regulatory changes that enabled a dual listing for the combined firm in Australia and the U.K. in exchange for the commitment to maintain the BHP Billiton Ltd. head office in Melbourne. As a result, Australia is home to one of the three giant mining conglomerates in the world rather than the ex-home of one of the pretenders to that echelon.

Finally, Investment Canada should be allowed to disallow any acquisition of a Canadian firm by a foreign firm that is government-owned or controlled. Large state-owned enterprises are becoming increasingly aggressive with respect to foreign acquisitions and we should have the right to access this issue on a case-by-case basis and ensure open-market forces prevail. CVRD is a company partially owned by agencies of the Brazilian government, which also owns its six “golden shares” that enable the government to prevent acquisition, relocation or even change the name CVRD.

Neither Inco nor any other global mining company could acquire CVRD; but CVRD can go into the international market and acquire firms such as Inco. This is not to suggest that CVRD should not have been allowed to acquire Inco, but rather that Canada should have policies to deal with these types of transactions.

Governments are going to increasingly compete as we get to the end-game of this transformational era and we can't allow foreign governments to block our international advances (directly or indirectly) while we let them do whatever they wish in Canada. We need to ensure reciprocity of regulatory protection and how we deal with government entities.

3) Regulation

In a spiky world, the quality of the home market from which global leaders attempt to arise is critical. It must be an environment featuring a combination of pressure and support. The pressure needs to come from intense competition and sophisticated, demanding customers, while the support needs to come from abundance of sophisticated resources, such as highly skilled human capital and specialized infrastructure, and the presence of related and supplier industries. Regulation can and does prevent Canadian companies from benefiting fully from a pressure and support-filled home environment.

Entry regulation reduces competitive intensity and dulls beneficial customer power. Interprovincial trade barriers stifle an already small market. Archaic securities regulation makes our capital markets less attractive and somewhat of an international embarrassment. In our biggest and highest wage industrial cluster – financial services – policy oriented toward a pre-spiky world prevents our banks from capitalizing on the same opportunities as global competitors. Government and regulatory policy has restricted consolidation, prevented the selling of insurance, imposed capital tax on foreign acquisitions and is more restrictive with respect to leverage. This, in combination, creates a very uneven playing field when competing internationally and increases the relative cost to Canadian banks of international growth.

Environmental, safety, and consumer protection regulation are as important to maintain as they ever have been. But regulation of competition and competitive dynamics must be done in the context of Canada's desired position at the end of this transformational age and not in the context of ages gone by.

4) Support of Our Global

Aspirants

In this great transformation, it is critical that Canadian governments support our global business aspirants. The future of our 39 $1-billion-plus global leaders is critical to Canada's economic health and prosperity, as is the future of our additional 32 global leaders between $100-million and $999-million in revenues. In addition, the firms that are not currently in the top five in their industries globally but are striving for that position matter. Together this group of perhaps 100 global aspirants deserves our country's support.

But support is a tricky concept. There is little evidence outside several industries that are highly subsidized by governments around the world – aerospace, for instance – that giving monetary subsidies to firms produces global leaders. Likewise, protecting them against competition works against rather than for global leadership.

However, making sure that these companies have access to sophisticated and demanding customers, highly specialized talent, world-class infrastructure and open foreign markets is critical to success and governments can and should provide support on all of these fronts.

Canadian governments should be in continuous contact with the global aspirants and asking what they need to succeed. Some things governments will be unable to provide, but others will be within their reach and should be a high priority.

Last up: Management's role

Government policy changes can do no more than set a positive context for Canadian senior managers. It is then up to corporate leaders to take their firms aggressively into the global market. It is arguable that Canadian managers have not been sufficiently aggressive in globalizing in the first half of this transformational age and it is critical for them to step up to the task in the latter half. In a spiky world, your firm either globalizes or eventually gets swallowed up by a globalizing corporation, typically headquartered elsewhere. Canadian managers ignoring this reality are fooling themselves and selling Canada short, as we need to ensure that this is an attractive country from which to grow.

They will need the Canadian capital providers behind them. If the capital providers treat international expansion as more dangerous than staying at home, corporate leaders will have a more difficult time expanding abroad.

This has been all too frequent for Canadian capital providers. The large Canadian pension funds need to recognize that if they want to invest in Canadian companies, they will need those Canadian companies to globalize aggressively or lose them to foreign buyers.

And while such acquisitions may produce handsome one-time premiums, the global acquirers will capture the long-term upside associated with owning a Canadian company. That may comfort Canadian capital providers in the short term, but in the long term they won't have Canadian global leaders in which to invest.

Canada is at a critical point in its economic history. The decisions it makes in the next few years will determine its position in the world for the next century. While Canada enjoys high prosperity currently, continued prosperity is contingent on our production of global leading companies. That means both helping our current global leaders prosper and maintain their Canadian ownership and growing new global leaders.

The current spate of foreign acquisitions of our significant Canadian companies suggests that we need to dramatically enhance the policy and managerial environment in Canada. In a global world, we are not competing within our borders but against companies and industries that are supported by the laws and policies of their home country and we have to ensure that we are at a minimum on an even playing field.

We need to change our taxation philosophy, fine tune Investment Canada's role and improve the regulatory environment to give our Canadian managers the best opportunity to build global leaders for the long term and succeed from a Canadian base. We urge action: Now is the time; now is the opportunity.

Deals, deals, deals

Target: Molson Inc. of Montreal

Acquirer: Adolph Coors Brewery Inc., Golden, Colo.

Value: $8-billion

Details: The deal marked the disappearance of one of Canada's oldest and most venerated family businesses and the country's largest brewer as a standalone company.

Target: Markham, Ont.'s ATI Technologies Inc.

Acquirer: Sunnyvale, Calif.-based AMD

Value: $5.4-billion (U.S.)

Details: AMD, the world's second-largest maker of computer chips, snapped up one of the biggest research and development spenders in Canada.

Target: Abitibi-Consolidated Inc. of Montreal

Acquirer: Bowater Inc., based in Greenville, S.C.

Value: A stock-swap “merger” of equals that will have annual revenue of about $7.9-billion (U.S.)

Details: Shareholders will vote on the proposed merger on July 26, but there is speculation Bowater shareholders may demand changes to the stock swap given the surge in the Canadian dollar.

CANADA'S CURRENT GLOBAL LEADERS, REVENUE, $1-BILLION +

Company	Revenue, December, 2005, $million
CAE**	1,107
Linamar	2,161
Magna	27,624
Agrium**	3,989
Methanex**	2,008
Nova Chemicals**	6,801
Potash Corp.**	4,732
Atco Ltd.*	2,860
SNC-Lavalin*	3,788
Manulife Financial	32,047
TD Waterhouse	- 1,018
Connors Brothers	1,084
Cott	2,126
McCain**	5,677
Weston Foods*	4,376
MDS*	1,489
Celestica*	8,471
CGI**	3,686
Northern Telecom (Nortel)	12,786
Research In Motion	2,473
Finning International (Finning Tractor & Equipment)*	4,835
Husky Injection Molding	1,067
Shawcor Ltd.	1,004
Cinram	2,541

Quebecor World**	7,728
Thomson Corp.	10,539
Alcan*	24,608
Barrick Gold	2,846
Cameco**	1,313
Fording (Elk Valley Coal)**	1,875
Teck-Cominco*	4,415
Abitibi-Consolidated*	5,342
Canfor**	3,788
Tembec*	3,082
CCL Industries	1,110
(Alimentation) Couche-Tard**	10,216
Bombardier*	17,760
CHC Helicopter**	1,012
CN Rail**	7,240

*denotes global leader in 1985 and currently

**denotes global leader currently but not in 1985

Note: No revenue data available for Scotia Mocatta, Jim Pattison Group, North American Fur Auctions, and Peerless Clothing

ROGER MARTIN is dean of the of the Rotman School of Management and an expert in global competitiveness

GORDON **NIXON** is chief executive officer of Royal Bank of Canada.