Insight

# The Government Should Not Ban Mergers and Buyouts

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In an effort to curb the market power of the largest tech companies, some legislators and public policy experts have proposed banning mergers and acquisitions for companies above a certain size. Senator Amy Klobuchar is most visible in this effort, as she has introduced a bill that would effectively ban any company with a market capitalization over $100 billion from engaging in mergers. By limiting any new expansion of the largest companies, the reasoning goes, smaller companies would be forced to step into the fray and become competitive instead of banking on a buyout by larger firms.

Not every entrant wants to expand, however. Indeed, what is most striking about these proposals is that they assume firms always want to expand and will never need to exit. In the end, a merger ban would seriously harm the innovation ecosystem and disincentivize new startups.

**Two Roads Diverge**

In extolling the virtues of a merger ban, Matt Stoller of the Open Markets Institute explained that "This would push VCs [Venture Capital firms] and entrepreneurs to truly compete with Google. Right now, their strategy isn't to do that because they want to get acquired."

As Stoller implies, successful startups typically have two paths to financial success: go public or get acquired. Going public isn't easy, though. On average, companies have to fork over 4 to 7 percent of their initial public offering's (IPO's) gross proceeds to an investment bank to sell shares of the stock, plus an additional $4.2 million in costs for the process. Then every year, because of the federal filing requirements, a company will have to incur a further $1 to $2 million in costs. And once public, a company will face capital markets that demand consistent growth.

It is helpful to compare Snap (the owners of Snapchat), which went public, with Instagram, which Facebook bought. After Snap went public in March of 2017, the company added its own advertising platform to help boost revenues. But lackluster revenues pushed the company to lay off a couple dozen people and reorganize. In a bid to turn around their fortunes, the company launched Spectacles, sunglasses embedded with a camera. The device flopped. It then redesigned the Snapchat app, which enraged the community and sparked a campaign to ditch the service—and nearly 2 percent of its users fled. At the beginning of September, Snap stock was down nearly 40 percent from its debut price.

While Instagram might have lost some independence in its acquisition, it has had much better fortunes in its deal with Facebook. It was able to massively upgrade its backend tech because of the engineers at Facebook. The company also got access to Facebook's ad platform, allowing it to consistently grow its revenues. Moreover, Facebook's management teams give Instagram the ability to launch and grow new products quickly. Instagram Stories surpassed Snapchat's daily active users within a year of launch.

Snap's difficulties highlight the reasons why the value of mergers is so much greater than that of IPOs. In 2016, for example, every dollar of IPO proceeds was matched by $143 in mergers and acquisitions. Many companies struggle to raise cash or expand. Zappos sold itself to Amazon for exactly this reason. As Zappos co-founder and CEO Tony Hsieh explained, he wanted to grow the business, but the recession and the credit crisis forced Zappos to reconsider its strategy.

A merger ban would cover some of the companies that are among the most active in acquiring smaller companies and bringing their products to market. It would include: Apple, Amazon, Alphabet, Microsoft, Facebook, Berkshire Hathaway, JPMorgan Chase, Johnson & Johnson, Bank of America, Visa, Wells Fargo, Intel, Chevron, Walmart, Nestle, UnitedHealth Group, Cisco Systems, Home Depot, Pfizer, Mastercard, Verizon Communications, Boeing, AT&T, Oracle, Citigroup, Procter & Gamble, Coca-Cola, AbbVie, Merck & Co., DowDuPont, NVIDIA, Walt Disney, Comcast, Netflix, PepsiCo, IBM, McDonald's, General Electric, Philip Morris International, 3M, Adobe Systems, Medtronic, Amgen, Nike, Honeywell International, Union Pacific, Abbott Laboratories, Texas Instruments, Altria Group, Accenture, and Broadcom.

The result of such a ban would be that smaller companies would have one option for growing their business cut off.

**Cascading Consequences**

Cutting off the option of a buyout could have a number of consequences for smaller companies and the economy's ability to innovate.

One likely effect would be that smaller companies with promising products would flounder without the resources and expertise of larger companies. Some companies, for example, have a product that is only viable when paired with others held by the largest companies. DeepMind was acquired by Google at a cost of nearly $650 million, but this division has been mainly used to analyze internal Google programs. An acquisition can mean that the company produces more economic value while benefitting from professional management and legitimacy.

Workers would likely be hurt by such a ban as well. While being part of a new company looks good on a resume, startups pay less and workers often clock in longer hours. Exits offer a large payout for everyone involved, especially if staff has taken equity shares in the company in lieu of higher salaries. And such a buyout can benefit the buyer, as well, as large companies might acquire a smaller one to gain its staff. Acqui-hires, as they are called, are common ways of bringing talent into a firm that has both a tax benefit and makes investors happy.

Still other companies might just want to be bought because they had intended it all along—that was their long-term goal. In such a case, the buyout does not harm consumers, nor does it benefit them. Instead, the owners of the smaller upstart can grab some of the larger company's returns in the sale. In economics, the seminal paper on the topic is by economist Eric Rasmusen and is titled, "Entry for Buyout." His key insight is that entry can be a kind of rent-seeking behavior, as entrants in some circumstances can use the threat of lowering prices to entice their larger competitor to buy them out. Yet in this circumstance it is not clear that consumers are hurt in a meaningful way.

Limiting the options of entrepreneurs to exit their startups would have a clear impact on innovation, too. Serial entrepreneurs, who open more than one business in their lifetime, create more productive businesses. Indeed, research finds

that “a large component of success in entrepreneurship and venture capital can be attributed to skill.” Exits give executives the ability to start a new company and take a chance on a new idea, creating further value and jobs for the economy. Peter Thiel, Marc Andreessen, Steve Case, and Mark Cuban have all had successful second acts.

**Allowing Mergers and Acquisitions**

Senator Klobuchar is not the only legislator looking at intervening in mergers and acquisitions. Senator Richard Blumenthal, a co-sponsor of Klobuchar’s bill, has called for more aggressive merger review at the Federal Trade Commission, and Senator Elizabeth Warren has been pushing for a breakup of some previously merged companies.

These efforts fail to ask a fundamental question: What do the startups want? Do most entrants want to grow to become a superstar firm, or are they looking for an exit, to be bought out by someone else who can take their product to market while offering a big payout? For all of the reasons detailed above, the second option is often more appealing.

Banning mergers assumes that smaller firms can and want to expand along a specific trajectory. Public policy needs to be agnostic to business decisions unless they harm consumers. That is the true standard by which mergers should be judged.