CANADA

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COMBINING INTERE

During the past few years, several large mergers have occurred in Canada, giving rise to many newspaper headlines and a great deal of public questioning about the benefits of large size in business. Commentators were especially critical of huge corporations that expanded by absorbing what, in comparison, were merely "big" ones. Many of these mergers, unfortunately, have not provided the gains anticipated by the shareholders of the buyers; sometimes, in fact, as in the case of Dome Petroleum's acquisition of Hudson's Bay Oil & Gas, the transactions contributed to a massive decline in the price of the buyers' stock.

While subject to criticism in the 1980s, mergers in Canada have enjoyed a long and successful history. One of our great enterprises, the Hudson's Bay Company (HBC) won many years of profitable life after an 1821 merger that, in terms of impact on the economy, was probably the most significant in Canadian history. The combination of HBC, headquartered in London, England, and the North West Company of Montreal not only restored profitability to the fur trade after a period of ruinous competition, but also, and perhaps of more interest for the accountant, employed financial techniques still considered imaginative more than 160 years later.

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Seeds of the merger

Incorporated by a royal charter in 1670, HBC had by 1820 effectively ruled British North America from Lake Superior to the Pacific for nearly 150 years. That royal charter granted HBC title to much of the land that is now Western Canada and a legal monopoly of the principal economic activity in the area — the fur trade. HBC was foreign owned and controlled, however, and, as in recent years, many people felt that a dominant foreign organization was harmful to Canadian development — especially as the expansion of the trade westward saw more trading posts serviced by ships sailing into Hudson's Bay rather than through Montreal.

By the late 18th century, some rivals to HBC had established themselves, but the only effective competition came from the North West Company. Formed in November 1804 by the combination of two fur-trading entities, the North West Company, like nearly every enterprise in that era, was a partnership. Although the advantages of a corporation with limited liability for investors were well known, since the South Sea bubble scandal of 1721 the creation of corporations for private purposes was not possible within the British

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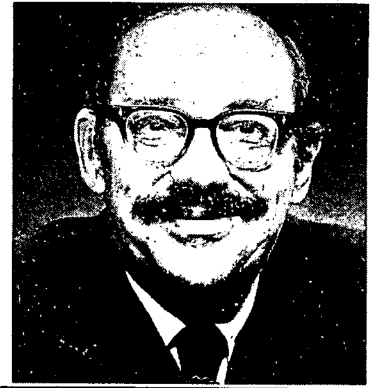

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realms. Therefore, HBC with its indefinite life and securities listed on the stock exchange could not be duplicated by a competitor.

The North West Company partners consisted of several "winterers" (so-called as they spent the winter in the fur territories) who traded with the Indians for furs and some Montreal merchants (the agents) who provided the necessary capital, mainly for trade goods, and undertook the marketing, principally in London. As was then common practice, the North West Company partnership agreement provided for a limited life; in 1822, the partnership was to be dissolved and either replaced by a new one or liquidated.

Establishing their major trading post at Fort William at the head of Lake Superior, the Northwesters aggressively competed for furs. In the end, that competition attained the status of a private war when, in 1819, an HBC group armed with cannon ambushed some of the winterers at the Grand Rapid of the Saskatchewan River. The economic results of the fierce rivalry are a textbook example of destructive business practices: fur-collecting costs rose as the Indians now had competing buyers; many areas were denuded of fur animals by overtrapping; and selling prices in England fell due to the increased supply.

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From the available, rather sparse financial records, HBC profits appear to have declined between 1804 and 1811 in spite of a substantial retrenchment in expenditures. Generally, only two or three ships per year sailed out of Hudson's Bay for London, and the delay of one such vessel over the September 30 financial year end could cause a significant loss. That occurred in 1812, and, although the 1813 arrival of the extra ship did create a profit, the trend was still down. From then on losses increased as costs stayed high, and sales declined (almost one-third between 1818 and 1820). In 1816 and 1817, ships again failed to arrive on time. In addition, dividends, suspended since 1809, were resumed in 1815 after the end of the Napoleonic Wars to restore investor confidence. As a result, HBC's loans from the Bank of England increased from £23,500 in 1814 to the limit of £75,000 in 1820, while other debts (payables) rose from £4,734 to £30,502 in the same period. At £105,502, liabilities in 1820 exceeded the nominal capital of £103,950.

Any conversion factor from sterling amounts 160 years ago can only be representative but, considering both price indexes in England linked to cover both 1820 and 1980 and the changes in the price of gold sovereigns, a reasonable conversion

figure is that one pound in 1820 had a buying power of about $140 in 1982. Expressed in those terms, by 1820, HBC was losing about $1,220,000 a year on sales of around $9,700,000 and paying out $580,000 a year in dividends. Its balance sheet was in bad shape: its liabilities (all in England) were $14,800,000 compared with issued capital of $14,600,000, and most assets, except for ships and a London office building, were in Canada. The future of HBC was dependent, therefore, on the continued support of the Bank of England.

If HBC was in difficulties, the financial condition of the North West Company was also deteriorating. Although no satisfactory financial data is available, it did not have the support of a major bank (the Bank of Montreal — the first in Canada — was only formed in 1817) and, as a partnership, the company had to distribute a substantial portion of its profits each year.

Negotiations

Many people in each organization realized that the competition was not beneficial to either group, and the Northwesters made overtures for a union of the companies in 1815 and 1817. By 1819, some of the winterers were suggesting that, when the North West partnership expired in 1822, they might get HBC to represent them in London. In late 1819, therefore, the agents attempted to negotiate the purchase of the largest block of HBC stock, which was held by Lord Selkirk, the founder of the Red River Settlement. (Suffering from consumption, Selkirk had left Canada in November 1818 to live in the south of France, where he died in April 1820.) Selkirk was mainly interested in preserving the settlement, which was heartily disliked by the Northwesters, and so had vigorously opposed their previous approaches to HBC. By 1819, however, he was in financial straits as well as in poor health, and so was willing to consider a sale of his HBC shares or a merger of the two concerns, provided his colony was secured.

When, at Christmas 1819, HBC discovered that some winterers might wish it to act for them, negotiations with the agents were discontinued. During 1820, little progress was made but, by the end of that year, representatives of the Montreal agents and the winterers had independently come to London to negotiate with HBC's committee (board of directors). Aware of the company's financial problems, they were eager to find a solution.

Even so, the process of satisfying all parties was difficult. HBC was obviously oriented toward the winterers, but any deal with them would run into conflict with its policy of "company only" trade, rather than private, individual trade. The agents, on the other hand, were better negotiators, had a significant capital investment, and seemed to have British government support for a compromise. As in all merger negotiations, there was a considerable amount of bluff, and the agents were the better bluffers; even though the North West Company was out of business after 1822, they alleged that the Northwesters had taken over HBC.

The solution

The form of "the coalition of the Companies" was ingenious and could still apply today. Although a combination of the businesses was essential, the considerable enmity between many individuals in both organizations, the differing methods of remunerating key personnel (salary or profit sharing) and the incompatible legal structures made a direct merger of the North West Company into the HBC impossible, and so a co-partnership or joint venture between the organization was formed, using the name and charter of HBC.

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That joint venture ("The Bay"), which was to have a life of 21 years and then terminate, was established by an agreement dated March 26, 1821 after approval by HBC's stockholders. Because of the lengthy travelling time to Canada, the Northwest partners do not appear to have had the opportunity to approve the agreement prior to its signing. All the parties seem to have considered that the agents and the few winterers in London satisfactorily represented everyone concerned.

Effective June 1, 1821, The Bay was to acquire, in exchange for capital contributions, all assets of both organizations, including inventories (trade goods), receivables (both from the Indians and employees), trading posts, ships and Hudson's Bay House in London. Rules for valuing the assets were set out in the agreement: inventories were to be valued according to the Tariff of Advance (resale value); neither the receivables from Indians nor the buildings and equipment of the trading posts were to be considered as having any value in determining the capital contributions; and receivables from employees were to be valued at the lesser of the debt or a year's wages.

The agreement also provided for £5,000 to be transferred from the North West Company to HBC in satisfaction of all claims between them. After completion of the various transfers and valuations, the capital accounts of two contributors were to be equalized by June 1, 1822 through a cash payment (with interest at 5% from June 1, 1821) by the party with the lower balance. Apparently, any furs on hand at the date of transfer would be retained by the previous organizations.

While The Bay's capital was to be divided equally, the profit allocation and control were not. Profits were to be allocated to the various interested parties as follows:

- HBC stockholders — 20%.
- North West Company proprietors (principally the agents) — 20%.
- "The persons actually employed in conducting the Trade in North America" (operating executives) — 40%.
- Estate of Lord Selkirk (in relation to claims against HBC) — 5%.
- London agents of the North West Company (in exchange for termination of the agency) — 5%.
- Reserve fund (on termination, one-half would go to HBC and one-half to the North West Company) — 10%.

On the other hand, control, as shown by the members of the board, was to lie with HBC. HBC's governor (chief executive) and two members of its committee (directors) were to be joined by two representatives (initially its London agents) from the North West Company. This board met in London and was responsible for financial affairs and selection of the key employees.

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The rules for determining The Bay's profit as set out in the agreement are intriguing. All assets including the ships and the London office building were to be valued on June 1 of every year on the same basis as the initial valuation, and any in-

crease or decrease in values were to be taken into account in establishing the profit or loss; in other words, changes in appraised values were included in lieu of depreciation — an early example of current cost accounting! In addition, a 5% return on the contributed capital was to be allocated to the investors before determining profits. (The agreement makes no reference to corporate income tax, as this concept lay many years in the future.) If, in any year, there were losses, future allocations of profit (other than to HBC or the North West Company) were to be suspended until any such prior loss has been recovered. It seems that HBC and the North West Company were thereby exempted from sharing in the losses.

As in all merger negotiations, there was a considerable amount of bluff.

The profit sharing with the operating executives in North America was The Bay's key to success. The 40% of profits allocated to such field staff was divided into 85 units. Depending on the size and importance of a trading post, the manager was either a chief factor or chief trader. Each of the 25 chief factors received two profit-sharing units, while each of the 28 chief traders got one. The remaining seven units were used as part of a pension plan — retired executives received half pay for the balance of their lives. In effect, key employees were to receive 36.7% of the profits as a bonus for their efforts. This incentive proved highly successful: in 1821, losses amounted to £196 a unit; in 1822 the profit was £203 a unit; and, by 1827, the unit profit had risen to £550 (equivalent to a current income of more than $150,000 a year for a chief factor) — a very fair return for their effort.

Because The Bay was distinct from HBC as a corporate entity and the position of the HBC stockholder was safeguarded, the Northwesters' claim to have taken over HBC could only be true in the limited sense that, by providing 32 of the 53 profit-sharing executives and half the capital, they received a little more than half the profits.

Combining the organizations

A major roadblock in nearly every merger is the combination of corporate cultures. Apart from the obvious difficulties arising from staff terminations, there is the stress created by attempting to mesh separate organizational structures. In a merger, two groups, each with its own unique traditions, objectives and standards, are thrown together and, inevitably, "we-they" attitudes arise. Fortunately, the then governor of HBC "resisted attempts by the Agents to victimize some of the Hudson's Bay men who had shown most spirit during the struggle; he achieved the initial exclusion of the more principled Northwesters and the Winterers who had rebelled against the Agents (during the North West Company's internal conflicts) were fully acknowledged in the new concern." The spirit of cooperation was shown by choosing Northwesters as more than half of both the chief factors and the chief traders — in other words, the best person for the job, irrespective of any past affiliations.

In addition, following North West Company practice, The Bay introduced annual management meetings of the chief factors of each of the two regional departments to determine policy, promotions and so on. These meetings aided the transition from the entrepreneurial style of the Northwesters — high salaries, support of women and children at the trading posts and generous credit to the Indians — to the lower-cost, more structured and probably more solid style of HBC leadership. In addition, the meetings helped ensure that the necessary pruning of staff was arranged to maximize efficiency.

In assessing the successes of The Bay, other stakeholders should be considered. The government, the Indians and the environment were all affected. The British government was pleased with the combination and, in 1821, granted The Bay a "License for Exclusive Trade," confirming HBC's royal charter. This licence, however, held certain obligations: acceptance of the Red River colony still fiercely opposed by the Northwesters, and a virtual prohibition of the use of alcohol as a trade good. As suppliers to a monopoly, the Indians suffered: credit was cut off, prices were reduced, and many were effectively put out of work when the policy of recuperation was applied. Under this policy, purchases from an area were temporarily stopped to allow the animals, especially beaver, time to replenish themselves, thus repairing previous environmental damage.

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Final merger

By 1824, after three years of operations, The Bay had successfully combined the two feuding parties and was turning a profit. The major profit source, however, was the Northern Department, which ran from Hudson's Bay to the Pacific. As The Bay had its own ships, this area was best served from London rather than Montreal; hence, the purchases from the agents were reduced, and they ran into financial difficulty. HBC still had a large overdraft, and expansion of the trade indicated the need for more capital. It seemed desirable, therefore, for HBC to acquire The Bay, resulting in a complete merger. This would allow additional money to be raised, provide liquidity to the agents and the Selkirk estate, and simplify the organization.

The plan adopted was facilitated by an increase in HBC stock price from £100 in July 1821 (just after the formation of The Bay) to £160 in July 1824. There were two stages to the plan: in the first, HBC raised £103,000 (sufficient to pay off the bank), and in the second stage, it bought out the profit interests other than those of the operating executives for stock. The separate existence of The Bay was then terminated, and the executives retained their 40% profit participation.

The fund raising was done by a one-for-one right issue at £100, followed by a 3% stock dividend on the new shares. As the stock price held steady, the issue, at an effective 34% discount to market, was very successful. On completion of the transactions, the former HBC stockholders, including the Selkirk estate, owned 56% of the increased capital (£397,692), while the former Northwesters held 44%. To maintain their control, however, HBC stockholders had been required to provide the equivalent of about $14,500,000.

The first megamerger

The stock market effect was gratifying. The elimination of the overdraft and the enhanced profit interest (60% from 20%) allowed an increase in the HBC dividend from 4% to 10% on the enlarged capital. The stock price continued to rise, increasing more than 60% to £260 by May 1825. In effect, the various transactions increased the market value of the enterprise to £1,034,000 or, after allowing for the additional funds provided by the existing stockholders, nine times the premerger (1821) value — an excellent deal for both the investors and the operating executives who continued to receive 40% of the profit.

The Canadian predecessor of today's megamergers was imaginatively executed and afforded beneficial results to investors and executives alike. Certainly, HBC stockholder gains, 27% a year compounded from 1821 to 1825, were better than the returns achieved today by the owners of some of the major acquirers. ■