

Toeholds, Takeovers and Football

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Last year the Department of Trade & Industry blocked BSkyB's bid for Manchester United following an MMC investigation. In this article we explain how game theory proved instrumental in reaching this decision. Although BSkyB claimed that it would not have gained any advantages in negotiations for Premier League broadcasting rights from its acquisition of Manchester United, the economic theory of 'toehold effects' demonstrated that this was untrue. It also explains why the subsequent scramble to obtain smaller 'toeholds' since the MMC decision is likely to prove an equally effective strategy for media interests wishing to gain influence in Premier League rights selling decisions.

Introduction

On March 12th last year the Monopolies and Mergers Commission sent the results of its extensive investigation into the proposed takeover of Manchester United by British Sky Broadcasting to the Trade and Industry Secretary. As we now know, the MMC's conclusion was a resounding no, based on careful arguments

concerning the advantages BSkyB would obtain in negotiating future deals for Premier League broadcasting rights, and the effects this would have on competition between downstream broadcasters.² BSkyB has meanwhile loudly protested its innocence. It claims that as owner of Manchester United it would not have gained any advantages in future sales of Premier League rights. It also protests that it was willing, in any case, to accept conditions sufficient to guarantee this.

So should the merger have been waved through after all? Game-theoretic arguments, based on the theory of 'toehold effects' in auctions, explain why no conditions on Manchester United's participation in the selling of Premier League broadcasting rights could have alleviated the MMC's concerns on this score.

Football Cartels

To understand the competition concerns raised by the proposed take-over, it is important to know something about the economics of pay television, and of live sports broadcasting in particular. First, football matches played by the top Premier League clubs are amongst the most commercially important for pay television companies. They attract huge audiences. In 1997 over 90% of all BSkyB subscribers took its Sports Channel, on which Premier League fixtures are shown. In the same year 25 of the top 30 programmes on satellite television were league football games. The industry perception is that sports broadcasting, and especially Premier League football, drives their subscriptions. Ownership of the rights to broadcast live Premier league matches would appear to confer a huge competitive advantage on a broadcaster. No pay TV company can survive without access to these games.

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² Monopolies and Mergers Commission *British Sky Broadcasting Group plc and Manchester United plc: A report on the proposed merger*, April 1999.

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Secondly, the FA Premier League sells the exclusive rights to all of the games it allows to be screened as a single package to a downstream broadcaster. If you want to broadcast any single match you must therefore acquire the rights to all of the matches. Once you have acquired the rights you are free to sell them on to your own customers, and to rival broadcasters, under any terms you choose. The FA Premier League, in other words, acts as a tight cartel. It sells the rights to 60 of its 380 matches to the highest bidder in periodic auctions.

BSkyB has held these exclusive rights since they were first sold in 1992. But how fair were the auctions for Premier League rights which BSKyB won in 1992 and 1996?

Auctions for Rights

In 1992 there were two bidders, ITV and BSKyB. BSKyB won the rights, however not before it was reportedly given an opportunity to submit a final bid after learning the value of ITV's bid. There were naturally complaints from ITV that it too should have been given an opportunity to revise its bid.³

The 1992 contract between BSKyB and the Premier League contained a 'meet the competition' clause in favour of BSKyB. This allowed BSKyB to match, or improve upon, the bid of any competitor in the 1996 auction. A 'meet the competition' clause is a huge advantage for a buyer in any selling procedure. It presents all other potential bidders with an aggravated form of what economists call "the Winners' Curse." The Winners' Curse occurs when a bidder in an auction has an overly optimistic estimate of the value of the object being sold, and consequently outbids all other rivals. But the very fact of winning should tell him that all the other bidders placed a lower value on the object being sold, and

hence that he must have overbid. Faced with a bidder who will always be given an opportunity to match your bid, you cannot possibly win an auction at a price which the other bidder would find it profitable to pay. Winning will then indeed be a 'curse', and it is something of a mystery why anyone bothered to bid against BSKyB in the 1996 auction at all.

This brings us back to the question at the heart of the recent MMC inquiry. Why should BSKyB have wished to acquire Manchester United? There was one obvious answer. FA Premier League rights are due to be auctioned again in 2001, unless the Restrictive Trade Practices Court rules this practice illegal. In this auction, BSKyB no longer has a 'meet the competition' clause, and new competitors have entered the pay TV market who might well be interested in bidding for these rights. BSKyB therefore risks losing the exclusive football broadcasting rights which have been the key to its success in the pay TV market.

Toeholds and Takeovers

How would the purchase of Manchester United have helped BSKyB? Game theory explains why using the idea of "toehold" effects. A "toehold" is a small asymmetry between the bidders in an auction, such as one bidder acquiring an ownership stake in the object being sold. Toeholds work by 'multiplying up' the effects of the Winners' Curse for the rival bidders. There is strong evidence that acquiring a toehold - even a very small one - can confer a huge competitive advantage on a bidder in an auction. An analysis of data from 1353 tender offer contests between 1971 and 1990 in the United States found that toeholds increase the likelihood of a single bidder contest, and that bidders without a toehold are less likely to revise their bids upwards after the initial round of bidding.⁴ This empirical evidence is

³ Reported in M. Horsman (1997) *Sky High*, Orion Business Books, Great Britain, pp. 97-100.

⁴ Betton, S. and B. Eckbo (1998) "State-contingent payoffs in takeovers: New structural estimates," mimeo, University of Pennsylvania.

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backed up by theory.⁵ In standard auction formats a bidder with a toehold is virtually guaranteed to win the auction, and at a lower price than it otherwise might have paid. When more than one bidder has a toehold, the bidder with the larger toehold retains a significant advantage. Having the second largest toehold is not much better than having no toehold at all!

Under Premier League revenue sharing rules, Manchester United receives about 8% of the revenues from the sale of live football broadcasting rights. Since Manchester United is the league's most successful team, this revenue share is larger, on average, than that received by any other team. If you want to obtain a toehold in Premier League live broadcasting rights, without finding your advantage nullified by another broadcaster purchasing a different team, Manchester United is the team to buy. Once BSKyB owned Manchester United, the club's revenue share in the Premier League would have accrued to BSKyB, giving BSKyB a commanding toehold in Premier League broadcasting rights.

How does a toehold 'multiply up' the Winners' Curse? The answer is remarkably simple. A bidder with a toehold is willing to bid a little more aggressively than otherwise because part of its bid will come back to it by virtue of its ownership stake. This has the effect of aggravating the winners' curse faced by the other bidders, who will then bid a little more conservatively. This allows the bidder with the toehold to bid more aggressively still, and so on.

BSkyB's ownership of Manchester United would have conferred a major advantage in future auctions for Premier League rights, provided that collective and exclusive selling continues. And

this toehold advantage could not have been alleviated by prohibiting Manchester United from participating in Premier League decisions. It was argued by the parties however, that BSKyB's toehold advantage could be reduced if the Premier League were to hold a sealed bid auction. It was also suggested that the Premier League would have every incentive to do this in order to maximise its own revenues.

These arguments were at best naïve, and at worst disingenuous, however. As the MMC recognised, maintaining a commitment to hold a sealed bid auction can be problematic in the face of perfectly legal inducements to accept higher subsequent offers. They were unconvinced that the Premier League would be able to abide by such a commitment. Critics of the toehold argument also underestimated the variety of ways in which advantages can be conferred, or small asymmetries created, in auctions. Information on rivals' bids can be (and has been) leaked. And we should not forget that BSKyB managed to obtain very significant advantages for itself in both of the previous rights auctions, even when it did not own Manchester United. Why should we expect this ability to be diminished once it owned the Premier League's most valuable football club?

What if the Premier League cartel is abolished and the clubs forced to sell their broadcasting rights individually? It would have been perilous to make precise predictions. However the MMC concluded that ownership of England's most popular and successful football club would have undoubtedly left BSKyB extremely well-placed to negotiate for exclusive broadcasting rights to the important matches with other clubs.

After the Decision: The Battle for Toeholds

In light of the MMC's decision, NTL dropped its bid for Newcastle United after being referred by the Trade and Industry Secretary to the (renamed) Competition Commission. This was despite the

⁵ Klemperer, P. (1998), "Auctions with almost common values: The 'Wallet Game' and its applications", *European Economic Review*, 42, 757—769 and Bulow, J., M. Huang, and P. Klemperer (1998) "Toeholds and takeovers," mimeo, Nuffield College, Oxford

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fact that NTL did not hold anything like BSkyB's pre-eminent position in the market for pay TV sports broadcasting and hence was never in a strong position to exploit any advantages it might thereby gain at the expense of its competitors. As the MMC observed, BSkyB retains significant incumbency advantages in the competition to obtain football broadcasting rights, which it may be difficult for other broadcasters to overcome.

Media and pay TV companies appear to view the MMC decision as implying that no football club should ever be owned by any broadcasting company. The decision was clearly based however, on BSkyB's pre-existing monopoly position in the sports broadcasting market, and on the influence that the acquisition of Manchester United would buy BSkyB in future rights negotiations. Bids by other companies for other football clubs will have to be considered on their merits.

Since the MMC decision however, broadcasters have hit upon a different, although potentially equally effective strategy for gaining influence over rights selling decisions. Recognising that lots of little toeholds may well be as useful as one big one, the scramble is now on to obtain stakes in as many football clubs as possible. BSkyB has retained its shareholding in Manchester United and in August signed a media alliance with Leeds United which resulted in it taking a 9% stake in the club for £13.8 million. BSkyB also recently acquired 5% of Sunderland football club and 9.9% of Manchester City.⁶ Similarly, NTL has increased its stake in Newcastle United to 9.8% and is now in talks with Aston Villa with a view to clinching a similar deal. Meanwhile, in July, Granada paid £22 million for a 9.9% stake in Liverpool FC. According to the press reports:

“Following the Department of Trade & Industry's decision to block BSkyB's bid for Manchester United, media groups have been looking for other ways to gain an influence at Premier League clubs. Broadcasters see holding a stake in major clubs as a way to gain influence in future rights negotiations ... and are jockeying for position to secure the next wave of television rights for football, which has been a major weapon in the pay TV market in the UK.”

None of this activity is likely to trigger intervention from any regulatory body, although the net result may well to distort the sale of football television rights as much as a wholesale takeover of Manchester United by BskyB would have done.

⁶ Under Football Association rules no single company can own more than 10% of more than one football club.