

MERGERS: IMPULSE, REGRET AND SUCCESS

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Introduction

The topic of mergers is one of those areas of finance that attracts interest from the general public as well as finance specialists and managers. There is nothing like an acrimonious bid battle to excite the press, where one side is portrayed as 'David' fighting the bullying 'Goliath', or where one national champion threatens the pride of another country by taking over a key industry. Each twist and turn of the campaign is reported on radio and television news broadcasts, and, finally, there is a victor and a victim. So many people have so much hanging on the outcome of the conflict that it is not surprising that a great deal of attention is given by local communities, national government, employees and trade unionists. The whole process can become emotional and over-hyped to the point where rational analysis is sometimes pushed to the side.

This chapter examines the reasons for mergers ranging from the gaining of economies of scale to managerial empire building. Then a major question is addressed: Do shareholders of acquiring firms gain from mergers? Evidence is presented which suggests that in less than one-half of corporate mergers do the shareholders of the acquiring firm benefit. To help the reader understand the causes of this level of failure the various managerial tasks involved in achieving a successful (that is, a shareholder wealth-enhancing) merger, including the 'soft' science issues, such as attending to the need to enlist the commitment of the newly acquired workforce, are discussed.

In the next chapter the merger process itself is described, along with the rules and regulations designed to prevent unfairness. Also discussed is the way in which mergers are financed.

The merger decision

Expanding the activities of the firm through acquisition involves significant uncertainties. Very often the acquiring management seriously underestimate the complexities involved in merger and post-merger integration.

Theoretically the acquisition of other companies should be evaluated on essentially the same criteria as any other investment decision, that is, using NPV. As Rappaport states: 'The basic objective of making acquisitions is identical to any other investment associated with a company's overall strategy, namely, to add value'.¹

In practice, the myriad collection of motivations for expansion through merger, and the diverse range of issues such an action raises, means that mergers are usually extremely difficult to evaluate using discounted cash flow techniques. Consider these two complicating factors.

- The benefits from mergers are often difficult to quantify. The motivation may be to ‘apply superior managerial skills’ or to ‘obtain unique technical capabilities’ or to ‘enter a new market’. The fruits of these labors may be real, and directors may judge that the strategic benefits far outweigh the cost, and yet these are difficult to express in numerical form.
- Acquiring companies often do not know what they are buying. If a firm expands by building a factory here, or buying in machinery there, it knows what it is getting for its money. With a merger, information is often sparse – especially if it is a hostile bid in which the target company’s managers are opposed to the merger. Most of the value of a typical firm is in the form of assets which cannot be expressed on a balance sheet, for example the reservoir of experience within the management team, the reputation with suppliers and customers, competitive position and so on. These attributes are extremely difficult to value, especially from a distance, and when there is a reluctance to release information. Even the quantifiable elements of value, such as stock, buildings and free cash flow, can be miscalculated by an ‘outsider’.

You say acquisition, I say merger

Throughout this book the word merger will be used to mean the *combining of two business entities under common ownership*.

Many people, for various reasons, differentiate between the terms merger, acquisition and takeover – for example, for accounting and legal purposes. However, most commentators use the three terms interchangeably, and with good reason. It is sometimes very difficult to decide if a particular unification of two companies is more like a merger, in the sense of being the coming together of roughly equal-sized firms on roughly equal terms, in which the shareholders remain as joint owners and both teams of executives share the managerial duties, or whether the act of union is closer to what some people would say is an acquisition or takeover – a purchase of one firm by another with the associated implication of financial and managerial domination. In reality it is often impossible to classify the relationships within the combined entity as a merger or a takeover. The literature is full of cases of so-called mergers of equals that turn out to be a takeover of managerial control by one set of managers at the expense of the other.² Jürgen Schrempp, the chairman of DaimlerChrysler, shocked the financial world with his honesty on this point. At the time of the union of Chrysler with Daimler Benz in 1998 it was described as a merger of equals. However, in 2000 Schrempp said, ‘The structure we have now with Chrysler [as a standalone division] was always the structure I wanted. We had to go a round-about way but it had to be done for psychological reasons. If I had gone and said Chrysler would be a division, everybody on their side would have said: “There is no way we’ll do a deal.”’³ Jack Welch, the well-respected industrialist, supports Schrempp: ‘This was a buy-out of Chrysler by Daimler. Trying to run it as a

merger of equals creates all kinds of problems ... There is no such thing as a merger of equals ... There has to be one way forward and clear rules.'⁴ Lord Browne, chief executive of BP, following the mergers with Amoco and Arco, also has strong views on this subject: 'There is a big cultural problem with mergers of equals ... in the end there has to be a controlling strain from the two companies.'⁵ This book will use the terms merger, acquisition and takeover interchangeably.

Types of mergers

Mergers have been classified into three categories: horizontal, vertical and conglomerate.

Horizontal

In a horizontal merger two companies engaged in similar lines of activity are combined. Recent examples include the merger of Carlton with Granada to form ITV plc and Wm Morrison and Safeway. One of the motives advanced for horizontal mergers is that economies of scale can be achieved. But not all horizontal mergers demonstrate such gains. Another major motive is the enhancement of market power resulting from the reduction in competition. Horizontal mergers often attract the attention of government competition agencies such as the Office of Fair Trading and the Competition Commission in the UK.

Vertical

Vertical mergers occur when firms from different stages of the production chain amalgamate. So, for instance, if a manufacturer of footwear merges with a retailer of shoes this would be a (downstream) vertical merger. If the manufacturer then bought a leather producer (an upstream vertical merger) there would be an even greater degree of vertical integration. The major players in the oil industry tend to be highly vertically integrated. They have exploration subsidiaries, drilling and production companies, refineries, distribution companies and petrol stations. Vertical integration often has the attraction of increased certainty of supply or market outlet. It also reduces costs of search, contracting, payment collection, advertising, communication and co-ordination of production. An increase in market power may also be a motivation: this is discussed later.

Conglomerate

A conglomerate merger is the combining of two firms which operate in unrelated business areas. For example, Vivendi Universal, originally a water utility spent the late 1990s buying up companies in fields as diverse as film and music production and telecommunications. Some conglomerate mergers are motivated by risk reduction through diversification; some by the opportunity for cost reduction and improved efficiency. Others have more complex driving motivations – many of which will be discussed later.

Merger statistics

The figures in Table 11.1 show that merger activity has occurred in waves, with peaks in the early 1970s, late 1980s, and late 1990s. The vast majority (over 95 percent) of these mergers were agreed ('friendly'), rather than opposed by the target (acquired) firm's management ('hostile'). Only a small, but often noisy, fraction enter into a bid battle stage. In the late 1990s shares became a more important means of payment as the stock market boomed. In the first part of the 1980s merger boom (1985–89) ordinary shares tended to be the preferred method of payment. However, after the October 1987 stock market decline there was a switch to cash. There was a similar pattern in the early 1970s: when share prices were on the rise (1970–72) shares were used most frequently. Following the collapse in 1973–74 cash became more common.

TABLE 11.1
UK merger activity, 1970–2002 (UK firms merging with UK firms)

Year	Number of UK companies acquired	Expenditure (£m)	Method of payment		
			Cash (%)	Ordinary shares (%)	Preference shares and loan stock %
1970	793	1,122	22	53	25
1971	884	911	31	48	21
1972	1,210	2,532	19	58	23
1973	1,205	1,304	53	36	11
1974	504	508	68	22	9
1975	315	291	59	32	9
1976	353	448	72	27	2
1977	481	824	62	37	1
1978	567	1,140	57	41	2
1979	534	1,656	56	31	13
1980	469	1,475	52	45	3
1981	452	1,144	68	30	3
1982	463	2,206	58	32	10
1983	447	2,343	44	54	2
1984	568	5,474	54	33	13
1985	474	7,090	40	52	8
1986	842	15,370	26	57	17
1987	1,528	16,539	35	60	5

TABLE 11.1 (CONTINUED)

Year	Number of UK companies acquired	Expenditure (£m)	Method of payment		
			Cash (%)	Ordinary shares (%)	Preference shares and loan stock %
1988	1,499	22,839	70	22	8
1989	1,337	27,250	82	13	5
1990	779	8,329	77	18	5
1991	506	10,434	70	29	1
1992	432	5,939	63	36	1
1993	526	7,063	81	16	3
1994	674	8,269	64	34	2
1995	505	32,600	78	20	2
1996	584	30,457	63	36	1
1997	506	26,829	41	58	1
1998	635	29,525	53	45	2
1999	493	26,166	62	37	1
2000	587	106,916	38	61	1
2001	492	28,994	29	66	5
2002	430	25,236	70	26	4

Source: Office for National Statistics, *Financial Statistics*. © Crown Copyright 2001. Reproduced by the permission of the Controller of HMSO and the Office for National Statistics.

Note: The figures include all industrial and commercial companies (and financial institutions from 1995) quoted or unquoted which reported the merger to the press (small private mergers are excluded).

On a worldwide scale merger activity grew dramatically through the 1990s. In the early part of the decade the value of companies merging rarely totaled more than \$400bn during a year. However, in 1999 and 2000 a staggering \$3,300bn and \$3,500bn respectively was achieved – it has since subsided.

It is not entirely clear why merger activity has boom periods, but some relationships have been observed and ideas advanced: companies go through confident expansion phases organically (that is, by internal growth) and through acquisitions, as the economy prospers, and corporate profitability and liquidity are high; perhaps some managers become over-confident after a few good years, and, impatient with internal growth, decide to grow in big steps through acquisition. The hubris hypothesis and other managerial explanations of mergers are discussed in the next section.

What drives firms to merge?

Firms decide to merge with other firms for a variety of reasons. Figure 11.1 identifies four classes of merger motives. This may not be complete but at least it helps us to focus.

FIGURE 11.1
Merger motives

Synergy	Bargain buying	Managerial motives	Third party motives
<p>The two firms together are worth more than the value of the firms apart.</p> <ul style="list-style-type: none"> • $PV_{AB} = PV_A + PV_B + \text{gains}$ • Market power • Economies of scale • Internalization of transactions • Entry to new markets and industries • Tax advantages • Risk diversification. 	<p>Target can be purchased at a price below the present value of the target's future cash flow when in the hands of new management.</p> <ul style="list-style-type: none"> • Elimination of inefficient and misguided management • Under-valued shares. 	<ul style="list-style-type: none"> • Empire building • Status • Power • Remuneration • Hubris • Survival: speedy growth strategy to reduce probability of being takeover target • Free cash flow: management prefer to use free cash flow for acquisitions rather than return it to shareholders. 	<ul style="list-style-type: none"> • Advisers. • At the insistence of customers or suppliers.

Synergy

In the first column of Figure 11.1 we have the classic word associated with merger announcements – synergy. The idea underlying this is that the combined entity will have a value greater than the sum of its parts. The increased value comes about because of boosts to revenue and/or the cost base. Perhaps complementary skills or complementary market outlets enable the combined firms to sell more goods. Sometimes the ability to share sources of supply or production facilities improves the competitive position of the firm. Some of the origins of synergy are listed in the figure. Before discussing these we will look at the concept of synergy in more detail.

If two firms, A and B, are to be combined a gain may result from synergistic benefits to provide a value above that of the present value of the two independent cash flows:

$$PV_{AB} = PV_A + PV_B + \text{gains}$$

where:

$$PV_A = \text{discounted cash flows of company A;}$$

$$PV_B = \text{discounted cash flows of company B;}$$

$$PV_{AB} = \text{discounted cash flows of the merged firm.}$$

Synergy is often expressed in the form $2 + 2 = 5$.

Value is created from a merger when the gain is greater than the transaction costs. These usually comprise advisers' fees, underwriters' fees, legal and accounting costs, stock exchange fees, public relations bills and so on. So if we assume that A and B as separate entities have present values of £20m and £10m respectively, the transaction costs total £2m and the value of the merged firms is £40m (£42m before paying transaction costs), then the net (after costs) gain from merger is £10m:

$$£40m = £20m + £10m + \text{gain}$$

But who is going to receive this extra value? The incremental value may be available for the acquirer or the target, or be split between the two. If company A is the acquirer, it might pay a price for B which is equal to the PV of B's cash flows (£10m), in which case all of the gain from the merger will accrue to A. However, this is highly unlikely. Usually an acquiring firm has to pay a price significantly above the pre-bid value of the target company to gain control – this is called the acquisition premium, bid premium or control premium.

If it is assumed that before the bid B was valued correctly on the basis of its expected future cash flows to shareholders then the bid premium represents the transferring of some of the gains to be derived from the created synergy. For example, if A paid £15m for B (and absorbed the £2m of costs) then B's shareholders receive £5m of the gain. If A has to pay £20m to acquire B then A receives no gain.

In 2000 Royal Bank of Scotland (RBS) paid £20.7bn to take over NatWest. Prior to the bidding period NatWest was valued at £16bn (market capitalization). RBS expected to make annualized revenue gains of £120m – by 2001 it had delivered £147m. It promised that £550m of annualized cost savings would be made – it found £653m of savings. Qualitative benefits were greater than expected. NatWest gained retail and corporate customers, and customer complaints were down by 15 percent. Even allowing for the 'costs of integration' of £1.6bn, RBS is confident that it has generated shareholder value from the deal.

Also, note another possibility known as the 'winner's curse' – the acquirer pays a price higher than the combined present value of the target and the potential gain. The winner's curse is illustrated by Marks & Spencer's overpaying for Brooks Brothers (*see* Exhibit 11.1).

Market power

One of the most important forces driving mergers is the attempt to increase market power. This is the ability to exercise some control over the price of the product. It can be achieved through either (a) monopoly, oligopoly or dominant producer positions, etc., or (b) collusion.

If a firm has a large share of a market it often has some degree of control over price. It may be able to push up the price of goods sold because customers have few alternative sources of supply. Even if the firm does not control the entire market, a reduction in the number of participating firms to a handful makes

Burnt fingers prompt painful exit from US

M&S plans to return to the international market. But investors will hope it has learnt from its past, writes Susanna Voyle

M&S's attempts to become an international retailer – stretching back decades – have done little other than waste investor money and distract management from the core UK business. A study of the moves shows a trail of ego-driven deals, muddled strategic thinking and overpayment for assets.

Brooks Brothers, sold yesterday for less than a third of its purchase price 13 years after it was bought, is a perfect case in point.

The iconic US suit retailer, with its select band of Ivy League shoppers, never really sat comfortably within M&S and failed to flourish in spite of heavy investment.

'It was not just wrong to buy it at that price,' said one former M&S executive involved in the deal, 'it was wrong to buy it, full stop.' ...

Towards the end of 1986, M&S chairman Lord Rayner sent a small group of trusted staff to the US to identify whether the M&S brand would translate to the American market. The team, led by Alan Smith, now chairman of Mothercare, quickly decided that the answer was no.

M&S had already been burnt by an unsuccessful foray into the Canadian market that then-chairman Lord Sieff blamed on a failure to study the market properly before entry.

But Lord Rayner was set on entering the US and asked Mr Smith and his team to identify possible small acquisitions that could be used as a toe in the water.

The plan was to buy one small clothing business and one small food chain.

'Rayner was determined to trade in America because he saw the globalisation of retailing ahead of him and thought that if he didn't learn how to do it M&S would be eaten up,' said one man who worked with both Lord Rayner and Mr Smith at the time.

However, when Lord Rayner was presented with a list of about six potential targets, he rejected it because Brooks was not included and he had set his eye on the chain.

Lord Rayner then approached Robert Campeau, the Canadian businessman who owned Brooks. He had acquired it under the highly leveraged Allied Stores deal, but he refused to sell.

The next year, however, when he was working to buy Federated Department Store and needed some capital, he returned to Lord Rayner and offered him the chain for \$750m. Lord Rayner, advised by NM Rothschild and Warburgs, jumped at the opportunity without haggling over the price.

Although a few voices within M&S tried to persuade him that he was overpaying, he drove the sale through in the typically autocratic style of many M&S chairmen. 'It was very much the triumph of one man's vision and ambition,' said a person who worked on the deal.

'He said the cultures were identical and liked its distinctive brand position. But really, it came down to the fact that he shopped there and liked it.' ...

EXHIBIT 11.1 Burnt fingers

Source: *Financial Times* 24/25 November 2001

collusion easier. Whether openly or not, the firms in a concentrated market may agree among themselves to charge customers higher prices and not to undercut each other. The regulatory authorities are watching out for such socially damaging activities and have fined a number of firms for such practices, for example in the cement, vitamins and chemicals industries.

Market power is a motivator in vertical as well as horizontal mergers. Downstream mergers are often formed in order to ensure a market for the acquirer's product and to shut out competing firms. Upstream mergers often lead to the raising or creating of barriers to entry or are designed to place competitors at a cost disadvantage.

Even conglomerate mergers can enhance market power. For example, a conglomerate may force suppliers to buy products from its different divisions under the threat that it will stop buying from them if they do not comply. It can also support each division in turn as it engages in predatory pricing designed to eliminate competitors. Or it may insist that customers buy products from one division if they want products from another.

According to the European Commission, General Electric, in trying to merge with Honeywell, was attempting to put competitors at a disadvantage. In the end the Competition Commissioner blocked the bid, much to the annoyance of GE and US politicians, including George W. Bush – see Exhibit 11.2.

GE to face call for Gecas separation

European Commission sees aircraft leasing arm as possible obstacle to Honeywell deal

Deborah Hargreaves

The European Commission is expected to press General Electric to separate the accounts and management of Gecas, its aircraft leasing arm, as a condition of giving the go-head to its \$41bn (£29bn) deal to buy Honeywell.

The Commission is also believed to be looking for some divestment of part of Honeywell's avionics business and its regional jet engines business . . .

Gecas offers aircraft financing, leasing and fleet management. Brussels has been concerned about GE's ability to bundle products when offering equipment to airlines – for example, by offering a cheaper engine if an airline agrees to take Honeywell avionics – and

its use of Gecas' market power to kit out airlines with GE products.

The Commission's statement of objections to the deal says: 'Gecas is therefore used by GE to influence the outcome of airlines' airframe purchasing decisions and act as a promoter of GE-powered airframes to the detriment of GE's engine manufacturer competitors and eventually results, through the use of its disproportionate power, in excluding competing engine sales.'

Gecas will specify the use of a GE engine in aircraft it wants buy. Brussels is worried that the leasing arm will do the same for Honeywell's avionics and other aircraft equipment.

EXHIBIT 11.2 GE to face call for Gecas separation

Source: *Financial Times*, 6 June 2001

Economies of scale

An important contributor to synergy is the ability to exploit economies of scale. Larger size often leads to lower cost per unit of output. Rationalizing and consolidating manufacturing capacity at fewer, larger sites can lead to economies of production utilizing larger machines. Economies in marketing can arise through the use of common distribution channels or joint advertising. There are also economies in administration, research and development and purchasing.

Even with mergers of the conglomerate type managers claim achievable economies of scale. They identify savings from the sharing of central services such as administrative activities and accounting. Also the development of executives might be better at a large firm with a structured program of training and access to a wider range of knowledgeable and experienced colleagues. Financial economies, such as being able to raise funds more cheaply in bulk, are also alluded to.

Many businesses possess assets such as buildings, machinery or people's skills that are not used to their full limits. For example, banks and building societies own high street sites. In most cases neither the buildings nor the employees are being used as intensively as they could be. Hence we have one of the motivating forces behind bank and building society mergers. Once a merger is completed, a number of branches can be closed, to leave one rather than two in a particular location. Thus the customer flow to the remaining branch will be, say, doubled, with the consequent saving on property and labor costs.

Another synergistic reason for financial service industry mergers is the ability to market successful products developed by one firm to the customers of the other. Also when two medium-sized banks or building societies become large, funds borrowed on the capital market are provided at a lower cost per unit of transaction and at lower interest rates.

Case study 11.1 on the oil industry demonstrates the importance of even greater size in an industry that already had giants.

Case study 11.1

Economies of scale in oil

Around the turn of the millennium there was a great deal of merger activity in the oil industry. Exxon and Mobil merged; as did Chevron and Texaco; Total, Fina and Elf; and B.P., Amoco and Arco, to name a few. The financial markets encouraged the trend, seeing the benefits from economies of scale. Greater size allows the possibility of cutting recurring costs, particularly in overlapping infrastructure. It also means access to cheaper capital. However, the most important advantage it gives is the ability to participate in the difficult game of twenty-first-century exploration and production. The easily accessible oil of the world has long been tapped. Today's oil companies have to search in awkward places like the waters off West Africa and China. The capital costs are enormous and risks are high. Only large companies can put up the required money and absorb the risk of a series of failed explorations. In addition, bigger oil companies have more political clout, particularly in George W. Bush's Washington, but also in developing country capitals around the world.

Internalization of transactions

By bringing together two firms at different stages of the production chain an acquirer may achieve more efficient co-ordination of the different levels. The focus here is on the costs of communication, the costs of bargaining, the costs of monitoring contract compliance and the costs of contract enforcement. Vertical integration reduces the uncertainty of supply or the prospect of finding an outlet. It also avoids the problems of having to deal with a supplier or customer in a strong bargaining position. Naturally, the savings have to be compared with the extra costs that may be generated because of the loss of competition between suppliers – managers of units may become complacent and inefficient because they are assured of a buyer for their output.

Across Europe the heavy building materials industry is vertically integrated. The manufacturers of cement also own ready-mix concrete divisions and/or aggregates businesses. 'Cement represents the main cost item in the production of ready mix concrete, so there are powerful incentives for ready mix suppliers to secure access to supplies of cement to add to their existing supplies of aggregates.'⁶

Entry to new markets and industries

If a firm has chosen to enter a particular market but lacks the right know-how, the quickest way of establishing itself may be through the purchase of an existing player in that product or geographical market. To grow into the market organically, that is, by developing the required skills and market strength through internal efforts alone, may mean that the firm, for many years, will not have the necessary critical size to become an effective competitor. During the growth period losses may well be incurred. Furthermore, creating a new participant in a market may generate over-supply and excessive competition, producing the danger of a price war and thus eliminating profits. An example of a market-entry type of merger is Cadbury Schweppes' takeover of Adams in the USA. As a result Cadbury quickly established a position in the gum (Stimorol/Trident/Dentyne chewing gum) and cough sweet (Hall's) markets and captured an effective distribution operation without creating additional capacity.

Many small firms are acquired by large ones because they possess particular technical skills. The small firm may have a unique product developed through the genius of a small team of enthusiasts, but the team may lack the interest and the skills to produce the product on a large scale, or to market it effectively. The purchaser might be aware that its present range of products are facing a declining market or are rapidly becoming obsolescent. It sees the chance of applying its general managerial skills and experience to a cutting-edge technology through a deal with the technologically literate enthusiasts. Thus the two firms are worth more together than apart because each gains something it does not already have. Many biotechnology companies have been bought by pharmaceutical giants for this reason.

Another reason for acquiring a company at the forefront of technology might be to apply the talent, knowledge and techniques to the parent company's existing and future product lines to give them a competitive edge. Consider the Daewoo purchase of Lotus (*see* Exhibit 11.3).

Daewoo ready to pay premium for Lotus

Daewoo, the Korean industrial group, is poised to pay a substantial premium to acquire Group Lotus, the UK sports car and engineering concern.

Daewoo urgently needs to double its motor vehicle engineering staff to 8,000. It has been determined to outbid other potential investors in the financially pressed UK concern to gain access to the 1,000-strong engineering staff at Lotus, considered among the world's most talented.

Daewoo is keen to expand its design and engineering capabilities to rush into production the much wider vehicle range needed to meet its ambitious target of joining the world's top 10 car makers ...

Daewoo is expected to pay some \$75m (£48m) to Mr Romano Artioli, the Italian entrepreneur and current owner of Lotus.

EXHIBIT 11.3 Daewoo ready to pay premium for Lotus

Source: *Financial Times*, 1 October 1996

Tax advantages

In some countries, notably the USA, if a firm makes a loss in a particular year, this can be used to reduce taxable profit in a future year. More significantly, for this discussion about mergers, not only can past losses be offset against current profits within one firm in one line of business, past losses of an acquired subsidiary can be used to reduce present profits of the parent company and thus lower tax bills. There is an incentive to buy firms which have accumulated tax losses.

In the UK the rules are more strict. The losses incurred by the acquired firm before it becomes part of the group cannot be offset against the profits of another member of the group. The losses can only be set against the future profits of the acquired company. Also that company has to continue operating in the same line of business.

Risk diversification

One of the primary reasons advanced for conglomerate mergers is that the overall income stream of the holding company will be less volatile if the cash flows come from a wide variety of products and markets. At first glance the pooling of unrelated income streams would seem to improve the position of shareholders. They obtain a reduction in risk without a decrease in return.

The problem with this argument is that investors can obtain the same risk reduction in an easier and cheaper way. They could simply buy a range of shares in the independent separately quoted firms. In addition, it is said that conglomerates lack focus – with managerial attention and resources being dissipated.

A justification on more solid theoretical grounds runs as follows. A greater stability of earnings will appeal to lenders, thus encouraging lower interest rates. Because of the reduced earnings volatility there is less likelihood of the firm producing negative returns and so it should avoid defaulting on interest or principal payments. The other group that may benefit from diversification is individuals who have most of their income eggs in one basket – that is, the directors and other employees.

Bargain buying

The first column of Figure 11.1 (see p. 259) deals with the potential gains available through the combining of two firms' trading operations. The second column shows benefits which might be available to an acquiring company which has a management team with superior ability, either at running a target's operations, or at identifying undervalued firms which can be bought at bargain prices.

Inefficient management

If the management of Firm X is more efficient than the management of Firm Y then a gain could be produced by a merger if X's management is dominant after the unification. Inefficient management may be able to survive in the short run but eventually the owners will attempt to remove them by, say, dismissing the senior directors and management team through a boardroom coup. Alternatively the shareholders might invite other management teams to make a bid for the firm, or simply accept an offer from another firm that is looking for an outlet for its perceived surplus managerial talent.

A variation on the above theme is where the target firm does have talented management but they are directing their efforts in their own interests and not in the interests of shareholders. In this case the takeover threat can serve as a control mechanism limiting the degree of divergence from shareholder wealth maximization.

Undervalued shares

Many people believe that stock markets occasionally underestimate the true value of a share. It may well be that the potential target firm is being operated in the most efficient manner possible and productivity could not be raised even if the most able managerial team in the world took over. Such a firm might be valued low by the stock market because the management are not very aware of the importance of a good stock market image. Perhaps they provide little infor-

mation beyond the statutory minimum and in this way engender suspicion and uncertainty. Investors hate uncertainty and will tend to avoid such a firm. On the other hand, the acquiring firm might be very conscious of its stock market image and put considerable effort into cultivating good relationships with the investment community.

In many of these situations the acquiring firm has knowledge which goes beyond that which is available to the general public. It may be intimately acquainted with the product markets, or the technology, of the target firm and so can value the target more accurately than most investors. Or it may simply be that the acquirer puts more resources into information searching than anyone else. Alternatively they may be insiders, using private information, and may buy shares illegally.

Managerial motives

The reasons for merger described in this section are often just as rational as the ones which have gone before, except, this time, the rational objective may not be shareholder wealth maximization.

One group which seems to do well out of merger activity is the management team of the acquiring firm. When all the dust has settled after a merger they end up controlling a larger enterprise. And, of course, having responsibility for a larger business means that the managers *have* to be paid a lot more money. Not only must they have higher monthly pay to induce them to give of their best, they must also have enhanced pension contributions and myriad perks. Being in charge of a larger business and receiving a higher salary also brings increased status. Some feel more successful and important, and the people they rub shoulders with tend to be in a more influential class.

As if these incentives to grow rapidly through mergers were not enough, some people simply enjoy putting together an empire – creating something grand and imposing gives a sense of achievement and satisfaction. To have control over ever-larger numbers of individuals appeals to basic instincts: some measure their social position and their stature by counting the number of employees under them. Warren Buffett comments, ‘The acquisition problem is often compounded by a biological bias: many CEO’s attain their positions in part because they possess an abundance of animal spirits and ego. If an executive is heavily endowed with these qualities – which, it should be acknowledged, sometimes have their advantages – they won’t disappear when he reaches the top. When such a CEO is encouraged by his advisors to make deals, he responds much as would a teenage boy who is encouraged by his father to have a normal sex life. It’s not a push he needs.’⁷

John Kay points out that many managers enjoy the excitement of the merger process itself:

For the modern manager, only acquisition reproduces the thrill of the chase, the adventures of military strategy. There is the buzz that comes from the late-night meetings in merchant banks, the morning conference calls with advisers to plan your strategy. Nothing else puts your picture and your pronouncements on the front page, nothing else offers so easy a way to expand your empire and emphasise your role.⁸

Exhibit 11.4 reproduces an article about a company which seems to have suffered from a badly executed merger strategy.

Weaning Simon off an addiction

Colleagues of Mr Maurice Dixon say his hair was already white when he became chief executive of Simon Engineering.

What is surprising is that he has any hair at all, given the difficulties facing the storage, process engineering and mobile platform group.

For Mr Dixon, turning Simon round has been like trying to rehabilitate a drug addict. When he arrived three years ago, he found himself in charge of an acquisition junkie that had spent £124.4m on often unrelated businesses.

To feed that habit, Simon had run up debts of £145.3m and had breached its

banking covenants. Sales halved to £386.1m between 1989 and 1993 – the year in which losses reached £160.3m.

‘When I arrived this company had about £10m of net worth and almost £150m of debt. It was a great big mess,’ recalls Mr Dixon.

Three years into the treatment, Simon has been weaned off acquisitions and made more than a dozen disposals, raising some £40m.

It has abandoned the flawed diversification strategy and refocused on three core divisions: Simon Storage, Carves – mainly process engineering – and Access, making mobile platforms.

Exhibit 11.4 Weaning Simon off an addiction

Source: *Financial Times*, 12 November 1996

These first four managerial motives for merger – empire building, status, power and remuneration – can be powerful forces impelling takeover activity. But, of course, they are rarely expressed openly, and certainly not shouted about during a takeover battle.

Hubris

The fifth reason, hubris, is also very important in explaining merger activity. It may help particularly to explain why mergers tend to occur in greatest numbers when the economy and companies generally have had a few good years of growth, and management are feeling rather pleased with themselves.

Richard Roll in 1986 spelt out his hubris hypothesis for merger activity. Hubris means over-weaning self-confidence, or less kindly, arrogance. Managers commit errors of over-optimism in evaluating merger opportunities due to excessive pride or faith in their own abilities. The suggestion is that some acquirers do not learn from their mistakes and may be convinced that they can

see an undervalued firm when others cannot. They may also think that they have the talent, experience and entrepreneurial flair to shake up a business and generate improved profit performance (*see* Exhibit 11.5).

On toads and princesses

Many managements apparently were overexposed in impressionable childhood years to the story in which the imprisoned handsome prince is released from the toad's body by a kiss from the beautiful princess. Consequently, they are certain that the managerial kiss will do wonders for the profitability of Company T(arget). Such optimism is essential. Absent that rosy view, why else should the shareholders of Company A(cquisitor) want to own an interest in T at the 2X takeover cost rather than at the X market price they

would pay if they made direct purchases on their own? In other words, investors can always buy toads at the going price for toads. If investors instead bankroll princesses who wish to pay double for the right to kiss a toad, those kisses had better pack some real dynamite. We've observed many kisses, but very few miracles. Nevertheless, many managerial princesses remain serenely confident about the future potency of their kisses – even after their corporate backyards are knee-deep in unresponsive toads.

EXHIBIT 11.5 Warren Buffett on hubris

Source: Berkshire Hathaway, Annual Report, 1981. Reprinted by kind permission of Warren Buffett. © Warren Buffett.

Note that the hubris hypothesis does not require the conscious pursuit of self-interest by managers. They may have worthy intentions but can make mistakes in judgment.

Survival

It has been noticed by both casual observers and empiricists that mergers tend to take place with a large acquirer and a smaller target. Potential target managements may come to believe that the best way to avoid being taken over, and then sacked or dominated, is to grow large themselves, and to do so quickly. Mergers can have a self-reinforcing mechanism or positive feedback loop – the more mergers there are, the more vulnerable management feel and the more they are inclined to carry out mergers. Firms may merge for the survival of the management team and not primarily for the benefit of shareholders.

Free cash flow

Free cash flow is defined as cash flow in excess of the amount needed to fund all projects that have positive NPVs. In theory, firms should retain money within the firm to invest in any project which will produce a return greater than the investors' opportunity cost of capital. Any cash flow surplus to this should be returned to shareholders (*see* Chapter 14).

However Jensen (1986) suggests that managers are not always keen on simply handing back the cash which is under their control. This would reduce their power. Also, if they needed to raise more funds the capital markets will require justification concerning the use of such money. So instead of giving shareholders free cash flow the managers use it to buy other firms. Peter Lynch is more blunt: '[I] believe in the bladder theory of corporate finance, as propounded by Hugh Liedtke of Pennzoil: The more cash that builds up in the treasury, the greater the pressure to piss it away.'⁹

Third party motives

Advisers

There are many highly paid individuals who benefit greatly from merger activity. Advisers charge fees to the bidding company to advise on such matters as identifying targets, the rules of the takeover game, regulations, monopoly references, finance, bidding tactics, stock market announcements, and so on. Advisers are also appointed to the target firms.

Other groups with a keen eye on the merger market include accountants and lawyers. Exhibit 11.6 gives some impression of the level of fees paid.

A lucrative business for some

The amount of money spent on advisers during merger battles is truly astonishing. In 2000 Klaus Esser, the chairman of Mannesmann, felt compelled to put an upper limit on the cost of advisers assisting the company trying to fend off a bid from Vodafone. What would you regard as a reasonable limit? £10m? or maybe £15m at a push? Surely that would buy a lot of merchant bankers', lawyers', and PR advisers' time? Well, Esser set the limit at €200m (£140m). Mannesmann employed four investment banks, four legal firms and a host of other consultants. The bidder spent even more – it was reckoned that the cost of the bid (including the transaction costs of setting up a joint venture with Bell Atlantic) amounted to £400m. Admittedly some of these costs are related to raising funds, but even so we are looking at handsome take-home pay for advisers.

Royal Bank of Scotland incurred £93m of advisory fees in bidding for NatWest. Bank of Scotland bid for NatWest at the same time. Even though it failed it spent £56m on advisory fees. In 2001 Bank of Scotland eventually found a partner in Halifax. The investment banks charged £40m to assist the marriage – and this was despite the fact that it was an agreed merger. The total cost of the deal was £76m, including financial advice, printing, postage and legal fees. This means that Barclays got a 'bargain' from its advisers: for its 2000 friendly merger with Woolwich the total transaction costs were a mere £30.5m, of which £21m went to advisers.

In 2003, total UK mergers and acquisition fees amounted to about £650m – and this is a year when the M&A market was at a low ebb! 'Typically, M&A fees average between 0.3 per cent and 0.5 per cent of the value of the target.'¹⁰

EXHIBIT 11.6 Advisers don't come cheap

There is also the press, ranging from tabloids to specialist publications. Even a cursory examination of them gives the distinct impression that they tend to have a statistical bias of articles which emphasize the positive aspects of mergers. It is difficult to find negative articles, especially at the time of a takeover. They like the excitement of the merger event and rarely follow up with a considered assessment of the outcome. Also the press reports generally portray acquirers as dynamic, forward-looking and entrepreneurial.

It seems reasonable to suppose that professionals engaged in the merger market might try to encourage or cajole firms to contemplate a merger and thus generate turnover in the market. Some provide reports on potential targets to try and tempt prospective clients into becoming acquirers.

Of course, the author would never suggest that such esteemed and dignified organizations would ever stoop to promote mergers for the sake of increasing fee levels alone. You may think that, but I could not possibly comment.

Suppliers and customers

In 1999 British Steel and Hoogovens merged to form Corus. One of the key drivers of the merger was the forecast that the major car producers would combine, meaning fewer buyers who would insist steel makers should supply car plants anywhere in the world. A similar logic applied to the mergers of Bosch with American Allied Signal and Lucas with Varity in the late 1990s. There was pressure from the customers – the car producers. They were intent on reducing the number of car-parts suppliers and to put increased responsibility on the few remaining suppliers. Instead of buying in small mechanical parts from dozens of suppliers and assembling them themselves into, say, a braking system, the assemblers wanted to buy the complete unit. To provide a high level of service Bosch, which is skilled in electronics, needed to team up with Allied Signal for its hydraulics expertise. Similarly Lucas, which specializes in mechanical aspects of braking, needed Varity's electronic know-how. Ford announced that it was intent on reducing its 1,600 suppliers to about 200 and is 'even acting as marriage broker to encourage smaller suppliers to hitch-up with bigger, first-tier suppliers'.¹¹ These suppliers would then be world players with the requisite financial, technical and managerial muscle.

An example of suppliers promoting mergers is at the other end of the car production chain. Motor dealers in the UK in the late 1990s were sent a clear message from the manufacturers that a higher degree of professionalism and service back-up is required. This prompted a flurry of merger activity as the franchisees sought to meet the new standards.

Figure 11.1 provided a long list of potential merger motives (see p. 259). This list is by no means complete. Examining the reasons for merger is far from straightforward. There is a great deal of complexity, and in any one takeover, perhaps half a dozen or more of the motives discussed are at play.

Do the shareholders of acquiring firms gain from mergers?

Some of the evidence on the effects of acquisitions on the shareholders of the bidding firm is that in slightly over half of the cases shareholders benefit. However, most studies show that acquiring firms give their shareholders poorer returns on average than firms that are not acquirers. Even studies which show a gain to acquiring shareholders tend to produce very small average gains – see Table 11.2.

TABLE 11.2

Summary of some of the evidence on merger performance from the acquiring shareholders' perspective

Study	Country of evidence	Comment
Meeks (1977)	UK	At least half of the mergers studied showed a considerable decline in profitability compared with industry averages.
Firth (1980)	UK	Relative share price losses are maintained for three years post-merger.
Government Green Paper (1978) (A review of monopolies and mergers policy) (1978)	UK	At least half or more of the mergers studied have proved to be unprofitable.
Ravenscraft and Scherer (1987)	USA	Small but significant decline in profitability on average.
Limmack (1991)	UK	Long-run under-performance by acquirers.
Franks and Harris (1989)	UK and USA	Share returns are poor for acquirers on average for the two years under one measurement technique, but better than the market as a whole when the CAPM is used as a benchmark.
Sudarsanam, Holl and Salami (1996)	UK	Poor return performance relative to the market for high-rated (judged by price to earnings ratio) acquirers taking over low-rated targets. However some firms do well when there is a complementary fit in terms of liquidity, slack and investment opportunities.
Manson, Stark and Thomas (1994)	UK	Cash flow improves after merger, suggesting operating performance is given a boost.
Gregory (1997)	UK	Share return performance is poor relative to the market for up to two years post-merger, particularly for equity-financed bids and single (as opposed to regular) bidders.

TABLE 11.2 (CONTINUED)

Study	Country of evidence	Comment
Loughran and Vijh (1997)	USA	In the five post-merger years firms that offer shares as payment show negative returns relative to the market. Those that offer cash show positive market-adjusted returns.
Rau and Vermaelen (1998)	USA	Acquirers under-perform post-merger. This is due to over-optimism by investors leading to over-pricing of some acquirers regarded as glamour stocks at the time of the merger.
Sudarsanam and Mahate (2003)	UK	Generally acquirers under-perform. Cash acquirers generate higher returns than equity payment acquirers. High price to earnings ratio (and low book to market ratio) acquirers do not perform as well as low PER acquirers and low book to market ratio acquirers.
Powell and Stark (2004)	UK	Takeovers result in modest improvements in operating performance of acquirers.

KPMG sent a report to the Press in November 1999 showing the poor performance of cross-border mergers in terms of shareholder value. They then, embarrassed, tried to retrieve the report before it received publicity. Many commentators said that the evidence, that only 17 percent of cross-border mergers increased shareholder value, would not help KPMG win business assisting firms conducting such mergers.

Much of the recent research has drawn attention to differences in post-acquisition performance of acquirers that are highly rated by investors at the time of the bid ('glamour shares') and the post-acquisition performance of low rated acquirer ('value shares'), e.g. low price earnings ratios or low share price relative to balance sheet net asset value. This over-valuation of glamorous shares seems to be at least a partial explanation for subsequent under-performance. Over time investors reassess the price premium placed on the glamour shares bringing their prices down – whether they are acquirers or not.

Managing mergers

Many mergers fail to produce shareholder wealth and yet there are companies that pursue a highly successful strategy of expansion through mergers. This section highlights some of the reasons for failure and some of the requirements for success.

The three stages

There are three phases in merger management. It is surprising how often the first and third are neglected while the second is given great amounts of managerial attention. The three stages are:

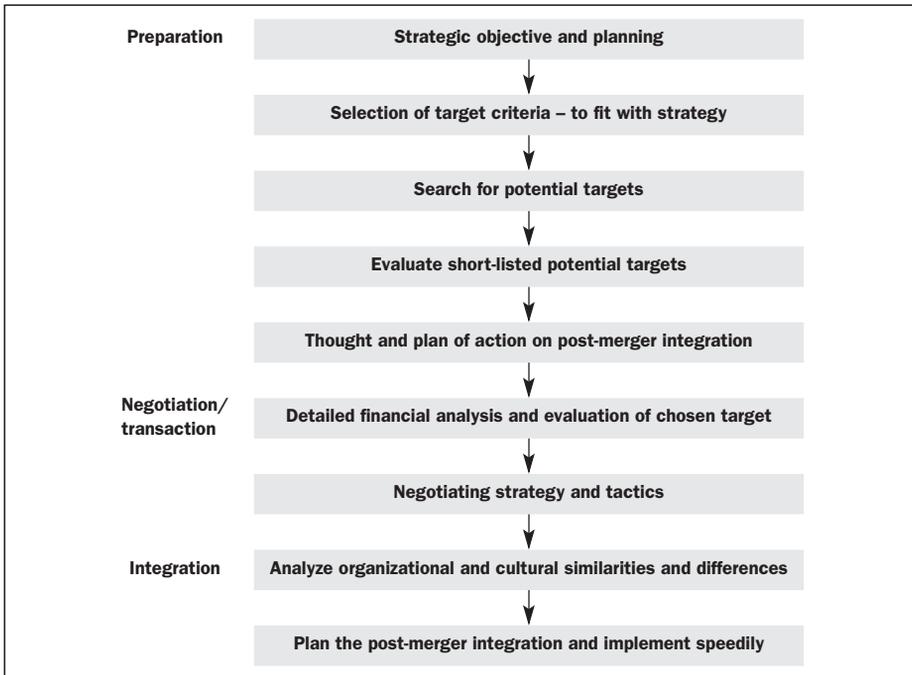
- preparation
- negotiation and transaction
- integration.

In the preparation stage strategic planning predominates. A sub-set of the strategic thrust of the business might be mergers. Targets need to be searched for and selected with a clear purpose – shareholder wealth maximization in the long term. There must be a thorough analysis of the potential value to flow from the combination and tremendous effort devoted to the plan of action which will lead to the successful integration of the target. The negotiation and transaction stage has two crucial aspects to it.

- *Financial analysis and target evaluation* This evaluation needs to go beyond mere quantitative analysis into fields such as human resources and competitive positioning.
- *Negotiating strategy and tactics* It is in the area of negotiating strategy and tactics that the specialist advisers are particularly useful. However the acquiring firm's management must keep a tight rein and remain in charge.

The integration stage is where so many mergers come apart. It is in this stage that the management need to consider the organizational and cultural similarities and differences between the firms. They also need to create a plan of action to obtain the best post-merger integration. The key elements of these stages are shown in Figure 11.2.

Too often the emphasis in managing mergers is firmly on the 'hard' world of identifiable and quantifiable data. Here economics, finance and accounting come to the fore. There is a worrying tendency to see the merger process as a series of logical and mechanical steps, each with an obvious rationale and a clear and describable set of costs and benefits. This approach all but ignores the potential for problems caused by non-quantifiable elements, for instance, human reactions and interrelationships. Matters such as potential conflict, discord, alienation and disloyalty are given little attention.¹² There is also a failure to make clear that the nature of decision-making in this area relies as much on informed guesses, best estimates and hunches as on cold facts and figures.

FIGURE 11.2**The progression of a merger****The organizational process approach**

The organizational process approach takes into account the ‘soft’ aspects of merger implementation and integration. Here the acquisition process, from initial strategic formulations to final complete integration, is perceived as a complex, multi-faceted program with the potential for a range of problems arising from the interplay of many different hard and soft factors. Each merger stage requires imaginative and skilled management for the corporate objective to be maximized (Sudarsanam (2003) is an excellent guide).

Problem areas in merger management

We now examine some of the areas where complications may arise.

The strategy, search and screening stage

The main complicating element at the stage of strategy, search and screening is generated by the multitude of perspectives regarding a particular target candidate. Each discipline within a management team may have a narrow competence and focus, so there is potential for a fragmented approach to the evaluation of targets. For example, the marketing team may focus exclusively on the potential for marketing economies and other benefits, the research and development team on

the technological aspects and so on. Communication between disparate teams of managers can become complicated and the tendency will be to concentrate the communication effort on those elements which can be translated into the main communicating channel of business: quantifiable features with 'bottom lines' attached. This kind of one-dimensional communication can, however, all too easily fail to convey the full nature of both the opportunities and the problems. The more subtle aspects of the merger are likely to be given inadequate attention.

Another problem arises when senior managers conduct merger analysis in isolation from managers at the operating level. Not only may these 'coal-face' managers be the best informed about the target, its industry and the potential for post-merger integration problems; their commitment is often vital to the integration program.

There is an obvious need to maximize the information flow effort, both to obtain a balanced, more complete view of the target, and to inform, involve and empower key players in the successful implementation of a merger strategy. An example of an incomplete view of the target prior to merger which led to an underestimation of the potential for cannibalization of sales of the acquirer and the tying up of managerial time is the case of the combination of JD Sports and First Sports – see Exhibit 11.7.

Warning hurts John David shares

Maija Pesola

Shares in John David Group lost a sixth of their value yesterday as the sporting goods retailer, which owns the JD Sports brand, warned that this year's profits were likely to fall 'significantly below' expectations.

The warning – the third in eight months – came as the company admitted it had underestimated the problems involved in integrating the First Sport chain of stores it bought last year. ...

The group bought the 209 First Sport stores from Blacks Leisure in May 2002 to take them upmarket. But it has struggled with the revamp, as attempts to rebrand First Sport into a football-focused retailer have foundered.

Roger Best, chairman, yesterday admitted the lengthy integration process had led to too many of the senior management being 'distracted' from their

primary duties, leading to poor purchasing and merchandising decisions.

He said First Sport stores had cannibalised sales at existing JD Sports shops more than expected. 'There are a large number of cross-over sites. It is something that we underestimated, and it is only in the last few months that we have realised the true extent of the problem,' Mr Best said.

The company is to close a larger number of First Sports stores than anticipated. Some 15 have already gone, with a further 38 planned to go by March 2005. ...

Analysts, who have branded the First Sports acquisition as 'disastrous' for the group, yesterday downgraded their forecasts for this year's profits to between £8.5 and £9m, compared with previous consensus estimates of £18m. ...

EXHIBIT 11.7 Warning hurts

Source: *Financial Times* 7 August 2003

The bidding stage

Once a merger bid is under way a strange psychology often takes over. Managers seem to feel compelled to complete a deal. To walk away would seem like an anticlimax, with vast amounts of money spent on advisers and nothing to show for it. Also they may feel that the investment community will perceive this management as being one unable to implement its avowed strategic plans. It may be seen as 'unexciting' and 'going nowhere' if it has to retreat to concentrate on its original business after all the excitement and promises surrounding a takeover bid.

Managers also often enjoy the thrill of the chase and develop a determination to 'win'. Pay, status and career prospects may hinge on rapid growth. Additionally, acquirers may be impelled to close the deal quickly by the fear of a counter-bid by a competitor, which, if successful, would have an adverse impact on the competitive position of the firm.

Thus mergers can take on a momentum that is difficult to stop. This is often nurtured by financial advisers keen on completing a transaction.

These phenomena may help to explain the heavy emphasis given to the merger transaction to the detriment of the preparation and integration stages. They may also go some way to explaining merger failure – in particular, failure to enhance shareholder value as a result of the winner's curse.

Expectations of the acquiring firm's operational managers regarding the post-merger integration stage

Clarity and planning are needed to avoid conflict and disappointment among managers. For example, the integration strategy may outline a number of different tasks to be undertaken in the 12–24 months following an acquisition. These may range from disposal of assets and combining operating facilities to new product development and financial reconstruction. Each of these actions may be led by a different manager. Their expectations regarding the speed of implementation and the order in which each of these actions will be taken may be different. A clear and rational resource-planning and allocation mechanism will reduce ambiguity and improve the co-ordination of decision-making.

Aiming for the wrong type of integration

There are different degrees of integration when two firms come together under one leadership. At one extreme is the complete *absorption* (or *integration*) of the target firm and the concomitant fusing of two cultures, two operational procedures and two corporate organizations. At the other, is the *holding company, preservation* or *portfolio approach* where the degree of change of the acquired subsidiary may amount merely to a change in some financial control procedures, but otherwise the target firm's management may continue with their own systems, unintegrated operations and culture.

The complete absorption approach is usually appropriate in situations where production and other operational costs can be reduced through economies of scale and other synergies, or revenues can be enhanced through, say, combined

marketing and distribution. The preservation approach is most suitable when it is recognized that the disbenefits of forcing organizations together outweigh the advantages, for example when the products and markets are completely different and the cultures are such that a fusion would cause an explosive clash. These arm's-length mergers are typical of the acquisitive conglomerates. In such mergers general management skills are transferred along with strict financial performance yardsticks and demanding incentive schemes, but little else has changed.

With *symbiosis-based* mergers there is a need to keep a large degree of difference, at least initially, in culture, organization and operating style, but at the same time to permit communication and cross-fertilization of ideas. There may also be a need to transfer skills from one part of the combined organization to another, whether through training and teaching or by personnel reassignment. An example might be where a book publisher acquires an internet service provider; each is engaged in a separate market but there is potential for profitable co-operation in some areas. As well as being aware of the need for mutual assistance, each organization may be jealous of its own way of doing things and does not want its *esprit de corps* disrupted by excessive integration.

Exhibit 11.8 expresses the failure of some acquirers to allow adequately for the complicating human factor.

Why do mergers fail to generate value for acquiring shareholders?

A definitive answer as why mergers fail to generate value for acquiring shareholders cannot be provided, because mergers fail for a host of reasons. However there do appear to be some recurring themes.

The strategy is misguided

History is littered with strategic plans that turned out to be value destroying rather than value creating. Daimler-Benz in combining Mercedes with Fokker and Dasa tried to gain synergies from an integrated transport company then it tried to become a global car producer by merging with Chrysler. Marconi sold off its defense businesses to concentrate on telecommunication equipment. It spent a fortune buying companies at the forefront of technology only to slam into the hi-tech recession in 2001 – its shares lost 98 percent of their value. At the turn of the millennium, Time Warner thought it needed to pay a very high price to merge with AOL so that it could take a leading part in the convergence of media and information/communication technology. Building societies, banks and insurance companies in the UK bought hundreds of estate agents in the 1980s in the belief that providing 'one-stop shopping' for the house-owner would be attractive. Many of these agency chains were sold off in the 1990s at knock-down prices. Fashion also seems to play its part, as with the conglomerate mergers of the 1960s, the cross-border European mergers of the early 1990s prompted by the development of the single market and the dot.com merger frenzy around the turn of the millennium.

Marrying in haste

Mergers and acquisitions continue apace in spite of an alarming failure rate and evidence that they often fail to benefit shareholders, writes

Michael Skapinker

A long list of studies have all reached the same conclusion: the majority of takeovers damage the interests of the shareholders of the acquiring company. They do, however, often reward the shareholders of the acquired company, who receive more for their shares than they were worth before the takeover was announced ...

Why do so many mergers and acquisitions fail to benefit shareholders? Colin Price, a partner at McKinsey, the management consultants, who specialises in mergers and acquisitions, says the majority of failed mergers suffer from poor implementation. And in about half of those, senior management failed to take account of the different cultures of the companies involved.

Melding corporate cultures takes time, which senior management does not have after a merger, Mr Price says. 'Most mergers are based on the idea of "let's increase revenues", but you have to have a functioning management team to manage that process. The nature of the problem is not so much that there's open warfare between the two sides. It's that the cultures don't meld quickly enough to take advantage of the opportunities. In the meantime, the marketplace has moved on.'

Many consultants refer to how little time companies spend before a merger thinking about whether their organisations are compatible. The benefits of mergers are usually couched in financial or commercial terms: cost-savings can be made or the two sides have complementary businesses that will allow them to increase revenues ...

Mergers are about compatibility, which means agreeing whose values will prevail and who will be the dominant partner. So it is no accident that managers as well as

journalists reach for marriage metaphors in describing them. Merging companies are said to 'tie the knot'. When mergers are called off, as with Deutsche Bank and Dresdner Bank, the two companies fail to 'make it up the aisle' or their relationship remains 'unconsummated'.

Yet the metaphor fails to convey the scale of risk companies run when they launch acquisitions or mergers. Even in countries with high divorce rates, marriages have a better success rate than mergers. And in an age of frequent pre-marital cohabitation, the bridal couple usually know one another better than the merging companies do.

A more appropriate comparison might be with second marriages, particularly where children are involved. This was the description used by John Reed, former chairman of Citicorp, which merged with Travelers Group in 1998 to create Citigroup. Mr Reed and Sandy Weill, head of Travelers, agreed to be joint chairmen of the merged company, a relationship that ended this year when Mr Reed retired.

Speaking to the US Academy of Management last year, before his departure, Mr Reed said: 'The literature on putting together two families speaks volumes to me. The problems of step-parents, the descriptions of some children rejecting other parents, and all of the children being generally ticked off, is all meaningful ... Sandy and I both have the problem that our "children" look up to us as they never did before, and reject the other parent with equal vigour.'

But Prof Sirower, who has written a book on acquisitions called *The Synergy Trap*, rejects the view that the principal problem is post-merger implementation. 'Many large acquisitions are dead on arrival, no matter how well they

are managed after the deal is done,' he says. Prof Sirower asks why managers should pay a premium to make an acquisition when their shareholders could invest in the target company themselves. How sure are managers that they can extract cost savings or revenue improvements from their acquisition that match the size of the takeover premium?

Prof Sirower denies he is saying companies should never make acquisitions. If 65 per cent of mergers fail to benefit shareholders, 35 per cent are successful.

How can acquirers try to ensure they are among the successful minority? Ken Favaro, managing partner of Marakon, a consultancy that has worked for Coca-Cola, Lloyds TSB and Boeing, suggests two conditions for success. The first is to define what success means. 'The combined entities have to deliver better returns to the shareholders than they

would separately. It's amazing how often that's not the pre-agreed measure of success,' Mr Favaro says.

Second merging companies need to decide in advance which partner's way of doing things will prevail. 'Mergers of equals can be so dangerous because it is not clear who is in charge,' says Mr Favaro.

Prof Sirower adds that managers need to ask what advantages they will bring to the acquired company that competitors will find difficult to replicate ...

Given how heavily the odds are stacked against successful mergers, managers should consider whether their time and the shareholders' money would not be better employed elsewhere – improving customer service, for example. Above all, they need to ask whether they are launching a takeover because their acquisition will improve their performance or because they cannot think what else to do.

EXHIBIT 11.8 Marrying in haste

Source: *Financial Times* 12 April 2000

Over-optimism

Acquiring managers have to cope with uncertainty about the future potential of their acquisition. It is possible for them to be over-optimistic about the market economics, the competitive position and the operating synergies available. They may underestimate the costs associated with the resistance to change they may encounter, or the reaction of competitors. Merger fever, the excitement of the battle, may lead to openness to persuasion that the target is worth more than it really is. A common mistake is to underestimate the investment required to make a merger work, particularly in terms of managerial time.

Failure of integration management

One problem is the over-rigid adherence to prepared integration plans. Usually plans require dynamic modification in the light of experience and altered circumstances. The integration program may have been based on incomplete information and may need post-merger adaptation to the new perception of reality.

Common management goals and the engendering of commitment to those goals is essential. The morale of the workforce can be badly damaged at the time of a merger. The natural uncertainty and anxiety has to be handled with under-

On masquerading skimmed milk, lame horses and sexy deals

We believe most deals do damage to the shareholders of the acquiring company. Too often, the words from *HMS Pinafore* apply: 'Things are seldom what they seem, skim milk masquerades as cream.' Specifically, sellers and their representatives invariably present financial projections having more entertainment value than educational value. In the production of rosy scenarios, Wall Street can hold its own against Washington.

In any case, why potential buyers even look at projections prepared by sellers baffles me. Charlie and I never give them a glance, but instead keep in mind the story of the man with an ailing horse. Visiting the vet, he said: 'Can you help me? Sometimes my horse walks just fine and sometimes he limps.' The Vet's reply was pointed: 'No problem – when he's walking fine, sell him.' ...

Talking to *Time Magazine* a few years back, Peter Drucker got to the heart of things: 'I will tell you a secret: Dealmaking beats working. Dealmaking

is exciting and fun, and working is grubby. Running anything is primarily an enormous amount of grubby detail work ... dealmaking is romantic, sexy. That's why you have deals that make no sense.'

... I can't resist repeating a tale told me last year by a corporate executive. The business he grew up in was a fine one, with a long-time record of leadership in its industry. Its main product, however, was distressing glamorless. So several decades ago, the company hired a management consultant who – naturally – advised diversification, the then-current fad. ('Focus' was not yet in style.) Before long, the company acquired a number of businesses, each after the consulting firm had gone through a long – and expensive – acquisition study. And the outcome? Said the executive sadly 'When we started we were getting 100% of our earnings from the original business. After ten years, we were getting 150%.'

EXHIBIT 11.9 Skimmed milk masquerades as cream

Source: Letter to shareholders, *Berkshire Hathaway Annual Report 1995*. © Warren Buffett

standing, tact, integrity and sympathy. Communication and clarity of purpose are essential as well as rapid implementation of change. Cultural differences need to be tackled with sensitivity and trust established. Lord Browne, of BP, advises quick integration: 'It's very important to mix the cultures early on. If the entities that existed previously still exist, then there is great reluctance to change anything.' He also suggests using a third party to help select the best managers. Following the merger with Amoco, BP sent 400 top executives to an independent recruitment agency for assessment. 'When you merge with a company, you basically play with half a deck [of cards] because you know all your people, and they know all theirs. So how do you find a way of actually knowing everything about everyone – the answer is get a third party in.'¹³

The absence of senior management commitment to the task of successful integration severely dents the confidence of target and acquired managers.

Coopers & Lybrand, the international business advisers, in 1992 conducted 'in-depth interviews with senior executives of the UK's top 100 companies covering 50 deals'. Some factors emerged which seem to contribute to failure, and others which are critical for raising the chances of success. These are shown in Figure 11.8.

FIGURE 11.3**Survey on the reasons for merger failure and success – Coopers & Lybrand**

The most commonly cited causes of failure include:		The most commonly cited reasons for success include:	
Target management attitudes and cultural differences	85%	Detailed post-acquisition plans and speed of implementation	76%
Little or no post-acquisition planning	80%	A clear purpose for making acquisitions	76%
Lack of knowledge of industry or target	45%	Good cultural fit	59%
Poor management and poor management practices in the acquired company	45%	High degree of management co-operation	47%
Little or no experience of acquisitions	30%	In-depth knowledge of the acquiree and his industry	41%

The ten rules listed in Figure 11.4 are NOT recommended for shareholder wealth-oriented managers.

FIGURE 11.4**Arnold's ten golden rules for alienating 'acquired' employees**

1. Sack people in an apparently arbitrary fashion.
2. Insist (as crudely as possible) that your culture is superior. Attack long-held beliefs, attitudes, systems, norms, etc.
3. Don't bother to find out the strengths and weaknesses of the new employees.
4. Lie to people – some old favourites are:
 - 'there will not be any redundancies';
 - 'this is a true merger of equals'.
5. Fail to communicate your integration strategy:
 - don't say why the pain and sacrifice is necessary, just impose it;
 - don't provide a sense of purpose.
6. Encourage the best employees to leave by generating as much uncertainty as possible.
7. Create stress, loss of morale and commitment, and a general sense of hopelessness by being indifferent and insensitive to employees' need for information.
8. Make sure you let everyone know that you are superior – after all, you won the merger battle.
9. Sack all the senior executives immediately – their knowledge and experience and the loyalty of their subordinates are cheap.
10. Insist that your senior management appear uninterested in the boring job of nuts-and-bolts integration management. After all, knighthoods and peerages depend upon the next high-public-profile acquisition.

Exhibit 11.10 highlights some aspects not yet covered, including:

- a management and personnel audit;
- an alternative to merger is a strategic alliance;
- acquirers that fail to deliver value often become targets themselves.

A sometimes fatal attraction

Vanessa Houlder

The problems with takeovers go beyond faulty strategic logic or paying too high a price. Even good deals founder if they are poorly managed after the merger ...

The task of successfully implementing an acquisition or merger is formidable. If the acquiring company's shareholders are to make money from the deal, sales must be increased and costs reduced to a level that compensates for the premium over the share price paid for the company. This is rarely less than 20 per cent.

Unless there is a large overlap between the companies there are few easy savings. The targets of hostile bids are not necessarily poor performers, according to a study of takeovers in the mid-1980s by the London Business School ...

[Most] companies delude themselves about the scale and nature of the task. They focus on revenue-enhancement opportunities rather than cost reduction, according to David Wightman, global head of strategy practice at PA Consulting Group. 'In fact revenue synergies are not often achieved in any great quantity, and frequently not at all.'

Companies also often delude themselves about the speed at which they should act. The desire to respect the culture of the acquired company and prevent the defection of important staff often slows the pace of integration ...

The disadvantage with a slow approach to integration is that it tends to dissipate momentum and enthusiasm. Moreover, delays can dilute the financial benefits of a deal ...

Nonetheless, the practical difficulty of integrating companies with different cultures cannot be underestimated.

Recent research by London's Imperial College into European cross-border deals found that differences in management style – the formality of procedures, the adherence to job descriptions, the structure of communications – bore a strong correlation to deals' chances of failure ...

[Consultants] urge managers to adopt different styles of management for different types of deal. Bill Pursche of McKinsey argues that different styles are appropriate depending on the degree of business overlap, the relative size of companies, the companies' skills, the urgency and source of the expected returns and the style of leadership.

For example, if cost savings are the main rationale of the merger, targets should be set at the top and passed through the organisation. If the goal is to achieve revenue synergies or longer-term skill transfers, then a more participatory approach, drawing recommendations from the 'grass roots', is appropriate. Pursche calls this 'empowering the troops' and says it can result in strong morale. But it is more common in merging companies to find poor morale, rising staff turnover and falling productivity.

There is probably no easy solution to poor morale. Reassuring staff about job security may not be possible – and may be counterproductive if proved false. Even so, companies are invariably advised to try to reduce uncertainty and explain the merger's rationale, through newsletters and meetings between senior executives and employees.

Unsurprisingly, pay is one of the most marked influences on morale. A London Business School study in 1987

found that in two-thirds of successful takeovers, the acquired management reported either improved performance incentives, better pension entitlements, better career prospects, or the introduction of share options.

The same study highlighted another important influence on the ultimate success of the acquisition: a thorough audit of the target company before the takeover.

Whereas all the buyers in the LBS study conducted financial audits of the acquired companies before they bought them, only 37 per cent carried out a management or personnel audit. Moreover, although buyers stressed the importance of the purchased company's middle management, 70 per cent did not meet these managers before the takeover.

The paucity of pre-merger planning causes frustration, particularly among managers concerned with human resources. A seminar of directors and financiers involved in takeovers sponsored by People in Business, a consultancy, uncovered a strongly held view that deals were too focused on financial measures ...

However, institutional investors are imposing a tougher discipline on bidders than 10–15 years ago, according to Julian Franks of London Business School. 'People who acquire badly, frequently become targets themselves,' he says.

Another feature of the 1990s is the growth in strategic alliances as a cheaper, less risky route to a strategic goal than takeovers.

EXHIBIT 11.10

Source: *Financial Times*, 11 September 1995

Conclusion

At a minimum this chapter should have made it clear that following a successful merger strategy is much more than simply 'doing the deal'. Preparation and integration are usually of greater significance to the creation of value than the negotiation and transaction stage. And yet, too often, it is towards this middle stage that most attention is directed.

Doubts have been raised about the purity of the motives for mergers but we should restrain ourselves from being too cynical as many mergers do create wealth for shareholders and society. Industries with a shifting technological or market base may need fewer larger firms to supply goods at a lower cost. The savings from superior managerial talent are genuine and to be praised in many cases. Restructuring, the sharing of facilities, talent and ideas, and the savings from the internalization of transactions are all positive outcomes and often outweigh the negative effects.

Like many tools in the armory of management, growth through mergers can be used to create or destroy.

Websites

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www.londonstockexchange.com	London Stock Exchange
www.thetakeoverpanel.org.uk	The Takeover Panel

Notes

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- 13 Lord Browne quoted in Buchan, D. and Buck, T. 'Refining BP's management', *Financial Times*, 1 August 2002, p. 21.