Why acquisitions fail to create value and what can be done about it?
Or
The Art of Mergers and Acquisitions

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That so many mergers and acquisitions have failed to deliver value for the shareholders of the acquiring firm (or merged firms) has become a dominant theme, the conventional wisdom of the post 2000 era. That is, of course, until the next wave of acquisitions washes in with its "implacable" logic and seductive rationale.

The evidence of failure at the game of M&A is harsh and overwhelming, or so it seems:

- Two **thirds** of all transactions completed during the 1980's ended up destroying value for the acquirer(Sirower,1997);
- Of 150 deals of over US 500M in the 1990's, **half** eroded the returns of the acquirer and only **17%** increased returns substantially (Accenture, 2001);
- From a study of 700 cross-border deals between 1996 and 1998, KPMG concludes that **53%** destroyed value; furthermore, they found that cross-border deals involving a U.K. and a U.S. company were **32% more likely** to succeed while deals involving U.S. and continental European firms were **11% less likely** to succeed.
- Based on a survey of 118 companies worldwide conducted in early 2001, KPMG estimates that **30%** of M&A transactions these companies engaged in have created value, 39% produced no discernible difference and **31%** actually destroyed value; they further observe that **24%** of

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companies in Europe and **35%** of companies in the US created value. A similar survey conducted two years earlier had found that only **17%** of transactions had created value.

Here is a question to the reader. Why did companies keep on acquiring other companies at an unprecedented rate throughout the 1990s and early 2000s despite this overwhelming evidence? What can explain this behavior on the part of highly paid, presumably sagacious, expensively advised CEOs? In our experience and based on abundant empirical evidence, the answer to that question is multiple.

1. The evidence may not be as compelling as it is made out to be.

The fact that the compilation of raw data tends to show that shareholders of acquired firms make substantial gains while shareholders of the acquirer experience losses, may actually result from the time perspective of those studies, as well as the difficulty of fully accounting for payment-in-stock transactions. Clearly, in a competently managed transaction, the seller has a good understanding of the value of his firm to the acquirer and will work to extract as much of that value as possible for its shareholders ***at the time of the transaction.***

For the acquirer's shareholders, the benefits may accrue over time and are often contingent upon successful integration. Furthermore, in the US and Canada, the risk of shareholder suits against the management and the board of directors of the seller provides a great incentive to get the maximum price for the company.

So, at the time of the transaction, shareholders of the acquired firm get an immediate premium while financial markets take a wait and see posture until the acquirer can demonstrate that the benefits factored into the price of the acquisition are indeed being achieved. Past experience has taught investors that the much touted "synergies", the hocus pocus word of the M&A magic show, may appear belatedly and in a shrunken form, or worse, may never materialize at all. Unless the

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evidence of “synergy” is compelling and/or the acquirer has a superb track record of successful acquisitions, the acquirer’s market value will be reduced on the announcement of the transaction often *by the very value of the premium paid for the target comp*any.

The problem is compounded if the payment for the transaction takes the form of the acquirer’s stock. If competently advised, the acquired firm will request a higher premium for the risk it is taking that the acquirer’s stock price may go down between the time the terms of the transaction are set and the moment it is finally consummated, sometimes several months later (particularly when regulatory issues are significant).

This risk is indeed considerable and produces a kind of vicious circle. The larger the premium, the more shares issued to the shareholders of the acquired firm; the more shares, the more dilution of the shareholders of the acquiring firm; the more dilution, the more the value of the deal depends on the size and credibility of the benefits and “synergies” claimed for the acquisition, and the larger the putative “synergies”, the more sceptical the markets about the acquirer’s ability to produce those benefits.

Clearly, the well advised or experienced seller will anticipate this market reaction and will ask a price that reflects this market phenomenon, and on spins the vicious circle. The acquirer ends up paying a premium it cannot recoup and thus destroys value.

However, this so-called unassailable evidence [that acquisitions tend to destroy value in many instances] does not deter many would-be acquirers.

Statistics are the refuge of timid souls in the minds of *can-do*, or *it-won’t-happen-to-me,* CEO’s. Men at the top of corporations (and soon we shall have enough empirical data to determine if that applies to women also) often exhibit the dual syndrome of exceptionalism and hubris.

Car accidents do happen, but to others, not to me, even though I drive fast and recklessly. Is it not also a fact that one third to one half of all acquisitions does produce value for the acquirer? Then,

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there is no reason why our deal would not be of that kind if we are thorough, careful and competent in our handling of the transaction and we have every intention of exhibiting those qualities in spade.

Is it not a fact that the risk of failure in starting a business is far greater than the odds given to a successful M&A transaction? Yet, no one questions the social and economic merits of entrepreneurship despite, or Schumpeter would say because of, the risk of failure.

Is it not a fact that very few new products launched are actually successful? Yet, this very rate of failure is hailed as a sign of the innovative spirit so essential to a dynamic economy.

The case can be made that these three economic activities, entrepreneurship, new product launch, and M&A's, are engines of productivity enhancement, of efficient allocation of capital, of adaptation to new economic contexts. Indeed, a recent and very thorough study by the US Conference Board concludes that over the period from 1977 to 1987, mergers and acquisitions have tended to boost significantly U.S. competitiveness (Conference Board, August 2001).

All three activities, however, punish very severely financial incompetence, poor judgment and mediocre management

No doubt there is a risk of hubris in this business of M&A, the sense of omnipotence born of past successes. Jack Welch in his book, *Jack: Straight from the Gut*, admits that a string of successful acquisitions, including RCA, generated in him an assurance that he could acquire and manage anything. GE's acquisition of Kidder-Peabody, in a typical "success breeds failure" fashion, was a disaster. No doubt that underneath the economic and strategic rationale for acquisitions lurk darker forces, which may have a decisive impact on the success or failure of these operations.

2. The M&A industry's relentless promotion

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"Mergers and acquisitions" (M&As) is a product hustled and promoted by a whole industry of competing firms with huge economic stakes in generating demand for that product. Investment bankers relentlessly court business leaders, plying their stock-in-trade, the "book" of potential targets, their valuation, their financial benefits to the acquirer, and so on.

Their siren song of the "bold move", the "smart strategy", the "creation of value for shareholders", is hard to resist. During the euphoric 90s, many CEOs succumbed to their entreaties. They and their shareholders have paid dearly for many ill-advised acquisitions.

Let's face it: acquisitions are fun, exhilarating, dramatic, adrenalin-boosting. You can almost develop a dependency, a bad habit on this heady stuff. More than one CEO has become so enamored of the game of acquisitions that the daily chore of running the business becomes boring. It is then delegated to a "chief operating officer" while the CEO "concentrates on strategic issues", namely doing more acquisitions.

3. Time is of the essence

But whatever malicious amusement can be extracted from the human frailties of CEOs, these peripheral motives do not fundamentally drive M&A operations. These transactions originate, for the most part, in serious assessment of benefits. Different economic times may change the character of those benefits. In times past, before the advent of strict, regulatory oversight, the elimination of bothersome competitors may have been a prime mover of these transactions. In our epoch, the overwhelming reason to engage in such transactions has to do with the press of time on those who lead corporations.

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This time pressure comes from two sources:

1. First, anytime a company's strategy calls for new capabilities, for expansion into new markets, for the addition of different products or services, the alternative, quite prevalent in previous epochs, of doing so through internal development is deemed too slow. Competitors may move faster and beat up on you. Furthermore, the executives' time horizon does not extend that far into the future. The choice of acquiring assets rather than building them provides firms with the ability, at least conceptually, to move fast in new directions, to implement a different strategy. No more is a firm dependent on, and constrained by, choices and investments made a while back. It can reinvent itself and redefine its future by playing in the game of asset swaps.

2. Financial markets were the be-all and the end-all of senior executives throughout the 90s and to this day. Financial markets, in the best of times, are impatient. More than ever, acquisitions played a strategic role in meeting the "street's" expectations. In the late 90s, the phenomenon got out of control when massive amounts of savings flowed in stock funds to be managed by people barely out of adolescence. Growth became the mantra, the elixir of value. How do you achieve fast growth to get and sustain a high price-earnings ratio for your stock? Through innovation, new products, new markets, new services! Yes, but that is uncertain and a tad too slow for our expectant analysts and fund managers. "But there is also the *accretive acquisition*," the friendly investment banker will murmur in your ear. You buy a company and pay for it with your inflated stock. Make sure that the target's net profits divided by the number of shares you will dish out to pay for it is more than your earnings per share before the acquisition (all of that before amortization of goodwill). Net, net after the deal, both your revenues <u>and</u> (cash!) earnings per share will have increased, giving further momentum to your growth and stock price. But that momentum must be sustained by a stream of acquisitions. Companies which bought into that Ponzi scheme paid dearly,

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or at least their shareholders did. Nortel and JDS Uniphase come to mind here, but they are not exceptional cases.

Ill-advised transactions, warped motivations, the reckless pursuit of growth through acquisitions, incompetent integration may explain a good number of spectacular failures at the game of acquisitions.

However, we want to zero in on the reasons why acquisitions and mergers are so troublesome and failure-prone ***even when based on compelling economics, planned carefully, and carried out very professionally***.

We contend that four issues and challenges account for the failure or mediocre results from well-planned, economically sound acquisitions.

These four challenges, or stumbling blocks, have tripped many acquirers and have transformed worthwhile transactions into mediocre or dismal operations:

1. The psychology of deal-making
2. The experience curve of acquirers
3. The integration challenge
4. The governance challenge

1. The Psychology of Deal-Making

Important deals in business usually begin, are made, or are aborted in CEO-to-CEO meetings, often one on one. Of course, many people, sundry executives, lawyers, bankers, advisers of all stripes,

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play their assigned role; but the interplay of personalities at the top of the organizations can have a determining impact on whether a transaction gets done and even on the terms of the transaction. The chemistry, the sway of one's personality over the other, the character and reputation of the protagonists all work in mysterious ways in these highly charged meetings. You can actually feel the current of positive or negative energy between the two leaders. If you watch carefully, you will catch the subtle signs of assertiveness/submissiveness, trust/mistrust. No doubt there is a form of wooing, of seduction, going on which, if successful, makes deals happen and at favourable terms.

The successful player in the game of M&A counts on the force of his/her personality to make deals others would have failed to close; but in some circumstances, this phenomenon may result in terms and conditions for a transaction that will penalize the acquirer or target firm and produce a value destroying deal for one of the parties. This aspect of the acquisition game has received little attention in the business literature; however, experienced leaders are very aware of this phenomenon.

2. The Experience Curve of Acquirers

All complex activities are subject to the law of the learning curve. Ability and performance improve very rapidly until it levels off after considerable practice. This phenomenon clearly applies to mergers and acquisitions. The successful companies at the game of acquisitions tend to have the following characteristics:

a) They have carried out a number of acquisitions over the years.

b) They are continuously assessing a number of potential transactions.

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c) From the start, they assembled some in-house capability to carry out those transactions. They made sure they would capture the full benefits of the experience gained at each transaction.

d) The team doing the transactions has been quite stable over the years.

e) They use investment bankers and other consultants sparingly and in a clearly defined subsidiary role. Investment bankers do not run the show.

The least effective acquirers, by contrast, never develop their internal capability; they rely heavily on investment bankers and other consultants.

Every transaction brings together a new team of people. Even if resorting to the same bankers and consultants, the turnover in these firms tends to be high and therefore new players are always brought to the table.

Although the advisers may be very adept at these sorts of transactions, their experience is never a substitute for the lack of experience of the principal, their client.

3. The Integration Challenge

In essence, economic calculus drives mergers and acquisitions. Economic arguments, whether valid or not, provide their rationale: economies of scale and scope, acquiring or leveraging assets, acquiring new competencies and technologies, penetration of new markets, consolidation of industry and so on. In the lexicon of M&As, firms buy assets or "properties". One gets the impression that acquiring another company is little different than buying real estate or a piece of

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machinery. But a firm is made up of people and organizations with their culture, values, mindsets, habits and expectations. In this day and age, more than ever, the value of acquired companies resides in the talent, know-how, and expertise of the people in that company.

Let's be clear: sound economics is ***a necessary but not sufficient*** condition of success. The ultimate success of these operations hinges on the acquirer's skills at dealing with people and organizations. **It comes from the acquirer being adept not only at the art of making deals but also at the art of making organizations work.** That is the core challenge of what has been called the *integration issue* in M&As.

Of course, the challenge here depends on the size of the acquired company, on the speed and degree of intended integration, and on the differences or similarities in values and culture between the two organizations. As one observer of the AOL-Time Warner merger put it "Getting these media people to work together will be like *herding cats*."

There is a dilemma here. Most acquisitions derive their economic value (i.e. the justification for the price paid for them) from deep and speedy integration of operations. Yet, in practice, the difficulties and hurdles of integrating two distinct entities may well slow down, or even force to abort, the whole process, thus destroying a good part of the economic value of the acquisition.

Why is that so prevalent? Mostly because management of the acquiring company concludes it cannot push for faster integration as this will seriously disrupt overall performance and may lead to the departure of key talent from the acquired company (or from their own); but their reluctance to

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demand faster integration, albeit grounded in real issues, quickly erodes the very value of the acquisition.

Let’s face it, putting together, meshing, two sizeable organizations brings forth all sorts of clashes – clashes of egos, of power groups, of cultures and values, of operating systems, of ways of doing and behaving. It can generate tons of insecurity and rivers of active and passive resistance.

All acquisitions face these issues to a varying degree. Just think of the merger of Air Canada and Canadian International and the challenge of bringing together these two companies with a history of hostile competition and intense dislike, of belligerent unions, of different values and ways of operating.

When a merger or acquisition requires a substantial or full integration to justify its value, a host of issues come up that may well deny the acquirer the full benefits for which he paid so dearly.

4. The Governance Challenge

It is obvious that any sizeable acquisition brings about a quantum leap in the complexity of managing the acquiring company; in general, financial markets dislike complexity. That leap in complexity happens whether the newly acquired company is to be fully integrated or kept independent from existing operations. For instance, in 1986, Bombardier acquired Canadair and operated that company as a new stand-alone business. Yet, the complexity of Bombardier increased substantially as a result and called for a fundamental change in the strategic (or internal) governance processes of the company.

We are not referring here to corporate governance, the relationship between shareholders, board members and management. What we are discussing here is the ability of top management to shape

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and control the destiny of the company. This governance issue is a subtle one to handle. It requires awareness on the part of the acquirer's leadership that the complexity of their company has shot up as a result of a sizeable acquisition and that it cannot be managed with the same approaches and processes as in the past.

All companies in their quest for growth reach a point where the level of diversity and complexity they have produced as a result calls for a very different style and very different processes of management. We call ***strategic governance the style of leadership and the processes, which are appropriate in this context.***

Acquisitions hasten this day of reckoning by swiftly increasing the number of different businesses making up the company and/or the number of different countries in which the company has operations.

Strategic governance is all about simplifying the leading and the operating of a diverse company. It means re-evaluating and possibly changing the corporate architecture of the company, the decision-making process, the role of strategic planning and budgets, the quality and autonomy of business leaders, the nature of motivation and reward systems. It also includes a clear, consistent message to financial markets and other constituencies about the game plan of the company and how its diversity creates value for the shareholders.

Strategic governance itself has limits in the complexity it can handle. If a company gets to include many businesses belonging to several different industries, or if the company operates with alliances and/or part ownership of some of its businesses (with the public or other companies owning the balance), it may well come to be seen as a **Financial Holding**. When, and if, it reaches that point, the company will be hard pressed to create value for its shareholders other than by demonstrating its

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shrewdness at buying or selling assets. That is why, in general, financial holdings or conglomerates are discounted by financial markets, unless and until led by a very savvy dealmaker.

When financial markets consider it too complex and difficult to understand, the company will be valued on the basis of the sum-of-its-parts (SOP) with some discount (ranging between 15% and 40% applied to that number).

Try as it may, Canadian Pacific (CP) could not shake a discount of some 25% on its SOP valuation and was broken down into a number of pure-play independent companies (Rail, Hotels, etc.).

Yet, some companies, such as GE, Emerson, and United Technologies have assembled a good deal of complexity in their fold without being penalized (for a good while anyway) by a "conglomerate discount." These companies have convinced the financial markets that their diversity and their strategic governance provide positive value for shareholders.

This point about the diversity and complexity of the company is critical for any management team embarking or planning to embark on a program of acquisitions.

Failure to deal with this issue of strategic governance explains a good number of the costly failures in the game of acquisitions that cannot be attributed to still more prevalent, amateurish mistakes. The savvy practitioners are very conscious of this issue.

M&A's fail to create value for all the reasons invoked in this paper: paying too much; an ill-conceived strategy; a faddish, me-too, motivation; an infatuation with growth for growth's sake or to placate financial markets; poorly planned or badly executed integration. Experienced leaders know how to avoid or deal with these well-charted land mines. However, there is a second order of

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difficulty, which makes M&As difficult, often disappointing operations, even under the best of circumstances. These are called ***the integration and the governance challenges***.

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