

The DEAL GURU



Freek Vermeulen

Acquisition Myths...

The famed investor, Warren Buffet, once said that many corporate acquirers think of themselves as beautiful princesses, sure that their kisses can turn toads into handsome princes. The acquirers pay substantial premiums over market value, believing that they can release the imprisoned princes. But, as Buffet said, “We’ve observed many kisses but very few miracles”.

Many beliefs, hear-say and stories are abounding about acquisitions; when they work, when they don’t, how come so many of them fail, and so forth. Undoubtedly, some of these stories carry some weight, but others are myths. However, it is not always easy to separate the wheat from the chaff. Here are three of those beliefs:

Size and profits: reversing cause and effect

The rationale for many acquisitions is presented by the acquiring firm in terms of gaining firm size: “This take-over will immediately make us the largest company in the industry” and statements alike. However, that firm size will make a company more successful is often a myth.

Surely being big can have certain advantages, but that doesn’t mean that bigger (let alone being the “biggest”) always automatically is better. True, company size is often associated with financial success. For

example, the firms that always feature on “the most admired companies” lists are usually Behemoths such as Toyota, Dell, Intel, Wal-Mart, and Pfizer. However, many of these firms grew bigger because they were successful. Adding size to your company is not necessarily going to enhance success.

Managers who opt for a strategy of increasing size often reverse cause and effect; although success will likely make you bigger, striving for size per se is not necessarily going to make you more successful. In fact, it is quite possible that focusing all ones resources and efforts on becoming bigger (for the sake of being big) might actually decrease a firm’s chances of becoming successful.

Success often breeds failure

A second myth is that an initial acquisition success will lead to more successes. People believe this because they assume that once a CEO has made a successful first acquisition, he will have figured it out, has learned from this first experience, and will from then on know how to conduct more of them and turn them into winners.

Although research does show that firms can learn how to do acquisitions better over time, it is not as easy as often thought. The evidence shows that, for the average firm,

things often get worse before they get better. Because acquisitions are so different, and require different approaches and have their own particularities, one needs quite a bit of experience to see them through.

In fact, specific research on CEOs, conducted by Professors Matthew Billett and Yiming Qian from the University of Iowa found some compelling evidence that initial successes led CEOs to become overconfident, which caused them to have ample subsequent failures. They discovered that those CEOs who had experienced a successful first take-over got the hots for deal-making; they were very likely to undertake even more acquisitions in the ensuing years. Those subsequent deals, however, on average destroyed shareholder value. First-time, successful deals make CEOs overconfident, which not only stimulates them to do even more deals, but also makes them inclined to pay even heftier take-over premiums for subsequent ones, which they usually were unable to recoup after the acquisition.

Overconfident CEOs are made (not born that way)

This also points at a third myth, and that is that overconfidence is some sort of a personality trait; that it is the type of person that makes a company take on too many acquisitions at too high a cost. Instead, there is compelling evidence that such CEOs are

not born overconfident but that their environment turns them that way.

It is the initial experience of success – discussed above – which gradually makes them overconfident, but also their environment, such as the media.

My former colleague at the London Business School, Professor Mathew Hayward, performed a slightly mischievous piece of analysis. He counted the number of favourable articles that had appeared about particular CEOs in the business press (such as the Financial Times, Business Week, etc.). Subsequently he computed whether CEOs who had received more media praise paid higher premiums for their acquisitions. The answer was: absolutely yes.

To be precise, each highly favourable article about a company's CEO would increase the premium paid with no less 4.8%. For an acquisition of a billion, this would be 48 million... And that is for every article!

And this really is 48 million down the drain, because Mathew also showed that CEOs with more favourable press were completely unable to create additional value out of those acquisitions. They had simply overestimated themselves. But their inclination to overestimate themselves had been built up by the media; all they were guilty of believed their own press.

To conclude, what determines acquisition success and failure is not always obvious. Digging deeper reveals a real understanding of the M&A phenomenon. And only when you really understand what is going on, can you begin to improve things, and really become a successful acquirer.

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Escalation of commitment

Escalation of commitment is the phenomenon that when we invest a lot of time and effort (and money) into setting up a particular big project, when things start to go wrong, we stubbornly persist in the failing course of action – often throwing good money after bad. It happens mostly when the project is big, fraught with uncertainty, and some very senior executive has thrown his weight – and, importantly, his reputation – behind it. We'll persist, no matter what! We see it very often with big acquisitions.

See for instance:

<http://freekvermeulen.blogspot.com/search?q=operation+market+garden>

Who can give an example of a deal which – perhaps in hindsight – we would qualify as "this was clearly a case of escalating commitment"?

Make the numbers fit the decision

Numbers are a dangerous thing in strategy. Numbers are usually extrapolations of the past, so if we insist on a "sound, quantified business plan" (with a "net present value calculation" or "pay-back time") we end up only doing incremental things, killing of the really radical innovations before they have even seen the light of day. Yet, they also force us to be careful and objective, so shunning them entirely might not be a good idea either... Not an easy trade-off to make. To make things worse, we can also make them say whatever we want them to say... If we want to bid a bit more for that acquisition target, we can always calculate some extra "synergies"; if we want the prospective market to look bigger, we can always find some more potential customers to quantify.

See, for instance,

<http://freekvermeulen.blogspot.com/2008/03/when-acquisitions-take-over-firms-are.html>

Do you have any blatant examples where the numbers were created to fit the deal, rather than the other way around?

Strategy meetings when really the decision has already been made...

Some time ago, I was watching an old television adaptation of Tolstoy's War and Peace. At some point, it showed the generals' meeting before the battle of Austerlitz; they were contemplating – at length – whether to have a battle or not. But it was very obvious that that decision had already been taken! Prince Andrei, who had noticed the same thing, wondered dreamingly why they were still talking about it in the first place; "the decision has already been taken, so why don't they all go home?"

It reminded me of one of the first strategy-making meetings I was ever present at: three CEOs and their cronies deciding whether to merge or not. After half a dozen lengthy meetings – surprise, surprise – the answer was "yes"; something that had been blatantly obvious from minute one.

Why do we do it? I am sure you must have been in meetings like that? Is there a purpose? What is it? Who can give an example of a deal which was preceded by many meetings and calculations although the decision had already long been made?

