Songs of the Sirens

Some companies think that mergers or acquisitions can put them on the path to greater success. **Freek Vermeulen** points out the warning signs along the path that show when a deal is not a good deal.

Studies from all over the world consistently show that about 70 per cent of acquisitions actually destroy value. This effect is especially prevalent in the long run (up to five years after the acquisition), rather than at the time the deal is announced.

Most executives know that the majority of acquisitions fail. Often, however, they feel that their own success rate will be considerably higher. This misperception can partly be explained by the fact that reported failures are usually not disastrous events that lead a company into turmoil. Instead, the failed acquisitions were simply deals in which the premium paid for the target was higher than the value that the transaction subsequently created for the acquirer.

Logically, the destruction of value has two potential causes. First, the agreed premium is excessively high; or, second, the merger value created (beyond the original two companies' original worth) is lower than anticipated. The complexity and uncertainty of acquisitions, in terms of strategic implications and requirements, are such that it is often difficult even for insiders to grasp all the considerations surrounding a deal, including whether value creation will take place. This assessment of a deal's consequences is even harder for relative outsiders, such as investors, directors and analysts, to make.

My own research, conducted in American and British companies in a variety of industries, has been aimed at uncovering the original motives behind a particular decision to acquire, the decision-making process leading up to the deal, the integration process, and the perceived consequences of the takeover. In addition, my in-depth research of two multinational companies considered the companies' acquisition strategies over the past two decades, including an analysis of takeovers, takeover announcements, top managers' remuneration, public awards, career paths and the evolution of the firms' overall financial performance. This research, and that of others, has revealed strong warning signs that indicate that a deal is potentially *value destroying.* These signs should cause the various parties involved to question their support for the transaction.

Managers who opt for a strategy of increasing size through acquisitions reverse cause and effect.

Preoccupation with size

Many managers see acquisitions as a relatively easy and quick way to increase the size of their company, in comparison to the painstaking process of organic growth. And, indeed, company size is often associated with financial success; for example, the firms featured on "the most admired companies" lists are usually behemoths such as Toyota, Dell, Intel, Wal-Mart and Pfizer. However, managers who opt for a strategy of increasing size through acquisitions reverse cause and effect: →

→ although success will likely make you bigger, striving for size per se is not necessarily going to make a company more successful.

A firm can, of course, increase in size quite dramatically in a short period as a result of mergers and acquisitions (M&A). Successful companies, however, often have a high level of coordination between their various activities and parts of the organization. This coordination involves not just technology and systems, but also intangible characteristics such as a shared culture and informal networks – which is clearly the case for companies such as Toyota, Dell and Intel. These organizational abilities take ample time to grow and develop. They cannot easily be implemented after a deal is completed, as the British supermarket chain, Morrisons, discovered after its dramatic acquisition of Safeway.

Thus, a strategy in which acquisitions are undertaken as a substitute for organic growth has a bad track record in terms of adding value to a company. Acquisitions performed to enable and enhance organic growth, rather than add size directly, perform markedly better. Successful Dutch brewer Heineken, for example, undertakes acquisitions with an explicit plan to create further opportunities for growth. Its focus is on profitability, rather than scale per se. As its former chairman, Alfred Heineken, used to say, "I don't want to be the biggest; I want to be the best."

Deal-eager executives

For executives, deal making is often an all-consuming process. They must assess acquisition candidates, negotiate with their counterparts and investment bankers, liaise with investors, and so on. Often, executives gradually get sucked into this, causing them to neglect the internal workings of their company.

Ahold, for example, and its former, fallen-from-grace CEO, Cees van der Hoeven, started out as very careful acquirers, painstakingly selecting and following their targets for an extended period of time, making multiple visits while making careful assessments before closing a deal. Over time, however, they became preoccupied with deal making and the thrill of selecting, chasing and seizing a target, often hastily decided during Monday's "Acquisition Lunch".

Typically, as in the case of Ahold, these escalating acquisition strategies result in a corporation that is not much more than a loosely connected portfolio of businesses. This may not result in a poorly performing firm – although it did in Ahold's case – but adding more companies to such a portfolio will seldom result in value beyond the premium paid for them.

In the short run, analysts, investors and the business press often praise successful acquirers. The company making the highest bid for a target, and as a result ending up purchasing it, is usually proclaimed the winner, while the company backing out of the deal due to the high price is considered the loser – while it is not at all clear why a company sensibly refusing to pay an unrealistic premium is not the real winner.

Moreover, with accumulating praise (in the form of "CEO awards", for example, that Ahold's van der Hoeven continued to receive until weeks before the firm's collapse) comes overestimation of one's own ability to add value to acquired companies. Research has revealed that, with every favourable article that appeared in the business press about a CEO, the subsequent premium his or her company paid for its target acquisitions increased no less than 4.8 per cent. Yet, there was no relation to value created.

To conclude, a strategy in which the company's executives are increasingly preoccupied with closing deals is unlikely to result in value creation in the long run, due to a lack of attention to internal integration and a possible overestimation of a firm's ability to add value.

Lack of acquisition experience

Paradoxically, the reverse may also be problematic. Companies that have shunned acquisitions altogether often struggle to add value to a transaction once they undertake it – Morrisons is, again, a case in point. Research shows that firms' ability to undertake acquisitions successfully can increase substantially with experience, although some companies never seem to learn. Codifying the experience, by means of developing blueprints, road maps, acquisition timelines, and so on – although they should not be treated dogmatically – is a crucial step in value creation.

Firms that have seldom undertaken acquisitions lack this valuable experience, but they are often at a disadvantage in yet another way. Companies that

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focus solely on internal development can, in the long run, become simplistic, narrow and rigid in terms of their portfolio, processes and culture, which may result in a lack of innovation. Employees of the acquired unit often find that the acquiring company is intolerant of different ways of doing things, which can lead to serious integration problems, employee turnover and, ultimately, the destruction of value.

It is the reluctant acquirers, such as Heineken, that aim to cultivate and stimulate organic growth as a result of transactions who have the best chance of creating value. They certainly don't shun acquisitions altogether, but they do not get seduced into an overly large number of them.

All-or-nothing integration plan

The integration strategy that a company employs greatly influences the firm's ability to create increased value. Often acquirers seem to develop a preference to either completely and quickly assimilate a target in order to avoid lengthy integration disturbances or to leave the acquired unit fully autonomous in order not to not disrupt existing systems and processes.

Indeed, both strategies usually manage to avoid severe integration tension. Yet, they also hamper value creation. In order to create value beyond the original two companies' worth, some form of blending has to take place that creates a new entity, since just increasing the scale of a company will seldom result in extra value.

When Novartis, for example, was created out of the merger of Ciba-Geigy and Sandoz, subsequent CEO Daniel Vasella explicitly set up an integration programme to create a new organization, which in many respects was entirely different from either of the companies previously. This approach doubled the company's value in about a year. Similarly, Igor Landau, former chairman of the merged pharmaceutical firm Aventis, said, "The strategy was to create a new company and not be the sum of the two previous companies. We decided either we create something new or we would pay the price down the line."

If companies seem to avoid integration tension altogether, and refrain from creating anything new as a result of the deal, the transaction is unlikely to create extra value.

Ad hoc rationale

When a particular transaction is being considered, executives must explain the logic for the deal to directors, investors and analysts. Frequently, however, a strategic rationale is only drawn up after it has been decided by management that the deal is desirable. Usually, this logic will appear contrived, overly complex or made to fit the acquisition rather than resulting from a well-thought-through strategy in the first place.

For example, in my qualitative research, I often heard the logic behind a transaction being explained in terms of complementarities: "Their product portfolio complements ours." Yet, just as often I would hear the logic being explained exactly the other way around; in terms of perfect overlap, for instance: "It is a perfect match because they are active in the exact same markets as we are." →

Best practice

→ Yet, value creation does not happen automatically. Instead, a strategic rationale to combine two companies should explicitly state how the merged entity will be able to accomplish something in the marketplace that neither of the companies could have achieved alone.

Negotiations focus on who will be in charge

Another warning sign that may arise during the acquisition process occurs when the single biggest hurdle for whether the deal will go through seems to be the question of who will be in charge after the merger: the CEO of company 1 or the CEO of company 2? If this is the case, the transaction is unlikely to create value, because it may be done for the wrong reasons.

The merger of Viacom and CBS, for example, completely hinged on whether CEOs Sumner Redstone and Mel Karmazin could figure out how to distribute responsibilities and power. In the end, they did – although it did not work for long, as so often happens – but regularly we hear rumours that a particular deal fell through because executives could not agree on who would take the helm. These kinds of negotiations indicate that the logic for a deal may have more to do with advancing the careers of the people in charge than advancing the value of the combined companies. Extra care, and some suspicion, is warranted in these situations.

Surprise synergies found during negotiations

Firms are expected to base the price, and hence the premium they are willing to pay, for a transaction on their calculations of how much synergy the deal would be able to generate. Although long-term value creation is always difficult to quantify with any certainty, firms usually do the best they can and then determine the price they are willing to pay.

However, an executive who has his or her mind set on acquiring a target, but is ultimately outbid, may find this situation difficult to swallow. Often, an executive is then tempted to go back to his people and instruct them to "find me another 100 million or so" in the target's books that would enable the company to up the bid. Recently, we saw indications of that when Mittal was bidding for Arcelor.

Clearly, this is a dangerous phase in a bidding process. Copious research (for instance, on "escalation of commitment" in M&A deals) has indicated that overexcited executives have a tendency not to walk away from a deal when they should. Mysteriously uncovering extra value in a transaction when rivals are starting to outbid the firm should be a clear warning sign for a company's directors and investors that their executives might be at risk of committing value to a deal that the company will not be able to recover.

Danger ahead?

The poet Nancy Willard once remarked, "Sometimes questions are more important than answers." If your company is approaching a possible merger or acquisition, you might like to ask these questions before you go too far down the road. Answer "yes" to one or more of these, and you might be wise to discuss the real drivers for the uniting of the two companies. It just may be that the "great deal" everyone has in mind isn't a good deal after all.

1. Are people spending more time focusing on the ultimate size of the merged company without demonstrating how the new company can grow after the union?
2. Are people talking a great deal about revenues and very little about profits?
3. Is the person who is leading the acquisition campaign someone who values, or yearns for, publicity – the acclaim that comes from making "big deals"?
4. Is the acquisition champion someone who has not proven himself a capable manager of the company he now controls?
5. Has your company done a poor job of integrating with other companies in the past?
6. Is your company planning to acquire another business and then "leave it alone" so that there will be no blending of business operations?
7. Is the rationale offered for the acquisition so abstract or malleable that it lacks any logical precision?
8. Is the CEO of your company unwilling to step down, or step aside, if the CEO of the acquired company is deemed to be a better fit as the leader of the new company?
9. If your company is in a bidding war to acquire a company, do the "synergies" implicit in the merger seem to grow every time a higher offer is being proffered?
10. At meetings to discuss the acquisition, do investment bankers or other outsiders seem to be managing the agenda?

Investment bank initiation

Of course, shareholders are not the only parties potentially benefiting from a transaction. A vast industry exists that initiates, values, negotiates and closes deals. However, the interests of such parties – for instance, investment bankers – may not always

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be aligned with those of the firm. Especially when few mergers and acquisitions are taking place, investment bankers may attempt to initiate deals that are not clearly to the benefit of the potential acquirer.

One could argue that investment bankers are not necessarily to blame for this; they are supposed to follow their interests, and it is up to the firm to refuse a proposed transaction. Furthermore, good deals have been known to come out of this. Moreover, long-term relationships between investment banks and client firms may mitigate misalignment of interests. Yet, deals can be seductive. One CEO of a large British company, in a private conversation, compared his experiences with investment bankers to the mythical Sirens in Homer's *Odyssey* who tried to lure passing ships onto the rocks.

In itself, it is not relevant who came up with the idea for a certain transaction. However, when the deal was initiated by an intermediary, extra care should be taken to analyse the strategic rationale and the potential to create surplus value through the transaction. Large acquisitions are highly complex transactions. To be able to discern the potential value that they may create, intimate knowledge of both businesses involved is required. Because of their complexity, especially for relative outsiders such as directors, investors and analysts, it is often impossible to determine if a particular transaction makes sense, in terms of offering more value than the premium being proposed.

The warning signs outlined above draw attention to the symptoms of several underlying problems that may make a deal unattractive. They are intended to cause directors and investors to reconsider their support for a transaction. ■

Although long-term value creation is always difficult to quantify with any certainty, firms usually do the best they can and then determine the price they are willing to pay.

Resources

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