

THE NEED FOR INTELLIGENCE IN MERGERS AND ACQUISITIONS

Mergers and acquisitions are an integral part of the global strategic and financial business landscape, whether one is part of the acquiring company, the target, a competitor, an advisor (including investment bankers, accountants, lawyers, and many others), an investor, a regulator, or someone living or working in the neighboring community.

Although fluctuating widely from periods of peaks and troughs of merger activity, the baseline size and growth of mergers is clear. In fact, the “slow” period of activity in 2002 was well in excess of the “peak” of activity in the late 1980s. Even the downturn following the financial crisis of 2007 and 2008 saw levels of M&A activity remaining well above \$2 trillion annually for at least six years, which isn’t much of a downturn when compared to levels only a dozen years earlier. At the time of writing, it is unclear whether M&A deal volume will increase or not from

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that level but, whether up or down, the absolute number of deals will certainly remain high.

Yet despite this impressive level of activity, mergers and acquisitions are often misunderstood and misrepresented in the press and by those who are engaged in each transaction. Deals, especially when hostile, cross-border, or among large companies, might be front-page news (and interestingly there are some days when *every* story covered on the first page of the *Financial Times* is about an acquisition), yet there is a great deal of conflicting evidence as to whether they are successful or not. This can sometimes be a function of senior management focus: for example, when we have observed boards during M&A deals, they often appear to spend more time discussing the new corporate name or the color and design of the new corporate logo than the key decisions regarding senior management positions or culture. Fortunately, our own research has shown improved performance from companies that make acquisitions, especially since the merger wave that began in 2003, so perhaps the focus on key integration decisions is changing.

Why do the public and many managers still believe that most deals fail? Partly, this is due to the propensity of journalists to write about the less successful deals. These make for great stories in the financial and popular press. Together with the (outdated) conventional wisdom that most deals fail, this creates a negative bias for the financial community that can result in a form of groupthink whereby investment managers and other equity analysts, as well as individual investors, are more likely to ignore positive information and mimic each other's negative investment decisions. This herd behavior has certainly resulted in many M&A deals not being accurately assessed on their own merits. In M&A, bad news appears to be a more popular subject with readers, who are more interested in value-destroying deals, than those executed smoothly, successfully, and often quietly.

That said, there do seem to be some inviolate truths about M&A deals:

1. Many fail to deliver the promised gains to shareholders.
2. Boards, CEOs, senior managers, and advisors pursue deals for personal reasons.
3. Success with one deal doesn't guarantee success in the next deal.
4. Deals have a momentum of their own and this means that they don't get dropped when they no longer make sense.
5. The deal doesn't end when the money changes hands; in fact, that point marks the start of the most difficult stage of a deal, the tough integration process that few get right.

Indeed, given the conventional wisdom that most deals fail, it must be that boards and chief executives either treat that conventional wisdom as applying to someone else or as hyperbole perpetuated by consultants and other advisors as justification for their services. Or it may be a matter of corporate "hubris" that refuses to see what is obvious and plan accordingly.

Some M&A failures have been dramatic. The AOL/Time Warner deal lost 93% of its value during the integration period as the internet service provider merged with the publishing company in an attempt to combine content with delivery. VeriSign, another internet-related services company, lost \$17 billion of its \$20 billion acquisition of Network Solutions in 2000, and its stock fell 98%. Failures are not unique to the United States. The Royal Bank of Scotland, together with Banco Santander and Fortis, purchased ABN AMRO in 2007; that deal contributed to the failure of Fortis and the semi-nationalization of RBS. It was pursued despite the signals in the marketplace which led to the financial crisis. Another classic example of failure – and one where the very basic elements of business intelligence were ignored – is Quaker Oats, a food and beverage company founded

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in 1901. In the brief case study that follows, look at the first word of the penultimate paragraph. It is the key identifier of an intelligence failure. The word is “following.” Incompatibility of cultures is one of the biggest post-acquisition killers.

Quaker Oats

On November 1, 1994, Quaker Oats acquired Snapple for approximately \$1.9 billion, becoming the third largest producer of soft drinks in the United States.

The Quaker Oats Company had been founded at the start of the 20th century, and its most famous product, Quaker Oats Cereal, originated in 1877. At the time of the initial acquisition, Quaker Oats was one of the leading manufacturers of cereal products in the United States, but it had also diversified into baby food, animal feed, chocolate (in Mexico), and honey (in the Netherlands). One of its most successful recent diversifications had been the acquisition in 1983 of Gatorade, a sports drink company. Under Quaker Oats’ ownership, Gatorade had grown tremendously. This success contributed to the feeling within Quaker Oats that, because its main business was mature, it should focus on “investment in brands with high growth potential and divestment of lower growth, lower-margin businesses,” as stated in its 1995 Annual Report.

Snapple was a trendy, slightly eccentric company, founded in 1972 by three entrepreneurs (two window washers and the owner of a health food store). Under the brand name “Snapple” (acquired in 1978), their product line had grown by word of mouth to become one of the best-selling fruit drinks lines in the northeast United States. They also sold iced tea drinks, which had been added in 1987.

Where Quaker Oats was an old-line national company, Snapple was a “New Age” company run as a regional family

business. However, as such, Snapple did not have the resources to continue to expand, and with increased new competition from the largest soft drink manufacturers (Coca-Cola and Pepsi), they looked for someone to acquire them.

Quaker Oats thought that there were important potential synergies between Gatorade and Snapple. On the surface, it appeared that they could share distribution channels (reducing costs) and they had complementary geographic areas. Quaker Oats also hoped that its conservative culture could be invigorated by Gatorade.

Following the acquisition, it was determined that the pricing strategy was different for the two product lines, the distribution different (Gatorade used a warehouse distribution system whereas Snapple used a single-serve, refrigerated delivery system) and, most importantly, the cultures were not compatible (affecting integration, advertising, and many other areas where coordination was required). In addition, in the quarter just prior to the acquisition, Snapple had experienced a 74% drop in sales on a year-over-year basis, a fact that was only told to Quaker Oats a few days before the deal was finalized. At the same time as sales volumes were decreasing, the cost of integration and national rollout under Quaker Oats was rising.

Less than three years later, in 1997, Quaker Oats sold off its Snapple division to Triarc Corporation for \$300 million.

In perhaps one of the more ironic stories of acquisition failure, in late 2013, G4S, a UK-based company which bills itself as the “world’s leading international security solutions group,” blamed “a short-term and over-aggressive acquisition strategy for a string of scandals,” according to the *Financial Times*. The new CEO announced that the company was considering

disposing of 35 underperforming business, some of which had only been recently acquired. Brilliant that a security company that conducts due diligence and other intelligence-related functions for its clients has effectively admitted that it was no good at its own intel!

One challenge in trying to determine the success of an acquisition lies in how to define “success.” Is it shareholder value? If so, over what period? Or should one look at sales growth? The ability to retain key customers and market share? Employee retention? Cost savings? And how would the company or companies have performed if they had not merged? Perhaps, as some have suggested, success should be defined by the publicized goals of the merging companies themselves and then measured against the achievement of those stated objectives.

No matter how it’s measured, a fair degree of consistency has emerged in the results of studies that examined M&A “success” through the 20th century. Essentially, all of the studies found that well over half of all mergers and acquisitions should never have taken place because they did not succeed by whatever definition of success used. Although many studies based on deals conducted in the 1980s and 1990s found that only 30 to 40% were successful, more recent studies have found that this success rate is improving, yet still only to around the 50% level. Yet most companies that have grown into global giants used M&A as part of their growth strategy and without those acquisitions and mergers would not be the size that they are today.

This paradox raises the following questions:

- Can a company become a large global player without having made acquisitions?
- Is organic growth sufficient to become a leading global or even a leading national player?

The challenge for management is to reconcile the relatively low odds of deal success with the need to incorporate acquisitions or mergers into their growth strategy, or to figure out how to beat the odds and be successful in takeovers. This is where business intelligence techniques are essential.

Prior experience may not be a predictor of success, although some studies have shown that acquirers do better when making an acquisition that is similar to deals they have done previously and that serial acquirers – those that do two or more significant deals a year – also have a better success rate than firms that are less frequent acquirers of other companies. Indeed, these serial acquirers have a great impact on the M&A market. Accenture, in their 2010 study of serial acquirers, found that, although serial acquirers represented only 9% of all acquiring companies, they conducted 35% of all the deals as measured by number of deals and 44% of the deal volume measured by size of deal. We will provide many examples in this book of these serial acquirers, given their importance to the market. It does appear to be true that acquirers who are active, frequent buyers and who are willing to do complex and big deals outperform those who are inactive and conservative. This does imply that a set of best practices exist, as we will discuss in this book. Maybe practice really does make perfect, or at least better.

Here again the utilization of specific intelligence is central. Many studies have shown that relatively inexperienced acquirers might inappropriately apply generalized acquisition experience to dissimilar acquisitions. The more sophisticated acquirers would appropriately differentiate between their acquisitions. In a deal that will be discussed later, VeriSign appears to have failed with its 2004 purchase of Jamba AG despite having made 17 other acquisitions in the prior six years, many in related internet businesses. Intelligence cannot, therefore, be taken for granted.

DIFFERENT TYPES OF MERGERS AND ACQUISITIONS

There is even some confusion about the terminology used. Many have questioned whether all mergers and consolidations are really acquisitions. This is because the result – sometimes as much as a decade later – is that the staff, culture, business model, or other characteristics of one of the two companies becomes dominant in the new, combined organization.

Name changes reflect merger realities:

Morgan Stanley

This reality of a merger can often be reflected in the name change. For example, in 1997 Morgan Stanley and Dean Witter Discover “merged.” Although the new company was renamed “Morgan Stanley Dean Witter,” within several years it was renamed just “Morgan Stanley.” In a power struggle at the top in the initial years after the merger, the former head of Dean Witter (Jack Purcell) dominated and the former president of Morgan Stanley (John Mack) left to become the head of a rival investment bank, Credit Suisse.

That was not the end. In 2005, eight years after the original “merger,” a palace coup of former Morgan Stanley managing directors forced the ousting of Purcell and reinstated Mack as head of the bank.

This was not a unique situation even for the brokerage industry as, over a decade earlier in 1981, the commodity trading firm Phibro Corp had acquired Salomon Brothers to create “Phibro-Salomon,” yet the Salomon managers ultimately prevailed and the company was renamed Salomon Inc. Salomon was later acquired again, and today what remains of Salomon is part of the global financial powerhouse Citigroup.

Clearly, care should be taken in using the terms “merger,” “acquisition,” “consolidation,” and other related words. In practice, however, these terms are used interchangeably. Additionally, “takeover” is a term that typically implies an unfriendly deal, but will often be used in the popular press when referring to any type of merger or acquisition. In this book, we will be as precise with the terminology as possible. Specifically, this means that when the term “acquisition” is used, it refers to a deal in which one company (usually the larger one) acquires another company: the buyer remains as a legal entity, albeit larger, and the target company ceases to exist as it is subsumed into the acquirer. “Merger” is when two companies come together to create a new, third, company; when that is done, the two previous companies cease to exist. As will be discussed in Chapter 10 on post-deal integration, there are rarely true mergers, as over time one of the two companies will dominate the new company. It should also be noted that there are many more acquisitions than mergers: of all deals since 2000, less than 10% are structured as mergers.

There are three major types of mergers/acquisitions which are driven by different goals at the outset and raise different issues for the use of business intelligence:

- **Horizontal** deals take place between competitors or those in the same industry operating before the merger at the same points in the production and sales process. For example, the deal between two automotive giants, Chrysler in the US and Daimler, the maker of Mercedes cars and trucks, in Germany, was a horizontal merger. The many consolidating deals in the mobile telecommunications industry in recent years would also fall into this category.

In horizontal deals, the managers on one side of the deal will know a lot about the business of the other side. Intelligence may be easy to gather, not just because there will likely be employees that have moved between the two companies

over time in the course of business, but also because the two firms will most likely share common clients, suppliers, and industry processes. These deals often include cost savings (frequently described as “synergies”) as a principal deal driver because it is more likely that there will be overlaps and therefore redundancies between the two companies. These synergies can be both on the expense side, such as reductions in overlapping factories or staffing, and revenues, such as products that can be packaged together.

- **Vertical** deals are between buyers and sellers within the same industry, and thus represent a combination of firms that operate at different stages of the same industry. One such example is a merger between a supplier of data and the company controlling the means through which that information is supplied to consumers, such as the merger between Time Warner, a content-driven firm owning a number of popular magazines, and AOL, the world’s largest internet portal company at the time of their merger. There is often less common knowledge between the two companies in a vertical deal, although there may still be some small degree of common clients and suppliers, plus some previously shared employee movement. Depending on the perspective of the firm, the vertical merger will either be a backwards expansion toward the source of supply or forwards toward the ultimate consumer. The 2003 acquisition of TNK (a Russian oil company with large oil and gas reserves but little Western refining capability or retail marketing) by BP (which had declining reserves and strong global marketing and refining operations) is one such example. We will visit this acquisition again, as well as the separation of the two companies in 2013.
- **Conglomerate** deals are between unrelated companies, not competitors and without a buyer/seller relationship (for example, the 1985 acquisition of General Foods, a diversified food products company, by Philip Morris, a tobacco manu-

facturer). Conglomerate deals do not have strategic rationalization as a driver (although often cost savings at the headquarters level can be achieved, or in the case of Philip Morris, it wished to diversify risk away from the litigious tobacco industry). This type of deal was common in the past, but has fallen out of favor with shareholders and the financial markets, although when they do occur they can benefit greatly from the more creative uses of business intelligence. For example, detailed scenario planning, involving simulations based on high quality information, can identify unforeseen problems that can drive such deals and provide a logical rationale.

Deals are either complementary or supplementary. A complementary acquisition is one that helps to compensate for some weakness of the acquiring firm. For example, the acquiring company might have a strong manufacturing base, but weak marketing or sales; the target may have strong marketing and sales, but poor quality control in manufacturing. Or the driver may be geographic: when Morgan Stanley made a bid to purchase S.G. Warburg in 1995, it wanted to complement its powerful position in the US market with Warburg's similar position in the UK and Europe. Similarly, Kraft, when it purchased Cadbury in 2010, sought Cadbury's strong market position in India, and several other emerging markets, as a complement to its own dominant position in the US. A supplementary deal is one in which the target reinforces an existing strength of the acquiring firm; therefore, the target is similar to the acquirer. A good example of such a deal would be when one cell phone company buys another, such as Sprint purchasing Nextel in 2005 to form Sprint Nextel. Most supplementary deals are horizontal.

The final descriptive distinguishing factor about a deal is whether it is hostile or friendly. A hostile deal is one in which the board of directors of the target company rejects the unwelcome

bid. In these situations, the bidder expects to go directly to the shareholders to overrule the board. Because of the requirement that a hostile deal is one where the shareholders disagree with management and the board, hostile deals can only occur with public companies where management does not own over 50% of the shares. For all deals since 2000 where the target has been public, only 1% have been hostile at the point where the shareholder vote was taken. Since these are often large deals, hostile deals are around 7.5% of the total on the basis of value.

It is possible for a bid to be friendly, with the support of the board, but then turn hostile if there is a change in the board's position. This can happen when the target's board uncovers negative information about the buyer or if the terms of the deal change to make it less attractive (as might happen if the buyer's share price declines dramatically in a deal in which the target was being paid with shares). Similarly, a hostile bid can turn friendly, which typically occurs when the buyer increases its purchase price or changes the terms (perhaps replacing a share offer with full or partial payment in cash or agreeing to retain the target's management). For example, when Kraft attempted its purchase of Cadbury, the bid was unsolicited and initially hostile as the Cadbury board twice rejected Kraft's formal bids. Ultimately, Kraft improved the terms of its bid with a higher price and a larger proportion of the consideration being in cash, with the result that the Cadbury board changed its recommendation to supporting the deal.

THE MERGER WAVES

Merger activity tends to take place in waves – times of increased activity followed by periods of relatively few acquisitions. The waves have been growing in size: the peak of the most recent wave (the Sixth Merger Wave, as discussed below) had its most



Figure 1.1: The World’s Largest Announced M&A Deals. (source: Bloomberg)

active year with announced deal volume of \$4.7 trillion in 2007. The previous wave had topped out at \$4.3 trillion in 1999, and the wave before that with a peak of only \$0.9 trillion in 1988. In fact, the largest deals of the most recent merger wave never exceeded those of the prior merger wave, as shown in Figure 1.1.

Each wave has been stimulated by events outside the merger world, but those external events have had a significant impact on the level of merger activity. Each wave is sharply distinguished from earlier waves, with creative new ways of consolidating companies and defeating the defenses of targets, although each builds on the merger techniques and other developments from the previous wave.

There is also the tendency, as with the military, of preparing to fight the last war’s battles. Just as the Maginot Line was bypassed by the Third Reich’s Panzers as they rolled through Belgium and into northern France at the start of World War II, it is not sufficient for a company to have out-of-date takeover defenses. Strategic initiative or power does not guarantee success for the bidder, as the United States learned militarily in Vietnam in the 1960s and in Iraq in the 1990s and 2000s. The parallel in business usually means relying too much on a large checkbook and first mover “advantage,” as Sir Philip Green discovered in 2004

when trying unsuccessfully to take over Marks & Spencer (M&S). He had not planned for the strong defense put up by M&S, including the hiring of a new CEO in the middle of the takeover battle.

Merger activity can be likened to the Cold War arms race, in which one country's development of new weapons stimulated the development of more sophisticated defensive systems, thus forcing the first country to make further advancements in their offensive weapons to remain ahead. In the M&A arena, as acquiring companies have developed more sophisticated tools to make the acquisition of companies more certain, faster, easier, or less expensive, the advisors to those target companies have designed stronger defenses for their clients. These defenses have then stimulated further activity to create better acquisition methods. Just as with the international arms race in the 1950s and 1960s, the process becomes more complicated and expensive for all the players.

Knowledge of previous takeover techniques is therefore important for any bidder or target – and is a critical aspect in the application of business intelligence. The development of these tactics has concentrated in the six major merger waves since the beginning of the 20th century, and focused during much of that time on the United States as the largest and arguably most open M&A market in the world. In most cases, the new developments in M&A were first tried in the US and then “exported” to other countries or regions, although before the 1990s the major economic regions had somewhat different waves but often driven by similar factors. Since the 1990s, the merger waves have been truly global.

The **first** merger wave began in 1897 and continued through to 1904. It started in the United States after the Depression of 1893 ended, and continued until the 1904 stock market crash, with a peak between 1898 and 1902. This merger wave featured horizontal deals (over three-quarters of the total) often resulting

in near monopolies in the consolidating industries: metals, food, oil, chemicals, trains, machinery, and coal. It was therefore also known as the “monopoly merger wave.” Some of the companies formed from this wave in the US have remained global powerhouses and included Dupont, Standard Oil (controlled 85% of the US domestic market), American Tobacco (controlled 90% of its market), General Electric (GE), Eastman Kodak, and US Steel (controlled 75% of its market). There was a similar trend in other markets, particularly Germany, France, and the United Kingdom.

The **second** merger wave was from 1916 until the Great Depression in 1929. The growth of this merger wave was facilitated by cooperation among businesses as part of the Great War (World War I) effort, when governments did not enforce antitrust laws and in fact encouraged businesses to work more closely together. For the first time, investment bankers were aggressive in funding mergers, and much of the capital was controlled by a small number of investment bankers (most notably J.P. Morgan). The role of investment bankers in driving the deal market continues today.

Over two-thirds of the acquisitions in the second merger wave were horizontal, while most of the others were vertical (thus, few conglomerate mergers). If the first merger wave could be characterized as “merging for monopoly,” then the second wave could best be described as “merging for oligopoly.” Many of these deals created huge economies of scale that made the firms economically stronger. Industries that had the most mergers were mining, oil, food products, chemicals, banking, and automobiles. Some of the companies created in the US in this period were General Motors, IBM, John Deere, and Union Carbide.

The **third** merger wave occurred from 1965 to 1969. Many deals in this wave were driven by what was later determined to be the irrational financial engineering of company stock market earnings ratios (similar in many ways to the exuberance of the dot.com era 30 years later). This wave was known as the

“conglomerate merger wave,” as 80% of all mergers in the decade 1965–1975 were conglomerate mergers. A classic example is the acquisition by ITT of companies as diverse as Sheraton Hotels, Avis Rent-a-Car, Continental Baking, a consumer credit company, various parking facilities, and several restaurant chains. Clearly, ITT would not be able to integrate these companies at the production, business, or client levels, so there was little in cost savings or strategic rationale that drove the deals despite claims of management efficiency at the headquarters level; instead, the growth of ITT was blessed by the market with an award of a high stock price!

One reason for such conglomerate deals was the worldwide growth after World War II in stronger antitrust rules (or the more vigorous enforcement of existing antitrust and monopoly regulations), thus forcing companies that wanted to expand by acquisition to look for unrelated businesses. The beginning of the end was the fall of conglomerate stock prices in 1968.

Inco vs. ESB and Colt vs. Garlock

Most deals during this early post-war era were friendly. The first significant hostile takeover in the US by a major firm was in 1973 when Inco (a mining company, originally named International Nickel Company) acquired ESB (a battery manufacturer, originally known as Electric Storage Battery); significantly, Inco was represented by Morgan Stanley, at the time the leading M&A advisor. Inco was successful in acquiring ESB, and this deal changed the rules of the game so that the large investment banks would now get involved in hostile bids. Note that the first hostile bid in the UK was in 1958 and 1959, when British Aluminium was acquired by Tube Investments and its American partner Reynolds Metals; the bidders were advised by S.G. Warburg.

Another deal, Colt Industries' lightning raid of Garlock in 1975, brought hostility to an all-time high. The new development in this deal was that Colt took the hostile negotiations public and advertised heavily, forcing Garlock even to hire a public relations firm, which may be common today but wasn't done in the early 1970s. Famously, its advertisements accused Colt of launching a "Saturday Night Special" (a term used in the US to denote unregistered hand guns purchased for immediate use in crime) which entered the M&A vernacular as a description for a takeover offer that is open only for a short period of time, thereby forcing target company shareholders to make a quick and not fully informed decision.

The **fourth** merger wave was from 1981 to 1989. During this wave, hostile deals came of age. Generally, the characteristics of this merger wave were that the number of hostile acquisitions rose dramatically, the role of the "corporate raider" developed, anti-takeover strategies and tactics became much more sophisticated, the investment bankers and attorneys played a more significant role than they had since the second merger wave, and the development of the high yield ("junk") bond market enabled companies to launch "megadeals" and even purchase companies larger than themselves. This last trend contributed to the high number of leveraged buy-outs with excessive use of debt and companies going private. Assisting this merger wave was relaxed antitrust enforcement, especially in the US under President Ronald Reagan and in the UK under Prime Minister Margaret Thatcher.

The **fifth** merger wave (1994–2000) was characterized by consolidations of industries and globalization. The dot.com boom and bust also occurred during this wave. Many "strategic" consolidations unfortunately failed to deliver on promised gains, such

as lower costs and greater synergies, and ended with the decline in stock prices worldwide beginning in 1999/2000. Nevertheless, there were a large number of significant deals during this wave in the following industries:

- Oil (BP/Amoco, Exxon/Mobil, Total/Petrofina)
- Financial services (Citicorp/Travelers, Deutsche Bank/Bankers Trust, Chase Manhattan/J.P. Morgan)
- Information technology (Compaq/Digital Equipment, Hewlett-Packard/Compaq)
- Telecommunications (Mannesmann/Vodafone, SBS Communications/Ameritech)
- Pharmaceuticals (Glaxo/Wellcome)
- Automotive (Daimler Benz/Chrysler)

The **sixth** merger wave began in 2003, less than three years following the end of the previous cycle, and ended abruptly as the financial crisis unfolded in 2008. That sixth merger wave was truly global and saw more focus on strategic fit and attention to post-deal integration issues. It was heavily influenced by the corporate governance scandals of the early years of the new millennium and the resulting laws and regulations that had been passed – most notably the Sarbanes-Oxley Act in the United States. It was also during this wave that the success rates for M&A deals began to improve. This was largely driven by three factors, as shown in Figure 1.2, which comes from a presentation that Towers Watson (then Towers Perrin before their own merger in 2010 with Watson Wyatt) developed together with Cass Business School.

An additional change in the sixth merger wave was the rise in activity by financial buyers (hedge funds, private equity funds, and venture capital funds) who do not and cannot have strategic interests as the primary driver. These funds purchase large stakes

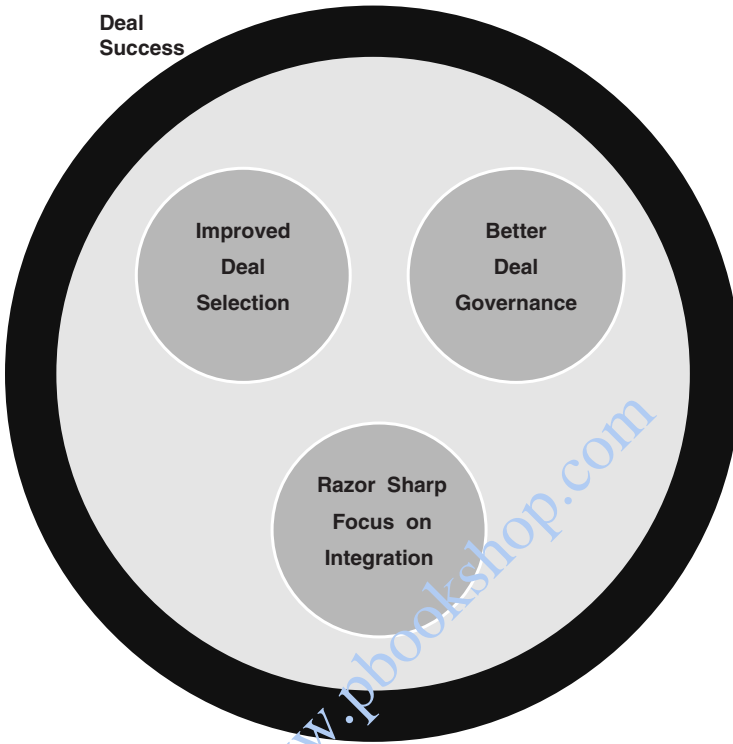


Figure 1.2: Sixth Merger Wave Success Factors.

in companies and then either purchase the remaining part of the company or force a reorganization through the exercise of their shareholder rights. In some cases these shareholder actions have stopped deals from taking place where the funds exerted pressure on management as they felt they could achieve higher returns in other ways, such as the return of cash to shareholders in the form of a special dividend or where the intrinsic growth potential of the company was seen to be excellent. This was the case in early 2005 when the Deutsche Börse was forced to withdraw its proposed takeover of the London Stock Exchange, despite the fact that the board of the Deutsche Börse had already approved the deal. More on this deal later. Financial buyers represented up to

40% of the M&A market in the US at one point before the sixth merger wave ended.

When will the next merger wave start? This has been the discussion among many market practitioners since the financial crisis in 2008. Most market practitioners are optimists, and have been forecasting the return of strong M&A market activity almost every year since. When it will occur is still uncertain. That it will at some point reoccur is almost a certainty. History will repeat itself, and not just in merger waves. Other ways in which this happens in M&A are the reasons and rationales driving the deals. Just as understanding the history of M&A is helpful in planning today's deals both offensively and defensively, understanding the drivers to deals is also critical.

Pharmaceutical industry consolidation: AstraZeneca's acquisition of Cambridge Antibody Technology

As one pharmaceutical industry expert told us in 2007, "No large pharma will be successful if they do not have a proportion of their pipeline coming from external sources. Most big pharma have around 30% of their pipeline in collaboration deals. Years ago the big pharmaceutical players thought they could exist on their own but they realized not. Merck were one of the last ones to realize this and had to get into trouble first [before they would consider the need for acquisitions] . . . In the early 1990s Merck was 'the' pharma company but they thought they could do it alone and look at them now. They have been hungry for deals in the last few years and have licensed a lot . . . All large pharma are saying the same thing 'The World is our Research Laboratory' . . . Of course, they are all mad!"

AstraZeneca was the UK's second largest pharmaceutical company. Its acquisition of Cambridge Antibody Technology (CAT), the UK's largest biotechnology company, began with an alliance. The relationship between the two firms had started in 2004 with AstraZeneca taking a 19.9% equity stake in CAT. According to the CAT website, they arranged a strategic alliance for the "joint discovery and development of human monoclonal antibody therapeutics, principally in the field of inflammatory disorders, including respiratory diseases." It was decided that CAT would be responsible for antibody discovery, manufacturing process development, and the supply of material for exploratory clinical trials. AstraZeneca was responsible for translational biology, clinical development programs, regulatory filings, and commercialization.

The results of the cooperation were encouraging and promised more for the future. Six discovery projects, one pre-existing CAT discovery program adopted into the alliance, and five new programs all had progressed on schedule by June 2005.

Building on the success of this existing collaboration, the companies decided to move further. On the morning of May 13, 2006, the shareholders of CAT woke up to some incredibly good news. AstraZeneca announced it was ready to pay an unprecedented 70% premium to acquire the remaining 80.1% of CAT's shares that it did not already own. AstraZeneca proposed paying 1320 pence per CAT share, higher than even the most optimistic analysts had expected, thus valuing the all-cash deal at £702 million.

AstraZeneca's purchase of CAT was a strategic step to secure operations in the biopharmaceutical market segment, build up future capabilities, strengthen its own positions, and limit the access of competitors to the technologies it considered critical.

REASONS FOR M&A DEALS

Some of the reasons for acquiring or merging may have started to become clear from the earlier discussions in this chapter, such as the need to control a source of raw materials in a backwards vertical acquisition, as BP announced when it acquired TNK. But it is usually necessary to dig deeper than the press statements from the parties involved. Very often the publicly stated reasons are quite different from the underlying strategic rationale (assuming such a rationale really existed at the time of the deal's genesis, as some deals are just opportunistic).

Merger creates the world's largest advertising company

In July 2013, Publicis and Omnicom announced that they would merge, creating the world's largest advertising firm by revenues. The combined companies would have sales of approximately \$23 billion, significantly higher than their rival, WPP, at over \$16 billion. The total market capitalization of the new company was \$35 billion, making it one of the largest deals of the year. The co-chief executives claimed that the deal would make over \$500 million in efficiency savings.

Such a large deal is complex. The companies said they were advised by "some of the best lawyers and do not expect any regulatory obstacles," yet it needed to be cleared by competition regulators in 45 countries. Competitors said the deal was bound to fail because the cultures of the two companies were so different, and, when the deal was announced, reports in the press predicted that there would be poaching of staff by those other firms. There would also need to be a review of client relationships as the combined company would have major

rivals now being served by the same advertising agency: Coke and Pepsi, Microsoft and Google, AT&T and Verizon, and Nestlé and Mars (according to a report in the *Financial Times*). The new company certainly hoped to keep both of each of these groupings.

The deal was expected to force a change in the industry, perhaps by making the other major players consider consolidating as well to achieve the same benefits of scale.

Numerous theories have been put forward regarding the reasons for mergers and acquisitions. Whether “. . . caught up in the ‘thrill of the hunt,’ driven to complete deals as a result of internal company politics, management bravado, or the need to boost divisional key performance indicators in order to reach bonus targets . . .,” as suggested to us by Sarah Byrne-Quinn, Group Director of Strategy and Business Development at Smith & Nephew, deals are often motivated by personal and financial as opposed to strategic considerations. Either way, to avoid peripheral issues taking center stage, organizations need to remain open minded when pursuing a deal, building teams which question assumptions on an ongoing basis and remain focused on the overall strategy for the company, while being motivated by the underlying “quality” of an acquisition at the right price.

There are often multiple reasons given, sometimes conflicting and overlapping. Generally speaking, the most common reasons used to justify a merger or an acquisition are claims of the need to increase market power, efficiency (in various forms, such as economies of scale), pure diversification (often because the core business is in a declining industry), information and signalling, agency problems, managerialism and hubris, and taxes. Each of these is discussed briefly in the box below.

Drivers to deals

- Size matters: many, if not most, deals are driven at least in part by the desire of management to gain more **market power**. These acquisitions are designed to increase influence through size and market share, tempered by the regulatory constraints of monopoly rules and regulations. As Maurice Lévy, the chief executive of Publicis, said in 2013 when announcing the aforementioned merger with Omnicom, thus creating the largest advertising company in the world, “What is true today is really not true tomorrow, and we have to be prepared for that . . . Size will matter.”
- **Basic efficiency** arguments claim synergies from an M&A deal are best illustrated by the oft-quoted equation “ $2 + 2 = 5$ ”; that is, the value of the newly merged firm is greater than the combined value of the individual firms prior to the merger. Thus, this is really a “growth” theory from both the shareholders’ and managers’ perspectives. More than any other factor, this one is used as an argument to convince shareholders that they should approve a deal. Although often independently verified, in most deals it is the bidder’s analysts that will provide the “proof” of these future synergies for both revenues and expenses.
- The first type of synergy is **revenue synergies**. These come from an ability for the newly-combined company to sell more products or services than the sum of the sales of the two previously-separate companies. Perhaps this is done because the new company can reach more clients, or they might be able to package products together in a way that was not possible earlier, thereby increasing sales. Often this is easier to project in the planning stages of the deal than to implement after the

deal closes, but this doesn't stop many deal architects from claiming these benefits as justification for the merger or acquisition.

- **Expense synergies** (sometimes referred to as “operational synergies”) take place when deals are done to achieve economies of scale where the aforementioned size matters or economies of scope where the efficiencies come from allocating expenses over a wider variety of activities. Mergers or acquisitions of scale and scope must be carefully constructed so as not to grow to a size where there are diseconomies of scale and scope; in other words, when the company becomes top-heavy and inefficient. Typically, in a merger situation, the management of the acquiring company will emphasize the cost synergies such as reduction in operating costs, elimination of duplicate facilities, and reduction in various departments (marketing, purchasing, sales, and so on). However, just as important should be the **revenue synergies** from the deal, which are often overlooked.
- **Financial synergies** arise if the internal capital market of the newly combined firms is considered to be more efficient than raising capital externally. This relates to the transfer of capital (money) from low to high return businesses. There is also the potential for increased debt capacity with lower borrowing rates if the company's credit rating improves due to the merger (although more commonly the credit ratings will be lower immediately following or even preceding a merger due to the uncertainty associated with the deal).
- A clever claim, that is most often hidden or only discussed within the bidder's consortium of insiders, is that there is **differential managerial efficiency**. This means that the bidder believes they have much better (“more efficient”)

managers than the target. Therefore, after the merger, the target's management efficiency will be raised to the level of the acquirer's as the bidder takes over senior management positions or trains the target's management to be better. If this is true, then the merger increases efficiency and creates shareholder wealth. This would be most likely where firms are in related businesses. Difficult to prove? Almost certainly. Common? Yes.

- The **strategic response** theory of takeovers focuses on the idea that a merger can be driven by a need to realign the firm in response to a changing external environment. The driver is therefore outside the company and may be due to product life cycles (where products or services are maturing, such as mobile phone manufacturing where the growth rates began declining in the early 2000s until smart phones began appearing) or product/service replacement (for example, when broadband began to replace dial-up modems for internet connections in homes). It may also be in response to the actions of competitors. One CEO of a Latin American bank told us that “if our competitors had not been buying other banks in the region, surely we would not be buying so aggressively. Sometimes you have to buy so that your competitor does not buy and does not get a dominant position in the market” – another example of the “arms race.”
- Individual companies may be **undervalued** or not valued properly by the stock market. Some deals therefore take place when the market value of the company before the acquisition does not reflect the full potential value to the acquiring company. Perhaps the value of the target was correct when it was a standalone company, but for a bidder taking into account some of the above factors (such as operating synergies and management efficiency),

the value of the company could be much greater to that particular buyer. If the deal is horizontal, the acquiring company may have better information than the financial markets about the long-term potential of the target in terms of competitive positioning, product development, sales, and so on. The problem here is that even if the acquirer has more information, they may fail to turn it into intelligence because the systems do not exist to do so. Often, knowledge will slosh around an organization without being adequately managed in order to deliver added value.

- **Pure diversification** can be valuable in its own right and may in fact also be faster and more efficient than growth through internal means. Diversification is often preferred by the existing management of the acquiring company, especially in situations where the existing markets (and therefore opportunities) are mature. Of course, shareholders can diversify much more efficiently and selectively than the company itself can, so what is best for the management and employees of the bidder may not be in the best interests of the stockholders.
- Although pure diversification is usually bad, **enhancing** deals can lead to greater post-deal success. These are deals where the acquirer's stated intention is to acquire to enhance or add capabilities (such as access to R&D or new technology) to its existing business. In a study released by Cass Business School's M&A Research Centre in early 2014, these 'enhancing deals' were significantly more frequent in a group of successful acquirers (34%) than in a group of acquirers where the deals ultimately failed (29%).
- One ploy sometimes used is called "**information and signaling.**" Just by making an offer, additional value is created as the target is put into play. This assumes and

follows the empirical evidence that most target company share prices rise when a new bid is received. If the offer carries new information (and the fact that there is an interested bidder may be sufficient new information), then the increase in share price may be permanent. But even when unsuccessful, it may result in a revaluation of the target's share price. In any case, the target management is now sensitized to the fact that they could be a takeover target and may work to make the company more efficient in response.

- Since it is almost impossible for shareholders in public companies to replace inefficient or poorly performing management, where **agency problems** (separation of ownership by shareholders and control by managers) exist – as in most public companies – acquisitions can be a solution. This is similar, therefore, to the differential management efficiency discussion above. Acquisitions are a discipline to managers when other, internal, mechanisms of corporate control have failed. The threat of being acquired can often be sufficient to assist in solving the agency problems.
- **Managerialism and hubris** drive deals all too often. Managers are interested in size (“big = better”) and do deals to increase the company size and therefore their personal power, compensation, perquisites, and so on. Managers are often overly optimistic in evaluating mergers, due to pride, “macho” culture, or hubris, and are prone to believe that “this deal will be different,” thus not learning from the past, as noted earlier, when most deals end in failure.
- **Tax considerations** are sometimes the impetus to merge – but rarely the only reason; there may be significant tax-minimizing opportunities in some mergers. One Latin American investment banker told us, following a tax

change in that region designed to foster M&A activity in order to encourage local company “champions” in the region: “The government wants [M&A] transactions happening inside the country. The sellers will be more willing to sell with the new tax measures.” Tax, as a deal driver, is not just a factor for developing countries. As reported by the *Financial Times* in August 2013, “Some of the biggest mergers and acquisitions so far in 2013 have involved so-called ‘tax inversions’ – where a US acquirer shifts overseas, to Europe in particular, to pay a lower rate.” They said that “a growing number of US companies are set to save hundreds of millions of dollars in tax by relocating to Europe after completing takeovers on the continent.” These included the US pharmaceutical company Perrigo, which purchased Ireland-based Elan and US advertising company Omnicom, which in turn purchased Netherlands-based Publicis.

Regardless of the drivers to the deal and the supporting analysis, the deal will also need to be sold – and justified – to a number of parties. Most important will be the owners of the company, which, in the case of a public company, will be the shareholders. As Michel Driessen, Senior Partner, Corporate Finance at EY, told us when speaking about the financial justification, “not only will buyers have to convince their own boards that an acquisition makes sense, they will have to share their analysis with the market at large. Key audiences for these public estimates of synergy benefits are shareholders and lenders, who use the information to help support their own valuations of the deal. Getting it wrong could undermine the buyer’s credibility and make it harder to justify acquisitions in the future.”

PUBLIC SECTOR MERGERS

Although the focus of this book and the examples shown are heavily weighted towards the private sector, the principles discussed apply to public and non-profit sector mergers as well. Certain differences should be noted. It would be a rare public sector deal that was hostile as these mergers are often the result of both long consultation periods and, at least in the democratic world, a long process driving toward consensus. That isn't to say that public sector mergers cannot be driven by one individual – such as New York City's Mayor Rudolph Giuliani's three attempts to merge two health departments in the State of New York, which were ultimately legislated on in November 2001. But even when initiated by one individual or group, the ultimate decision usually follows a democratic process.

Public sector mergers are, by their very nature, more political and often driven by politicians and government ministers. As governments change and new leaders come into office, one consideration is whether they can demonstrate change through the merging or de-merging of departments, offices, and public services. Of course, this is not to say that the private sector is immune to the demands of politicians in regard to mergers or acquisitions. One only needs to look at the pressure that certain banks came under when the financial sector was imploding in 2008 (J.P. Morgan in the case of their acquisitions of failing banks Bear Stearns and Washington Mutual, Bank of America's purchase of Merrill Lynch, and Lloyds TSB's purchase of Halifax Bank of Scotland).

Public sector mergers are becoming more common. Indeed, one of the regulators of the M&A industry in the UK is even merging, with the merger of the Competition Commission and the competition functions of the Office of Fair Trading into a single Competition and Markets Authority in April 2014. Many of these mergers have been driven by budgetary pressures and the

increases in demand for accountability that have forced governments and non-profit organizations to improve their performance and achieve key targets to satisfy the public demand for their services, as shown in the example from the UK's National Health Service (NHS) in the box.

Mergers and acquisitions within the National Health Service in the UK

The NHS runs the lion's share of hospitals, primary care facilities, ambulance services, and many other health care services in the UK. In recent years, there has been a significant effort to upgrade the standards of health services in the NHS through the creation of Foundation Trusts, with standards originally modeled after the private sector.

As part of this upgrade, the UK government has been encouraging NHS trusts to merge. This is expected to be especially attractive to the government when a well-run trust – which has already achieved Foundation Trust status – merges with a trust that has been in trouble, either on financial grounds, because there has been a clinical failure, or because it has otherwise missed key government targets in terms of standards.

The first such merger took place in 2007, between the Heart of England Foundation Trust and Good Hope Hospital. This had the approval of the Strategic Health Authority and the boards of the two organizations. The support of Monitor, the UK regulator of the Foundation Trusts, in all such mergers was conditional on the outcome of risk evaluation assessments. The deal was expected to allow for the improvement of health services in the region around Birmingham served by the two NHS organizations. Numerous mergers have continued within the NHS, in which it can be said that there has been a “merger wave” of consolidation since that time.

There may be a natural cap to this trend, however, as numerous studies (mainly from the US and Canada, which both have different health care systems to the UK) have shown that the health care sector begins to see diseconomies of scale as hospitals merge. In one study from 1997, the authors (Ferguson et al.) found that hospital scale economies became exhausted in the 100–200 bed range and diseconomies began between 300 and 600 beds, depending on the type of hospital. Indeed, in a small survey conducted by a student from Cass Business School in 2012, 69% of respondents said that they disagreed with the statement “Do you believe that mergers in the NHS lead to economies of scale?” Similar studies have found that economies of scale are difficult in Health Maintenance Organizations (HMOs) in the US in terms of enrolment numbers.

As with private sector acquisitions, public sector mergers can also be triggered by external shocks. The terrorist attacks in the United States on September 11, 2001 led to a reorganization within the federal government of the US whereby some 22 departments (including border patrol, immigration screening, and airport security) were combined to form the Department of Homeland Security. This was akin to a similar reorganization that took place in the US after World War II, when the War Department became the principal component of the newly created Department of Defense. These mergers were driven by demands to improve the quality of management and services, as well as the need to increase efficiency, coordination, accountability, and cost savings. However, as is shown in the box below, the merger of public sector departments is even older.

Merger of the UK Foreign Office and Commonwealth Office

The Foreign Office was formed in 1782, originally as the Foreign Department. In 1919, it merged with the Diplomatic Service and was merged again in 1943 with the Commercial Diplomatic Service and the Consular Service. These changes were in response to the increasing complexity of the management of foreign relations, such as an increase in embassies throughout the world and the expanding demand for passport issuance as greater numbers of people traveled.

The Commonwealth Office was formed from a merger of the Commonwealth Relations Office and the Colonial Office in 1966. This was driven by a change in the status of the former British colonies after World War II. Most of those colonies were now independent and the Colonial Office was no longer needed. The Colonial Office had been set up in 1660 from the Council for Trade and Plantation, so had a history even longer than the Foreign Office.

The new office – the Foreign and Commonwealth Office – was formed in October 1968, having taken seven months to complete. It was driven by the need to increase efficiency and eliminate overlapping roles with the changes in the nature of the former colonies and other countries. It was an amicable deal, and both organizations supported the combination. Given that both had long histories of prior mergers, it was seen as just another step in a long line of change, although naturally there were significant differences in the drivers of the most recent merger.

The third sector – charities, including volunteer and other non-profit organizations – can also be active in merging and acquiring, often for many of the same reasons as private sector companies. These reasons often include the need for increased

scale and scope, greater efficiencies in operations through economies of scale, the acquisition of management and organizational talent, and even for particular assets (such as donor lists). Local and central governments are under pressure to reduce their direct social care costs because of budgetary pressures, and this has led to a trend towards a greater reliance on charities and other voluntary organizations. In addition, in the past some of these organizations received funding directly from the state, which is now being reduced. These two forces are combining to increase pressure towards having increased size and scope, thus leading to the need for consolidation in the charity industry.

Mergers creating the Royal National Institute of Blind People

On April 1, 2009, the Royal National Institute of Blind People (RNIB), founded in 1868, announced that it was merging with another UK charity, Action for Blind People, which had been founded in 1857. As the RNIB had conducted a number of mergers in the prior five years, the new merger cemented its position as the number one sight-loss charity in the UK. Further mergers have taken place. This is an example of a classic roll-up, or consolidation, M&A strategy.

The RNIB's CEO, Lesley-Anne Alexander CBE, had often stated that it was counter-productive to the well-being of blind people that there were over 700 charities in the UK dedicated to serving their needs. Her vision was to have a single national charity providing high volume and large scale services and campaigns which also supported a UK wide covering of independent local charities responsible for individual engagement with blind people. This model would drive sig-

nificant efficiencies in fund raising and financial and support services, whilst at the same time ensuring consistent and high quality service provision for blind people and their families. Accordingly, soon after joining the RNIB, Alexander initiated a programme of mergers with a notable event in 2007, which was joining the National Braille Library with the National Talking Books Service.

As Alexander explained to us, “We don’t have a share price. We don’t have a dividend. We don’t have a share value. So we don’t have traditional drivers for mergers. They have to come from the heart in our sector.”

CONCLUSION

From whichever perspective one views M&A activity – whether economic, strategic, financial, managerial, organizational, or personal – corporate takeovers should permit firms and organizations to promote growth and offer savings while achieving a significant and sustainable competitive advantage over their rivals within the global marketplace. With new markets opening at an unprecedented pace, the evolution of the competitive landscape means that acquisitions must be made in order for the company to succeed in filling the product, geographic coverage, and talent gaps. As such, an acquisition provides senior management or a board of directors with the opportunity to grow more quickly than would otherwise be possible, with access to new customers, new technologies, greater synergies, and the power that comes with size. It is also an adrenaline rush for all involved at the top, despite the possibility that many will be made redundant, including some of the senior managers driving the deal.

M&A deals are risky. A full merger or acquisition should be attempted only as a last resort. (We will briefly discuss the alternatives to M&A later, in Chapter 5.) Full integration may take years to complete and will necessarily include its own expenses, and therefore the payback and other financial benefits may be a long time coming. Current employees, customers, and suppliers may be neglected. There's the tendency to overpay when acquiring another company, not just because of the auction effect if there are multiple bidders for the target, but also because the sellers are motivated to get the highest price possible and they are the ones who know their own company best - where the skeletons are hidden and which assets are most valuable. For bidder and target alike, it is critical to use business intelligence efficiently. There are just too many areas where mistakes can be made in the acquisition of another company.

Merging or acquiring can be a threat to the current shareholders or a great opportunity. The outcome is never preordained and certainly is an excellent business application of Prussian Field Marshal Helmuth von Moltke the Elder's maxim that "No battle plan survives contact with the enemy." It is necessary to crawl carefully through the minefield, using as much intelligence as possible to avoid the potential and often very real dangers.