

A User's Guide to Successful M&As

Herman Vantrappen and Petter Kilefors

The global number of mergers and acquisitions has rebounded strongly since 2004. Many top executives are wondering whether it's worth getting back into M&A as a tool for growth - and if so what best-practice maximises the chances of success. As Vantrappen and Kilefors explore in their article, not all mergers and acquisitions make sense. They provide a summary of what academia has to say, the steps to success and what executives need to do to make the best from the complicated world of M&A.

After the bursting of the stock-market bubble in 2000, merger and acquisition (M&A) activity collapsed spectacularly. The year 2004 saw a clear rebound, which has continued even more strongly this year. At a time of such a strong upward trend, many business executives are asking themselves how they should best go about takeovers.

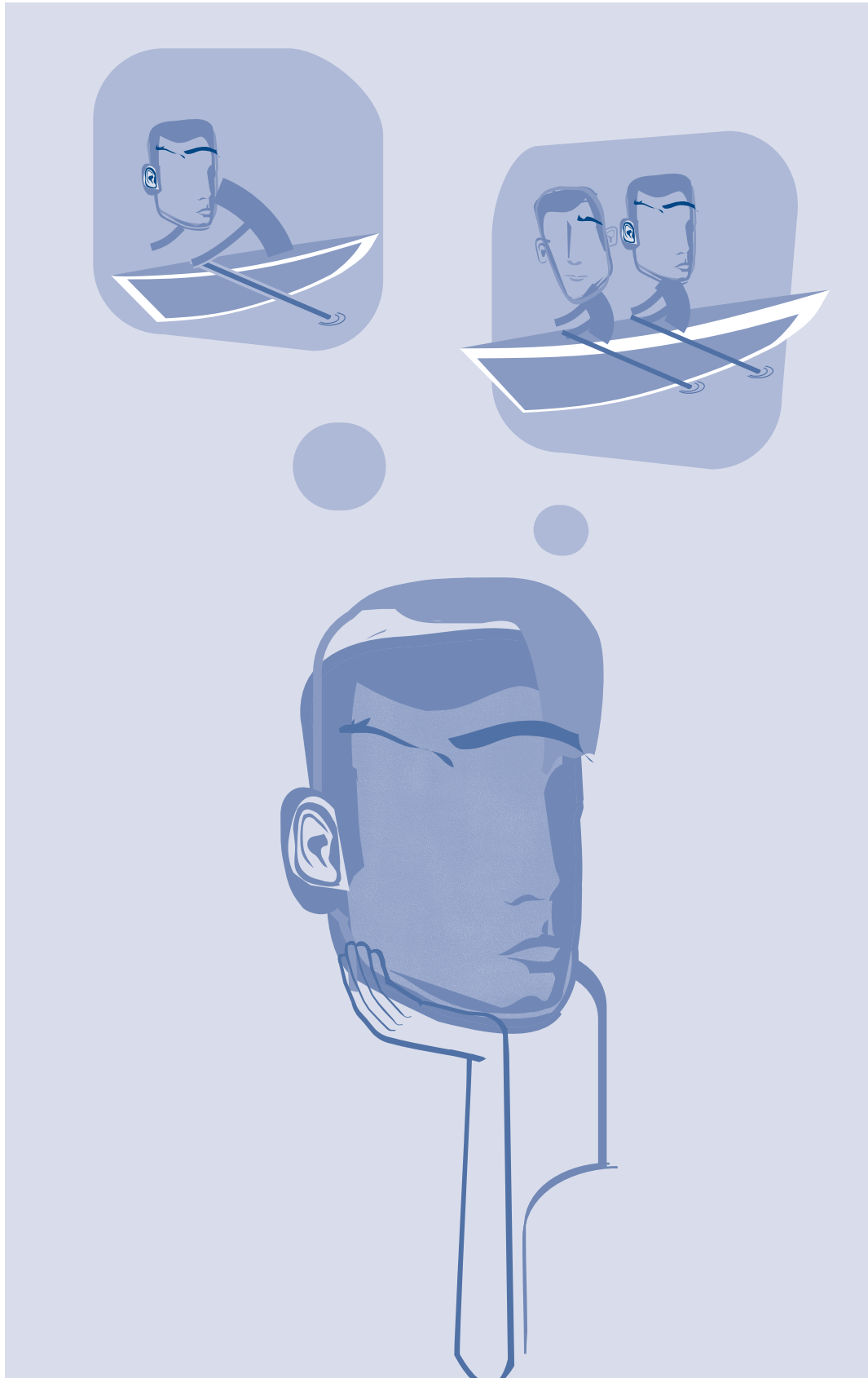
On the one hand, executives and investors have become more critical with respect to the synergies that are promised to materialise from a takeover. But, on the other hand, they remain under constant pressure to increase revenues, profits and share prices fast. As organic growth is slower than growth by acquisition, the latter is an attractive-looking alternative.

The purpose of this article is to present a framework that executives can apply when establishing and implementing an M&A strategy for their company. The article gives an overview of the status quaestionis regarding M&As. It is based upon our hands-on experience with M&A situations and conversations with a number of executives, plus a thorough review of the recent scientific literature in this field.

Where we are coming from

At its peak in 2000, the worldwide value of announced M&A transactions was more than US\$ 3,700 billion. Two years later, the value hit barely the US\$ 1,300 billion mark. A combination of mutually reinforcing factors explains this collapse:

- **Economics:** The economic downturn pushed topics other than M&As to the top of the management agenda, such as the integration of previously acquired activities, restructuring, delocalisation, debt reduction, etc. "Cash is king" was the new tune;



- **Finance:** Takeovers cost money, and suddenly cheap money was scarce. The sharp fall in share prices made the financing of takeovers with shares less attractive. Banks raised their terms for debt financing;
- **Governance:** In the wake of a series of sensational corporate scandals, the concept of corporate governance gained importance and the Sarbanes-Oxley Act was introduced. Directors and shareholders became more risk-averse and started studying takeover files and the executives who promoted them with a more critical eye, not least through US GAAP/IFRS regulations on purchase price allocations and goodwill impairment testing;
- **Psychology:** Part of the M&A activity in the bubble years can be attributed to herd behaviour. If your competitors are doing takeovers all over the place, it is hard to stay on the sideline. But with the bursting of the bubble, the former "hero" soon became a "fool", and the stamp "decisiveness" changed into "a flight forward";
- **Markets:** There is a market for companies and parts thereof, with buyers and sellers. In the post-bubble period, sellers considered prices too low, and were waiting for times that would value their companies correctly. At the same time buyers turned more risk-averse, waiting for prices to drop further.

In 2004, however, there was a clear revival of M&A activity, not only in the number of transactions but also in value. The worldwide value of announced transactions clocked at more than US\$ 2,000 billion. The factors that had led to the collapse were turning around. In 2004 the world economy grew at its fastest pace for three decades. Lots of companies are sitting on a mountain of cash, as evidenced also by major share buy-backs and dividend pay-outs. Most stock exchanges have largely recovered from the crash. Real interest rates are at a historically low level. And "private equity" players have had a catalytic effect on the M&A market: in 2004 they accounted for 11 per cent of the market in value terms, compared to just 2.5 percent in 2000.

This M&A revival confronts executives with a dilemma. On the one hand, the memories of the bubble-bursting still have a sobering effect, which is compounded by the conclusions from a large number of scientific studies that seem to indicate that value-creation through M&A is far from obvious. On the other hand, there are still many valid reasons, as well as internal and external pressures, for engaging in takeovers.

Economists identify five reasons why companies engage in takeovers. The first two are the most important ones:

1. Increasing **efficiency** through economies of scale or other so-called "synergies";
2. Gaining **market power**, sometimes by forming a monopoly or oligopoly;
3. Removing **incompetent management** in the target company;
4. Satisfying the self-serving **expansion desire** of the acquiring company's management;
5. Taking advantage of opportunities for **diversification**.

1. Increasing efficiency

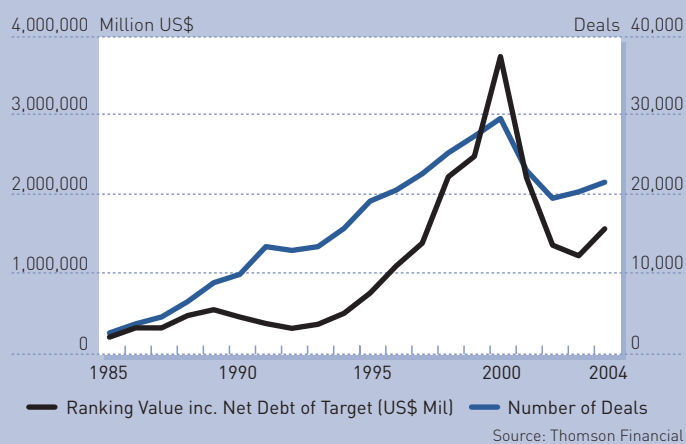
If one company acquires another, in most cases it pays the target's owners a takeover premium on top of the latest share price or, in case of non-listed companies, the assumed intrinsic value. The average takeover premium for listed companies was 15 percent and 22 percent in 2004 and 2003, respectively. Historically, the takeover premium has usually been between 10 percent and 40 percent. If we assume that capital markets are fairly efficient, the share price accurately represents the value of the company on a stand-alone basis. If an acquirer nevertheless is prepared to pay a premium for a target, it means he must see unique opportunities to increase the efficiency of the combination of acquirer and target and thus recoup the premium. If he were not convinced of the ability to realise these "synergies", the acquirer would consciously destroy shareholder value.

Such synergies are varied in nature. First, there are economies of scale. For example, economies of scale in R&D and sales were often advanced in the pharmaceutical industry to explain the emergence of giants like GlaxoSmithKline within a period of 10 years. Second, there are economies of scope. For example, Ford Motor Company acquired Aston Martin (1987), Jaguar (1989), Volvo Car (1999) and Land Rover (2000), thereby seeking opportunities to share costs in development, purchasing or manufacturing, while preserving the identity of each brand. Third, a takeover enables a company to build a new business faster and/or with lower expenditures and/or at lower risk than would be possible through internal R&D efforts. The takeovers of biotech companies by pharmaceutical companies are good examples.

The Magnitude of the M&A Phenomenon

Takeovers have gained considerable importance in recent decades. In 1985, announced transactions accounted for a worldwide transaction value of hardly US\$ 200 billion. At its peak in 2000, the value stood at more than US\$ 3,700 billion. During that period, the number of transactions rose from 2,500 to 30,000.

Exhibit 1 Worldwide Transactions Between 1985 and 2004



The average transaction value is also increasing. In 2004, takeovers with a transaction value of more than US\$1 billion accounted for 54 percent of the total value.

2. Gaining market power

In industries subjected to strong price pressure, a company can use a takeover to become bigger and carry more weight relative to customers and/or suppliers, and thus exact higher prices from customers and/or pay lower prices to suppliers. Such strategy applies in particular in industries where overcapacity leads to price pressure. A series of takeovers can lead to consolidation and the reduction of capacity. In such situations, it is a matter of eating or being eaten. The same strategy can also apply in industries where the price pressure is the result of an imbalance in the level of concentration of the supplier industry on one hand and the customer industry

on the other hand. When very many small suppliers provide similar products to a very few large customers, the latter can exert strong price pressure.

The steel industry, for example, is still highly fragmented, with the 10 largest steel manufacturers accounting for only one quarter of total supply. But the two principal supplier industries, i.e. iron ore and coking coal, are very concentrated, with three and four mining companies accounting for 70 percent and 75 percent of iron ore and coal exports respectively. The same is true for many of the steel industry's customer industries, such as the car industry, where five groups account for 65 percent of the world market. Despite the recent boom and capacity utilisation of 95 percent in early 2004, a new wave of consolidation in the steel industry can be expected.

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3. Removing incompetent management

Some acquirers take over a target because they consider that the target is poorly managed. By removing the incumbent managers, they hope to improve performance and create value. This type of takeover was in the spotlight in the 1980s, when a couple of notorious corporate raiders such as Carl Icahn and T. Boone Pickens performed spectacular takeovers in sectors such as oil, steel and airlines.

4. Satisfying expansion desire

Some managers launch takeovers not to create shareholder value but for dubious self-serving reasons, such as being seen as empire-builders. For them, the mere fact of closing a transaction is a measure of success. Many observers consider the spectacular makeover of Vivendi from a utility company into a media company (including the takeover of Universal) to be an example of this phenomenon, one that ended badly for the shareholders. The share price peaked at € 122 in February 2000, and was trading at about € 25 at the start of 2005, the same price as 10 years earlier. Obviously, misplaced financial incentives and a lack of supervision play a role in what economists call an "agency problem".

5. Taking advantage of opportunities for diversification

Diversification as such rarely creates shareholder value. Nevertheless, a takeover may enable a company to diversify

in a way that does create value. For example, as a result of its larger size, the company may be able to reduce the risk of bankruptcy and thus lower its cost of capital. Or, as a result of absorption by a larger parent company, a target may be able to finance its investment projects more cheaply than when having to call on the capital market directly. Opportunities for multiple arbitrages may also prevail, in particular for private equity investors consolidating fragmented industries.

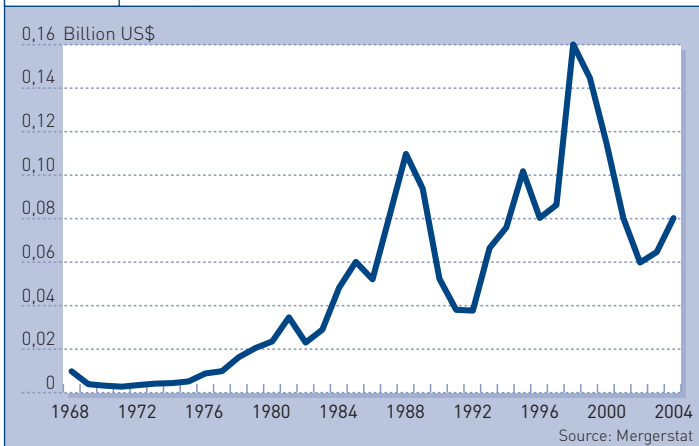
Obviously, several of the above reasons may be at play simultaneously at any one given takeover. Whatever the reasons, the question remains whether a takeover creates value. Let's look at what economic scientists can tell us.

What the Scientists tell us

Economists study two fundamental questions:

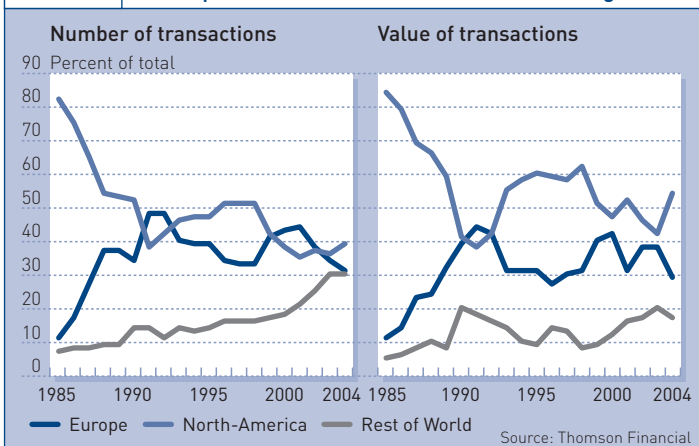
1. Do takeovers create value for the shareholders of the acquiring and/or acquired firm?

Exhibit 2 Average Transaction Value (US and US Cross-Border)



North American companies dominated the takeover market 20 years ago, accounting for more than 80 percent of all transactions worldwide, both in value and volume. Since the start of the 1990s, European companies account for about one-third of all transactions. The rest of the world is now catching up: while it accounted for barely 5 percent in 1985, the rest of the world accounted for 30 percent of the volume and 17 percent of the value of all transactions in 2004 (see exhibit 4).

Exhibit 3 Development of Transactions in Different Regions



2. If one looks at the takeovers that did create shareholder value, which factors made the difference?

Despite decades of scientific research, there are still no remotely unanimous or conclusive answers to these two questions. By itself, that should not worry, let alone discourage, the business executive too much. For one thing, scientific research runs into methodological constraints. For example, science cannot assess whether the acquiring company would have created more or less value if it had not launched the takeover. Also, most of the research focuses necessarily on takeovers by and of listed companies, i.e. with publicly accessible financial information, rather than on takeovers of private companies or parts of companies.

Most importantly of all, the averages that are found through research by definition mask the better-than-average cases. For example, studies show that value destruction is concentrated in a limited number of super-large takeovers. The challenge for the individual executive is to make sure that his or her company scores better than average.

Despite the absence of a final verdict from science about value creation at takeovers, the literature does give a number of hints. First, as far as returns are concerned:

- On average, the shareholders of the **targets** are clearly winners of takeover transactions. The average abnormal return on shares of the target between announcement of the takeover and closure of the transaction is around 25 percent;
- On average and in the short term, the shareholders of the **acquirer** certainly are not the winning party. Most estimates indicate even a slightly negative abnormal return of minus 4 percent;
- Most estimates indicate that the abnormal short-term return for the **combination** of acquirer and target is slightly positive on average, at plus 2 percent. This could be interpreted as meaning that the shareholders of the acquirer are subsidising the transaction;

The fact that abnormal returns are quasi nil should not be surprising. In a competitive economy with efficient capital markets, it is hard for companies to consistently make investment decisions that yield abnormal returns.

Shareholders should be extremely wary when a large company wants to make a one-off acquisition of another large listed company in an unrelated industry, paying with its own shares and without there being other bidders.

- The estimates and conclusions about the **long-term effect** of takeovers on share price, profitability and operational cash flows are very divergent. The fact that abnormal returns are quasi nil should not be surprising. In a competitive economy with efficient capital markets, it is hard for companies to consistently make investment decisions that yield abnormal returns.

Second, in terms of factors that could explain variations in returns, there are some indicative conclusions from the scientific literature:

- **Target size:** Takeovers of targets that are small compared to the acquirer may yield higher returns for the acquirer than takeovers of similarly sized targets;
- **Acquirer size:** Takeovers by small companies may yield higher returns than takeovers by large companies. Large companies are suspected of paying higher takeover premiums;
- **Relatedness of acquirer and target:** Takeovers in which acquirer and target hail from the same industry may yield higher returns than takeovers that entail a diversification by the acquirer;
- **Frequency of takeovers:** Companies that repeatedly complete small takeovers may realise higher returns than companies that complete fewer and larger takeovers. Learning effects could explain this phenomenon;
- **Cash versus shares:** Takeovers that are financed exclusively with shares may yield lower returns, both for the shareholders of the acquirer and the target, than those that are financed with cash. One explanation could be that an acquirer may want to pay with his own shares when he deems his shares are over-valued;
- **Nature of the target's owner:** An acquirer may realise higher returns when taking over a private company or a subsidiary than when taking over a listed target. One explanation could be that the acquirer gets a discount

to compensate for the illiquid character of the target shares;

- **Number of bidders:** Situations in which there is more than one bidder may create more value for the eventual acquirer than situations in which the latter is the only bidder. While this finding is counter-intuitive, the explanation could be that an obvious opportunity to create value attracts several bidders, whereas only one fool buys a pig in a poke.

In other words - and in as far as the above conclusions from science stand up - shareholders should be extremely wary when a large company wants to make a one-off acquisition of another large listed company in an unrelated industry, paying with its own shares and without there being other bidders.

What Executives can do

The scientific literature on takeovers is insufficiently conclusive to be able to present clear normative instructions to executives. However, by combining the insights from the literature with the experience of seasoned acquirers and, let's face it, common business sense, it is possible to produce a best-practice framework with guidelines that should enable executives to enhance their chances of creating value in takeovers.

These guidelines fall into five categories:

1. Align your M&A strategy with your **business strategy**;
2. Look at M&As as one among several **collaboration strategies**;
3. Build a permanent **M&A competence**;
4. Handle a takeover as a **trajectory** instead of a transaction;
5. Show **discipline** in managing the takeover process.

Instead of purposefully searching for acquisition opportunities, executives sometimes launch takeovers when an apparently exciting opportunity passes by.

1. Align your M&A strategy with your business strategy

A takeover is a means to an end, i.e. to make the business strategy happen and create value. It sounds obvious yet is sometimes forgotten. Instead of purposefully searching for acquisition opportunities, executives sometimes launch takeovers when an apparently exciting opportunity passes by. If a cogent business strategy exists, on the other hand, and if it has demonstrated its value-creating power, it will be much easier for an executive to resist internal or external pressure to grab a “unique” yet ill-advised opportunity.

Assuming the existence of a cogent business strategy, an effective M&A strategy should enable the executive to act quickly and correctly when a real opportunity emerges. The M&A strategy addresses the following aspects:

- The fields in which the business will look for takeover opportunities;
- The reasons why the business will look for takeovers, such as realising economies of scale or gaining market power;
- The “must” and “want” criteria that potential targets will have to satisfy;
- A pipeline of potential targets, and the priority given to each of these so that the business can change gear fast when required or possible;
- The reasons why the business could be an attractive acquirer for the potential targets.

Establishing an effective M&A strategy is one thing. Controlling its proper application is another. In the heat of a takeover process, the business strategy and shareholders' interests must prevail. Both company management and directors should be watchful of phenomena such as hubris, empire-building, herd behaviour and moral hazards. Herd behaviour can be described as the feeling that it is better to be collectively wrong than to be possibly the

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only person to be right. Moral hazards can occur when, for example, an executive's remuneration depends solely on the size of the business he or she manages, or when the approval by the target's manager of a takeover is facilitated by a generous farewell premium.

2. Look at M&As as one among several collaboration strategies

A takeover is one among many collaboration strategies. An alliance is the most closely related to a takeover. One can distinguish between a contractual alliance (collaboration without a separate legal entity) and a joint venture. Other collaboration strategies involve licence agreements, corporate venturing, or asset deals.

Takeovers and alliances should not be considered competitors of each other. Depending on the objectives and circumstances, one or the other is the more appropriate. The following aspects should be considered:

- An alliance allows a company to “test the waters”, putting a limit on the duration, risks and costs of the collaboration;
- An alliance can be used as a first step in the permanent withdrawal from or full entry into a business (for example, BP and Solvay merged their polyethylene production into joint ventures in 2001, from which Solvay fully exited four years later);
- An alliance may be the only available alternative, for legal or competition reasons (for example, in certain countries or sectors, takeovers by foreign owners are barred);
- An alliance between several parties can be set to steer industry developments into a favourable direction (for example, technology alliances to promote emerging standards);
- For a young company, an alliance can be a source of financing without forcing the company to give up its

autonomy (for example, a large company can pay part of the product development costs in exchange for the exclusive right to market the resulting product in a specific region).

3. Build a permanent M&A competence

Successfully planning and realising takeovers requires know-how, both from the executive as an individual and the company as an organisation. While each takeover is a case apart and needs evaluating on its own merits, there are large similarities between takeovers from a process perspective: screening the target, establishing a preliminary agreement, conducting the due diligence, structuring the transaction, informing all relevant stakeholders, closing the transaction and processing post-acquisition claims.

It is recommended that this process be codified and embedded into the organisation in terms of tasks, responsibilities, sequence and expected outputs. An almost routine-like handling of the takeover process will reduce the likelihood of mistakes and omissions. In order to learn, formal debriefings after the takeover are equally important.

For large companies, it may make sense to establish an M&A department, whose tasks include:

- Helping to shape the M&A strategy;
- Maintaining the pipeline of takeover targets and watching competitors' actions;
- Steering the takeover process when concrete opportunities materialise;
- Fulfilling specialist takeover tasks related to valuation, financing and communication, in close cooperation with other specialist departments (legal, finance, communications, human resources, etc) and the business managers concerned;

While each takeover is a case apart and needs evaluating on its own merits, there are large similarities between takeovers from a process perspective.

- Selecting, managing and coordinating the contributions of the external advisers (investment bankers, auditors, lawyers, strategy consultants, etc);
- Taking care of the interface with the target's M&A department;
- Taking care of the interface with the integration team that gets off to a start as the takeover process progresses;
- Keeping an eye on the costs of the takeover process;
- Conducting a debriefing upon closure of the transaction and translating the findings into improvement actions;
- Fulfilling the above tasks also for divestments and alliances.

In other companies, the business development department may take care of these tasks. Whatever the set-up, the important thing is to be able to rapidly mobilise a multi-disciplinary team under central command and with clear responsibilities whenever a concrete takeover opportunity comes into view.

4. Handle a takeover as a trajectory instead of a transaction

A takeover is a means to create value. The value is not created at the moment the transaction is closed and the paperwork gets signed. On the contrary, at the moment of signature, it only starts. The subsequent successful integration of the target will determine how much of the projected value is created in actual fact. To ensure successful integration, one should think through the integration strategy and act correspondingly, from the very start of the takeover process. In other words, a takeover should be handled as a trajectory and not just as a transaction.

The acquirer must get into his hands the levers for creating and maintaining value. Therefore the integration strategy depends on the very reasons for undertaking the

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takeover. If efficiency gains through economies of scale are the primary objective, full and fast operational absorption is called for. If the purpose is to benefit from economies of scope, selective assimilation is often appropriate (for example, integrating the purchasing activities yet keeping brand management separate). If the goal is to eliminate overcapacity and gain greater market power, all-inclusive integration is the way to go.

Whatever the integration strategy, the human side of the matter is crucial:

- Turn the business managers of both acquirer and target, especially those at the middle level, into owners of the integration. Notwithstanding the sometimes tough negotiations, as an acquirer build relationship capital with the target's managers as early in the process as possible - at least if you intend to keep them after the takeover. Give business managers incentives linked to a successful integration. Make employees from both companies work together on concrete opportunities as soon as possible;
- Limit uncertainty through clear and continuous communication. A takeover leads to important change, both at the acquirer and target, and thus to uncertainty about job security, management structures, roles, reporting lines and career opportunities. Uncertainty feeds irritation and speculation, which are usually counter-productive and paralysing. Realising short-term synergies by pursuing quick wins is a concrete way to communicate positively and keep spirits up;
- Stick to agreements made during the takeover negotiations. Non-observance of the letter and spirit of agreements can seriously sour the climate. In that context, it makes sense to include one of the members of the negotiation team in the integration team.

In addition, for large takeovers many companies appoint an integration manager. He or she stands alongside the business managers of the acquiring and acquired companies in order to steer the integration process. The integration manager comes from the organisation of the acquir-

The acquirer must get into his hands the levers for creating and maintaining value. Therefore the integration strategy depends on the very reasons for undertaking the takeover.

er. One of the most important selection criteria is the person's intimate knowledge of the organisation's activities. Furthermore, he or she should not be afraid of tabling all issues and breaking through the internal politics.

5. Show discipline in managing the takeover process

As we have demonstrated earlier, the roots of a successful takeover lie in a well thought-out strategy. Equally important is a meticulous approach to the operational aspects of the takeover process at all stages. Attention to detail and discipline are vital, despite or precisely because of the time pressure, nervous tension and secrecy that usually accompany a takeover. For good reason, it is said that "a deal is not a deal until the deal is done."

Within that context, it pays to keep in mind all stakeholders at all times. Depending on the industry sector and the nature of the takeover, these can include: the shareholders, boards of directors, management and employees of the acquirer and the target; the lenders; the lawyers and other advisers; the regulatory authorities (competition, securities, etc.); unions and employee representatives; non-governmental organisations and pressure groups; the financial analysts and investor community; the media and the community at large (local authorities, etc). Certainly for complex takeovers with a big impact, a systematic risk analysis and a communications plan with regard to each stakeholder group are a necessity and not an extravagance.

A takeover is usually an intense episode. As the takeover process progresses, the excitement, invested energy - including at the emotional level - and commitment toward the other party keep mounting. In such circumstances it is sometimes hard to stay dispassionate at all times. Senior executives can fall prey to deal fever, displaying symptoms such as visual stricture and reduced resistance. Among the best precautionary measures and remedies are the following:

- A clear business strategy that serves to validate the rationale of the takeover at hand;

Senior executives can fall prey to deal fever, displaying symptoms such as visual stricture and reduced resistance.

- Effective governance, with directors who can be a counterweight to senior management when required;
- Terms (such as the walk-away price) that have been set beforehand and from which no deviation shall be allowed;
- Implacable acceptance of the outcomes of the due diligence;
- Splitting up the negotiation team into separate sub-teams;
- Having a fall-back alternative for the takeover of the target, so as to better assess its relative value.

To put it differently: the good feeling from a successful takeover remains long after the irritation of an extra appraisal or negotiation round has been forgotten.

Insights for the Executive

Generic and normative guidelines for completing takeovers are hard to come by because of the diversity of situations and the absence of scientific grounding. What is possible, though, is to stimulate reflexes that can be applied to specific situations by executives with common sense and a nose for nuance (see exhibit 4). Does the takeover fit with my business strategy? Does it create value? Are there any alternatives to the takeover? Haven't I lost sight of vital financial, legal or regulatory aspects?



Can my management team cope with the extraordinarily large number of decisions that have to be made within a short time-frame? Have I done everything possible to sustain value creation after closure of the transaction? What have I learnt from previous takeover trajectories?

A takeover is as good as the management and board of the acquirer are. At the end of the day, it is all a matter of bundling clear strategy formulation and careful execution.

This text is an English summary and adaptation of a white paper originally written in Dutch by Herman Vantrappen and two co-authors (Koen Dejonckheere and Paul Van Hooghten) on behalf of Metena, a business think-tank based in Belgium. For the full original text and complete literature reference list, please refer to www.metena.be/publicaties

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