CHAPTER ONE

Introduction

There are few activities in the world of business that can match mergers and acquisitions (M&A) in terms of opportunity to transform, potential for reward and risk of danger. A successful merger or acquisition can allow a mid-tier company to leap into the top tier. The effect for the company can be transformational; the rewards for that company, its shareholders, employees and management can be rich indeed. Economies of scale can widen margins, new territories can be entered and new technologies adopted, for example. On the other hand, when a merger fails, before or after the 'deal is done', the impact can be devastating, resulting in the loss of credibility, destruction of value and in some cases bringing all parties to ruin.

And indeed, there are few activities which are so likely to fail and cost so much when they do. Depending on how you measure it, between 50% and 80% of M&A deals fail to attain their objectives. This book is all about avoiding those failures. It gives you a clear framework and a set of tools to manage and successfully deliver M&A from outset to complete integration time and time again.

This section addresses the subject of M&A in general. As such, it forms the foundation for understanding the topic and is also the foundation of this book. It provides an introduction to M&A and introduces the lifecycle that

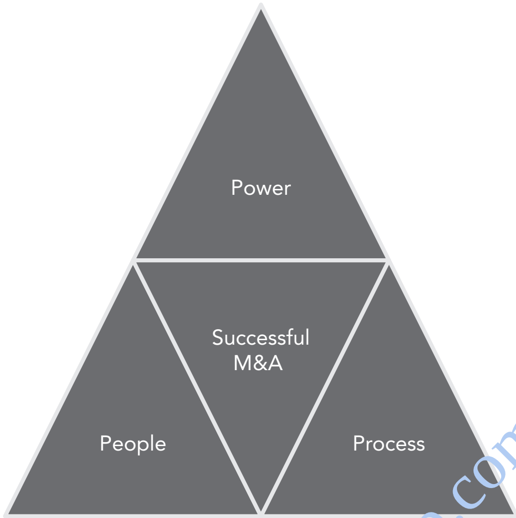


FIGURE 1.1 Three capabilities for successful M&A

deals generally follow. Different types of M&A and motivations for entering M&A activities are examined and recent trends in M&A are also explored. This section also examines the challenges of M&A, the very high degree of failure that is experienced and the causes of those failures, as well as the risk behaviour exhibited and the managerial challenges. The particular and unique challenges of banking deals are explored. This is particularly important in the light of several 'shotgun marriages' which have taken place among European and American financial institutions since 2008.

Of course, there are many reasons why firms embark on this route; as stated earlier there are great rewards available, which this section will look at. It is important to understand that, even if they involve the same firm, every M&A transaction is unique. A consequence of this is that there is no 'one size fits all' solution to successful M&A integration. To be successful at acquisition, at a minimum, the acquiring organisation and both partners in a merger need to possess three core M&A capabilities. These three core capabilities are:

- **Power** – The vision, capability, knowledge and will to deliver not only the deal but also a successful integration across organisational and cultural boundaries.
- **People** – The ability to manage effectively all the key stakeholders involved, not just employees but regulators, unions, customers and more.

- **Process** – Possessing the necessary knowledge of the systems and processes in each organisation combined with the change management and control capacity to implement the end deal.

If you are already versed in this field, you might feel a temptation to skip some or all of this section. Whilst that is your prerogative I would encourage you to at least browse this section as it provides the framework for the remainder of the book.

Each one of these capabilities is described and explored in greater depth later in the book. Failure to possess any of these capabilities is the surest route to M&A failure. In providing an introduction to M&A we will examine the types of M&A deals that can occur and the structure of an M&A through its lifecycle; we will present current trends in M&A and consider what the future may hold.

FUNDAMENTALS OF MERGERS AND ACQUISITIONS

Before embarking on any discussion there are a few points in relation to M&A you need to be aware of:

- Volumes (the number of deals) and values (the price of those deals) of M&A deals have tended to grow over time. But they usually grow in waves rather than continuously.
- People tend to get emotional about them, for many good reasons, but this can distract and cloud judgement.
- They are very complex.
- They can have a tremendous impact on the organisation.
- Most importantly, they are very risky, and as a consequence they are prone to failure.

When people talk about Mergers & Acquisitions what are they really talking about? M&A is a collective description for a series of related corporate activities with the purpose of leading one or more, or sometimes parts of, companies to the change of control stage. A merger is when two organisations agree to come together to form a new enhanced merged organisation. The resources, assets and liabilities form the new company. The ownership of the merged organisations is shared among the combined owners. In effect each individual owner agrees to be a relatively smaller fish in a bigger pool. An acquisition, on the other hand, is when the ownership of a company is transferred, in full or in part, to the acquiring firm. In turn, the acquiring firm rewards the owners of the acquired firm by paying for the acquired company. This payment can be made in a number of ways, the most common being cash or shares (stock), or a combination of the two. There is great variety in M&A activity and no 'standard form'. Later in this section we will see the rich variety of activities that can occur. The M&A activities can also include demergers, sometimes called a 'sell off', 'split' or 'break up'. A demerger is where a company splits part of its business away to become a separate unit which can be sold.

The purposes of M&A are varied, and they frequently result in generating further M&A-related activities. While it frequently relates to a whole organisation, an acquisition may be of a business unit or division. It is common, therefore, for a business unit to need to be demerged (separated) from its parent organisation in addition to being acquired.

Generally, M&A activity has grown considerably over the years. Whilst it experiences periods of rapid growth and periods of decline, each growth period brings new highs each higher than the last. The level of activity is also a reflection of overall business confidence. Interestingly, the *Economist* notes also that M&A activity is 'more common in countries with strong, egalitarian stock markets' (*Economist*, 1999, p. 130). In the remainder of this section the very nature of the M&A deal, its drivers, challenges and impact will be examined. We will start by looking at definitions of M&A deals and how failure-intensive they can be.

TYPES OF M&A DEALS

It is absolutely true to say that no two deals are ever the same. That said there are broad categories into which deals can be grouped or classified based on:

- The change in corporate ownership taking place;
- The impact of the deal on market structure;
- The rationale and objectives of the deal.

Changes in corporate ownership

The three most basic types are merger, acquisition and demerger. These three have further variations defined by how they are contested (or not) and how payment is made. Another common term in the language of M&A is 'takeover'. What exactly is a merger, an acquisition (takeover) or a demerger?

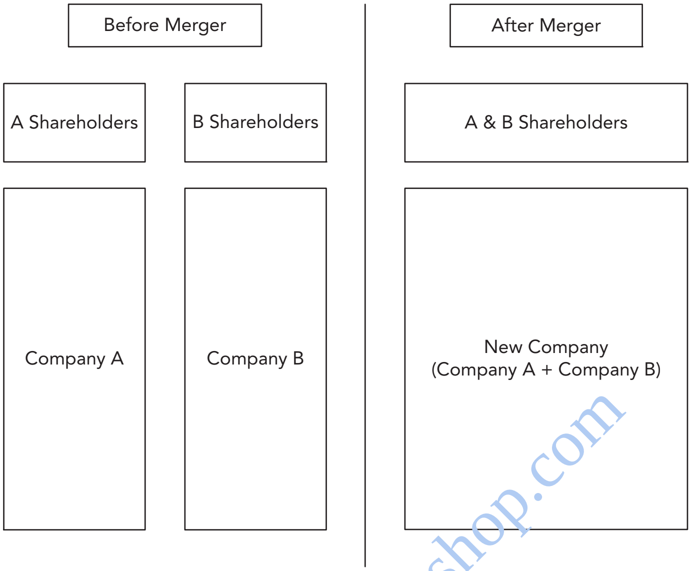


FIGURE 1.2 Impact of a merger

Merger

A merger is the joining of two separately owned corporate entities. The resources of the two firms are combined in the belief that the two firms combined are in some way better than the two firms as separate entities. The ownership of the combined firm is shared among the original shareholders and investors of the original two companies.

Mergers take place when two companies agree to combine to form one. The assets and liabilities of the two companies are brought together and the ownership is shared between the original owners of the respective companies.

Acquisition

An acquisition sees one firm take over the ownership of another and combine it with their organisation. The acquired firm (the one being taken over) is typically bought at a premium over its market value. The payment may be in the form of cash, stock (shares) or other assets. The acquiring shareholders become the owners of the new combined company. Though when stock is

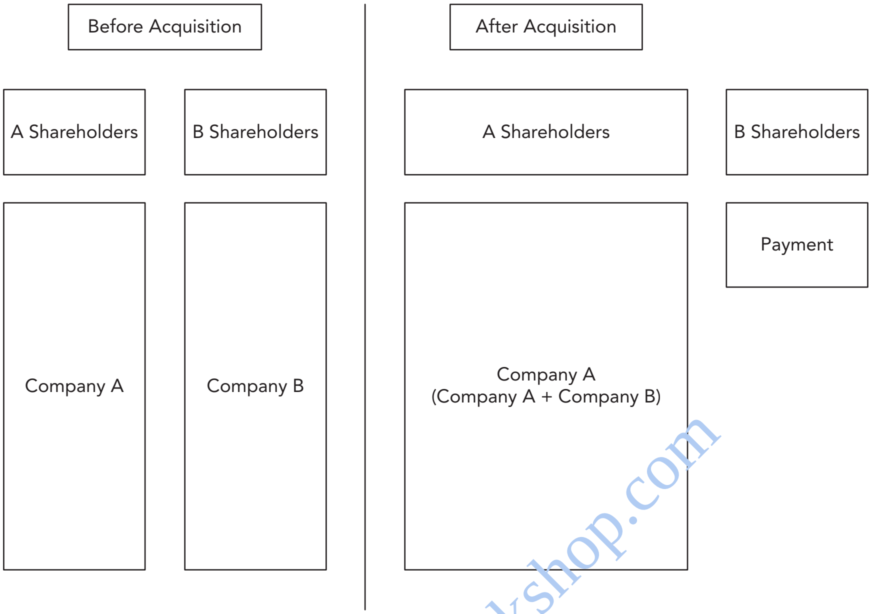


FIGURE 1.3 Impact of an acquisition

used to pay for the acquisition the transaction can, in theory, take on some of the characteristics of a merger as both sets of shareholders share the ownership.

The assets and liabilities of the acquired firm (unless otherwise agreed) are assumed by the acquiring firm.

Demerger

A demerger occurs when part of an organisation is sold to an acquirer or a business unit is being 'spun off', that is it's allowed to become a separate legal entity. In some cases the ownership of the new company is initially the same as that of the 'parent company', or there might be an initial public offering (IPO) to place the stock on the stock exchange, a management buy-out (MBO) where the management of the business unit buy the business unit or the unit is simply sold to another.

It is critical in these situations to have clarity around the assets and liabilities that are being separated to form the new company.

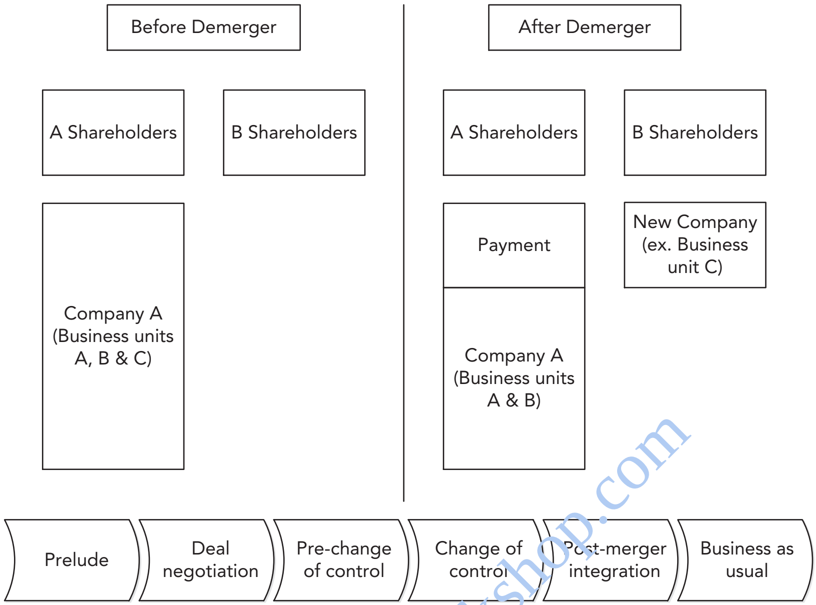


FIGURE 1.4 Impact of a demerger

> CASE: In March 2008, the Ford Motor Company, in order to generate positive cash-flow to allow it to restructure in the face of the recession, sold its Jaguar and Land Rover marques to the Indian conglomerate Tata for US$2.3bn. This necessitated that Jaguar and Land Rover be demerged from Ford to enable them to be merged into Tata.

Mergers versus acquisitions

It is probably also worth remembering that many mergers are, in fact, acquisitions. Presenting an acquisition as a merger has both tax impacts, which will be discussed later, and softer personnel impacts. It allays fears and any 'hard feelings' among the company and the customers being acquired. To truly be a merger two or more companies of roughly equal size come together to form a new entity. In this scenario, money need not change hands from one company to another.

In an acquisition, a company is paying, by way of cash or equity, for an ownership stake in another company. The acquired company then becomes part of the acquirer's company.

Mergers can be seen in terms of transfer of ownership and consolidation. The 'shape' of a deal can also be understood in terms of the type of integration being achieved. There are a number of basic shapes to a merger.

The demerger sees the resources of a corporation being divided. Typically part of the corporation, say a division or wholly owned subsidiary, is legally separated from its parent company. This allows it to become a separate company that can then be sold for divestment purposes or set up as a standalone company in order to satisfy a market of regulatory pressures, such as:

- Anti-trust legislation;
- Economic efficiency;
- Corporate restructuring.

Changes in market structure

Another way to classify M&A deals is to consider their impact on market structure. Here we talk about mergers, but it applies equally to acquisitions.

Horizontal mergers

Horizontal mergers occur when two similar companies combine. An example might be if two chains of newspaper outlets were to combine. Typically, the goal of a horizontal merger is to create a new, larger organisation which can take advantage of greater economies of scale and greater market presence and share. It is helped by the fact that typically the firms will be similar so integration and consolidation are relatively straightforward.

Vertical mergers

Vertical mergers occur when two companies in the same industry, but in different parts of that industry's supply chain, combine. An example might be a merger between a chain of newspaper stores and a newspaper distribution company. Control of the distribution channel would allow for better pricing opportunities and possibly better product or service quality.

Conglomerate mergers

Conglomerate mergers occur when two organisations in unrelated markets merge. While there might be some scale and synergy benefits, these would be few. The benefit might be opportunistic, meaning that the firm could use the merged partner to attain some larger goal. It might be speculative, which is more common in acquisitions – the belief that there will be greater growth in the merged entity. Or there is the advantage that the new, parent organisation gains diversity in its business portfolio. A shoe company may join with a water filter manufacturer in accordance with a theory that business would rarely be down in both markets at the same time. Many holding companies are built upon this theory.

The reasons for pursuing M&A are various and multi-faceted and are discussed a little later in the section 'Reasons for M&A' on page 14.

CHALLENGES OF M&A DEALS

This section examines some of the key challenges of M&A and integration.

Impact of the deal

Consider this story (the names of the parties have been changed).

It must have seemed as though the best of times had arrived. A warm September sunset was filling the boardroom of law firm Warren & White in Boston as the final copies of the merger agreement were laid on the long mahogany table. All the working papers had been cleared away and after months of selection and due diligence it had come down to this. The copies awaited signing. The merger of Union Pharmacia, a West Coast drug store chain, and the larger Crest Drug, with stores in the North East stretching into the Mid-West, was about to happen. Even Gerard Jackson, Union's CFO, allowed himself a little smile. After the signing of the deal, Darby White, managing partner at Warren & White, gave a little nod and the champagne was wheeled in. What a glorious moment.

As the team from Crest Drug left, the COO commented to Jackson that the hard work was 'about to begin'. Jackson agreed but pointed out that Union were 'just like us, only smaller. How hard can this be?' Three years later, after a global recession, a drawn out integration plagued with systems integration issues, countless HR problems and supplier problems, the expanded Union Drug filed for Chapter 11 protection. It must have seemed as though the worst of times had arrived.

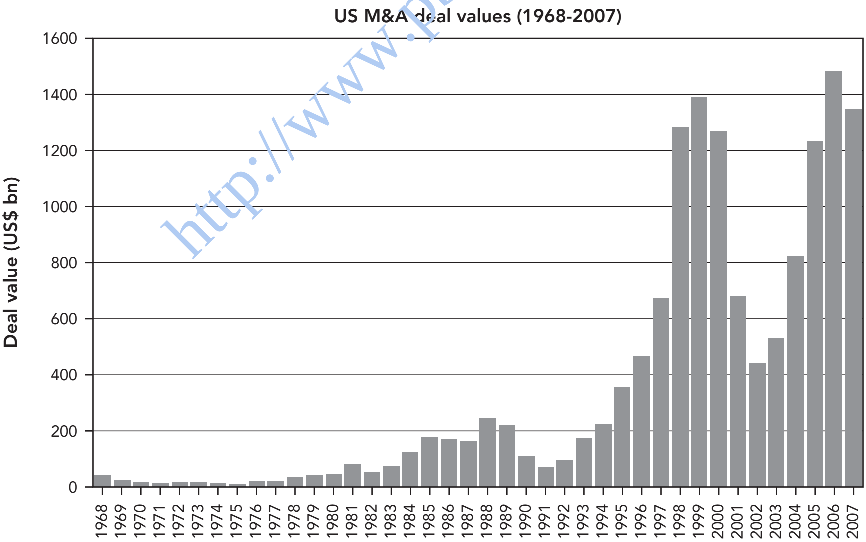
Failure-intensive

M&A activity is a failure-intensive activity. Some deals, even once agreed, are never completed. When such a falling apart of a deal happens it often has significant consequences. In 1998 two pharmaceutical firms cancelled their planned merger. The share price of one dropped 8% and the other 15% that very morning. Sometimes after completion of the deal it becomes apparent that the merger is not going to work. One US media merger resulted in the merged company writing down approximately US$60bn worth of assets.

Most failures are not so spectacular. Merged companies usually fail to attain their original objectives. Estimates vary as to how widespread this is. Practitioner estimates suggest the failure rate is in the 70–80% range. Yes, 70–80% of M&A activity will not result in the objective being reached. Quite a sobering thought! Therefore, in moving from agreeing a deal to completing the change of control and then moving from there to securing the M&A benefits, every reasonable effort needs to be made to avoid failure. Evidence and experience shows that following the right processes and controls leads to reduced failure rates.

Activity

Overall, M&A activity is on the rise as this book goes to print (summer 2011) and some are quite spectacular deals. Acquisitions such as Bank of America



Source: Mergerstat.com

FIGURE 1.5 Merger values 1968–2007

acquiring Merrill Lynch, Lloyds TSB Group acquiring Halifax Bank of Scotland, and the demerger of parts of Lehman Brothers to Barclays Bank and Nomura are all signs that in good times and bad there can be demand for M&A activity among banks. These deals will contribute to another busy year for M&A activity.

This growth in activity is not restricted to banking either as M&A activity in the US, for example, has been very strong over the last 20 years.

Over the next five to ten years we can expect a number of drivers will further M&A growth:

- Achievement of restructuring in the banking sector;
- Industry consolidation following the recent recession;
- Emergence and maturity of companies in emerging economies resulting from home market consolidation, continued foreign investment, economic growth and acquisition of market share and brands in developed markets by companies in developing markets;
- Closer cooperation between companies due to reasons such as technology and capital transfer.

FIGURE 1.6 Recent merger activity, 2008–2010[1]

[1] Year to November 25.

REASONS FOR M&A

There are many reasons why firms engage in M&A activity. Reasons include:

- Maximising shareholder value – the value of the combined firm is greater than that of the two individual firms, even after the costs of the transaction and possibly a premium to acquire the target firm.
- Protection of the firm by virtue of size – the firm feels that by not increasing its size it may become vulnerable to market conditions or be taken over.
- To support growth.
- To acquire new markets, technologies or resources.
- M&A may allow the firm to better manage capital or cash-flows.
- Management may also see personal benefits such as the following:
  - A larger firm could improve their standing and remuneration.
  - They can deploy skills that are under-used.
  - It diversifies risk leading to job security.
  - As stated earlier, it reduces the risk of being taken over and thus can also contribute to job security.

Rationale/drivers for M&A

As already discussed M&A activities tend to be quite failure-intensive. This begs the question, if they are so risky why then are organisations inclined to pursue them?

The reason is that there are potentially huge rewards available for the companies involved, their managers and their shareholders. As you might expect there are wealth creation opportunities available as a result of synergies, economies of scale, growth and enhanced buying power. And when you look at M&A announcements these sorts of reasons are often cited. Sometimes this is referred to as good 'fit'. Fit is a term often used to cover the overall attractiveness of the deal in terms of how the two firms would work together; it is very non-specific and so very hard to pin down. Nonetheless, fit is very important, but I will try to show that there can be other more complex and sometimes more subtle motivations behind the drive for M&A. These other drivers may not be about growth and creation of wealth for shareholders. The corporate strategy to grow by acquisition is typically created by management and may be influenced by many factors. Not all of these will necessarily be in the shareholders' interest. Additionally, in many countries we have seen 'shotgun marriages' facilitated by central government or regulators. Again, these are at least in part being promoted for reasons that are not in the interests of shareholders, such as political or macro-economic considerations. Typically, in both of these situations the role of the shareholder is surprisingly weak. It is not unreasonable to consider that regulators and management will wield power and influence with relatively little consideration for the needs or impact upon the shareholders.

It has been suggested that the reason that so many M&A deals fail is because they are motivated by managerial self-interest. I don't believe that this is necessarily true. Nonetheless, managerial self-interest can cloud or bias the decision-making process, which can tilt the process one way or the other. Managers' self-interest can also influence their perception of risk and their decisions relating to risk.

The shareholder perspective

The shareholder is concerned with the current and future performance and therefore value of their company. They hence look for ways of increasing that value either in the short term or over a longer period, or ideally both. The same logic applies to mergers and acquisitions for both sets of shareholders. An example might illustrate the point – for reasons of clarity and ease of explanation I will refer in the following example to an acquisition situation in which Company A is looking to acquire Company B.

Let us assume that the increase in value of Company A in acquiring company B is $100m. This is the value of the combined company (A & B) after the acquisition less the original value of Company A. This is the value added by the acquisition. The acquirer sees an increase in value because they have acquired Company B. The shareholders will see a net increase in the value of Company A provided the value increase is more than the total cost of the transaction which is the cost of the acquired firm and any transaction costs.

If the shareholders in Company B get a price which is sufficiently above the current value they too will typically be satisfied with the deal, although there are examples of shareholders selecting a lower priced offer, such as the 1988 acquisition of Irish Distillers.

Let's look at an example:

Initial value of Company A	$300m
Initial value of Company B	$60m
Company A's offer for Company B	$75m
Combined value of Company A & B (post-merger)	$400m
Cost of transaction	$8m
Total cost of transaction	$83m ($75m + $8m)
Value increase for shareholders in Company A	$17m ($100m − $83m)
Value increase for shareholders in Company B	$15m ($75m − $60m)

This is, of course, a highly rational view of shareholder motivation and behaviour. The reality is that there are often many and sometimes contradictory motivations. Many shareholders do take this rather rational view of their investments, in particular large institutional investors for whom an individual firm is a component of their total portfolio. Depending on the shareholders' involvement with the organisation and other factors they may be inherently reluctant to sell. Non-institutional shareholders, who can represent significant shareholdings in medium-sized and smaller firms, can have other motivations. They may have a personal affinity with the company, or they may wish to see it remain independent, or favour selling it to a particular company even though they may not be offering the highest price. There may be other attractions such as creating a national 'champion' that will keep jobs in the local economy.

Managerial perspectives

In smaller and medium-sized firms management and ownership are generally closely linked. Because of this the motivations of management and shareholders are more likely to be closely aligned. These motivations may be to maximise value, but can also be focused on other objectives. For example, family run firms may well be owned by individuals who are not inclined to sell no matter how much is offered for the firm.

That said, as corporations get larger the link between management and ownership generally gets weaker. It is reasonable to say that in most developed economies large corporations play an important role in the economy, and in such firms the role owned by management is generally small. Management is no longer the owner but is employed by the shareholders to act on their behalf. The management are agents for the shareholders but may not always act in the shareholders' best interests. This cost to the shareholders is called the agency cost.

Managers who act with continuous disregard for the shareholders' interest will typically destroy the shareholders' investment. Such managers are rare and probably do not succeed over the long term. It is possible to imagine that there are managers who in making decisions will allow themselves, knowingly or otherwise, to be influenced by self-interest. This will be suboptimal for the shareholder in many cases.

Self-interest might, for example, cause management to promote the sale of the company that will best reward them and not the shareholder. These types of conflict of interest may cause management to:

- Pursue a merger or acquisition strategy when an organic growth strategy might be more appropriate;
- Select poorer acquisition targets;
- Fail to create the expected value from a deal for shareholders;
- Overestimate the value creation potential of a deal;
- Overvalue a firm to be acquired or under-value their own company;
- Incur unnecessary transaction costs, for example by engaging in a contested takeover when other equally good targets are available;
- Rush to make decisions with insufficient information which will drive longer term costs.

It is very difficult to discern the true motivation of managers in these situations. Managers are often in a position where they can easily justify their decisions and actions in terms of value creation before and after the event. It is imperative for any M&A practitioner to keep this in mind as it is possible that the motivation for management may sometimes be part of the true objective of the deal. Management may decide to pursue M&A strategies for the following, self-interested reasons.

- **Job security:** By acquiring another firm they may make it more difficult and therefore less likely that the firm might me acquired, which could result in them losing their positions. This can also be achieved by acquiring firms very different from their own. Acquiring a firm which is very different from one's own is a form of risk diversification. Enlargement makes the firm more expensive to acquire and potentially less attractive. At the same time the diversification makes the firm less likely to suffer financial distress. If for example, a firm making high technology consumer products merges with a company manufacturing consumer cleaning products there will be a very low correlation between the cash-flows generated by the two companies. Fluctuation in the economy will have less of an impact on the company because of the product diversification and therefore safeguard management's position. Risk diversification is of course sometimes a legitimate business objective. However, there is evidence that the diversification of risk should be performed at the investment portfolio level rather than at the individual organisation level. That is not to say that risk reduction through diversity is always against the interest of the shareholder. Reducing the company's overall risk profile can allow the company to raise capital from sources that might otherwise be unavailable.

- **Management investment.** The management are often highly invested in a firm, not through simple equity but through a multitude of factors. This investment can take many forms:

  - They draw their income from the firm.
  - They may be paid bonuses.
  - Their pension is drawn from the firm.
  - Shares and options may be awarded.

The skills which a manager may possess might be highly valued in their current company. But this may be because of company-specific knowledge – they may not be so valued in any other firm. In addition, while their holdings of stock and options may not be very significant compared to the ownership of the firm, it is probably disproportionately part of the managers overall investment portfolio. Because of these factors managers may be highly 'invested' in the firm in a way that is both undiversified and greater than the majority of shareholders. Their motivations may therefore be very different from the majority of shareholders.

- **Job enrichment.** The desire for self-fulfilment in one's role is almost universal. Under-used management talent can manifest itself in the form of managers not using all of their skills and finding their work unrewarding. Acquiring a firm can itself stretch a firm's management talent; in addition the new enlarged firm may present new opportunities. Obviously this makes M&A very attractive.

- **Reward.** There is clearly an advantage to being a manager in a larger organisation. The enlargement of the firm brings prestige, power and enhanced financial reward to the managers that remain. Research shows that the financial reward typically materialises even if there is no increase in the value of the firm (Jensen, 1986).

Strictly speaking, the management of this agency conflict is in the hands of the shareholders. To have a realistic hope of addressing it requires that there be effective governance in place, in particular through the presence

CASE: PRUDENTIAL'S ATTEMPT TO ACQUIRE AIA

At the start of March 2010 Prudential, one of the UK's largest financial institutions announced a 'transformational' deal with AIG (American International Group) to purchase AIG's American International Assurance (AIA). AIA is a market leader in the Asian financial services market. The value of the deal at US$35.5bn would require the issuing of US$20bn of new stock. Tijande Thiam, the Chief Executive of Prudential, confirmed that the rights issue of US$20bn had been agreed with major shareholders. Even so, the value of Prudential's stock fell 12% on the day of the announcement. Whatever the truth, the deal began to unravel very quickly. The day following the announcement the rating agency Fitch announced that it was placing Prudential on 'watch negative'. A lot of negativity began to surround the deal. Within a few days a flood of stories of dissatisfied corporate investors with significant holdings began to emerge. It seemed Prudential had a queue of significant shareholders who did not support the deal. In spite of a significant cut in the price of the deal to US$30.4bn being offered by AIG senior management, stockholders rejected the deal. On 1 June 2010, three months to the day after the deal being announced, the *Financial Times* 'Lex' column concluded 'Prudential, in the end, was hoist by its own petard'. Prudential spent GPB£450m on fees for the failed transaction. AIA was floated on the Hong Kong Stock Exchange at the end of October 2010. At the end of the first day of trading it was worth US$35.8bn, slightly more than Prudential were willing to pay, and over US$5.4bn more than AIG were ultimately willing to sell it for.

of non-executive directors. Additionally, holders of large blocks of equity are in a position to hold managers to account in a way that is not possible for small shareholders. Traditionally, large institutional shareholders such as fund managers have been reluctant to get directly involved in the running of companies they hold shares in. This is changing: senior investors were very active in holding the management of Prudential Life to account and challenging them in the face of their planned takeover of AIG's Asian business.

The other source of counterbalance to the risk of agency cost is the rise of activist investors. Activist shareholders have become better organised and have started to exert power by overturning executive decisions, sometimes even leading to the replacement of management.

Finally, the market will, to a certain degree, reward or punish management according to how well they use the resources available to them. Those who manage well are rewarded by rising corporate performance, investor confidence and financial regards.