PART I

THE STRATEGIC DRIVERS

CHAPTER 1

M&A OVERVIEW

CHAPTER SUMMARY

This chapter looks at the different types of M&A and the drivers behind the decision to purchase. It discusses the factors that need to be taken into account in deciding how much to pay and highlights the importance of setting the criteria for success early on.

There is also an overview of the M&A deal process, which sets out the key stages. It is surprising how few people know and understand the overall deal process, but without this understanding they cannot plan or deliver. These sections provide a starting point for the topics, with more detail following in later chapters.

Later in the chapter, we discuss the importance of reflecting the overall business strategy in the integration plan and of ensuring that the learning derived from the process is not lost when the deal is closed.

WHAT TYPES OF M&A ARE THERE?

"First, have a clear organic growth strategy and a clear investment strategy, then buy where we need to augment growth."

John Peace, Chairman, Experian

Organizations looking for growth can go down one of three paths – organic growth, joint venture (JV, or partnerships) and M&A. All companies should constantly be looking at all three. Organic growth must be the first and main area of priority. Businesses then need to look at the other two and move forward depending on their skill set, cash flow and aims. Many companies do all three. Some decide they don't want to do M&A now because they don't have the funds or the skills/capability to move forward. Some decide M&A is the only way forward and that owning part of a company does not provide them with the control they need to move forward fast enough.

There are a number of different entities available to buy. In a mature marketplace one strategy is to consolidate the market by buying competitors. There will be a large overlap in what the two companies do, but this can be removed, reducing the overall cost base. These are what we refer to as the cost synergies.

Some companies are looking for geographic expansion – they are keen to enter into a growth sector or economy, like India, Brazil or Russia, for example. This type of purchase will bring the business new contacts, knowledge and skills and the aim will most probably be to keep everyone and everything. There may be very few cost synergies. The main aim of the merger is to invest, to cross-/up-sell and to reap "revenue synergies" thus creating more profit.

Other reasons for purchasing a business can include the desire to bring a new product or service under the company umbrella. The product may be complementary to the buying company's range and can easily be sold to existing customers through established sales channels.

The need to continually keep ahead of the game is another common driver for acquisition. R&D is very costly, so an option is to let others in the market create the new technology then buy it at an early stage with a view to developing and exploiting the potential in-house.

Table 1.1 M&A strategy

M&A strategy	Integration thinking
Market overcapacity	Standardize processes – deliver cost synergies Understand cultures and move towards one Restructure
Geographic expansion	Roll out key processes and products across new regions
Product, service or market extension	Understand new product, service or market Deliver revenue synergies
Buying R&D	Move quickly to retain knowledge and people Create a new culture
Buying competence or technology	Move quickly to retain knowledge and people Incentivize people to stay Great communications during integration

The strategic reason for the purchase must be reflected in both the communication and integration process if the M&A is to be a success (Table 1.1).

Buying R&D or technological expertise, for example, may contain large amounts of cost and revenue synergies, though the aim is growth. The business is integrating for revenue and profit improvement.

A different reason for purchase calls for a different strategy and also a different way of approaching the integration. The process may be similar, but the activity, action and outcome will be very different in each case.

HOW MUCH SHOULD WE PAY?

"Don't buy unless you're clear on why and on the return."

John Peace, Chairman, Experian

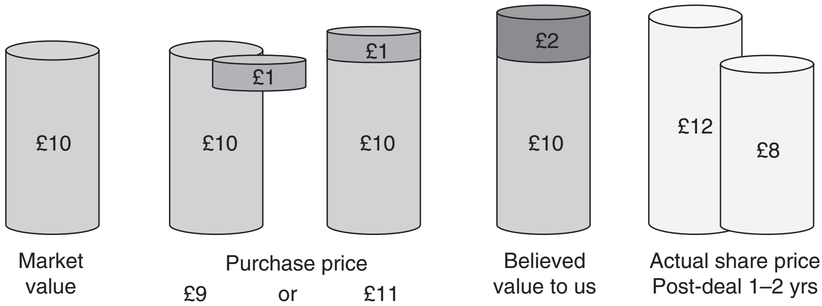

Figure 1.1: Company value depends on who is looking at it

Companies acquire other companies so that they can bring in new technology, new skills, new products and new customers. Acquiring another business helps them consolidate their position in the market, increase revenue and ensure future stability. Getting the price right at the outset is critical if the M&A process is to succeed. Often companies pay a 40% premium for publicly listed companies, sometimes more.

Figure 1.1 shows the company we want to buy, company A. Its share price is £10. We decide to purchase it. Negotiations start and our aim is to buy at £9, but the seller wants a premium for it and tries to sell at £11. Value is often dependent on your view and in due diligence we must always understand why the company is for sale. What does the current owner know that we don't?

If we owned company A, it may be worth £12, if we follow a strategy of helping it grow faster by injecting cash or knowledge and cutting costs in a way it cannot do by itself. For example, after purchase there will be two head offices. Cutting one will save money, so company A will be worth £12 in two years' time once it is under our group ownership.

There is a discrepancy between the current £10 valuation and ours of £12. Who is right? This discrepancy causes a negotiation and purchase at £11 where all parties win. An acquisition occurs and integration starts.

Of course the company may not actually be worth £10. We may find we have bought a dud, and it's only worth £8. This could be because our initial valuation was wrong, because there were some surprises along the way or because the integration did not go well and the value has been destroyed. Whatever the reason, the deal has been a failure.

Integrate well, however, and some companies are able to find an extra £1 and make the company worth £13.

Some deals are wrong from the start. A company pays £20 for a company worth £10 because they have not done enough due diligence (pre-deal investigation). The merger between Quaker and Snapple is the biggest identified loser (bought for $2.4 bn, sold shortly afterwards for $300 m due to an inability to extend an existing distribution system to a new product line), while the Chiron/Cetus merger in health care is the biggest identified winner.

> *"Be clear on strategic fit, clear on where the value is and clear on the integration plan all before the deal."*
>
> **John Peace, Chairman, Experian**

MOST MERGERS FAIL

Eighty per cent of mergers fail!

> *"Success or failure, defined by the academics: The existence of synergy implies that the combined firm will improve its performance, at a faster rate after the merger than when the firms are operating separately."*
>
> ***The Value of Synergy*, Aswath Damodaran,**
> **Stern School of Business, October 2005**

There is a database with the share price and financial information for companies and deals. The only sensible way to measure

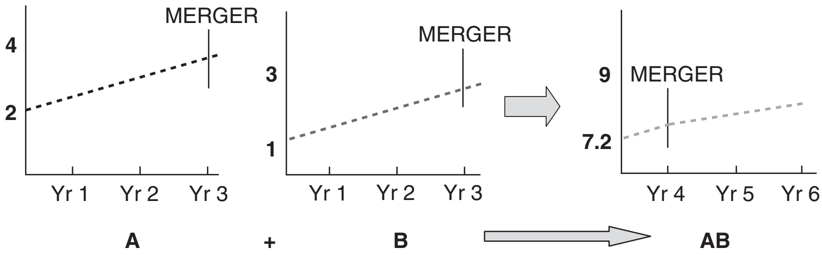

Figure 1.2: Success depends on your viewpoint

success from an outside view is to see if the share price increases because of the purchase.

In Figure 1.2 both companies have an upwards share price graph, with improvement at the same rate (similar gradient). If the first buys the second the resulting share price should be the two added together with continuation at the same growth rate or better. This example shows a merger that did not create value and so would be considered a failure.

The premium paid by the acquiring party does not necessarily have to be higher than the costs of internal growth or the costs for establishing increased profitability.

This is viewed externally as a failure.

Again, there is an M&A failure in Figure 1.3. A FTSE 100 company has a strong growth rate but can see its demise in the near future (five years). It goes out to buy a company to fill the

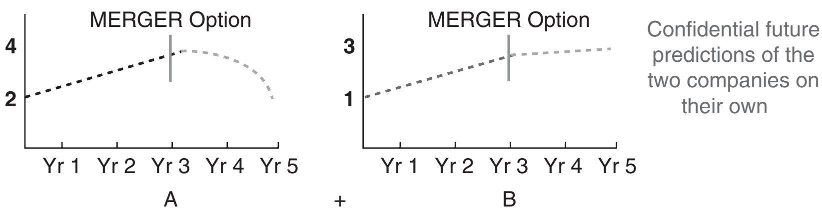

Figure 1.3: M&A failure

strategic or profit gap it foresees. The public at large would not be told of this future impending doom and so will see this purchase and subsequent integration as failing to deliver improved or increased value, i.e. no shareholder price improvement.

When asked how to judge success or failure, shareholder view is clearly the only way to go. However, looking internally can provide an improved understanding of the purchase.

> *"Many mergers fail. Why? I believe it is because:*
>
> - *There is a lack of knowledge of what fundamentally makes the company valuable and whether this can survive a merger, e.g. an entrepreneurial culture. Due diligence is often legal and financial as opposed to commercial, strategic and cultural.*
> - *The acquisition is defensive in nature, i.e. it is an opportunity to cut costs but is presented to shareholders and investors as a growth deal. Expectations are not met and the deal is considered a failure.*
> - *The integration is not properly planned. People are unclear about what should happen – and can thus destroy the very thing they have bought, e.g. by dismissing the very management that made the business valuable in the first place, in favour of their 'own' staff."*
>
> **Matthew Lester, CFO, ICAP**

Some are doomed to failure

Some mergers are doomed to failure. Pay too much, and there is nothing that can be done to rectify this. Pay the right amount (or close to it), and suddenly the integration becomes very important, for the short- and long-term growth of both companies.

Making good estimates of the synergies and how much these will cost to implement will enable improved pre-deal pricing. The pre-deal cost/synergy model stays through the merger and dictates the direction, together with the strategic pre-deal rationale.

There is a pot of money for integration. Decisions must be made on how and where to spend it to deliver most benefit. The key is to evaluate what to do and don't try to do everything.

DEFINE SUCCESS

"What is success:

- *Commercial success: Creating long term value.*
- *Integration: Did we keep the people we wanted to keep?*
- *Products: Did we get all of our new products (acquired and legacy) to market? Did the merger slow this process?"*

Brent Stiefel, Executive Vice President, Global Corporate Development & Global Product Portfolio, Stiefel Laboratories, Inc.

There are many ways to define success in a merger. Create a yardstick to be measured by; don't let anyone else say what success should look like. Come to a clear set of criteria, laying them open for all to see. These will then be used to guide the integration director and managers in both companies.

THE M&A PROCESS

"Structure of the integration: we involve the business teams in the front end of the M&A process, they own the numbers and have responsibility for delivering the forecasted performance in the integration. I believe this is key to ensuring that management energy is focused on the integration exercise."

Ian Lambert, Director M&A, Smiths Group

Figure 1.4 shows the M&A process.

Most people have not seen and do not understand the M&A process. Telling them about it – and explaining the reasoning behind the purchase – will greatly improve their commitment to change.

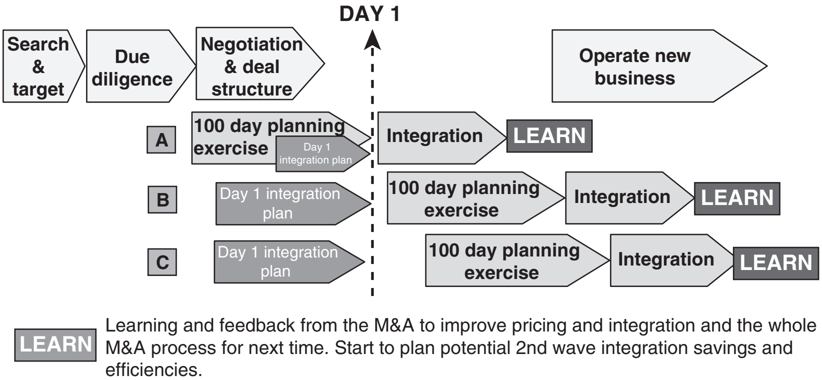

Figure 1.4: M&A process

Search & Target: Should another company be bought? Some companies know they want to buy and have pre-deal M&A teams that track target companies for months or years, waiting for the right time and price. Some spot a bargain and acquire. Others rely on banks to make suggestions. There is always a reason for their suggestion, and they may not have your best interest at heart.

Due Diligence: Investigate the target and try to understand it. Historically this has been about risk management. The risks might be that the company has a large black hole in its books, owes money or is just about to be sued, for example. People now think of it as being a fuller search of the target businesses. If it were possible to fully understand our purchase, we would. Unfortunately this is not always possible. There are often surprises on day 1 or after.

Negotiations & Deal Structure: This often involves the lawyers and can be a hectic period, which exhausts the whole team. Remember, don't pay too much. It's always tough to walk away from a deal. Barclays, having done a lot of work on the acquisition of ABN Amro, eventually walked away. They were slated in the newspapers for failing to buy for months afterwards. We don't know what they knew. It may have been the right decision for them. ABN Amro was finally acquired by Royal Bank of Scotland. Only time will tell if this was a wise decision, but at the moment it's not looking too good.

100 Day Planning: This is the process of taking our initial synergy (revenue and cost) and turning it into a fuller and comprehensive plan for integration with a first stab at getting specific projects down on paper, including actions and activities, together with specific business and functional cost/benefit estimates.

Integration: This is the delivery of our 100 day plan. It's about mobilizing people into the required teams to deliver the changes needed to move the business forward.

Flexibility: There is always a need to be flexible during the integration. Problems will crop up and plans will need to change. Be rigid enough, however, to ensure people know their direction and goals.

Scenario A: Always "plan" the integration as early as possible. Without the plan, delivery cannot start and time is lost. This creates uncertainty and leads to loss of profit. There is a trade-off; early planning can create improved integration delivery. If the deal does not take place (Barclays buying ABN Amro) then a lot of money has been wasted planning an integration that never took place.

Scenario B: Start planning as early as possible given the small chance the deal may not take place.

Scenario C: Some companies are tied up with the deal process (pre-deal) and do not think about what they will do with the company once they own it. As a general principle the longer the time that elapses between purchase and integration, the worse it will be. People are ready for change on day 1. That is the best time to give it to them; don't leave them hanging for months.

Some companies will wait up to one year before integration, to more fully understand their newly acquired business and so better handle the integration. This generally applies to mega corporates buying very small ones where there is the potential for the small to be completely consumed. They deliberately delay in an attempt to stop the small company becoming lost.

Some companies wait before integrating by accident and then find they cannot integrate. Centrica bought The AA, and did not integrate. The fact that it was a standalone unit, however, made it easy to sell off years later (at nearly twice the purchase price, making them a £600 m profit).

The decision to wait a given time period after acquisition before integrating must be a conscious one, rather than the consequence of poor organization, thinking and planning.

As the deal progresses from one stage to the next, the people involved may vary but it is important to ensure the information and learning flows through the processes and is fed back into any subsequent merger. If this is not done, the integration will be disjointed, slower and most probably a failure. The next M&A action will be no better, and no one will understand why.

One of the key things in M&A, for example, is to pay the right price for a company. This can only really be done if the pre-deal team is linked to the post-deal team and the synergies to be used in the pricing model are real and deliverable. The integration team can bring their learning to this cycle and can help to improve the overall chance of a good acquisition from start to finish.

There are some companies that pay over the odds time and time again. They are constantly overambitious because they are not involving the people who know and understand the business and need to deliver it.

The key to success is to start thinking about the whole M&A life cycle, taking knowledge from inside the company to help us learn and better price future deals.

STRATEGIC M&A PROCESS

> *"When looking at M&A with the financial services sector, the city is not well dispositional towards deals. The city looks for a well thought through deal and integration plan together with a strong track record of integration delivery. People clearly buy into the cost savings but are sceptical of the revenue enhancements promised. The city wants strong strategic rationale and then looks to see this running through the whole of the deal and rolling into normal day to day numbers, showing increased earning (eps)."*
>
> **Ian Roundell, Head of Investor Relations for Credit Suisse**

Having looked at the nuts and bolts of the M&A deal process, we now need to pay attention to the overall strategy and how this is reflected in the integration process.

We need to:

- Revisit the reason for the purchase (geographic, technological, expansion, defensive)
- Look at the financial business case (the costs and benefits)
- Plan the integration. How will the two entities be put together? What will be gained from the amalgamation?

Gaps in thinking will lead to gaps in delivery of the synergies and integration will become tough or impossible. We need to think about the people, IT, management and process, where people are focusing their attention and where the uncertainty is. This will enable better delivery and results.

STRATEGY: LINKING PRE-DEAL AND POST-DEAL STRATEGY

Before buying, use knowledge of the company to help negotiate the price. John Leggate (CBE), IT Director, BP Group, likens buying a company to buying a second-hand car. When you look at the car, you walk around it, drawing in breath, while kicking the tyres. You point out the fuel pump will need changing as will the tyres and offer £200 less than the asking price. In the same way, when buying a company, you can look at the IT systems and see that changing or updating them will cost $500 m or $1 bn and use this as a negotiating tool to help bring the purchase price down.

Use this pre-deal information to start planning post-deal integration activity. What will need to be changed, where and when? Figure 1.5 shows the concept of how each of the functions is "linked" with others and parts of the business. IT is used in the HR function and will also help change the way people feel. If the email and telephone systems are not changed, people will not "feel" part of the new company. Put some of your people on the ground in the new company to make contact so that they can answer questions and feedback. Start to understand what

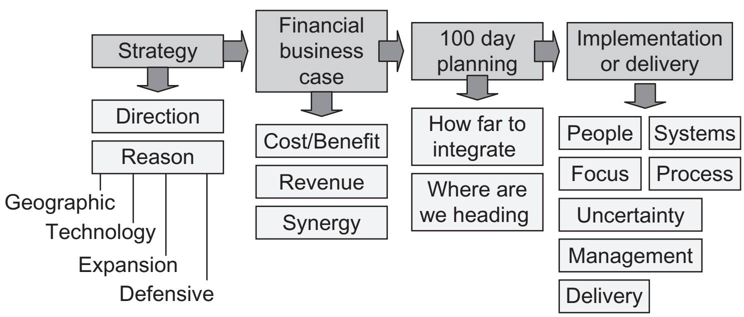

Figure 1.5: Strategic M&A process

systems have been bought through the deal, the previous investment in them and people's capability. It may be, for example, that the acquired business has more IT capability than you do in some areas, in which case make sure you use this.

Cost synergies

How should the synergies be evaluated? What do you need to do to understand, track and deliver them?

Cost synergies often underpin the implementation plan. Plan to deliver these synergies by starting to split the planning process into smaller areas which are easier to track, manage and deliver. Break them down into different functional areas and then into sub-projects. Start by looking at synergies in the value chain and take a closer look at the operational synergies.

Work through these stages and benchmark where possible, understanding competitors' cost base and processes. Integration is a large change and an opportunity to deliver large improvements. One strategy is to choose the best parts of each company best of breed.

As an example, two companies each with large finance departments join together. One has 3,000 people in finance globally, the other 4,000. Initially, integration looks to reduce the total to 4,000. However, when studying other companies in similar sectors it is found that for corporations made up of 100,000 people, all of the competitors run off a ratio of 2,000 finance people per 100,000 employees.

It is also important to study the differences in culture between the companies. Will having extra people in finance bring in more sales and profit? What do the finance people do? It is very easy to assume finance can be cut in half but this may lead to future problems. Some of the people are engaged in statutory work, while others are involved in planning, budgeting and marketing activity which may increase sales. Avoid looking at one department in isolation, fully understand the cultures when looking at benchmarks, and avoid taking a simplistic view on reducing numbers.

Unless people's roles are fully understood, there is a risk of removing competitive advantage.

Pre-planning phase

"Strategy, strategy, strategy & focus."

John Peace, Chairman, Experian

There is always some planning to do before day 1, even if 100 day planning occurs after purchase. There are things that must happen on or very soon after day 1.

Table 1.2 Day 1 plan

	Wk 1	Wk 2	Wk 3	Wk 4	Wk 5	Wk 6
Start-up						
Write integration strategy						
Senior management interviews and workshop						
Ensure day-to-day business is stable						
Communications						
Resource for integration						
Confirm and update synergies						
Plan day 1 activities						
Start 100 day planning						

Break down the integration planning into more phases and levels. Table 1.2 shows in detailed pre-day 1 planning. It includes the integration strategy, communication of that to the team and board, together with the activities that should be planned pre-deal.

The 100 day planning team should include a person from each function. Set the team up, decide what they should be doing and point them in the right direction. Interviewing senior management can be a big help for this team. Without good direction they will not plan well.