CHAPTER 1

Introduction and Executive Summary

AN URGENT PROBLEM: HOW CAN MY TEAM DO BETTER THAN THE AVERAGES?

M&A (*mergers* and *acquisitions*)[1] is no easy path to riches or career advancement. On average, it looks like buyers earn just the going rate of return on their acquisitions. However, around the average is a wide variance. We learn about the stupendously bad deals from the media: They make lurid reading and sell copy. Unfortunately, we know less about the real winners, probably because successful buyers do not want to alert the competition. Nevertheless, we know enough to say that it *is possible* to succeed through M&A.

Most firms have no better alternative. M&A is one of the most important means by which companies respond to changing conditions. It is an instrument of macroeconomic renewal. And even if you did opt out of M&A, the odds are that your competitors would use it to reach for strategic or financial advantage, with consequences that might be disastrous for your firm in the long run. Simply opting out of M&A is not feasible.

Some writers portray M&A as the kind of losing proposition that compulsive gamblers face in Las Vegas: You can't win; you can't break even; and you can't get out of the game. This is unduly pessimistic. Though M&A is a very competitive business activity, it *is* possible to succeed. But competitive forces limit true success to a fortunate few.

So here's the problem: How do you succeed at an activity in which you must participate and in which the odds of great success are slim? The problem manifests itself in four ways:

1. ***Getting a handle on the subject.*** Good practice begins with a good grasp of what is happening. "How can I make sense of what's going on around me?" M&A is one of the most aggressive change agents in the business economy: volatile and disruptive. The volume of deals and their dollar value grew explosively over the past 30 years. Journalists, legislators, and consumers have watched this activity with fascination and concern. Those inside the firms have felt elation or anxiety as they watched deals hatch. The thoughtful practitioner needs an objective grasp of M&A to serve as an anchor amidst the emotional froth.

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2. ***Setting goals and benchmarks.*** As one executive asked me, "What drives success in M&A? What will it take for my firm to do better than the averages?" The mystery about M&A deepens if one has no clear definition of success. The decision maker needs a guideline for action.
3. ***Getting prepared.*** Succeeding in M&A has a personal perspective. As an educator I am often asked, "What do *I* need to know? How can I best prepare myself to be effective, or at least survive, in the M&A arena?" Executives and analysts new to the field rarely know how to launch a program of personal development.
4. ***Adopting best practice.*** Most M&A professionals have some influence on the policies and practices of those who work with them. Executives, particularly, want to know, "What expectations should I set for the development of our M&A business processes? If I wanted to raise the bar in any dimensions, where should I do it?"

This book speaks to these problems. First, the book takes a pragmatic approach, highlighting useful insights wherever they are to be found. As a result, the discussion here synthesizes a range of perspectives rather than just focusing on one silo of ideas. Second, the book highlights seven important ideas that open fresh insights on subjects previously thought to be too narrow or confusing for meaningful commentary. Finally, the discussion here emphasizes that M&A is a world of contingencies and that therefore the M&A professional needs to become competent at forming a view for him- or herself. One finds few universal absolute truths about M&A success. While that frustrates the seeker of hard answers, it is good news to the professional adviser and business developer, for it dictates that there will always be a market for diligent research, sound judgment, and artful execution.

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OVERVIEW OF A FRAMEWORK FOR M&A SUCCESS

"Success" in M&A is not so different from "success" achieved by value-style investing and created by the perfection of an analysis discipline that allows good judgment. The winners follow it over and over, and never deviate from the discipline. An aim of this book is to bring M&A analysis discipline to the forefront, in much the same way that Benjamin Graham and David Dodd did for securities analysis and Warren Buffett put into practice.

Even though success in M&A is uncertain, research and practice suggest the outlines of its key drivers. The perspective developed in this book is that success is driven by both the *structure* of the M&A opportunity one faces, as well as the *conduct* by which one pursues it. This venerable[2] model is useful for sorting out the determinants of success in M&A. Exhibit 1.1 summarizes the direction of influence: Structure drives conduct and *outcomes*; and conduct shapes structure[3] and drives outcomes. This has intuitive appeal when you consider the simple idea that where you wind up is a matter of the resources, opportunities, and constraints you began with, and of what you did along the way. The random strokes of good or bad luck also have an influence; therefore, your conduct of M&A needs to anticipate the possibility of both.

The structure of the M&A situation is like the setup of a game, the resources

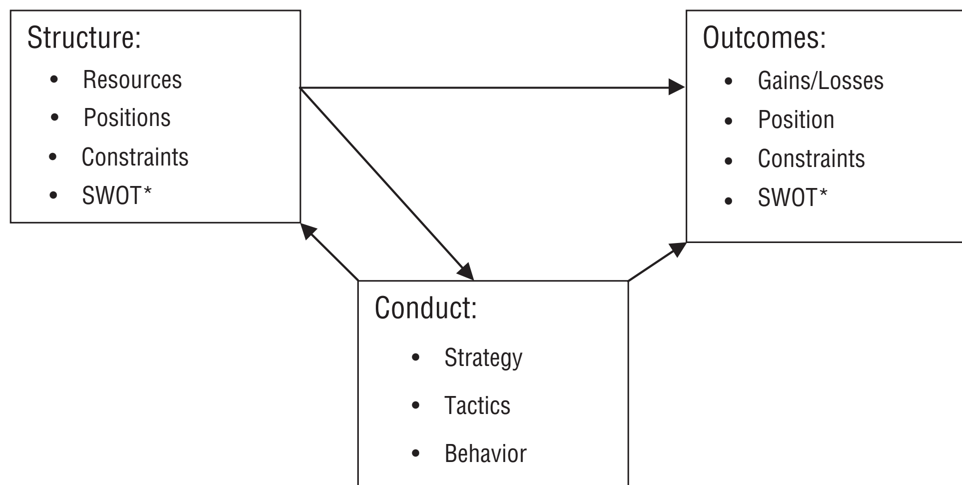

EXHIBIT 1.1 A Model of the Drivers of Outcomes
*"SWOT" stands for strengths, weaknesses, opportunities, and threats. The use of SWOT analysis to develop strategy is discussed in Chapter 6.

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(the sports equipment you have), opportunities (the team you recruit), and constraints (the rules) under which you operate. In M&A, the elements of structure include:

- ***Economics of the opportunity.*** This is simply the distribution of costs and revenues that determine cash flows, and ultimately net present values of investment. The "economics" also refers to the financial impact of the transaction on the buyer and target shareholders. From the buyer's standpoint, the financial impact consists of the potential value to be created (as measured by net present value) as well as the effects of deal financing. Synergies are a key driver of the economic impact of the deal. Valuation analysis is the cluster of tools that enables one to assess the likelihood of the deal to create value. Best practitioners in M&A are rigorous analysts of the *economics of an opportunity*. In short, "economics" embraces the factors determining the financial risk and return of a deal. Chapters 9 through 17 outline the economic analysis of M&A opportunities; Chapters 18 through 24 present an economic lens through which to assess the design of transactions.
- ***Strategy.*** The recognition of a strategic threat or opportunity in the firm's competitive arena motivates most deals. The industry positions of the buyer and target are important determinants of the attractiveness of a deal. The firm may want to engage in M&A activity to acquire special capabilities and to improve its strategic position. *Strategy* is not only a direct driver of deal success, but also a driver of the economics, organization, and reputational structure of the deal. Successful acquirers are critical analysts of the strategic positions of the buyer and the target. Chapters 4 through 7 explore the strategic perspective and present several tools with which to assess the position of a firm and the strategic attractiveness of a deal.

- ***Organization.*** The buyer and the target come to the deal with organizations that are unique in terms of their structure, leadership, and culture. The ability of two organizations to mesh has a huge influence on the ability of the new firm to realize merger synergies and strategic benefits. Failure to integrate well can torpedo a deal that, on paper, looked like a winner. Thus, best practice acquirers devote serious attention to the organizational profiles of the two firms, and to the postmerger integration challenge. Chapters 24, 36, and 37 assess the influence of social issues and the challenges of postmerger integration.
- ***"Brand."*** The reputation and influence of the buyer and target go largely unrecognized in conventional assessments of M&A, yet practitioners consider these to be a key influence on the conduct of the M&A effort. Economists think of the *brand* in terms of "signaling," the ability of a firm to distinguish itself from other firms. Signals can have a large influence on prices and even the ability to close a deal. But for them to have much effect, they must be costly or difficult, and unambiguous. Brand names are signals of quality or other special attributes. Brands and signals have special influence where interaction with customers or counterparties is repeated over time. Best practitioners seek to create and preserve brand value, and to understand the sources of the counterparty's brand. Worth noting is that in M&A *personal brand* is also important: The aura of a CEO, financial adviser, or operating manager has been known to advance or stall a deal. Chapters 30 through 33 explore some of the implications of reputation in M&A.
- ***Law.*** The matrix of laws and regulations in the business environment constrain the actions of the buyer and target firms and of specific players such as CEOs, directors, accountants, analysts, and insiders. The businessperson must ask, "What is our legal exposure in this situation and how can we manage it?" Chapters 26 through 29 explore the structural influence of laws and regulations in M&A.
- ***Ethics.*** In the professional literature on M&A, very little has been written about ethical dilemmas. Yet practitioners struggle through these virtually daily. Chapter 2 argues that the best practitioners consciously address the ethical dimension in deal development and assiduously avoid taint that might accrue from an ethical lapse.

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To focus only on structure is to be a determinist: "If X is the condition, Y is the outcome." Yet to be a determinist is to settle for a limited view of the world. Causality might be more complicated than initially believed, as the followers of Karl Marx and Sigmund Freud discovered. Human behavior is *uncertain*. This uncertainty muddies the causal effects of structure. For instance, a machine can hit a tennis ball over the net with great predictability. Humans, on the other hand, are less predictable—differences in skill, strength, and strategy can force opponents to make bets about the behavior of each other. Such is also the case in M&A, a game in which one's conduct has a large influence on outcomes. *Conduct* intervenes in the pursuit of good outcomes anytime one must make a strategic choice or adopt tactics for behavior. In short, best practice requires that we augment the *deterministic* focus on structure with a *probabilistic* focus on conduct, in areas such as the following:

- ***Search for partners.*** Chapter 6 argues that the search for acquisition targets is one part structured research and another part serendipity: In the modern jargon, good discovery relies on networking, which itself relies on social skills that are not readily given to deterministic description.
- ***Due diligence.*** This is the structured search for risk. Here again, we have a discovery *process* that depends on both organized inquiry and agile thinking. Chapter 8 argues that *due diligence* is least successful when reduced to rote fact checking. Instead, the right way to discover hidden risks is to research curious details, anomalies, inconsistencies, and discontinuities—all under tight time pressure and efforts by the seller to put a gloss on things. Here, the uncertainty of conduct arises from the investigator's stamina, care, and capacity for critical thinking.
- ***Negotiation and bidding.*** The probabilistic influence of psychology and self-discipline appear most vividly in settings where M&A parties grapple with one another. Chapter 30 reviews research that shows that attitudes, appetites, and negotiation tactics have a large influence on deal prices and terms. Chapter 31 shows that auctions and deal frenzy can prompt a bidder to make an offer beyond the rational maximum—this results in the "winner's curse." Chapters 32 and 33 emphasize that hostile takeovers are games in which psychology and beliefs about competitors have huge influences on the step-by-step movements of the competitors.
- ***Dealing with laws, regulations, and the judicial system.*** Laws and regulations may seem like constraints on actions, though to the artful practitioner they may raise new opportunities and/or mitigate threats. Lobbying regulators and legislators and appealing to the courts for relief are means by which the practitioner might actually *shape* the structure of the M&A situation. Chapters 26 through 29, 32, and 33 survey the dimensions in which laws, regulations, and the courts may affect M&A conduct.
- ***Deal design.*** Chapters 18 and 25 frame the deal design effort as a search for trade-offs that can accumulate to a winning outcome for both buyer and target, the so-called win-win deal. This search is yet another discovery process, more like a dance than an engineering problem. And as dancers know, it takes skill and coordination to come to an end with graceful bow and applause rather than stumbles and embarrassed gasps.
- ***Postmerger integration.*** William Blake once said, "Execution is the chariot of genius." No matter how good the deal design, implementing the merger integration is where the hypothesized deal benefits are won or lost. Choosing the right integration strategy is a matter of judgment; implementing it well is a matter of managerial skill. Chapter 36 argues that acquisitions trigger fear and anxiety among employees in the target firm and that these emotions can torpedo efforts to realize benefits from the deal.
- ***Leadership and communication.*** As adept public speakers know, it is not merely what you say, but also *how* you say it, that counts. Differences in expression are some of the most subtle and powerful ways in which conduct can intervene in the realization of outcomes. Communication issues permeate the deal process. This book addresses them in numerous areas, including ethics (Chapter 2), deal search (Chapter 7), due diligence (Chapter 8), accounting (Chapter 16), social issues (Chapter 24), disclosure to markets (Chapter 27),

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negotiation (Chapter 30), auctions (Chapter 31), hostile takeovers (Chapters 32 and 33), the presentation of proposals (Chapter 35), postmerger integration (Chapter 36), and the leadership of the deal process (Chapter 37).

- ***Managing the deal development process.*** A special perspective of this book is an emphasis on the importance of good *process* as one of the key drivers of good outcomes. Best practitioners make deal management into a strategic capability. Process lends discipline to one's thinking, fights the psychological trap of deal frenzy, and helps to motivate the creative search for solutions to thorny problems. How one might structure good M&A process is the subject of discussion in chapters on deal search (7), due diligence (8), valuation (9), deal development (25), negotiation (30), communication (35), and best practice (38).

The final element of the structure-conduct-outcomes framework is *outcomes*, the whole point of the M&A effort. Quite simply, this could be measured in terms of the fulfillment of one's intentions for doing the deal. The thoughtful practitioner will benchmark the deal's outcomes against at least seven measures:

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1. ***Creation of market value.*** As Chapter 9 suggests, one needs to think like an investor, which means harnessing the perspective of the providers of capital. The creation of *market value* is measured straightforwardly by the change in share values, net of changes in the stock market.
2. ***Financial stability.*** Some of the saddest M&A deals are those that, rather than making the buyer stronger, actually destabilize it. In most of these cases, the buyer overreaches its financial capacity. Financial stability can be measured by changes in debt ratings, default risk, or other measures of financial capacity outlined in Chapters 13 and 20.
3. ***Improved strategic position.*** Many M&A transactions are motivated by a strategic purpose that seeks to improve the firm's competitive position, acquire new capabilities, improve agility, or obtain resources that are vital to future prosperity. Chapter 6 sketches these considerations. Also, many deals respond directly to turbulent forces in the firm's environment—these are surveyed in Chapters 4 and 5.
4. ***Organizational strength.*** Knitting together two firms is especially challenging from an organizational perspective. Most CEOs would agree with the old slogan "People are our most important asset." Chapters 36 and 37 survey what this might mean in practice. In essence, one could measure organizational strength in terms of depth of talent and leadership, effectiveness of business processes, and the transmission of culture and values.
5. ***Enhanced "brand."*** The deal should improve the reputation of the acquirer and its deal architects. Usually, the realization of these other aims will do just that. But one can imagine deals that depend on acrimony, subterfuge, and win-lose mentality—in a world of repeated play, the executive must consider how these qualities might affect one's M&A success in future deals.
6. ***Observance of the letter and spirit of ethical norms and laws.*** You can gain financial, organizational, and strategic objectives in M&A, but in ways that violate norms such as equity, duty, honesty, and lawful observance. After the corporate scandals of recent years, any assessment of outcomes would be incomplete without consideration of laws (Chapters 25 through 29) and *ethics* (Chapter 2).

7. ***Improved process.*** The process orientation of this book emphasizes the importance of learning from each deal. As illustrated in Chapter 37, good practitioners try to capture the lessons of each deal in an effort to accumulate an improvement of practice for the next time around. This is the way a firm turns mere skills into truly strategic capabilities.

Exhibit 1.2 summarizes the success framework for M&A. It suggests that one must first assess the structure of the business environment and deal opportunity. The structure will suggest the outlines of a deal design. Next, the thoughtful practitioner must tailor a deal development process and conduct the process in ways that achieve an attractive outcome. In other words, Exhibit 1.2 summarizes a way for practitioners to organize and execute good deal development. Think of Exhibit 1.2 as a bull's-eye target, useful for practicing your aim at various points in the merger process. The balance of this book adds the details.

SEVEN DISRUPTIVE IDEAS WORTHY OF BEST PRACTITIONERS

This book advises business practitioners and students about the best ways to analyze, design, and implement mergers and acquisitions. The "best," of course, are always moving targets. Therefore, students of best practices can never rest. In the

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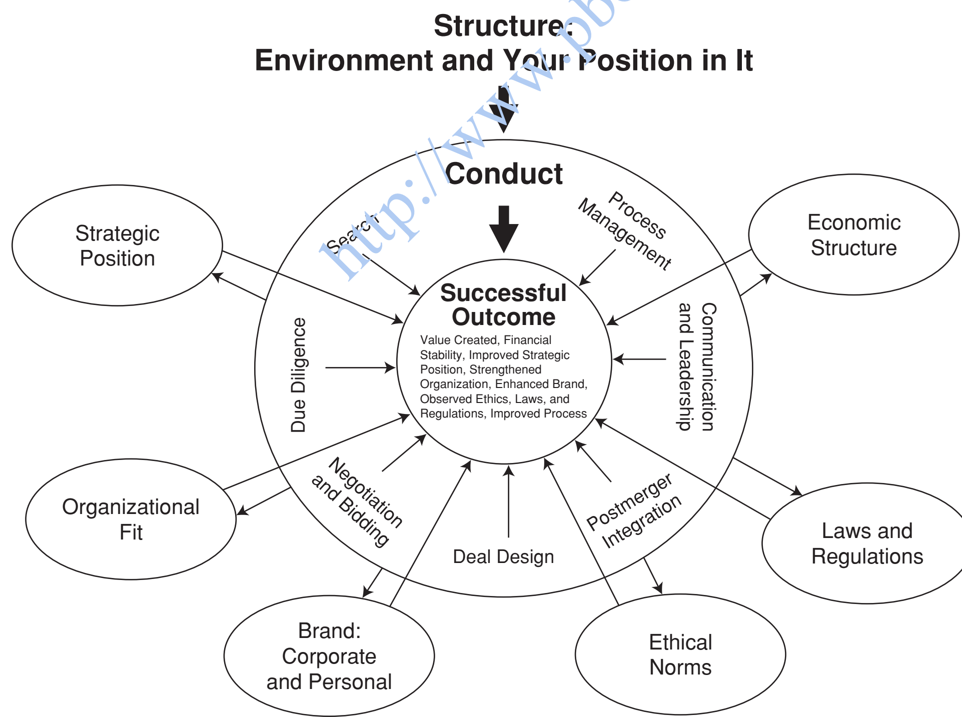

EXHIBIT 1.2 Drivers of Success in M&A

marketplace for ideas, the tried-and-true notions are constantly being elbowed aside by disruptive new ideas that reshape the landscape. This book sketches that jockeying: It aims to synthesize the enduring and upstart ideas into a comprehensive perspective on best practice in M&A. While many of these ideas originated in academia, the book emphasizes their practical application—hence, the name *Applied Mergers and Acquisitions*. This book heralds seven important ideas that have received scant attention in M&A practice. Yet they yield valuable insights. I highlight them because they have the capacity to disrupt conventional practice.

1. ***A deal is a system.*** This presentation discusses the systemic nature of M&A transactions. In this, it draws on basic concepts from systems engineering to illuminate the trade-offs that occur within the design of a deal. Chapter 18 outlines several important implications for the practitioner, including the following:

   - *Internal consistency.* If a deal is a system, then the parts need to fit together in a sensible way. One must negotiate the pieces of the deal with a view toward an integrated whole.
   - *Unanticipated side effects.* The systems view gives a wide-angle perspective. It encourages the deal designer to look out for the cumulative effect of tinkering. Just as a balloon squeezed in the middle will bulge at the ends, it is likely that hard bargaining on one point will lead to stress somewhere else.
   - *What "best" means.* A systems view admits the possibility that there may be *many* great deal structures that satisfy the objectives of all parties and set *Newco*[4] up to succeed. If there are many good deals, then it is probably true that there is no single right solution to a deal design problem—but there may be many wrong ones. One's aim should be to avoid the wrong and find the attractive right.

   This systems view of deal design may disrupt M&A practice by granting the practitioners of this view greater creativity in negotiation and deal design. The ways in which this might occur are explored in Chapters 18, 25, and 30.
2. ***Optionality.*** Options are pervasive in the M&A environment. The theory of option pricing that debuted in 1973 has had immense influence on virtually all areas of business. Recent research on real options develops important new insights that can improve decision making. But the optionality present in M&A transactions remains largely to be explored. Options thinking is a fertile guide for best practice. Chapters 10, 14, 15, 23, 29, and 33 survey the presence of options in M&A and their effect on valuation and behavior. Optionality is a disruptive idea in M&A practice because it can afford practitioners greater analytic power and creativity, leading to more insights about the drivers of value creation and to new bargaining strategies and innovations in deal design.
3. ***Critical thinking about market integration and efficiency.*** Tools of finance now in use presuppose that securities markets function well enough for decision makers to refer to market prices for clues to success. This assumption is a reasonable point of departure for one's analysis, but it deserves thoughtful reexamination in many M&A settings. The first obvious case is cross-border

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M&A. Chapters 5 and 12 suggest that differences between one's home country and the country of the target firm may be large enough to warrant careful adjustment in the use of financial tools. The second obvious case is the world of very high leverage. Chapters 13, 20, and 34 explore this world and suggest that it requires thoughtful judgment rather than blind application of tools. Finally, the third case is the world of the privately owned firm. Here, control and liquidity of the investment may differ materially from that of the publicly held large corporation. Chapter 15 explores the impact of those differences on firm value. At issue in these three cases is the extent to which asset markets are integrated and efficient. An ability to think critically about integration and efficiency is potentially disruptive to conventional M&A practice because it arms the practitioner with tools to view markets more insightfully.

4. ***Good governance is valuable.*** Recent corporate scandals remind us of the importance of good systems of corporate oversight and control. Indeed, a growing body of research finds that good governance pays. Chapter 26 considers the role for systems of governance in the world of M&A, giving particular attention to duties of the board of directors, laws and regulations, accounting, and takeover defense. Chapter 17 on momentum acquisition explores the potential destruction of value when managers focus on the wrong aims. As this is being written, it seems that a revolution in corporate governance is merely beginning. Changes in governance will inevitably disrupt old practices in M&A.
5. ***Valuation and value creation through deal design.*** Financial economics teaches that prices should drive managerial decisions, which in turn affect shareholder wealth. Valuation is the practice by which we assess the actual fairness of prices. Numerous chapters in this book survey the state of the art in valuation and extend those tools to discrete new problems of particular importance to practitioners: valuation of synergies, valuation of real options, and valuation of assets across borders. This book also emphasizes the normative implications of managers' duty to create shareholder wealth, and carefully details how deal design choices can create or destroy value. Better valuation practices will disrupt older M&A approaches by arming future deal designers with greater insight into the risks and economic potential in a deal.
6. ***Behavioral effects.*** We know from extensive anecdotal evidence and the emerging field of behavioral finance that decision makers can deviate from value-creating choices, owing to a variety of personal and group behavioral influences. Chapters 30 through 33 and 36 discuss behavioral influences in M&A, especially as they appear in negotiations, auctions, competitive bidding, hostile takeovers, and process leadership.
7. ***Integration among deal design, strategy, and implementation.*** The process orientation in this book reinforces a central theme: the need to integrate the M&A effort across disciplines. The failure of the right hand to let the left hand know what is going on is one of the oldest administrative problems in history. Yet the revolution of business process reengineering over the past 20 years lends new urgency and sophistication to the integration message—you cannot afford to neglect the effort to integrate across M&A specialties, because, in all probability, your competitors and counterparties are doing it already. Business excellence depends on it.

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CONCLUSION

"What *were* you thinking?" is a favorite tag line of comedians. Best practitioners use it more seriously in reference to M&A deals. The following chapters give you the frameworks, tools, and processes with which to anticipate that question and/or critique the conclusions of others. Rigorous thinking about M&A is indispensable. This book highlights new ideas, the diffusion of which will shape best practice in coming years and raise our understanding about M&A success.

NOTES

1. The *Oxford English Dictionary* defines "merger" as the "consolidation or combination of one firm or trading company with another." The French have a good word for it: *fusion*—this conveys the emergence of a new structure out of two old ones. An "acquisition," on the other hand, is simply a purchase. Generally, the terms are used interchangeably. But where one is negotiating, drafting legal documents, managing tax exposure, or reporting financial results, it pays to mince words. More on this follows in later chapters.
2. Joseph Bain, a founder of the field of industrial organization economics, bequeathed the notion that the structure of an industry and conduct of competition within that industry drive investment returns.
3. How you behave can affect your position in the competitive arena.
4. "Newco" designates the new firm that emerges from a merger or acquisition.

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