Yaakov Weber
Shlomo Tarba
Christina Öberg

A Comprehensive Guide to Mergers & Acquisitions

Managing the Critical Success Factors Across Every Stage of the M&A Process

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Yaakov Weber
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To:

Alice, for friendship and support

Dania, Ohad, and Tahel, for giving my life meaning and comic relief

To the memory of my mother, Otilia

Thanks you for being there for me the time or two that I have fallen behind.
I'll always be there for you, too.

—Y.W.

To the memory of my father, Ruslan,

who is always in my heart.

—S.Y.T.

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Preface

One of the enduring paradoxes in merger and acquisition (M&A) activity has been the propensity of corporations and executives to engage in M&As despite consistent evidence that post-merger performance of acquiring firms is disappointing. For example, in 2011, global M&A activity shattered previous years' deal volume records, and recent surveys reveal that despite the financial market crisis, executives remain upbeat about their M&A plans around the world (Deloitte 2012; Bloomberg 2012). However, the success of the M&A remains questionable. For example, managers of acquiring firms report that only 56 percent of their acquisitions can be considered successful against the original objectives set for them (Schoenberg 2006). A possible explanation to this paradox is that existing knowledge on M&As provides a limited and insufficient understanding of different parts of this important phenomenon. For instance, it is possible that top executives might perceive an M&A as a good step for corporate growth at the pre-merger stage, but poorly implemented during the post-merger process. Despite their popularity, M&As remain poorly understood and poorly executed.

This book is about developing a better knowledge on how to make an M&A work. We have written this book as a comprehensive guide to help executives and managers to navigate a successful M&A. Thus, the book provides a general framework that describes all stages of the M&A in which actions and processes are explained versus major problems confronting managers who plan and execute the M&A.

This book is grounded in both experience and research on many firms and in many industries. During the last 30 years, we have conducted research on the factors that lead to value creation in the M&A. At the same time, we accumulated experience in consulting to executives about various stages of M&As and developed managerial tools to deal with various challenges at the M&A planning, negotiation, and post-merger integration (PMI) stages.

There are several main advantages of this book. First and foremost, it does not only look at all M&A stages, but also at the essential interrelationships between them. Thus, such activities as comparing M&A alternatives, planning, negotiating, and choosing an M&A, for instance, depends, in addition to financial and strategic factors, on the implementation challenges. Thus, a buyer can use, after assessment, the integration process challenges expected during the PMI stage, for instance, in negotiation of price, terms, and processes, before the deal is signed, as well as level and duration of payments based on the accomplishment of some objectives after the deal.

Second, a review of scholarly and practitioner-focused writing on M&As reveals that important topics have been occasionally mentioned only in passing. Even in those cases

in which important subjects were mentioned, not many details were presented on how these issues make a difference and how to use them for M&A success. Therefore, this book elaborates and articulates on many neglected, but essential, topics, such as the use of cultural differences in all M&A stages, trust, leadership, Human Resource practices, communication, and more that other scholars and practitioners recognize but have not developed.

Finally, the highly dismal performance track record of M&As might stem from a lack of synchronization between different M&A process stages. The framework suggested in Chapter 2, "An Integrated Model for Value Creation in Mergers and Acquisitions," and elaborated through different chapters, provides tools to synchronize all M&A stages, actions, and processes. Our hope is that this book can reduce the failure rate of M&As and increase M&As' success so that they can reach their potential.

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1

THE M&A PARADOX: FACTORS OF SUCCESS AND FAILURE IN MERGERS AND ACQUISITIONS

Why do experienced senior managers fail again and again in mergers and acquisitions (M&A)?[1] For example, in a well-documented case, Daimler had to separate from Chrysler, which it had purchased approximately 10 years before, after continuous losses of billions of dollars. And in another case that was widely covered in newspapers, in October 2007, Patricia Russo, the CEO of the Alcatel-Lucent merger, admitted that after three sequential profit warnings, the results of the merger were lower than expected (*The Associated Press*, October 31, 2007). In contrast, few companies succeed persistently in M&A, such as Heinz, Unilever, and Electrolux.

Does the success of a few companies explain the continuous increase in the number of M&A? The main drivers for M&A relate to various growth opportunities such as acquiring new products, expansion into new geographical areas, or access to new customers. This is in addition to such motives as improving profitability and the company's strategic capabilities and positioning. Thus, there is no surprise that the activity of M&A in 2011 showed continued recovery from the downturn of 2008 and 2009, despite the U.S. debt downgrade, Europe's ongoing debt crisis, and heightened worries about global economic conditions.

Many research studies conducted over the decades clearly show that the rate of failures is at least 50 percent. In surveys conducted in recent years, the percentage of companies

1 The term *merger* refers generally to a "merger between equals" and *acquisition* refers to the situation in which the management of the acquiring company controls the acquired company. Experience shows that even if a "'merger between equals" is declared, within days or weeks it is clear to each one of the parties who is controlling and who is being controlled. This book therefore does not make any distinction between these terms and uses them interchangeably.

that failed to achieve the goals of the merger reached 83 percent. Following these findings, it can be expected that senior managers and boards of directors would avoid merger and acquisition activities as much as possible and would search for other strategies to achieve market share and profitability goals. However, reality indicates the opposite. The trend of mergers and acquisitions has been constantly increasing over the past 20 years. Moreover, the number of mergers and acquisitions and the sums of money invested in them have shattered the all-time record almost every year!

Global M&A deal volume rose from 27,460 transactions in 2010 to 30,366 in 2011, an 11 percent increase according to WilmerHale report from 2012 on M&A activity. Similarly, global M&A deal value increased 53 percent to $3.11 trillion in 2011, up from $2.03 trillion in 2010. Average global deal size grew to $102.6 million in 2011, up from $73.8 million in 2010. In the United States, the volume of M&A activity was fairly steady, increasing 7 percent, from 9,238 transactions in 2010 to 9,923 in 2011. U.S. deal value jumped 79 percent, from $887.3 billion in 2010 to $1.59 trillion in 2011, due to a spate of large transactions.

In Europe, both deal volume and deal value continued to increase from their 2010 levels. Deal volume increased 15 percent, from 11,736 transactions in 2010 to 13,501 in 2011. Boosted by a number of large transactions, total European deal value increased 91 percent, from $780.5 billion to $1.49 trillion. The Asia-Pacific region also experienced growth in deal volume and value. The number of Asia-Pacific deals increased 12 percent, from 7,970 transactions in 2010 to 8,905 in 2011, whereas aggregate deal value increased 26 percent, from $652.5 billion to $822.2 billion. According to Bloomberg's M&A report from 2012, China's appetite for buying opportunities continued to increase, with $158 billion worth of deals announced in 2011, a moderate 9 percent increase from $145 billion in 2010.

And the forecast? According to a survey report of financial market professionals made by Bloomberg, the M&A activity will continue to grow. Asia-Pacific companies are expected to be the most aggressive buyers, whereas respondents expect the most attractive targets to be found among firms in the European region.

Yet, even if the number of mergers and acquisitions declines in the next few years, it is clear that this strategy will continue to remain important to many organizations. In addition, the increase of international activities and processes of globalization will encourage international mergers and acquisitions. Will the high rate of failures continue to characterize the M&A activities? It is hard to say. There are reasons to believe that certain dimensions of M&A remain difficult due to the complexity of M&A.

The primary reasons for failures is related to the fact that it is easy to buy but hard to perform an M&A. In general, many mergers and acquisitions are characterized by the lack of planning, limited synergies, differences in the management/organizational/international culture, negotiation mistakes, and difficulties in the implementation of

the strategy following the choice of an incorrect integration approach on the part of the merging organizations after the agreement is signed. Most failure factors indicate a lack of knowledge among senior managers for the management tools that enable coping with the known problems of M&A.

The sharp increase in M&A activities during the second half of the past century on the one hand, and the tremendous amount of failures on the other hand, draw research interests from different areas of business administration and economics. Each area of interest has a special point of view and different measures of success. This chapter describes the factors of success or failure in mergers and acquisitions according to three main areas: economics and finance, strategic management, and organizational behavior. The overarching theme of this book is that only the combination of knowledge from all these areas can bring M&A success.

Finance and the Capital Market

Researchers from economics and finance areas measure success by the change in the stock rates (with the reduction of industry fluctuations) in the first few days after the announcement of the merger. When the stocks rise, the merger is successful, and when the stock price falls, the merger is described as a failure. The basic assumption of economics/finance scholars is that the stock value reflects the company value in an objective manner based on all the existing public information. The idea is that the immediate change in the stock price reflects changed expectations on the value of the firm, and thereby indicates a long-term trend. Therefore, they assert that every M&A that causes an immediate rise in the stock value (after the reduction for fluctuations in the capital market), reflects success and creates value for the stockholders. In contrast, a merger that causes the decline in the stock price in the first days after the announcement of the merger reflects failure and loss for the stockholders.

A conclusion accepted today, after decades of research, is that only stockholders of the acquired company profit, whereas the stockholders of the acquiring firm do not, on the average, receive any benefit from the merger. The main reason for failures, according to this perspective, is that the acquiring company pays a premium that reaches above the value of the acquired company. This premium is generally so high that even successful management activities after the acquisition do not provide return on investment and do not remedy the valuation "error." The capital market identifies this mistake and responds in the change of the stock price. For example, the stocks of AOL declined in the first 24 hours after the acquisition of Time Warner was announced. The assumption was that the price paid for Time Warner was very high and not justifiable. Its stocks continued to decline for many months after the acquisition. It should be noted though that the capital market's valuation makes mistake in many cases, such as the Daimler-Chrysler merger. In that case, the stock price rose immediately after the merger announcement. However,

2 years following it, the stock value declined to 50 percent of its value at the time of the merger.

It also becomes clear that the over-payment for acquisitions is a frequent problem also for other reasons. The personal interests of senior management are not always commensurate with those of the stockholders. The CEO and his peers see personal advantages in the merger, such as greater empowerment and control of a larger organization, improvement of the social-management status, and higher salaries and benefits. In addition, senior managers have the possibility of moving to the management of another company from an improved position following the merger because of the considerable experience that characterizes a larger company. In other words, one of the main reasons for the failures of M&A, according to finance and economics researchers, is the ego of the CEO and his management. One of the senior vice managers of the large pharmaceutical company Glaxo Welcome addressed this issue: "Ego has precedence over future strategies" (*Fortune*, March 1998). In other words, the personal considerations of senior managers precede rational considerations that are supposed to be expressed in the prior planning of the future strategies of the organization.

Another reason for failures, related to the ego of the CEO and the over-payment, is known as the *hubris hypothesis* or the *sin of pride*. This issue addresses the considerable self-confidence that a person has in his ability to overcome mishaps and succeed even when the chances are low. The concept is known from Aristotle's model of tragedy, in which successful and talented people suffer from pride or excessive self-confidence and thus fail. The tragedy is that they, more than other people, can avert the failure. Exactly like Icarus, who, according to Greek myth, despite his father's warnings, flew too high with his wax wings, which melted when he was too close to the sun—and he fell to the sea and drowned. In the Israeli version of the "Icarus" story, there are several expressions that indicate the sin of pride, such as "Trust me," "It will be alright," and "It won't happen to me." In other words, the CEO is certain that despite the over-payment, the merger/acquisition is worthwhile. He is certain that under his management and through integration of the organizations, effectiveness will increase, new options will be created, the performances of the acquired company will improve within a short period of time, and the advantages of the merger will be realized.

It should be noted that there are cases in which it became clear that the over-payment was worthwhile. When Electra was acquired by Elco, for instance, approximately 30 percent more than the worth, according to the stock value, was paid, but eventually it became clear that the acquisition was very beneficial, at least in the field of manufacturing and sales of air-conditioning units.

In any event, despite the lack of profitability of the acquiring companies, the activity of mergers and acquisitions continues to grow and break records. Why? Following are several possible explanations for this conundrum:

- One possibility is that although there is no potential for profit, the activity continues because
    1. Managers make mistakes in the evaluation of the value.
    2. Managers search to maximize their profit, even at the expense of the stockholders.
    3. Managers act out of pressure from the board of directors and stockholders to show continuous growth.
- Mergers have the potential for profit but
    1. Organizational problems that occur after the merger entail many costs that negate the potential profit or do not allow for the realization of the M&A.
    2. There is a methodological problem with the measurement of the success and profitability of mergers and acquisitions, and therefore the existing profitability is not evident.
    3. The M&A causes reactions among external stakeholders that offset possible positive consequence. Such reactions include how customers decide to change their ways of buying products, whereas a continuous cash flow from these customers was part of the valuation of the acquired party. It is possible that only certain types of mergers bring a profit to the stockholders, whereas others do not.

The reasons in the first preceding topic lead to two other areas that explain differently the factors of success and failure of mergers and acquisitions: strategic management and organizational behavior.

Strategic Management

Researchers from the field of strategic management focus on the management of the organization itself and its long-term planning. Strategic management does not accept the assumptions of economic/finance researchers and of the capital market approach that maintains that

- It is possible to precisely predict the future cash flow of the firm for a period of several years.
- There is the potential for increased inner effectiveness that is greater than the performance of the acquired party's managers.

The experience and knowledge that have accumulated in the realm of strategic management show that strategies change following the frequent environmental shifts and following implementation difficulties. Therefore, future cash flow, which constitutes a main basis for the value evaluation, is difficult to predict.

In addition, strategic management scholars maintain that the ability of inner improvement of effectiveness of the organization is limited, and at some stage, it may detrimentally influence its competitive ability. In contrast, the ideas advocated by economics/finance reseachers led at the end of the 1980s to a growth of hostile takeovers and leveraging using finance and LBO (acquisition of the company using the leveraging by managers and workers). Capital actors who adopted these methods believed that it was possible to increase the effectiveness of the organization and thereby boost its value. However, these hostile takeovers nearly vanished in the 1990s. In addition, it must be remembered that this economics/finance approach is influenced by the American capital market for the measurement of M&A success and emphasizes the short-term effects. In Japan and Europe, the tendency is to focus on performance and long-term strategic goals, and the measurements and reward systems are commensurate with this tendency.

The strategic management approach addresses a large number of measures of success, including the size of sales, the increase of the market share, the improvement of competitive abilities, and of course the change in profitability after the merger in relation to a period before the M&A. These measures are influenced, according to strategic management researchers, by the fit between the organizations, and therefore the main factor of success/failure in the merger/acquisition is the degree of strategic fit between the two companies. Strategic fit is expressed in the synergy potential (2 + 2 = 5) of the merger. (The topic of synergy will be discussed separately in Chapter 5, "Synergy Potential and Realization.") Simply put, there is synergy when it is possible to operate two business units more profitably when they are under the control of one factor than when each one operates separately. Strategic fit and synergy exist in the related merger in which the two organizations operate in the same industry or in related industries. The clearest example is the merger of competitors, when it is then possible to unite administrations and operative functions. Thus, it is possible to achieve the joint level of sales (or more than that) at lower costs, such as in the merger of Elco and Electra in the beginning 1990s in the field of air-conditioning units.

In contrast, when Elco acquired Shekem, which included a food chain and a clothing chain, the synergy was low (only evident in the area of the marketing of electronic products). This was similarly the situation in which a building contractor acquired the Pizza Hut chain. There was no potential for synergies, and the merger was defined as an unrelated merger. Some people asserted that there were synergies because Pizza Hut restaurants are situated in buildings. (Cynics maintained that the only synergy would be if pizzas were sold with a cement sauce.) These unrelated mergers did not succeed. The recommendation in the strategic management approach is unequivocal: Only synergetic mergers are recommended, and unrelated mergers should be avoided, with the exception of highly specific cases.

However, even in related mergers, the number of failures is high. Research conducted by Professor Michael Porter from Harvard examined the percentage of success among

related mergers. The criterion of success/failure was the percentage of organizational divorce in a period of 5 years (and even more) after the merger/acquisition. The sample included large firms in the United States, and the basic assumption was that in related mergers, the intention is to maintain the acquired party for a long period of time to realize the synergy potential. In this sample, too, the percentage of divorce was high, above 50 percent. The conclusion was that a firm that is forced to resell a company it has acquired does so after several attempts to connect the organizations and to exploit the synergy, and when it finally despairs, after much suffering, it "vomits" the company. This was the case in the merger of Madge and the Israeli company Lannet. Lannet was acquired for 330 million dollars and was sold after approximately 3 years to Lucent for approximately 100 million dollars. The integration process of the organizations did not succeed. Madge's profits dropped, and its stock value reached approximately 5 percent of the value on the day of the merger.

Explanations to the miserable results of related mergers are that the potential of synergy is not always realized in the implementation. There are two main reasons for such lack of synergy realization. First, the synergy is not exploited because of lack of prior planning. Using prior planning, it is possible to avoid superfluous costs, to identify the main sources of synergy, and to enable the actualization of the synergy potential in a relatively short time frame. Without a defined plan, the potential of synergy melts away in long and complex organizational processes that do not bear fruit. (Part II, "Analysis Tools for Key Success Facgors," is dedicated to the process of planning.) The second reason for the lack of synergy realization in related mergers is linked to the lack of focus on human factors, namely, the managers and the workers, and then primarily those of the acquired company. This reason is the topic discussed under the title of organizational behavior next.

Organizational Behavior

Researchers and counselors from the field of organizational behavior maintain that the primary cause of failure in mergers and acquisitions is the lack of consideration of the human factor during the process of the planning and implementation of the merger. In other words, even given the conditions of success according to the first two areas, namely, payment appropriate to the acquired company's value and the M&A being conducted between two related organizations with the potential for synergy, the human factor might cause the merger failure. Managers and workers that do not adjust to the merger, consciously or subconsciously, as the consequence of cultural or management style differences, cause considerable costs and disable the exploitation of the synergy potential.

Following comprehensive research performed in recent years and the accumulated experience in many mergers, it is known that, in essence, the main factor that influences the managers and the workers, primarily in the acquired company, is the degree of the

management/organizational culture differences between the two merging organizations. When the difference of the management culture is considerable, the merger is fated for failure. (Management/organizational culture differences exist between organizations in every field and in every country. International culture differences add to the difference that exists between the organizations.) Thus, the CEO of Daimler-Chrysler, the German Juergen Schrempp, maintained that the American James Holden did not succeed in adjusting to his management approach that includes, for example, a policy of cutting expenses and ongoing reporting of the important developments in Chrysler and thus induced ongoing uncertainty. Figure 1.1, which is based on research conducted in the United States and Israel including domestic and international mergers, explains the impact of cultural differences on acquisition success/failure.

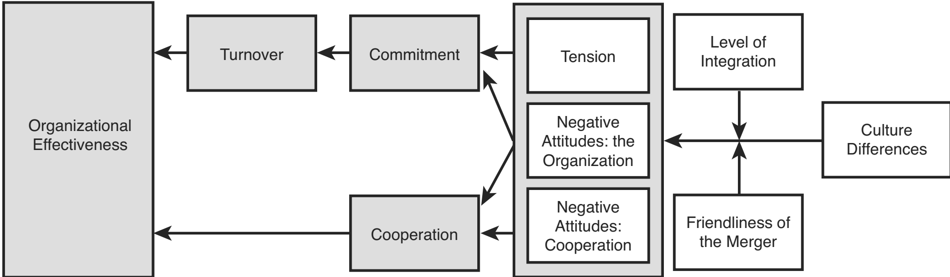

Figure 1.1 The Impact of the Management Culture Differences on the Success of Mergers and Acquisitions

This figure indicates that the culture differences cause tension/pressure and negative attitudes among managers and workers, primarily those of the acquired company. Following the tension and negative attitudes toward the acquiring organization, the commitment of the managers to the success of the merger is impaired. In addition, the level of cooperation between the two sides greatly declines. Thus, senior managers in the acquired company abandon the company and move to competitors or to other firms. This departure of managers, most of which occurs in the first year after the merger, is found in research studies to be related to the decline in the financial performances of the merger.

It is not surprising that Amos Michelson, the owner of the Canadian Company Creo, which purchased the preprinting division of the Israeli company Scitex, said, 1 year after the acquisition was completed that “This merger is not a simple task.” Indeed, 20 of the 25 senior managers of Scitex left in the first year after the merger because they did not want to adjust to the management style of Creo. At the end of that year, Michelson admitted that the return to the pace of growth of 30 percent a year that characterized Creo before the merger would occur only several years later. Actually, the company never returned to these performances.

The problem of the departure of managers and key personnel is especially exacerbated among hi-tech companies. In these companies, the professional knowledge is held by the people, and the ability to develop and innovate is also related to the interaction among the people on the research and development teams. In essence, a main reason for the acquisition is the innovativeness, professional knowledge, and talented personnel. If managers and key personnel leave the acquired company, then the acquiring company is left without the value that it paid for. It is not surprising that such mergers/acquisitions are doomed to fail, especially if the cultural differences and their influences are not identified and analyzed ahead and treated immediately, before, during, and after the papers are signed. This, of course, is important in every industry and in every area.

Indeed, Eli Horowitz, the previous chairman of the Board of Teva, which, due to M&A, has become the world's largest generic pharmaceutical company, noted that "When companies are merged, it is possible to transfer a productive line but the organizational culture is difficult to transfer."

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