CHAPTER 21 Takeovers and Mergers

Overview

The pursuit of growth through takeover or merger has made a small select group very wealthy while diminishing the wealth of a vast number of shareholders. CFOs and Controllers have a moral dilemma here which only they can decide what is appropriate. In many cases the forces are huge to transact the takeover. This chapter explores why so many takeover and mergers, which have been based on perceived synergies and cost savings, fail and if involved in one why you need to move on before reality strikes.

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It is often quoted, and even great leaders seem to forget, that "history has a habit of repeating itself." Company executives, directors, and the major institutional investors (whose support is often a prerequisite) need to learn the lessons and think more carefully before they commit to a takeover or merger (TOM).

Reasons for a Takeover or Merger

To understand the forces at play you need to look at the various reasons for a Takeover or Merger (TOM) that include:

Purchasing future profits from either a related or diversified sector	Here the new subsidiary is left to grow in their own way. This method is characterized by successful investment companies like Berkshire Hathaway.
Purchasing to gain synergy	Here the argument is 1+1=3. These are the mergers/ takeovers typically targeted by Investment banks and have a history of failure.
Purchasing for increased market share	Driven by aggressive executives, the cost frequently outweighing the structural costs that follow such a TOM. Also have a history of failure.
Purchasing to gain access to a	The Kraft Cadbury takeover was undertaken

new channels / new products	so Kraft could access rapidly developing economies such as India, Brazil and Mexico where Cadbury was well entrenched.
Purchasing as a defensive move	Used to prevent another aggressive competitor gaining market share from a company that has become a soft takeover target. Often have duplication of assets that is both costly and time consuming to rationalize
To prevent the newly acquired company to provide services to competitors	Volkswagen purchasing the car designer Italdesign Giugiaro
Asset swaps	GSK-Novartis deal where each party swapped some operations.

Some Big Failures

Warren Buffet described the trouble he had making a successful merger by quoting Bobby Bare, a country singer: "I've never gone to bed with an ugly woman, but I've sure woken up with a few."

The landscape of mergers and acquisitions is littered with business flops, some catastrophic, highly visible disasters that were often hugely hyped before their eventual doom.

AOL and Time Warner

The media giants American Online (AOL) and Time Warner combined their businesses in what is usually described as the worst merger of all time. In 2001, Time Warner consolidated with AOL, the Internet and email provider, in a deal worth a staggering $111bn (£65bn). The merger was seen as a revolutionary partnership between a content owner and a company active in the brave new online world.

AOL and Time Warner parted company in December 2009, after almost nine years of nightmares. In less than a decade, the tie-up had destroyed close to $200bn of shareholder wealth.

Vodafone/Mannesmann

Vodafone's takeover of German rival Mannesmann is difficult to beat for sheer shareholder value destruction. In February 2000 at the height of millennial dotcom madness, the agreed merger of Vodafone AirTouch and Mannesmann created a telecoms giant. The £112bn all-share deal to acquire

Mannesmann turned the merged group into the world's fourth-largest company, worth £224bn.

In 2006 Vodafone plunged to massive losses after one-off costs of more than £23.5bn connected to the Mannesmann deal.

Glaxo Wellcome/SmithKline Beecham

In December 2000, two of the UK's largest pharmaceutical companies, Glaxo Wellcome and SmithKline Beecham came together to form global giant GlaxoSmithKline. At that time, GSK's share price was close to £21, valuing the firm at close to £110bn and putting it in the top three of the FTSE 100.

Fast forward 15 years and GSK's share price is around £14, or about a third lower than at the time of the merger, destroying roughly £30bn of shareholder wealth.

The driving forces behind TOMs

I met an investment banker on a recent flight who told me about the takeover and merger game that is being played by large investment bankers around the world. It never made any sense to me, because everybody knows only one in six mergers breaks even and many have lost billions off the balance sheet.

The game is called "transactional fees" and involves the study, by the investment bankers, in minute detail of the motivational factors of the key players. They end up knowing more about the private lives of the CFO, CEO, board members, and fund managers than they would like their partner to know. Investment bankers go to the CEO and CFO with a proposed merger and acquisition deal, and they often fail. The CFOs and CEOs know that these deals seldom work.

The investment bankers then go to the influential board members, and the CFO and CEO have to fight it out in the boardroom, which they typically will win. The investment bankers, who have now spent hundreds of thousands of dollars in research, are not finished. They go to the fund managers, who are the major shareholders, and say, "The board has lost the plot; they do not recognize the value in this deal!" The fund managers put pressure on the board, whose members in turn say to the CEO and CFO, "If we do not do this deal, the fund managers will change the board structure — but before that, we will see that you go first." The CEO says, "What the hell, we will do it." Here is the interesting part. The CEO is offered a big sum to go quietly, and this, with the investment bankers ' fees are now amortized, through poorly thought out accounting principles, slowly kills the combined company for years to come.

How Takeovers or Mergers Go Wrong

There are many reasons why TOMs go wrong. Set out below are some of the common ones.

The Synergy Calculations Are Totally Flawed

My interest in the failure rate of TOMs dates back to the Economist[1] series on six major takeovers or mergers (TOMs). In the articles, the writers commented that over half of TOMs had destroyed shareholder value and a further third had made no discernible difference.

KPMG undertook a cutting edge study[2] into TOMs and is a must read for CFOs and Controllers involved in a TOM. The study found:

> "Only 17% of deals had added value to the combined company, 30% produced no discernible difference, and as many as 53% actually destroyed value. **In other words, 83% of mergers were unsuccessful** in producing any business benefit as regards shareholder value."

TOM advisors and hungry executives are as accurate with potential cost savings estimates as they are with assessing the cost of their own home renovations (in other words, pretty hopeless). Press clippings are easily gathered with CEOs stating that the anticipated savings have taken longer to eventuate. The reason: It can take up to four years to merge the information technology platforms together, and even when this is achieved, many of the future efficiency and effectiveness initiatives have been put on the back burner.

CFOs and Controllers, as the experts with the numbers, need to ensure that the CEO and the Board are under no illusion about the extent of the cost savings synergies. You can put your last dollar on the fact that the Investment Bank behind the deal has well and truly overstated these benefits.

The synergy calculations never allow enough costs for; the myriad of consultants who are in a feeding frenzy and largely left to their own devices, staff redundancies, loss of some key customers, productivity shortfalls due to uncertainty and the costs of recruiting for key positions as talented staff have decide to move to a less stressed organization.

Case Study: The Morrisons' TOMs Go Rotten

Morrisons, a relatively small but profitably supermarket based in the North of England, has made a number of failed takeovers.

It purchased **Safeway** for $3bn, based on the following logic:

- Both businesses were supermarkets, so the merged company could apply greater pressure to suppliers.
- Back-office, distribution and marketing costs could be cut because of economies of scale.
- Morrison's had a reputation for being very tightly run with good cost controls and these skills could be applied to the much larger Safeway.

The merger went through in early 2004 and within the next 15 months, or so, Morrisons had to issue five profit warnings. In the year to the end of January 2006, the group made a pre-tax loss of around £300m compared to combined profit of about £650m before the merger. The mistakes made included;

- Alienating the 300 Safeway staff at their head office, severely damaging morale.
- Morrison's failed to persuade many key Safeway staff to move north to the group's headquarters.
- Did not protect the key Safeway IT staff who left leaving little knowledge of the Safeway IT system.
- Mixing the two brands, Safeway stores began stocking Morrisons-branded products which were deemed inferior by Safeway customers
- Underestimating the difficultly to integrate the two company's IT systems - a common mistake.

To prove the lessons had not been learnt in 2011 Morrison's made its first entry into online retailing by paying £70 million to acquire **Kiddicare** - a leading baby products retailer. The rational was that the US online retailer would give it a cut-price entry into online retailing even though the baby goods website had no grocery related software.

Just three years later, Morrisons sold Kiddicare to a specialist private equity company (Endless) for just £2m, with the grocery retailer also left with substantial ongoing liabilities for shop leases and other commitments it had made as it tried to grow the Kiddicare business under its control. The total cost of the disastrous takeover for Morrison's shareholders was in excess of £100m.

Loss of Focus on Customers

There is no better way to lose sight of the ball than a merger. Merging the operations will distract management and staff from the basic task of making money. While meeting after meeting occurs at the office and sales staff focus on their futures (either applying for positions elsewhere or joining in the ugly scramble for the new positions), the customers are up for grabs. Researchers, sales staff, and marketers are all busy back at their desks trying to perform damage - control exercises as they either jockey for the lifeboats or stay on board to try to keep the ship afloat. It would be an interesting Ph.D. thesis to assess the loss of customers due to merger activity.

Culture Clash

Managing the aftermath of a TOM is like herding wild cats. Where have readers seen cultures merged successfully? In reality, one culture takes over another. This is okay when one culture is fundamentally flawed. However, in many mergers, both entities have cultures that work. Now you have a problem. Many competent staff members may choose to leave rather than work in a culture that does not suit their working style.

There Is No Heart in a Merged Organization

How long does it take for a company to develop a heart? This is more than just the culture; it includes the living and pumping lifeblood of the organization. I think it takes years, and some consistency among the management and staff. The merged organization thus cannot have a heart. The organization can be kept alive on life support, but just like a critical patient, it is effectively bedridden and will be in intensive care for some time.

Loss of Years of Intangibles

An organization is a collection of thousands of years of experience, knowledge, networking, research, projects, and methodologies. If a major blue chip company said that it was going to disestablish all its staff and management, shareholder analysts would think management had simply lost control. The stock values would fall. This is exactly what a merger does. Research and development is another victim. How do you keep on projects and maintain the level of momentum with unhappy research staff? At worst, you will be moving one team to a new location, making redundant those whom you believe are making the least contribution, and hemorrhaging talent. Research basically gets decimated.

The Wrong Management Rises to the Top

I have a theory that the main beneficiaries of a merger are the piranhas, those managers who see burying a dagger in someone's back as a necessary occurrence. . The result is quite interesting; the merged company very soon becomes dysfunctional as more and more of these caustic managers rise to the top.

The senior management meetings make the feeding frenzy over a carcass on the plains of Africa look orderly. These managers do not live and breathe the organization; the ones who did have long since left.

Salary Costs Escalate

There are many financial time bombs that impact shareholder value.

Severance packages can create further waste as staff members, especially the talented staffers, leave before generous severance terms disappear. Thus to retain such people, further salary incentives need to be made that create further pressure on the bottom line.

The TOM is often the time when the shareholders realize the dilution they have been a silent party to comes into full swing, the conversion of options. The surge of the share price as speculators play with the stock means

that options can be exercised profitably by the executives who then leave the shareholders holding the rotten TOM.

Human Beings Find It Hard to Conceptualize the Intangibles

For many of us, conceptualizing the abstract is very difficult. A company is most definitely an abstract quantity. It is not a balance sheet; it is much more and much less. Executives in major corporations can write off the annual gross national product of a small country on a failed merger and still not lose sleep at night. The numbers are so large that they appear unbelievable, and the senior management team (SMT) seems to be able to pass them off as just poor management decisions. Yet they are a catastrophe for the investor whose savings are now reduced and the retiree who was relying on the dividends to cover yearly living expenses.

It is impossible for the average board and SMT to completely appreciate all the implications of a merger.

Mergers Are Seldom Done from a Position of Strength

Most mergers are defensive; management is on the back foot trying to make something happen. Defensive TOMs are not a great idea as the companies escaping from a threat often bring their problems into the marriage.

Alternatively, TOMs occur because management consider themselves invincible. They talk to the general public through the press, reveling in their moment in the limelight. Their brief track record of stellar growth is now extrapolated out of all proportion.

There Is Never Enough Time to Fully Evaluate the Target

A merger is like an auction. The buyer rarely has more than a cursory look at the goods before bidding. Management often does not want to find the dirty laundry as it would mean going back to square one again.

It is important not to limit due diligence in the haste to close the deal, as you tend to know less about each other than you think. The dirty laundry often takes years to discover and clean.

Avoiding a Lemon

Some companies are still making fictitious money like Enron did. They are shams, and we need to avoid purchasing a lemon. The Enron documentary should be compulsory watching for all investors and employees with pensions invested in their companies. The lessons from Enron and other similar collapses provide a useful guide to predicting corporate collapses.

Takeover or Merger Scorecard

I have designed a scorecard covering the aspects executives need to know before boldly going where others have mistakenly gone before (five out of six TOMs fail to achieve the synergism planned). If the merger must go ahead, then please look at the TOM scorecard and get to it. I will not wish you good luck, as that would not be adequate enough.

The current talk is about getting the first 100 days right. Using the findings from Chapter 2 Selling & Leading Change I would recommend that you master Kaffron and Logan's and John Kotter's work. Applying these learnings I suggest the following:

Select influential staff from each organization to be part of a Joint Council	Their role is to: • Identify at risk key staff • Identify the oracles that need to get behind the merger • Be full time on the project with a project office at both head offices • Communicate to staff across the organization what will happen • Develop strategies to capitalize f the synergies that are available
Communication strategy	• To staff What teams are merging what are not? What rhetoric in the lead to the merger needs to be dispelled / clarified? • To key customers (giving assurances about services and quality standards) • To key suppliers (likely impact on future ordering) • Select some PR consultants who know each organization and use them to draft all communications which will be delivered by

	respected and familiar faces. Remember the wise words of John Kotter, outlined in Chapter 2, you will under communicate by at least a factor of 10 and at worse a factor of 100.
Synergy strategies	Ignoring the TOM hype what are the real synergies available to the combined operation? Which ones offer the easiest goal and thus should be accessed first?
Intellectual property strategy	Both organizations will have IP that is under development. It is important that these are not slowed down or abandoned unintentionally.
Asset strategy	Which assets are duplicated and which ones should be sold on?
Information systems strategy	Which systems are to stay as they are, which systems need to be integrated and which systems may get integrated? In today's world having both entities using one system is not necessary. Systems can now convey information through the reporting tools that are now available. The costs of changing an accounting system are horrific in time taken and lost opportunities for the finance team. Leave them as they are. Should, at some later stage, the desired replacement GL be identical for both operations, then merge the accounting systems. This event however will be rarer than you think. Far better to use a consolidation and a forecasting and planning tool to coordinate forecasting and reporting.
Labor strategy	What staff reduction can be achieved via natural attrition, targeted early retirement, and finally redundancy? As discussed in Chapter 22 the cost of downsizing maybe greater than retaining the staff.

Whilst tempting avoid bringing in outside consultants to run this transition process. Most of their previous assignments will have failed (five out of six mergers fail) and they will have no credibility in-house. Far better to use takeover specialists as advisers to the joint committee.

Alternatives to a Rotten TOM

Why is it then that senior management and boards rush like lemmings for this self - annihilation? It is understandable why the investment community and shareholders make the mistake; they are simply naive. Try to find an analyst who has been a successful manager in business. The individual ' s skill is in adding numbers up and the ability to write seemingly sensible evaluations based on little or no knowledge of why mergers cannot work. Shareholders usually have little time for research or are just plain greedy, looking for supernormal returns and believing all the promotional material that merely lifts share prices over the short term.

There are options other than a TOM. You can:

- Remain a boutique operator with strategic alliances. This may be better than risking the fate of many failed TOMs.
- Pay back shareholders the surplus reserves and let them reinvest elsewhere.
- Improve performance by focusing on underperforming assets (that is often the reason why the other company is interested in you in the first place).
- Look to grow the old - fashioned way by expanding from within.
- Invest as a silent partner (Warren Buffett style) in small but fast - growing companies with complementary services and extract value by internationalizing their innovations.

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The PDF download for this chapter includes:

- The Warning Signs Of A Lemon Checklist
- Takeover or Merger Scorecard
- Interesting Articles and Papers

Notes

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[1] "How Mergers Go Wrong, " The Economist , July 22 – August 26, 2000.

[2] KPMG Mergers & Acquisitions, A Global Research Report, 2000