CHAPTER 1

THE NEED FOR INTELLIGENCE IN MERGERS AND ACQUISITIONS

Mergers and acquisitions are an integral part of the global strategic and financial business landscape, whether one is part of the acquiring company, the target, a competitor, an advisor (including investment bankers, accountants, lawyers, and many others), an investor, a regulator, or someone living or working in the neighboring community.

Although fluctuating widely from periods of peaks and troughs of merger activity, the baseline size and growth of mergers is clear. In fact, the 'slow' period of activity in 2002 was well in excess of the 'peak' of activity in the late 1980s.

Yet despite this impressive trend, mergers and acquisitions are often misunderstood and misrepresented in the press and by those who are engaged in each transaction. Deals, especially when hostile, cross border, or among large companies, might be front-page news (and interestingly there are some days when *every* story covered on the first page of the *Financial Times* is about an acquisition), yet there is a great deal of conflicting evidence as to whether they are successful or not. Our own research has shown an improved performance of companies that make acquisitions, especially in the merger wave that began in 2003.

That said, there do seem to be some inviolate truths about M&A deals:

1. Many fail to deliver the promised gains to shareholders.
2. Boards, CEOs, senior managers, and advisors pursue deals for personal reasons.
3. Deals have a momentum of their own and this means that they don't get dropped when they no longer make sense.
4. The deal doesn't end when the money changes hands; in fact, that point marks the start of the most difficult stage of a deal, the tough integration process that few get right.
5. Success with one deal doesn't guarantee success in the next deal.

Some M&A failures have been dramatic. The AOL/Time Warner deal lost 93% of its value during the integration period as the internet service provider merged with the publishing company in an attempt to combine content with delivery. VeriSign, another internet-related services company, lost $17 billion of its $20 billion acquisition of Network Solutions in 2000, and its stock fell 98%. It is not just the fallout from dot.com failures that have lost money following a major acquisition, as another classic example of failure – and one where the very basic elements of business intelligence were ignored – is Quaker Oats, a food and beverage company founded in 1901. In the brief case study which follows, look at the first word of the penultimate paragraph. It is the key identifier of an intelligence failure. The word is 'following.' Incompatibility of cultures is one of the biggest post-acquisition killers.

Quaker Oats

On November 1, 1994, Quaker Oats acquired Snapple for approximately $1.9 billion, becoming the third largest producer of soft drinks in the United States.

The Quaker Oats Company had been founded at the start of the 20th century, and its most famous product, Quaker Oats Cereal, originated in 1877. At the time of the initial acquisition, Quaker Oats was one of the leading manufacturers of cereal products in the United States, but it had also diversified into baby food, animal feed, chocolate (in Mexico), and honey (in the Netherlands). One of its most successful recent diversifications had been the acquisition in 1983 of Gatorade, a sports drink company. Under Quaker Oats' ownership, Gatorade had grown tremendously. This success contributed to the feeling within Quaker Oats that, because its main business was mature, it should focus on 'investment in brands with high growth potential and divestment of lower growth, lower-margin businesses', as stated in its 1995 Annual Report.

Snapple was a trendy, slightly eccentric company, founded in 1972 by three entrepreneurs (two window washers and the owner of a health food store). Under the brand name 'Snapple' (acquired in 1978), their product line had grown by word of mouth to be one of the best-selling fruit drinks lines in the northeast United States. They also sold iced tea drinks, which had been added in 1987.

Where Quaker Oats was an old-line national company, Snapple was a 'New Age' company run as a regional family business. However, as such, Snapple did not have the resources to continue to expand, and with increased new competition from the largest soft drink manufacturers (Coca-Cola and Pepsi), they looked for someone to acquire them.

Quaker Oats thought that there were important potential synergies between Gatorade and Snapple. On the surface, it appeared that they could share distribution channels (reducing costs) and they had complementary geographic areas. Quaker Oats also hoped that its conservative culture could be invigorated by Gatorade.

Following the acquisition, it was determined that the pricing strategy was different for the two product lines, the distribution different (Gatorade used a warehouse distribution system whereas Snapple used a single-serve, refrigerated delivery system) and, most importantly, the cultures were not compatible (affecting integration, advertising, and many other areas where coordination was required). In addition, in the quarter just prior to the acquisition, Snapple had experienced a 74% drop in sales on a year-over-year basis, a fact that was only told to Quaker Oats a few days before the deal was finalized. At the same time as sales volumes were decreasing, the cost of integration and national rollout under Quaker Oats was rising.

Less than three years later, in 1997, Quaker Oats sold off its Snapple division to Triarc Corporation for $300 million.

One challenge in trying to determine success of an acquisition lies in how to define 'success.' Is it shareholder value? If so, over what period? Or should one look at sales growth? The ability to retain key customers? Employee retention? Cost savings? And how would the company or companies have performed if they had not merged? Perhaps as some have suggested, success should be defined by the publicized goals of the merging companies themselves and then measured against achieving those stated objectives.

No matter how measured, a fair degree of consistency has emerged in the results of studies that have examined M&A 'success' through the 20th century. Essentially all of the studies found that well over half of all mergers and acquisitions should never have taken place because they did not succeed by whatever definition of success used. Many studies found that only 30 to 40% were successful. Yet most companies that have grown into global giants used M&A as part of their growth strategy.

This paradox raises the following questions:

- Can a company become a large global player without having made acquisitions?
- Is organic growth sufficient to become a leading global player?

The challenge for management is to reconcile the low odds of deal success with the need to incorporate acquisitions or mergers into their growth strategy. Figure out how to beat the odds and be successful in takeovers. This is where business intelligence techniques are essential.

Prior experience may not be a predictor of success, although some studies have shown that acquirers do better when making an acquisition that is similar to deals they have done previously. Here again the need for specific intelligence is central. Many studies have shown that relatively inexperienced acquirers might inappropriately apply generalized acquisition experience to dissimilar acquisitions. The more sophisticated acquirers would appropriately differentiate between their acquisitions. In a deal that will be discussed later, VeriSign appears to have failed with its 2004 purchase of Jamba AG despite having made 17 other acquisitions in the prior six years, many in related internet businesses. Intelligence cannot, therefore, be taken for granted.

DIFFERENT TYPES OF MERGERS AND ACQUISITIONS

There even is some confusion about the terminology used. Many have questioned whether all mergers and consolidations are really acquisitions. This is because the result – sometimes as much as a decade later – is that the staff, culture, business model, or other characteristics of one of the two companies becomes dominant in the new, combined organization.

Name changes reflect merger realities: Morgan Stanley

This reality of a merger can often be reflected in the name change. For example, in 1997, Morgan Stanley and Dean Witter Discover 'merged.' Although the new company was renamed 'Morgan Stanley Dean Witter,' within several years it was renamed just 'Morgan Stanley.' In a power struggle at the top in the initial years after the merger, the former head of Dean Witter (Jack Purcell) dominated and the former president of Morgan Stanley (John Mack) left to become the head of a rival investment bank, Credit Suisse.

That was not the end. In 2005, eight years after the original 'merger', a palace coup of former Morgan Stanley managing directors forced the ouster of Purcell and reinstated Mack as head of the bank.

This was not a unique situation even for the brokerage industry, as over decade earlier in 1981, the commodity trading firm Phibro Corp had acquired Salomon Brothers to create 'Phibro-Salomon,' yet the Salomon managers ultimately prevailed and the company was renamed Salomon Inc. Salomon was later acquired again, and today is part of the global financial powerhouse Citigroup, although rumors consistently arise that Salomon may again be independent.

Although one therefore should be careful in using the terms 'merger,' 'acquisition,' and 'consolidation' and other related words, in practice these terms are used interchangeably. Additionally, 'takeover' is a term that typically implies an unfriendly deal, but will often be used when referring to any type of merger or acquisition. In this book, we will most often use the term 'merger,' even when the transaction could be or has been structured as an 'acquisition.'

The three major types of mergers/acquisitions are driven by different goals at the outset and raise different issues for the use of business intelligence.

- **Horizontal mergers** are mergers among competitors or those in the same industry operating before the merger at the same points in the production and sales process. For example, the deal between two automotive giants, Chrysler in the US and Daimler, the maker of Mercedes cars and trucks, in Germany, was a horizontal merger.

  In horizontal mergers, the managers of one side of the deal will know a lot about the business of the other side. Intelligence may be easy to gather, not just because there will likely be employees that have moved between the two companies over time in the course of business, but the two firms will also most likely share common clients, suppliers, and industry processes. These deals often include cost savings as a principal deal driver, as it is more likely that there will be overlaps and therefore redundancies between the two companies.
- **Vertical mergers** are deals between buyers and sellers or a combination of firms that operate at different stages of the same industry. One such example is a merger between a supplier of data and the company controlling the means through which that information is supplied to consumers, such as the merger between Time Warner, a content-driven firm owning a number of popular magazines, and AOL, the world's largest internet portal company at the time of their merger. There is often less common knowledge between the two companies in a vertical

deal, although there may still be some small degree of common clients and suppliers, plus some previously shared employee movement. Depending on the perspective of the firm, the vertical merger will either be a backwards expansion toward the source of supply or forwards toward the ultimate consumer. The 2003 acquisition of TNK (a Russian oil company with large oil and gas reserves but little western refining capability or retail marketing) by BP (which had declining reserves and strong global marketing and refining operations) is one such example. We will visit this acquisition again.

- **Conglomerate** mergers are between unrelated companies, not competitors and without a buyer/seller relationship (for example, the 1985 acquisition of General Foods, a diversified food products company, by Philip Morris, a tobacco manufacturer). Conglomerate mergers do not have a strategic rationalization as a driver (although often cost savings at the headquarters level can be achieved, or in the case of Philip Morris, it wished to diversify risk away from the litigious tobacco industry). This type of merger was common in the past, but has fallen out of favor with shareholders and the financial markets, although when they do occur, they can benefit greatly from the more creative uses of business intelligence. For example, detailed scenario planning involving simulations based on high quality information can identify unforeseen issues that can drive such deals and provide a logical rationale.

Deals are either complementary or supplementary. A complementary acquisition is one that helps to compensate for some weakness of the acquiring firm. For example, the acquiring company might have strong manufacturing, but weak marketing or sales; the target may have strong marketing and sales, but poor quality control in manufacturing. Or the driver may be geographic: when Morgan Stanley made a bid to purchase S.G. Warburg in

1995, it wanted to complement its powerful position in the US market with Warburg's similar position in the UK and Europe. A supplementary deal is one where the target reinforces an existing strength of the acquiring firm; therefore, the target is similar to the acquirer. A good example of such a deal would be when one oil company buys another oil company, such as the aforementioned 2003 deal when BP purchased a controlling interest in TNK, a Russian oil company with large oil reserves.

THE MERGER WAVES

Merger activity tends to take place in waves – a time of increased activity followed by a period of relatively few acquisitions. Each wave has been stimulated by events outside the merger world, but which have had a significant impact on the level of merger activity. Each wave is sharply distinguished from earlier waves with creative new ways of consolidating companies and defeating the defenses of targets, although each wave built on the merger techniques and other developments from the previous wave.

There is also the tendency, as with the military, of preparing to fight the last war's battles. Just as the Maginot Line couldn't stop the Third Reich's panzers as they rolled through Belgium and into northern France, it is not sufficient for a company to have out-of-date takeover defenses. Strategic initiative or power does not guarantee success to the bidder, as the United States learned militarily in Vietnam in the 1960s and in Iraq in the 1990s and 2000s. The parallel in business usually means relying too much on a large checkbook and first mover 'advantage' as Sir Philip Green discovered in 2004 when trying unsuccessfully to take over Marks & Spencer.

Merger activity can be likened to the Cold War arms race where one country's development of new weapons stimulates the development of more sophisticated defensive systems, thus forcing the first country to make further advancements in their offensive weapons to remain ahead. In the M&A arena, as acquiring companies have developed more sophisticated tools to make the acquisition of companies more certain, faster, easier, or less expensive, the advisors to the target companies have designed stronger defenses for their clients. These defenses have then stimulated further activity to create better acquisition methods. Just as with the arms race, the process becomes more complicated and expensive for all the players.

Knowledge of previous takeover techniques is therefore important for any bidder or target – and is a critical aspect in the application of business intelligence. The development of these tactics has concentrated in the six major merger waves since the beginning of the 20th century, and focused during much of that time on the United States as the largest and arguably the most open M&A market in the world. In most cases, the new developments in M&A were first tried in the US and then 'exported' to other countries or regions, although before the 1990s the major economic regions had waves somewhat different to the US but often driven by similar factors. Since the 1990s, the merger waves have been truly global.

The **first** merger wave took place from 1897 and continued through 1904. It started in the United States after the Depression of 1893 ended, and continued until the 1904 stock market crash, with a peak between 1898 and 1902. This merger wave featured horizontal mergers (over three-quarters of all mergers then) often resulting in a near monopolistic industry in the consolidating industries: metals, food, oil, chemicals, trains, machinery, and coal. It was therefore also known as the 'monopoly merger wave.' Some of the companies formed from this wave in the US have remained global powerhouses and included: Dupont, Standard Oil (controlled 85% of the US domestic market), American Tobacco (controlled 90% of its market), General Electric, Eastman Kodak, and US Steel (controlled 75% of its market). There was a similar trend in other markets, particularly Germany, France, and Great Britain.

The **second** merger wave was from 1916 until the Great Depression in 1929. The growth of this merger wave was facilitated by cooperation among businesses as part of the Great War (World War I) effort, when governments did not enforce antitrust laws and in fact encouraged businesses to cooperate. For the first time, investment bankers were aggressive in funding mergers, and much of the capital was controlled by a small number of investment bankers (most notably J.P. Morgan). The role of investment bankers in driving the deal market continues today.

Over two-thirds of the second merger wave acquisitions were horizontal, while most of the others were vertical (thus, few conglomerate mergers). If the first merger wave could be characterized as 'merging for monopoly,' then the second wave could best be described as 'merging for oligopoly.' Many of these mergers created huge economies of scale that made the firms economically stronger. Industries that had the most mergers were mining, oil, food products, chemicals, banking, and automobiles. Some of the companies created in the US in this period were General Motors, IBM, John Deere, and Union Carbide.

The **third** merger wave occurred from 1965 to 1969. Many deals in this wave were driven by what was later determined to be the irrational financial engineering of company stock market earnings ratios (similar in many ways to the exuberance of the dot.com era 30 years later). This wave was known as the 'conglomerate merger wave,' as 80% of all mergers in the decade 1965–1975 were conglomerate mergers. A classic example of such a merger is the acquisition by ITT of companies as diverse as Sheraton Hotels, Avis Rent-a-Car, Continental Baking, a consumer credit company, various parking facilities, and several restaurant chains. Clearly, ITT would not be able to integrate these companies at the production, business, or client levels, so there was little in cost savings or strategic rationale that drove the deals despite claims of management efficiency at the headquarters level; instead, the growth of ITT was blessed by the market with an award of a high stock price!

One reason for such conglomerate mergers was the world-wide growth after World War II in stronger antitrust rules (or the more vigorous enforcement of existing antitrust and monopoly regulations), thus forcing companies that wanted to expand by acquisition to look for unrelated businesses. The beginning of the end was the fall of conglomerate stock prices in 1968.

Inco vs ESB and Colt vs Garlock

Most deals during this early post-war era were friendly. The first significant hostile takeover in the US by a major firm was in 1973 when Inco (a mining company, originally named International Nickel Company) acquired ESB (a battery manufacturer, originally known as Electric Storage Battery); significantly, Inco was represented by Morgan Stanley, at the time the leading M&A advisor. Inco was successful in acquiring ESB, and this deal changed the rules of the game where the large investment banks would now get involved in hostile bids. Note that the first hostile bid in the UK was in 1958 and 1959 when British Aluminium was acquired by Tube Investments and its American partner Reynolds Metals; the bidders were advised by S.G. Warburg.

Another deal, Colt Industries' lightning raid of Garlock in 1975, brought hostility to an all-time high. The new development in this deal was that Colt took the hostile negotiations public and advertised heavily, forcing Garlock even to hire a public relations firm, which may be common today but would not have been done in the early 1970s. Famously, its advertisements accused Colt of launching a 'Saturday Night Special' (a term used in the US to denote unregistered hand guns purchased for immediate use in crime) which entered the M&A vernacular as a description for a takeover offer that is open only for a short period of time, thereby forcing target company shareholders to make a quick but not fully informed decision.

The **fourth** merger wave was from 1981 to 1989. During this wave, hostile deals came of age. Generally, the characteristics of this merger wave were that the number of hostile mergers rose dramatically, the role of the 'corporate raider' developed, anti-takeover strategies and tactics became much more sophisticated, the investment bankers and attorneys played a more significant role than they had since the second merger wave, and the development of the high yield ('junk') bond market enabled companies to launch 'megadeals' and even purchase companies larger than themselves. This last trend contributed to the high number of leveraged buyouts with excessive use of debt and companies going private. Assisting this merger wave was relaxed antitrust enforcement, especially in the US under President Ronald Reagan and in the UK under Prime Minister Margaret Thatcher.

The **fifth** merger wave (1994–2000) was characterized by consolidations of industries and globalization. The dot.com boom and bust also occurred during this wave. Many 'strategic' consolidations unfortunately failed to deliver on promised gains, such as lower costs and greater synergies, and ended with the decline in stock prices worldwide beginning in 1999/2000. Nevertheless, there were a large number of significant deals during this wave, in the following industries:

- Oil (BP/Amoco, Exxon/Mobil, Total/Petrofina).
- Financial services (Citicorp/Travelers, Deutsche Bank/Bankers Trust, Chase Manhattan/J.P. Morgan).
- Information technology (Compaq/Digital Equipment, Hewlett Packard/Compaq).
- Telecommunications (Mannesmann/Vodafone, SBS Communications/Ameritech).
- Pharmaceuticals (Glaxo/Wellcome).
- Automotive (Daimler Benz/Chrysler).

The **sixth** merger wave began in 2003, less than three years following the end of the previous cycle. Merger waves therefore are occurring on a more frequent basis with a much shorter quiet period. This sixth merger wave has been truly global and has seen more focus on strategic fit and attention to post-merger integration issues. It has been heavily influenced by the corporate governance scandals of the early years of the new millennium and the resulting laws and regulations that have been passed – most notably the Sarbanes-Oxley Act in the United States. Success for these deals has been largely driven by three factors, as shown in Figure 1.1, which comes from a presentation that Towers Perrin developed together with Cass Business School.

An additional change in the sixth merger wave has been the rise in activity by financial buyers (hedge funds, private equity funds, and venture capital funds) who therefore do not and cannot have strategic interests as the primary driver. These funds purchase large stakes in companies and then either purchase the remaining part of the company or force a reorganization through the exercise of their shareholder rights. In some cases these shareholder actions have stopped deals from taking place where the funds exerted pressure on management as they felt they could achieve higher returns in other ways, such as the return of cash to shareholders in the form of a special dividend or where the intrinsic growth potential of the company was seen to be

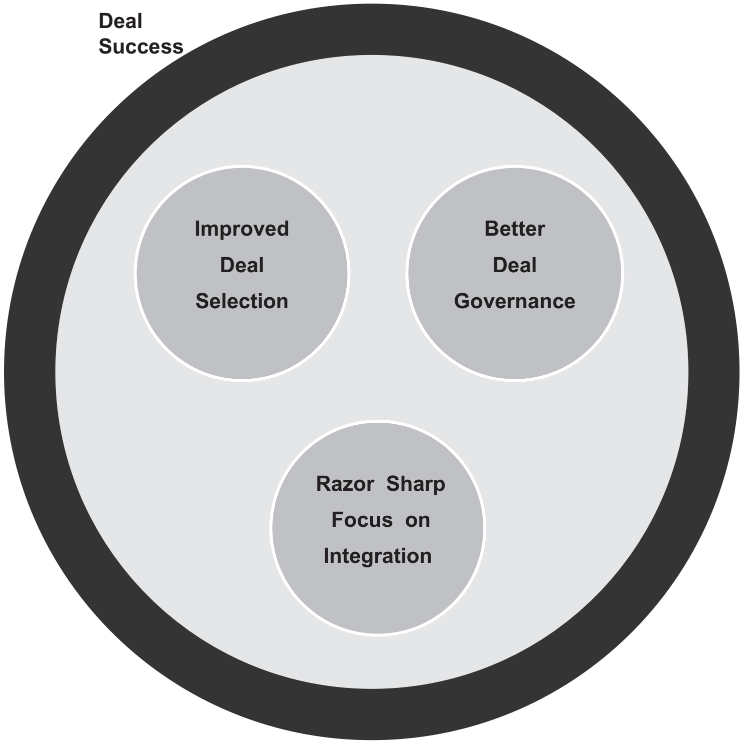

Figure 1.1 Sixth Merger Wave Success Factors.

excellent. This was the case in early 2005 when the Deutsche Börse was forced to withdraw its proposed takeover of the London Stock Exchange, despite the fact that the board of the Deutsche Börse had already approved the deal. More on this deal later.

Unlike previous merger waves, more companies have been successful with their acquisitions than not, although it is not clear whether this trend will continue. As shown in Figure 1.2, our analysis, in consultation with Towers Perrin, of shareholder performance in deals during the 1980s and 1990s was negative when compared to the market, whereas the performance of deals in the recent merger wave is thus far better than the market.

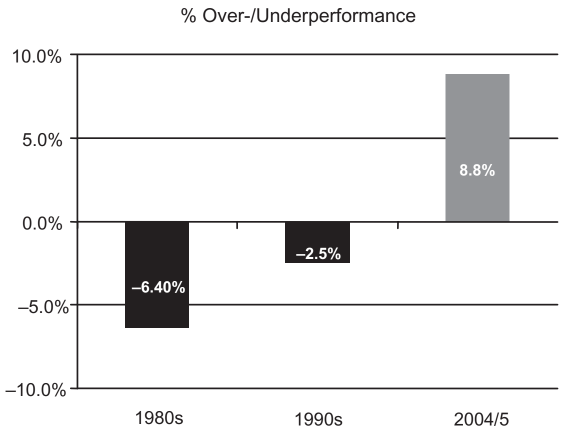

Figure 1.2 Average Deal Performance vs the Market.

History will repeat itself, and one way in which this happens in M&A is the reasons and rationale driving the deals. Just as understanding the history of M&A is helpful in planning today's deals both offensively and defensively, understanding the reasons behind a deal are also critical.

Pharmaceutical industry consolidation: AstraZeneca's acquisition of Cambridge Antibody Technology

As one pharmaceutical industry expert told us, 'No large pharma will be successful if they do not have a proportion of their pipeline coming from external sources. Most big pharma have around 30% of their pipeline in collaboration deals. Years ago the big pharmaceutical players thought they could exist on their own but they realized not. Merck were one of the last ones to realize this and had to get into trouble first . . . in the early 1990s Merck was "the" pharma company but they thought they could do it alone and look at them now. They have been hungry for deals in the last few years and have licensed a lot . . . All large pharma are saying the same thing

"The World is our Research Laboratory" . . . of course, they are all mad!'

AstraZeneca was the UK's second largest pharmaceutical company. Its acquisition of Cambridge Antibody Technology (CAT), the UK's largest biotechnology company, began with an alliance. The relationship between the two firms had started, in 2004, with AstraZeneca taking a 19.9% equity stake in CAT. According to the CAT website, they arranged a strategic alliance for the 'joint discovery and development of human monoclonal antibody therapeutics, principally in the field of inflammatory disorders, including respiratory diseases.' It was decided that CAT would be responsible for antibody discovery, manufacturing process development, and the supply of material for exploratory clinical trials. AstraZeneca was responsible for translational biology, clinical development programs, regulatory filings, and commercialization.

The results of the cooperation were encouraging and promised more for the future. Six discovery projects, one pre-existing CAT discovery program adopted into the alliance, and five new programs all had progressed on schedule by June 2005.

Building on the success of this existing collaboration, the companies decided to move further. On the morning of May 13, 2006, the shareholders of CAT woke up to some incredibly good news. AstraZeneca announced it was ready to pay an unprecedented 70% premium to acquire the remaining 80.1% of CAT's shares that it did not already own. AstraZeneca proposed paying 1320 pence per CAT share, higher than even the most optimistic analysts had expected, thus valuing the all-cash deal at £702 million.

AstraZeneca's purchase of CAT was a strategic step to secure operations in the biopharmaceutical market segment, build up future capabilities, strengthen its own positions, and limit access of competitors to the technologies it considered critical.

REASONS FOR M&A DEALS

Some of the reasons to acquire or merge may have started to become clear from the earlier discussions in this chapter, such as the need to control a source of raw materials in a backwards vertical acquisition, as BP announced when it acquired TNK. But it is usually necessary to dig deeper than the press statements from the parties involved. Very often the publicly stated reason is quite different from the underlying strategic rationale (assuming such a rationale really existed).

Numerous theories have been put forward regarding the reasons for mergers and acquisitions. Whether '. . . caught up in the "thrill of the hunt," driven to complete deals as a result of internal company politics, management bravado, or the need to boost divisional key performance indicators in order to reach bonus targets . . . ,' as suggested to us by Sarah Byrne-Quinn, Group Director of Strategy and Business Development at Smith & Nephew, deals are often motivated by personal and financial as opposed to strategic considerations. Either way, to avoid peripheral issues taking center stage, organizations need to remain open minded when pursuing a deal, building teams to question assumptions on an ongoing basis and to remain focused on the overall strategy for the company, while being motivated by the underlying 'quality' of an acquisition at the right price for an organization.

There are often multiple reasons given, sometimes conflicting and overlapping. Generally speaking, the most common reasons used to justify a merger or an acquisition are claims of market power, efficiency (in various forms), pure diversification, information and signaling, agency problems, managerialism and hubris, and taxes. Each of these is discussed briefly in the box.

Drivers to deals

- Size matters: many, if not most, deals are driven at least in part by the desire of management to gain more **market power**. These acquisitions are designed to increase influence through size and market share, tempered by the regulatory constraints of monopoly rules and regulations.
- **Basic efficiency** arguments claim synergies from an M&A deal and are best shown by the equation 2 + 2 = 5; that is, the value of the newly merged firm is greater than the combined value of the individual firms prior to the merger. Thus, this theory is really a 'growth' theory from both the shareholders' and managers' perspectives. More than any other factor, this one is used as an argument to shareholders that they should approve a deal. Although often independently verified, in most deals it is the bidder's analysts that will provide the 'proof' of these future synergies for both revenues and expenses.
- A clever claim, that is most often hidden or only discussed within the bidder's consortium of insiders, is that there is **differential managerial efficiency**. This means that the bidder believes they have much better ('more efficient') managers than the target. Therefore, after the merger, the target's management efficiency will be raised to the level of the acquirer's as the bidder takes over senior management positions or trains the target's management to be better. If this could be true, then the merger increases efficiency and creates shareholder wealth. This would be most likely where firms are in related businesses. Difficult to prove? Almost certainly. Common? Yes.
- **Operating synergies** take place when deals are done to achieve economies of scale where size matters or economies of scope where the efficiencies come from allocating expenses over a wider variety of activities. Mergers of scale

and scope must be carefully constructed so as not to grow to a size where there are diseconomies of scale and scope; in other words, where the company becomes top heavy and inefficient. Typically in a merger situation, management of the acquiring company will emphasize the cost synergies such as reduction in operating costs, elimination of duplicate facilities, and reduction in various departments (marketing, purchasing, sales, and so on). However, just as important should be the revenue increases from the merger, which are often overlooked.

- **Financial synergies** arise if the internal capital market of the newly combined firms is considered to be more efficient than raising capital externally. This relates to the transfer of capital (money) from low to high return businesses. There is also the potential for increased debt capacity with lower borrowing rates if the company's credit rating improves due to the merger (although more commonly the credit ratings will be lower immediately following or even preceding a merger due to the uncertainty associated with the deal).
- The **strategic response** theory of takeovers focuses on the idea that a merger can be driven by a need to realign the firm in response to a changing external environment. The driver is therefore outside the company and may be due to product life cycles (where products or services are maturing, such as mobile phones where the growth rates began declining in the early 2000s) or product/service replacement (for example, when broadband began to replace dial-up modems for internet connections in homes).
- Individual companies may be **undervalued** or not valued properly by the stock market. Some mergers therefore take place when the market value of the company before the merger does not reflect the full potential value to the acquiring company. Perhaps the value of the target was

correct when it was a standalone company, but for a bidder taking into account some of the above factors (such as operating synergies and management efficiency), the value of the company could be much greater to that particular buyer. If the deal is a horizontal deal, the acquiring company may have better information than the financial markets about the long-term potential of the target in terms of competitive positioning, product development, sales, and so on. The problem here is that even if the acquirer has more information, they may fail to turn it into intelligence because the systems do not exist to do so. Often, knowledge will slosh around an organization without being adequately managed in order to deliver added value.

- **Pure diversification** can be valuable in its own right and may in fact also be faster and more efficient than growth through internal means. Diversification is often preferred by the existing management of the acquiring company, especially in situations where the existing markets (and therefore opportunities) are mature. Of course, shareholders can diversify much more efficiently and selectively than can the company itself, so what is best for the management and employees of the bidder may not be in the best interest of the stockholders.
- One ploy sometimes used is called **'information and signaling.'** Just by making an offer, additional value is created as the target is put into play. This assumes and follows the empirical evidence that most target company share prices rise when a new bid is received. If the offer carries new information (and the fact that there is an interested bidder may be sufficient new information), then the increase in share price may be permanent. But even when unsuccessful, it may result in a revaluation of the target's share price. In any case, the target management is now

sensitized to the fact that they could be a takeover target and may work to make the company more efficient in response.

- Since it is almost impossible for shareholders in public companies to replace inefficient or poorly performing management, where **agency problems** (separation of ownership by shareholders and control by managers) exist – as in most public companies – acquisitions can be a solution. This is similar, therefore, to the differential management efficiency discussion above. Acquisitions are a discipline to managers when other, internal, mechanisms of corporate control have failed. The threat of being acquired can often be sufficient to assist in solving the agency problems.
- **Managerialism and hubris** drive deals all too often. Managers are interested in size ('big = better') and do deals to increase the company size and therefore their personal power, compensation, perquisites, and so on. Managers are often overly optimistic in evaluating mergers, due to pride, 'macho' culture, or hubris, and do not learn from the past when most deals end in failure.
- **Tax considerations** are sometimes the impetus to merge – but rarely the only reason; there may be tax-minimizing opportunities in some mergers.

PUBLIC SECTOR MERGERS

Although the focus of this book and the examples shown are heavily from the private sector, the principles discussed apply to public and non-profit sector mergers as well. Certain differences should be noted. It would be a rare public sector deal that was hostile, as these mergers are often the result of both long consultation periods and, at least in the democratic world, a long process driving toward consensus. That isn't to say that public sector mergers cannot be driven by one individual – such as New York City's Mayor Rudolph Giuliani's three attempts to merge two health departments in the State of New York which were ultimately legislated in November 2001. But even when initiated by one individual or group, the ultimate decision usually follows a democratic process.

Public sector mergers are becoming more common. This is largely in response to budget pressures and the increase in demands for accountability that have forced governments and non-profit organizations to improve their performance and achieve key targets to satisfy the public demand for their services, as shown in the example from the UK's NHS in the box.

Mergers and acquisitions within the National Health Service in the UK

The National Health Service (NHS) runs the lion's share of hospitals, primary care facilities, ambulance services, and many other services in the health sector in the UK. In recent years, there has been a significant effort to upgrade the standards of health services in the NHS through the creation of Foundation Trusts, with standards originally modeled after the private sector.

As part of this upgrade, the UK government has been encouraging NHS Trusts to merge. This is expected to be especially attractive to the government when a well-run trust – which has already achieved Foundation Trust status – would merge with a trust that has been in trouble, either on financial grounds, because there has been a clinical failure, or because it has otherwise missed key government targets in terms of standards.

The first such merger has taken place between the Heart of England Foundation Trust and Good Hope Hospital. This had the approval of the Strategic Health Authority and the boards of the two organizations. The support of Monitor, the UK regulator of the Foundation Trusts, in all such mergers was conditional on the outcome of risk evaluations assessments. The deal is expected to allow for the improvement of health services in the region around Birmingham served by the two NHS organizations.

As with private sector acquisitions, public sector mergers can also be triggered by external shocks. The terrorist attacks in the United States on September 11, 2001 led to a reorganization within the federal government of the US where some 22 departments (including border patrol, immigration screening, and airport security) were combined to form the Department of Homeland Security. This was akin to a similar reorganization that took place in the US after World War II when the War Department became the principal component of the newly created Department of Defense. These mergers were driven by demands to improve the quality of management and services as well as the need to increase efficiency, coordination, accountability, and cost savings.

Merger of the UK Foreign Office and Commonwealth Office

The Foreign Office was formed in 1782 originally as the Foreign Department. In 1919, Lord Palmerston merged it with the Diplomatic Service and again in 1943, it merged with the Commercial Diplomatic Service and the Consular Service. These changes were in response to the increasing complexity of the management of foreign relations, such as an increase in embassies throughout the world and the expanding demand for passport issuance as greater numbers of people traveled.

The Commonwealth Office was formed from a merger of the Commonwealth Relations Office and the Colonial Office in 1966. This was driven by a change in the status of the former British colonies after World War II. Most of those colonies were now independent and the Colonial Office was no longer needed. The Colonial Office had been set up in 1660 from the Council for Trade and Plantation, so had a history even longer than the Foreign Office.

The new office – the Foreign and Commonwealth Office – was formed in October 1968, having taken seven months to complete. It was driven by the need to increase efficiency and eliminate overlapping roles with the changes in the nature of the former colonies and other countries. It was an amicable deal, and both organizations supported the combination. Given that both had long histories of prior mergers, it was seen as just another step in a long line of change, although naturally there were significant differences in drivers to the most recent merger.

CONCLUSION

From whichever perspective one views M&A activity – whether economic, strategic, financial, managerial, organizational, or personal – corporate takeovers should permit firms and organizations to promote growth and offer savings while achieving a significant and sustainable competitive advantage over their rivals within the global marketplace. With new geographic and service markets opening at an unprecedented pace, the evolution of the competitive landscape means that acquisitions must be made in order for the company to succeed in filling the product, geographic coverage, and talent gaps. As such, an acquisition provides senior management or a board of directors with the opportunity to grow more quickly than would otherwise be possible, with access to new customers, new technologies, greater synergies, and the power that comes with size. It is also an adrenaline rush for all involved at the top, despite the possibility that many will be made redundant including some senior managers driving the deal.

M&A deals are risky. A full merger or acquisition should be attempted only as a last resort. (We will briefly discuss the alternatives to M&A later in Chapter 5.) Full integration may take years to complete, and therefore the benefits may be a long time coming. Current employees, customers, and suppliers may be neglected. There's the tendency to overpay when acquiring another company, not just because of the auction effect if there are multiple bidders for the target, but also because the sellers are motivated to get the highest price possible and they are the ones who know their own company best – where the skeletons are hidden and which assets are most valuable. For bidder and target alike, it is critical to use business intelligence efficiently. There are many areas where mistakes can be made in the acquisition of another company.

Merging or acquiring can be a threat to the current shareholders or a great opportunity. The outcome is never preordained. It is necessary to crawl carefully through the minefield, using as much intelligence as possible to avoid the potential and often very real dangers.