Avoiding the acquisition curse

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Summary

Surveys show that, in average, mergers and acquisitions destroy value. Highly publicized successes are not sufficient to compensate for disastrous operations.
Yet, it is relatively easy to set the rules of good acquisition practices. M&A professionals know them well, but seem to keep breaking the rules: make acquisitions beyond the scope of their strategy, produce unrealistic business projections to accommodate for sellers exorbitant demands, or fail to implement integration plans.
The mechanisms leading to these repeated mistakes are powerful enough to overcome experience and wisdom; because M&A is a fascinating activity, with stakes far beyond simple efficient business; because closing an acquisition is a short term objective, and making it profitable is a long term activity. A matter of egos, passion and consistency over time.

Introduction

Mergers & Acquisitions underperform

The measure of acquisition success is the Net Present Value of the operation: initial price and transaction cost (cash out), and resulting cash flows that would NOT have occurred, wouldn't the acquisition have taken place.
A positive NPV means the cash used produced more value than if it had been paid back as a dividend to the shareholder.
Surveys consistently illustrate that:
one fourth of all acquisitions create value far in excess of initial expectations (very positive NPV, above budget)
one fourth of all acquisitions perform less than expected, but pay the cost of capital (positive NPV, below budget)
one fourth of all acquisitions destroy some value (negative NPV) even though cash flows remain positive
one fourth of all acquisitions end up generating negative cash flows.
In half of the cases, the buyer would have been better off not doing the acquisition. And worse, the aggregated Net Present Value of all M&A activities seems to be significantly negative. In other terms, humankind would be better off without M&A… But we don't really want to hear this, do we?

M&A is of course not only a matter of NPV. It's a way to remodel industries, to create new businesses, to change corporate culture, to introduce new talents in the organization, and to bring additional growth beyond internal growth... And M&A is a lot of fun. In other terms, we would rather accept negative NPVs than live in a world without M&A. Fair enough. But we also want to improve the M&A process, don't we?

The M&A curse

M&A teams are usually high profile professionals and acquisitions are under top management scrutiny. So why would bright people perform less in acquisitions than in other activities?

Some deals occur that should have never closed. Some decisions to drop a deal are never taken, because acquisition teams are exposed to pressure that biases them towards closing deals at any cost:

- pressure for short term external growth: in publicly traded companies, boards commit to external growth; closing a deal is always a good short term result, while real NPV is measured many years later, and with unreliable measures…

- pressure from partners: Mergers and Acquisitions involve actors (banks and consultancies) whose retribution depends on the conclusion of the deal; they tend to heavily influence decisions toward making the deal at any cost; in the expression "success fee", success often means "deal closing", instead of "good deal closing" AND "bad deal dropping"…

- pressure from inside; acquisition teams invest a lot of passion, determination and intelligence, and the process is long; the more it progresses, the more it becomes difficult to interrupt, even when some rational reasons suggest that the whole project is uneconomical.

- pressure from top management: acquisition is not merely a matter of fine economy, but also a matter of leaders' egos. The moral satisfaction of increasing the size of one's business through an acquisition may help make bad decisions to buy… Overdeveloped egos have a cost.

In addition, the value of an acquisition comes from years of good operation. Yet, the team that makes the acquisition is not the team that will extract the value. Not one person or group can be made accountable for the whole process.

So yes, there is a curse on M&A. It is somehow like poker: players who drift away from purely rational processes lose money… And it is also like derivative banking: the transaction is a short term objective, disconnected from the long term profitability…

It takes outstanding procedures to remain on the safe side and resist pressure. Or it takes to be familiar with all the processes that may affect judgment at each step of the acquisition process.

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Zooming on problems

All acquisitions are decided on the **base of positive projected NPVs**. If real NPV is negative, it means either that the **initial projections were wrong**, or that the **post acquisition process goes wrong**. Or a bit of both. And it may also mean that the **acquisition should have never been considered** in the first place!

We will see how this can happen during three essential phases of the acquisition process:

- Target screening: this is where the global strategic fit of a target is assessed.
- Deal negotiation: the team builds a business case that provides a realistic NPV, given a fair purchase price
- Acquisition integration: a team is built to implement the planned integration process.

1 - Global Strategic fit

The theory

Targets that are not within the scope of the global strategy should not be considered at all. They are bound to become failures, even if they may look at first glance as good opportunities.

If part of the target business is within the strategy, and part is not, make it break apart before you consider buying the piece that fits your strategy.

- "Hey, look at this opportunity... The guy wants to retire, he likes us, he is one of my main partners. I'm sure I can negotiate a good price. Let's go for it...

- But, Sir, it's the first time I hear of them as a target. They do not fit at all our growth strategy. We do business with them, but at least 60% of their business is absolutely NOT within our field of competence, and clearly not in the scope of our growth strategy!

- Come on! It's good business, it's profitable, it's revenue... And it's cheap!"

Strategic fit challenge

The wisdom behind the theory

But why should we ignore a business "just because it does not fit our strategy"? After all, we are in business to make value for the shareholder.

Efficiency

We all dream of being omniscient geniuses, but we are not: we develop over time a competence and a culture in specific sectors, and this is where we can strive for excellence. Entering a business where we have not competence is costly. If we do it, this cost has to be considered, as part of the company's strategy.

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In the example above, 60% of this business is not within the field of competence of the potential buyer. The buyer will not be able to maintain the operating margin, because he does not know this business. The acquisition will not be profitable.

Sustainability
Sooner or later, the acquired business will require some investment. And investment money is a limited resource: inside a corporation, projects and businesses are in competition to obtain a share of available investment money. It is highly unlikely that the acquired business will get investment money in 3 years time, even if he deserves it, just because it is simply not in the focus of the company. A business outside the strategic scope is bound to fade and fail.

The reality
The target screening process is very subjective, and non-measurable factors have a very heavy influence. Few corporations have a clear strategy, with an easy-to-use and objective model to assess the strategic fit of an acquisition. This leaves a lot of room for manipulation.

Twist the strategy
Starting with a sound strategy, with proper market definition and clear core activities, it is easy to widen the scope of the strategy to make it encompass the target:

- Define "necessary complementary activities" to core activities: typically, a service activity that was not considered initially can become part of the strategy if someone explains clearly that the core product business cannot develop without services. The problem is that service activities require a very different skill set, and provide very different returns…
- Extend the definition of a market to encompass the activity of the target.

Influence the perception of the target
It is very easy in an analysis report on the target business to reduce the importance of the non-core businesses, or increase their apparent profitability to make them more appealing, underestimate costs, or overestimate the capability to divest non core businesses.

Good practice
External growth opportunities can be defined properly during the strategic review phase, to help local managers screen efficiently potential targets. Some corporations express their strategy with objective tools (strategic matrices for instance) that leave little room for creative interpretation.

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Work around strategic priorities
Some external factors help soften the rigor of the strategic fit analysis:

- if a business has not received acquisition money for some time, it's targets may be considered with more tolerance
- the candidates of a political heavyweight may be exposed to a more lenient screening
- than others.

- "Hey, the owner is crazy, he is asking twice the price for his business. Can we pay that much?
- That's above our NPV. How does he justify this?
- He says that sustainable profitability is way higher than it looks on the latest statements...
- Hmmm. May be. Then I can increase post acquisition cash flows... But NPV is still negative for this price. Anything you can do?
- Now that I look carefully, there is another synergy that we could take into account... "

Playing around with figures

2 - Realistic NPV given a fair purchase price

The purchase price negotiation is an external process (between the buyer and the seller) AND ALSO AN INTERNAL PROCESS, as the acquisition group negotiates the NPV of the deal.

The goal is to make it not only positive, but also more attractive than the NPV of other competing acquisition targets!

The NPV projections for the deal attractiveness (short term) are also the base of post acquisition integration budgets.

The theory

Terms
To express the theory, we need to remember some simple terms:

- P1 is the amount of money that this business represents for the owner today, as it is: Net Present Value for the seller of the cash he would generate with his business, with reasonable growth and sustainable profitability.
- SP is the minimum price the seller wants (in technical terms, the seller's reservation price). SP is often way higher than P1 (can be double), as business owners add emotional value to the true realistic economic value.

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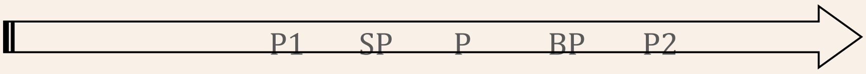
- P2 is the amount of money that this business will represent in the hands of the buyer: Net Present Value for the buyer of all future cash flows that can be attributed 100% to this acquisition, once all the synergies have been calculated.
- BP is the price the buyer's acquisition group negotiates internally: it represents the buyer's maximum price, also called the buyer's reservation price. BP is lower than P2, but often close.
- P is the negotiated purchase price.

Basic negotiation theory

The conditions to make a deal possible are:

- P2 must be above P1, so that the acquisition makes sense from an economic point of view;
- SP must be lower than BP, so that it is possible to make a deal.



The seller starts somewhere above SP. Buyer starts somewhere below BP. P is somewhere in the middle depending on the very complex mechanism of negotiation.

The wisdom behind the theory

From a purely rational and theoretical point of view:

- P1 represents a value that belongs to the seller.
- P2-P1 represents a value that should go to the buyer, as it is the value of the synergies that the buyer will be able to extract from the acquisition.

The negotiation will split P2 – P1 in a part that will go to the seller (P – P1), as a result of his negotiation capability, and a part that will go to the buyer (P2 – P), as an extra benefit for his cash.

The reality, beyond pure negotiation

The buyer determines initially his P2 and BP, based on his perception of the company, and an anticipation of P. Over the course of the negotiation, he may revise both P2 and BP, if he finds relevant and valid reasons to do so.

The seller drifts

What the seller has in mind at the beginning of the negotiation is an opinion on SP, but not an accurate P1, for 2 important reasons:

- the seller is emotional

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- to compute his P1, the seller always projects a business where HE continues to put efforts every day (and night) to make it grow, taking chances, using all his entrepreneurial skills. In reality, P1 is the opportunistic cost of stopping this business to start doing something else (holidays, new business, or salaried job with buyer to continue running the business post acquisition).

In addition, the seller can claim that the value [P2 – SP] only exists if he accepts to sell… And he will try to get a share of this value during the negotiation, in particular if there are several potential buyers. The seller is a "lean and mean" guy, tough minded, and a shrewd businessman.

The situation: Seller has 2 businesses:
- business A runs at below average profitability; it presents potential synergies, as buyer knows it well, and runs it at a high profitability;
- business B runs well; it represents no synergy, it is expected to run after acquisition at constant profitability.

The trick: adjust projections, decreasing A's real profitability, and increasing B's profitability: the gain in profitability from synergies on A will be way higher, and P2 will increase.

A recipe for higher P2

Hence the almost crazy prices that some sellers announce. It may happen that SP is higher than P2. Or that the seller's entry price is above P2. If buyers were rational, they would of course negotiate down quietly, and walk away if the seller persists.

The buyer drifts

The buyer's team is under pressure to make the deal, as we saw earlier. And P2 is subjective… because it integrates synergies, which are financial projections of future efficiencies… It is easier to re-work P2, rather than take a chance to break the negotiation, or tell the boss that the deal is impossible. So, the acquisition team goes back to Excel. Excel does amazing things when handled properly to justify about anything:

- Shift costs from recurring to extraordinary: long term post acquisition profitability will increase
- Shift revenues from extraordinary to recurring (same effect)
- Increase the marginal profitability of synergies
- Increase the scope of some synergies
- Transfer some synergies from "possible" to "certain"
- Reduce and delay some future investments

Anything that improves the final year cash flows boosts the value of the perpetuity… In the end, the acquisition team may negotiate a price way above anything acceptable, and the acquisition will NEVER be a good one, because the price is way too high.

None of the above is dishonest. And nobody can blame an acquisition specialist for fine tuning his perception of the business. But when needed, fine tuning will mean increasing P2 more often than it should.

Good practice

On the right price

Determining the right price is complex, and there is a lot of literature on the topic.

Some gurus stick staunchly to one method (see in the box) that usually provides a very low price. Of course, life requires a little flexibility, but there are still some rules with which none should cheat, and that negotiators should repeat as a mantra before any negotiation exercise:

- Anything above P1 (no-growth no synergy) belongs to the buyer, not to the seller. Because the **value of growth belongs to the manager that makes it happen**.
- Any cent above this value is strictly a matter of negotiation skills, and that's where the **negotiator is evaluated.**
- The negotiator's maximum price should be the **NPV of the most likely synergistic case, with three years cash projection, no investment and a simple perpetuity**.

A good practice is to establish negotiator's incentive to reduce pressure on deal closing and increase pressure on "bad deal dropping". The negotiator should be rewarded if he loses to a competitor, but forces the competitor to buy at a price OVER P2.

On NPVs

NPV is both a necessity, and a fool's game.

It is a necessity because of the amount of work it takes. Making proper projections brings a better knowledge of the target business. It also is a necessity to compare projects competing for the same acquisition money. But it also is a fool's game because then, it may only tell who is the most talented and credible liar…

Finally, computing NPV can become a toxic exercise when acquisition teams start building NPVs to justify a purchase price. As NPVs look like math, they may influence decision makers, and comfort them in bad decisions. NPVs should only be made by the people who are going to manage the business, as they are their budget.

> I asked the question to a specialist of LBOs for non-technology, no growth businesses, and he said: "6.5 times net result". Then I asked again: "what if the business is growing?" He said: "6.5 times net result". And then I asked: "what if there are some brilliant synergies with my business?" He said: "6.5 times net result".
>
> I finally cried: "what if the seller does not want to sell at that price?" He said: "Walk away." I would never work with this guy, but I would ask him to invest my money.
>
> *The right price*

The negotiator should never be entitled to discuss the NPVs. Not even “under supervision”: if the negotiator is good, he will negotiate P2 up with his supervisor!

Synergies should be discussed ONLY with business people not involved in the negotiation process.

3 - Sound integration process

If there is one thing on which all modern managers agree, it is the importance of the integration process. And still, in reality, this process is mostly overlooked. The study of best practices gives the following guidelines:

- Dedicated integration team
- Free the previous owner in the first year

Yet, in reality, things happen very differently, and always for apparently very sound reasons.

Dedicated integration team

The theory

Recommendations based on commonsense are:

- Include the integration team cost in the acquisition costs, or as a negative synergy, or as a cost of synergy, and budget it.
- Create an integration team made of one person from the acquiring company (A) and one person of the target company (B) FULL TIME FOR AT LEAST SIX MONTHS, and some more part time resources from A and B;
- Create an integration review committee, meeting once a week for 6 months, then monthly for two years, including one of the key people of A's negotiation team.

The wisdom behind the theory

Integration team

- The goal is to have on both side a person from each culture making the transition, and solving the problems through a JOINT approach taking A's AND B's culture, not just A's culture.
- The two workers from A and B have as a mission to get to understand the culture of the other company, to explain the discrepancies, and prepare the "action" phase.
- People who have two part time activities tend to favor the easiest and most rewarding activity. Integration work is very difficult to reward based on incentives. If people are not

full time o such activities, they may end up doing little to nothing for their integration duties.

Review Committee

- the member of the negotiation team is a key element: the negotiation process brings a lot of information on people's hidden agendas, company's informal processes, and it also creates scars that only the people who ran the negotiation may understand.
- Review committee must not dissolve once an "action list" has been exhausted: problems appear after several months, as a consequence of the acquisition, and someone must be there to monitor it.

The reality

Integration teams are budgeted part-time, because in general "none in A or B can all of a sudden stop doing his usual work and dedicate his time to pure integration tasks…" I agree, it may look particularly straining on an organization to dedicate so much time to integration. But it is so easy to destroy value that it is worth doing it.

Mr A, from company A has been asked to devote half of his time helping integrating B. In order to be fair, his objectives have been divided by 2, with some soft criteria to evaluate his performance on integration. Integration is a difficult process: who can enjoy being constantly between an anvil and a bunch of hammers? Mr. A will end up dedicating 80 % of his time to his usual duties, exceeding by far his objectives, and performing relatively bad on integration, whose performance anyhow cannot be measured objectively.

A common practice is to select the most open persons in B, ask them to get to know A on their spare time, and act as transmission chain for B towards A. This ignores that A also needs to talk to B, and that A may have to adapt marginally to B, not just B to A!

The acquisition integration team comprises some people from the due diligence team. But the negotiators are usually high profile guys, who immediately jump on their next negotiation, far more valued than an integration.

DUE DILIGENCE DOES NOT PROVIDE THE SAME UNDERSTANDING AS NEGOTIATION. So this valuable information is lost.

Action plan

The theory

"Observe for three months, prepare for three months, announce after 6 months, implement in a week, fine tune over 6 months, everything is finished after one year".

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The wisdom behind the theory

The reason for this is not a male display of action oriented management style. It is based on several human rhythms:

- It takes some time for people to speak up. People in B will not speak openly: an acquisition is a trauma, and it will take some time before people open up. So please remain patient and only listen for three months.
- It takes six months for anyone to understand a new environment: a new job, a new house, a new organization; you cannot expect to make sound decisions before.
- People expect changes to happen, whatever has been promised to them. If changes do not appear, after a year, people are disappointed and start playing a new game.
    - People cannot perform in the first months following an acquisition: because of stress, because of the additional burden to understand and adapt to new constrains; because there is an easy scapegoat when things do not go right: the acquisition! After six months people are ready for change, and change is urgent.
    - If things do not change, there are bad side effects after a year: relationships between former colleagues spoil, and some irreversible moves are made. It takes a year to disaggregate a human system that goes through the trauma of an acquisition.

In B, people know who is good, and who is bad. They expect the bad people to be let go, and the good people to be identified, promoted and rewarded. A must not disappoint this expectation. This means listen, plan, and act.

Of course, acting after 6 months may cause to make some mistakes. But mistakes made at this time hurt much less than expected actions not undertaken. And mistakes will be quickly forgotten if people are back at work with clear objectives, and a confident future.

The reality

People speak before they listen. We all do. And we all tend to agree with the simple idea that "there is no reason to wait to make the administrative integration, so let's proceed now". It is wrong for 2 reasons.

- Existing administrative processes usually match operational reality and sometimes some human particularities: B may have some very specific habits that are not compatible with A's standard administrative processes. Of course, B will adapt, but it may affect operations adversely.
- A's stiffness on processes may be a good business practice, but it will be perceived by B as a lack of care, or worse. Acquirers have a reputation of being arrogant: as A is in a

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dominant position, A’s middle management may be tempted to abuse. Any process that reinforces this impression during the initial phase is negative, and often useless.

Some things go quickly, and some other things never occur! In some cases managers in A will say: "the best thing is NOT to touch anything! It will be business as usual; the acquisition will be transparent". It is not only wishful thinking, it is a mistake, and it often covers the reluctance to do changes. There is no such thing like business as usual after an acquisition. For many reasons including three major:

- The owners have sold: they were the fearless devoted leaders, they are now the fat Ferrari drivers. Their troops do not consider them as before the acquisition, and it is in itself a drastic change.
- B was permanently at risk, B within A is NOT anymore: this may not be true, but it is B's employees' perception. And this is again a major change.
- Customers of B do not have the same perception and attitude as before. Funny enough: they will NOT accept anymore some mistakes that they were tolerating from B, and at the same time, they will expect B to inherit all the bad habits of A!

In addition, action is not always nice. It means firing people. It means taking chances selecting the people who should go and the people who should stay. For some managers in A, it is the first time of their professional life that they have to restructure. The first time is not easy. And when things are not easy, it is often simpler to postpone them. BUT, people in B expect things to change. They expect some restructuring, and from day one, they have started to anticipate: single out the least appreciated people, promoting oneself, all the non-glorious attitudes that we animals tend to adopt when threatened. It is struggle for life, and it also creates wounds. These wounds, if not healed, get infected, and infection propagates.

Good practice
All integrations are transitions. The virtues of transition management compared to ordinary management are now well understood in all industries. Integration should just be handed to transition managers for 18 months, until they are ready to hand back the business to standard operation. No more, but no less.

I may add that some things should be purely and simply prohibited:

- pretend in any way that business after the acquisition will be “business as usual”.
- make an integration task list, and consider that once the final box has been ticked, the integration job is over.
- pretend that line managers are able to handle an acquisition without special skills and training.

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Conclusion

The economic crisis that we are experiencing has demonstrated at length that professionals with excellent technical skills could work their best to create major failures affecting people's lives. Some of the lessons learnt were:

- short term goals may lead to major wrong decisions
- excessive trust in technicality obscures economic reality
- self interest make people lose all commonsense
- passion for figures and money challenges consideration for other human beings.

Lessons learnt from acquisitions are very similar in many aspects.

But money pains are not the most important.

Integration is a matter of helping professionals who had dedicated their working time to a certain way to do business, transition to a new professional life. There is much more than figures at stake. All acquisitions result in some people losing their job. Fair enough: business also follows some kind of Darwinian evolution. But bad integration results in unnecessary and often irreversible human damage. And managers should never accept that. It's not an operational mistake anymore, but a human fault.

It may also result in simple destruction of an activity, of a production capability, of a previously dynamic business, of a creative or innovative momentum. I will describe such a thing in a next paper. Then, beyond the fault, it's a lack of elegance, a "crime against business aesthetics…" Not to be forgiven.

The author

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10 years ago, I was doing acquisitions for a large industrial conglomerate. I had been asked to make an exhaustive study on 48 acquisitions made by this company over 10 years, and draw some hindsight.

I gathered some popular wisdom on acquisition. Some points were easy to understand, with a bit of common sense and business education. Some were less obvious.

One start-up company I was working for was acquired by a large corporation for a very decent amount of money. For 14 months, I was given the opportunity to witness and experiment from

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within a failed integration process that eventually almost destroyed entirely the value of the acquisition. It helped me understand some of the "less obvious" wisdom: it requested a finer understanding of some human mechanisms that I did not suspect in the beginning.

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