The Urge to Merge — and the Role of CI

CI should be a key part of the M&A process, with CI analysts using their skills to look beyond the headline financial figures.

By Arthur Weiss, AWARE

The start of the millennium (2000) was celebrated not only with fireworks, but also with global merger and acquisition (M&A) activity valued at over $3 trillion. Although M&A activity has fallen considerably since this peak, the total value of activity at the end of 2002 was still over a trillion dollars. Yet, according to a *Business Week* report from October 14, 2002 (Mergers: Why most big deals don't pay off), the majority of mergers ended up destroying shareholder value. The question is why?

WHY COMPANIES MERGE

Companies merge for a variety of reasons – some rational, and some, in hindsight, less so, despite the spin given to shareholders at the time. Essentially, there are five main reasons that companies merge:

- ego – the opportunity to be the biggest company, or to remove an old enemy by merging with it
- perceived synergies and economies of scale
- market entry or fast expansion
- purchase of expertise – either as skills, products, patents, or technologies
- defensive – where a merger protects the company enabling it to survive, spreads business risk, or blocks an acquisition by a competitor

Other reasons include spending excess money, hubris, and a general strategy of consolidation, although these tend to be less common. Only ego and hubris appear to be reasons not to merge.

Typically, the advice given to shareholders emphasizes how the combined organization will offer savings, promote growth, and so on. Yet, study after study has shown that this is not true: Half or more of the big mergers, acquisitions, and alliances you read about in the newspapers fail to create significant shareholder value. . .(The McKinsey Quarterly 2001 Number 1, 'Deals that create value.')

A Booz-Allen & Hamilton study showed that over half of all deals failed to achieve expected results. (2001, 'Merger integration: delivering on the promise.') KPMG was even more negative. Their research suggested that 83% of corporate mergers and acquisitions failed to enhance shareholder value: More than 8 in 10 deals fail to enhance shareholder value because of poor planning or execution or both. . .(Press release, 29 November, 1999.)

Merger activity is unlikely to stop, especially as most reasons for merging are valid. So, can CI help improve the odds and lead to more successful mergers?

MERGER FAILURE

The key reason mergers fail is that bidders paid too much – the so called *winner's curse*. Rather than assessing the true value of the deal, the excitement of the M&A process led to an inflated premium. Managers also underestimated the work to consolidate the purchase, overestimated the cost-savings, and failed to account for the human aspects involved.

Part of the problem lies in the typical M&A process, which fails to examine the target company in sufficient depth. There is an emphasis on assets, finances, regulatory concerns, and perceived strategic fit. There is not sufficient examination of cultural issues, processes, operations and how to integrate two groups of people into a single organization. All these latter areas fall within the capabilities of the CI function.

SIDEBAR: ASSESSING CORPORATE CULTURE

One approach to looking at corporate cultures characterizes companies on two dimensions: solidarity and sociability. (Rob Goffee and Gareth Jones, 'What holds the modern company together,' *Harvard Business Review*, November-December 1996.) Solidarity looks at the degree that employees within a company share objectives, while sociability examines the level of shared values in the company.

Solidarity is task based, focusing on shared goals, mutual interests, and common tasks that benefit the organization as a whole. High-solidarity organizations tend to respond quickly to external threats and are very intolerant to low performers. Consensus has low worth compared to achieving high individual performance, and employees are clear on their roles and place in the organization.

In contrast, a high-sociability organization encourages employee friendships and relationships, and views the organization as a community or even family. The team perspective is more important than the individual's, and decisions are made through compromise. At the same time, there is a willingness to experiment with new ideas, leading to innovation and *out-of-the-box* thinking. The emphasis is on the process, rather than the outcome.

Organizations vary in the degree they fall on the two scales, leading to one of four cultural states as shown:

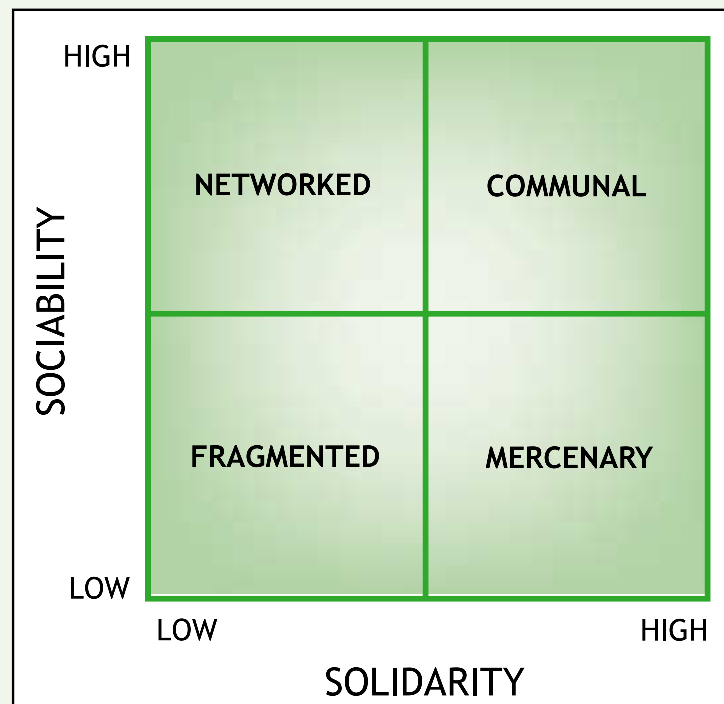
In Communal organizations, employees work well together in teams, have a strong feeling of belonging, but are also focused on the tasks necessary for success. Leaders tend to be inspirational or even charismatic, with a clear vision of the future. There may be problems maintaining the balance between trust and efficiency and communal organizations often expect long-hours and dedication from employees. Companies such as Hewlett-Packard follow a communal cultural style.

Fragmented organizations tend to be flexible, giving considerable individual freedom. The primary focus is high performance from the employees, who are judged solely on their productivity and the quality of their work. However there is minimal organizational loyalty. Many professional service firms follow a fragmented style culture.

Networked cultures tend to be open, encouraging information sharing. Employees are seen as family members and friends. But this focus can tolerate poor performance, with weaker staff supported or assisted by others. There is also often a lack in organizational focus and a risk that political cliques may form, causing some level of conflict between different parts of the organization. Decisions are often collaborative, and companies such as Unilever and Heineken are sited as examples of networked cultures.

Mercenary cultures, in contrast, have high motivation and drive. Staff need to be highly goal-oriented, and things get done quickly, with a high sense of purpose. The focus on goals and objectivity results in a low level of organizational politics. These organizations can be exciting environments to work in, but at the same time can be ruthless and competitive, having absolutely no mercy on anybody perceived as under-performing. Mars, Campbell Soup and Komatsu are viewed as typical mercenary cultures.

This cultural approach can modify M&A valuations. By plotting the two companies on the grid, you can see the relative distance between their cultures. These distances can be given values and used to discount the merger's expected value using the following formula:



*Cost of gap = Expected merger benefits * risk discount*

The risk discount is a factor relating to the cultural distance between the two companies. So, for example, a merger between a strong mercenary company and a strongly networked company could be viewed as high-risk with a risk discount approaching 50%. Thus the real benefits likely from the merger would be half of those expected from a purely financial analysis.

A CLASSICAL M&A PROCESS

So, what can be done? A key issue is involving CI personnel at all stages of the M&A process. But unless CI analysts have the ear of the CEO, they are unlikely to be included in the merger team. Instead, external advisors do the due diligence. This classical M&A process has three key stages:

- **Pre-deal:** examining finances, shareholder interests, and strategic fit in terms of products, markets, channels and customers. The external advisor is usually not equipped to look at the softer issues such as cultural fit, processes, tacit knowledge held by individuals, and so on. Thus these are ignored as irrelevant at this stage. Even the more concrete aspects such as the product, market, channel and customer research is generally rudimentary and based on secondary or internal company data sources.
- **Deal:** looking at legal aspects, in-depth financial analysis, the price, and key leadership positions. It may include an initial look at how the companies could be integrated, but often only from a physical perspective involving locations.
- **Post-deal:** establishing an integration team to look at cultural issues, operations, processes, compensation plans, etc.

This approach defers examining areas that can lead to failure after the deal is done. Undue attention is placed on the short-term financial and legal issues involved in completing the deal, rather than establishing the merged identity (which is, of course, the ultimate aim).

The only stakeholder viewed as important are shareholders. Yet it is employees, suppliers, and customers and their loyalty that makes the deal work. If this loyalty and the resulting commitment is absent, then the deal will fail.

THE ROLE OF CI

Now include CI and the M&A process changes. Potential acquisition targets are examined for not only their perceived strategic fit, but also their operational and cultural fit. Only if such a fit is seen should a bid be considered.

Subsequent work then looks at wider issues than the purely financial and regulatory aspects. It now includes the identification of potential integration trouble spots and other non-financial problems. Addressing such issues early on gives management a better negotiating position, and leads to more realistic pricing, thus reducing the risks of overbidding.

Overpaying makes many merged companies worth less than their individual pre-merger values. But pulling out of an auction may be perceived as a sign of weakness, so the bids get higher – above the real value of the target.

Moreover, many of the players have a vested interest in seeing as much money pass hands as possible to the shareholders of the target company, and the firms advising both parties. The press focuses on how high the price can go rather than whether the purchase is actually worth the price, further stimulating the bidding process.

Consequently it's essential to develop an accurate assessment of the target company's value. This still needs to include full financial and legal due diligence. But CI can strategically examine how the two companies will meld together. (Just because two companies appear complementary does not mean that they will fit well together. Two keys may look the same: this does not mean that they can both open the same doors).

TAKING A DETAILED LOOK

The CI analyst takes a detailed look at much more than the traditional basic product, market, and customer segment overlap. What are the market perceptions on the two company products? Having no product overlap does not necessarily mean that the two product lines can be merged. Similarly, having an overlap does not mean that one product can be jettisoned in post-merger cost-cutting exercises. If there are loyal customers for each equivalent product, then cutting one product line in the assumption that customers will switch to the survivor may turn out to be a false hope.

Are the production processes used compatible? For example, would a company that emphasizes quality and operating rigorous quality assurance checks blend well with another that focuses on sourcing materials from the lowest price supplier while accepting a higher level of rejects? Similarly, if the two companies are highly reliant on information technology, how easy will it be for the two IT systems to blend?

CULTURE PLAYS A ROLE

One of the most difficult areas for integrating two companies is combining corporate cultures. Culture expresses itself in many ways: leadership style, organization structure, company values and beliefs, and even areas such as recruitment policies, training, and retention.

At a senior management level, two companies may feel that they have a lot in common. However, can the two managements work together? Are their leadership styles similar enough? Still more important is the overall organizational culture. Even where there is a full strategic, operational, and market level fit, if the two organizational cultures are different then the integration will be much more difficult, and increase the likelihood for failure.

Questions that need asking are:

- What are the values and assumptions of the organization?
- How are decisions made within the organization and how do things get done?

- How are people motivated?
- What kinds of people and behavior are rewarded?

Some answers can come from identifying how people talk about success or failure within the target organization. Stories can give a wealth of information on the organization's cultural priorities. How does the company see the business? Are they actively part of their community, or just located in the community with no role in it? Is there a staff social club, or is there almost no social activity at all? Such questions can give a very good feel for a company's culture. (See Sidebar for one way to analyze corporate cultures).

Where the cultures are very different, it can be much more difficult to integrate the two companies. In some cases it may be better to abandon the merger, or if the merger proceeds, run the two organizations as separate entities.

WORKING ACROSS BORDERS

For cross-border mergers, what is the current political situation in the target company's country? Is this likely to change? Often overlooked are the differences in regulations, taxation, employee rights and national cultures and attitudes. (Consider vacation time in the US versus Germany, where 25 vacation days plus national holidays is typical, with a shorter working week. A US corporation trying to impose US style working practices would quickly run into serious problems).

National cultures differ in the degree in which people act as individuals (making their own decisions) or collectives (where the team takes decisions). They also have variations in what degrees of assertiveness and competition they find acceptable, their approach to risk, their respect for authority, and how they view the future (saving for a rainy day, or living for today).

For example, in US culture, there is a higher emphasis placed on individual achievements: people are expected to stand on their own two feet. People value honesty and openness in business communications, laying their cards on the table. In contrast, US individualism is frowned on in some Asian societies which tend to be hierarchical, collectivist, and sensitive to tradition.

Even within Western countries there can be large differences. In the UK, meetings tend to stick to the agenda: the objective is to end in a decision. In France it is often acceptable to stray from the agenda in discussions – the purpose is more to provide inputs that help the decision process, rather than make the decisions.

THE LIMITS OF THE TRADITIONAL APPROACH

The traditional approach to due diligence emphasizes understanding the target company's financials, legal aspects (regulatory issues), and looking for unpleasant surprises. Financial analysis is viewed as the most important aspect. Yet invariably financials are historical and based on accounting principles, rather than looking at future market potential and the longer-term prospects.

The traditional approach's M&A team, consisting of accountants and lawyers, will fail to appropriately assess:

- product and market fit, looking at complementary products, channels and customer growth potential
- cultural fit, examining organizational structure and culture, regional or national culture, leadership style, employment practices, etc.
- operations and systems fit, focusing on processes, IT integration, resource management, etc.

Although these aspects may be addressed to a limited degree in the early deal stages, the experts looking at such areas are not included as part of the M&A team, so have little part in the final decision.

Only 10% of respondents to an Accenture survey of M&A practitioners said that the due diligence process included four or more sources outside the company. (Michael May et.al., 'Avoiding the perils of traditional due diligence.' 2002.) Less than a third of respondents included interviews with customers from the target company. Yet it is these customers who ultimately provide value to the deal. In the majority of deals, other players, such as competitors and their customers, suppliers, joint-venture partners, former employees and so on, are also ignored. Is it any wonder that so many deals fail to provide value?

A REVISED MODEL FOR M&A DUE DILIGENCE

A more strategic approach includes all these aspects, yet also looks forward to what needs to be done to make the merger succeed from a customer perspective. Here, CI and marketing intelligence functions provide a key input.

M&A activity is one of the most high-profile and expensive activities that companies engage in. A concern among CI analysts is showing the value of CI to the corporation. Being part of the due diligence process and helping their companies improve the odds against merger failure by increasing shareholder value after an acquisition is providing value in ways that can be easily measured.

Arthur Weiss is the managing partner of AWARE, a UK-based CI consultancy offering CI research, analysis and training services. Arthur can be contacted at a.weiss@competitive-intelligence.co.uk