December, 2002

# Mergers and Acquisitions - The Directors' View

Mark E Pickering

# Mergers and Acquisitions – the Directors' View

*By Mark Pickering*

***This article was published in Company Director, the journal of the Australian Institute of Company Directors, in December 2002 (Vol. 18 No. 11, pages 13 to 16).***

*Mergers and acquisitions (M&A) can be an extremely valuable tool to transform organisations and to accelerate growth strategies. However, poorly conceived and implemented acquisitions can result in significant distraction, substantial financial write-offs and, in extreme cases, put the acquirer's future in jeopardy. Directors play an important role in the M&A decision process and should delve into key components of proposed acquisitions to improve M&A outcomes.*

## Introduction

There are few greater or higher risk decisions for directors than whether to approve a proposed acquisition or merger. Many high profile global examples exist where companies have been placed under significant pressure due to their post merger organisation not meeting market expectations. Vivendi, AOL-Time Warner, Tyco, WorldCom internationally and NAB-Homeside AMP-GIO and Sausage Software provide recent examples in the Australian marketplace.

It is now a recognised fact that many mergers and acquisitions (M&As) destroy value for the acquiring company's shareholders, with research pointing to reductions in the market value of the acquiring company's shares in a staggering seventy percent of instances. A recent Deloitte Research study supports this finding in its conclusion that less than 26% of companies rate themselves as successful acquirers.

Merger and acquisition decisions are inherently problematic. Very large investment decisions must be made extremely quickly on the basis of limited information. Often these decisions are considered "once in a lifetime" opportunities that change the strategic direction of the firm – often into business areas that are not familiar to directors or senior management.

Achieving the expected benefits of a merger after the deal is likewise fraught with difficulties. The workload is substantial. Full integration can require working on dozens of integration projects, including major systems implementation and premise moves – many of which are of such magnitude that they could paralyse an organisation if not successfully executed. These projects need to be performed while egos and corporate cultures are clashing, and managers and staff are struggling with new perceived threats to the security of their careers.

Directors play an important role in the approval process of M&A strategies and individual M&A transactions. It is critical to note, however, that the directors are often removed from the escalating commitment to a potential deal that management often experience as they sink substantial effort into a potential bid.

"Merger and acquisition decisions are inherently problematic. Very large investment decisions must be made quickly on the basis of limited information"

So how can directors maximise the chances that deals that they approve are successful, that they remain informed on progress of integration and reduce the risk of disastrous surprises? The following represents some questions that you can ask to help guide your decisions.

## Pre-acquisition Questions

Before approving an acquisition, directors should be comfortable that the M&A makes strategic sense, the management team is up to the task of integrating and managing the target, potential synergies actually exist, and that initial integration planning has been performed to identify the material risks. To do this, the following questions should be addressed.

### *1. Does the potential acquisition make strategic sense?*

Corporate growth, cost reduction and the development of new capabilities can be achieved through internal growth or via an M&A. M&As generally offer a substantially faster path to achieve these objectives. Often acquisition opportunities will arise that were not previously considered during the development of the acquirer's strategy. Before a deal, directors must ensure that the M&A is aligned with existing company and M&A strategies or that any implicit change to strategy makes sense and is explicitly accepted. Important questions include:

- What capability will the merger bring, leverage or create?
- What benefits will this provide customers of both firms and will they pay for these benefits?
- Does it make sense for how products/services are purchased and used?
- How will customers and competitors react to the deal?

After acquiring one of its major suppliers, an aircraft manufacturing company was shocked when one of the new subsidiary's largest customers (another aircraft manufacturing company) switched suppliers. The customer did not want to purchase from its competitor. As a result of the flawed strategy, significant value was destroyed for the merging firms.

### 2. *Does the management team have the experience, skills and attitudes necessary to integrate and manage the potential acquiree?*

This capability includes knowledge of the industry of the acquired company and experience acquiring and integrating companies. Many executives are skilled at communicating a vision and enjoy the hunt of acquiring companies. These managers may not have the experience or the patience required to perform the hard work of integration.

In more recent years serial acquirers have run into trouble when the acquisition flow has stopped, share prices fallen and it becomes obvious that deficient integration and control mechanisms have resulted in poor control over acquired entities and the dissipation of the much "hyped" synergy opportunities. Often acquisitive executives exit the organisation, leaving the integration or disposal of acquired companies to new executives.

Talented executives and mangers can learn acquisition and integration skills and disciplines during an initial acquisition. However, you probably don't want this learning to take place on a 'bet the business' transaction.

Directors should ask – have prior acquisitions been integrated and does the management team include those who will manage the integration and understand the business of the acquired company?

### 3. *Have people from the business been included in pre-acquisition analysis?*

Many companies only include the business development, accounting and legal staff in the pre-transaction stage. The newly acquired company is "thrown over the fence" for operational management to integrate and operate.

The staff analysing the transaction prior to the purchase may not have the detailed business knowledge to evaluate capabilities or identify operating issues.

Inclusion of operations staff during the pre-acquisition analysis provides more comfort to directors that practical issues will be identified. Operational management will also be more committed to achieving synergies that they have been involved in identifying.

### 4. *Do expected synergies and capabilities actually exist?*

The share price of the target represents future profits after all expected future improvements. Any premium paid by your company represents an additional cost that acquiring shareholders would not have paid if they bought target shares in their own right. To retain value, your management team will therefore need to achieve the performance built into the target share price plus synergies at least equal to the premium paid.

> "Any premium paid by your company represents an additional cost that acquiring shareholders would not have paid if they bought target shares in their own right."

Not only must potential benefits from the M&A be identified, they need to be verified as much as possible and the plan for their realisation developed before the deal is complete. Difficult questions need to be continually asked and the critical issues addressed during due diligence.

One telecommunications company paid a premium to buy another telecommunications company in order to obtain a quality customer base and a replacement billing system. Unfortunately after the acquisition the customer base was found to be poor, with low spend and high churn and the billing system was found to be insufficiently scaleable to accommodate the customers of both businesses. Strategic and operational due diligence could have confirmed or denied these benefits before the transaction.

### 5. *Have initial integration strategies and plans been developed and estimated integration costs considered in valuations?*

This evaluation includes consideration of the degree of integration and timing. Will this acquiree become an autonomous business unit or will it be broken up and merged into the acquiring company? All M&As are not the same and the integration strategy and plan must be tailored to the specific benefits and risks associated with the deal at hand.

These initial plans have to be developed quickly with limited information, but they are vital in estimating the management and other resources required for integration and the timing of potential benefits. This enables evaluation of the availability of internal resources to perform integration, and for reasonable estimates of integration costs to be included in valuations.

### 6. *Have people issues been considered?*

These exist at all stages of the M&A process. People issues are even more difficult than the technical issues of an M&A. Some of the important questions are:

- Who will lead the combined entity? Will the M&A fall over due to disagreement over who will be top dog?

- Do the organisations have enough competent managers to run the operations of both businesses and to perform all of the integration tasks? Does the target company have competent management? If not does our business have the skills and knowledge in the target industry and enough managers to address this?
- Which executive will be responsible for integration?
- Do the companies have compatible corporate cultures? If not, how will this be managed?
- How will the combined entity be structured? How will management and staff roles be filled?
- What executives, managers and staff must be retained and what plans are in place to ensure retention?

***7. What can go wrong and how can this be mitigated?***

Post integration M&As can be difficult and costly to reverse. It is critical that directors consider at the pre-acquisition stage the specific risk management plan management has in place to obviate future difficulties, including the identification of major post-acquisition risks, how have they been mitigated and what responses are planned.

Addressing these acquisition questions will often be a phased process. The assessment of the appropriateness of strategy, the industry and the merger execution capabilities of management will often be performed prior to the approval of a merger strategy. This initial assessment should be performed in relation to a specific M&A prior to approval to launch into the costly strategic, operational, financial and legal due diligence and integration planning.

## Post Acquisition Questions

After the acquisition is announced there is little time for relaxation. Directors need to be comfortable that integration teams and processes are in place to ensure synergies are realised, but equally that the fundamental underlying businesses are performing. Given the necessary speed of pre-acquisition analysis and the limited information informing its decisions, it is unlikely that all analyses were correct. After the deal, with greater access to information and staff of the target, valued synergies can be verified and additional synergies identified.

***1. Are integration and reporting processes in place to ensure that the existing businesses are protected, synergies are realised, integration costs managed and progress and issues reported to the board?***

Restructuring can be tough. Moving premises is not much fun. Implementing an information system is very difficult. Changing a corporate culture is a real challenge. Integration does all these – at the same time! And the existing businesses need to continue to receive a strong focus because competitors will not call a time out. There is no better time for them to attack in the market than while your company is internally focussed.

Some questions to consider during integration are:

- Is a talented group of managers focused on and responsible for integration?
- Are the talents and capabilities of the acquired firm being utilised?
- Have synergy targets been set and are benefits achieved measured against these targets?
- Have the costs of integration projects been estimated and are they tracked and reported?
- Have actions been prioritised, and is the initial focus on high value and "quick win" synergies?
- Are processes in place to ensure performance is reported to the Board?
- Have all significant risks been identified and is risk management in place? Are mechanisms in place to ensure major risks and issues are raised at Board level?
- Are continuous communications with staff, customers, suppliers and other stakeholders occurring?
- Is integration affecting ongoing operational performance and/or customer relationships? How are sales, profits, employee and customer churn tracking?

## Conclusions

"directors should be proactive in questioning the fit of a proposed acquisition and the ability of management to integrate and create value"

Mergers and acquisitions are often very large and risky transactions that can fundamentally change a company's strategy. Before approving a transaction, directors should be proactive in questioning the fit of a proposed acquisition and the ability of management to integrate and create value up to or above the premium paid.

While management are responsible for the day to day running of the organisation, directors should make themselves satisfied that integration structures, processes and reporting are in place to achieve objectives and ensure directors are informed of progress and issues.


### *Author*

*At original publication Mark Pickering was a partner at Deloitte Touche Tohmatsu.*

### *Updated Author Details (March 2014)*

*Dr. Mark Pickering is a principal of Pickering Byrnes Consulting and an Adjunct Research Fellow at Swinburne University.*

**Contact details:** Mark Pickering: Tel. 0416 147 790; Email: mpickering@pickeringbyrnes.com.au.