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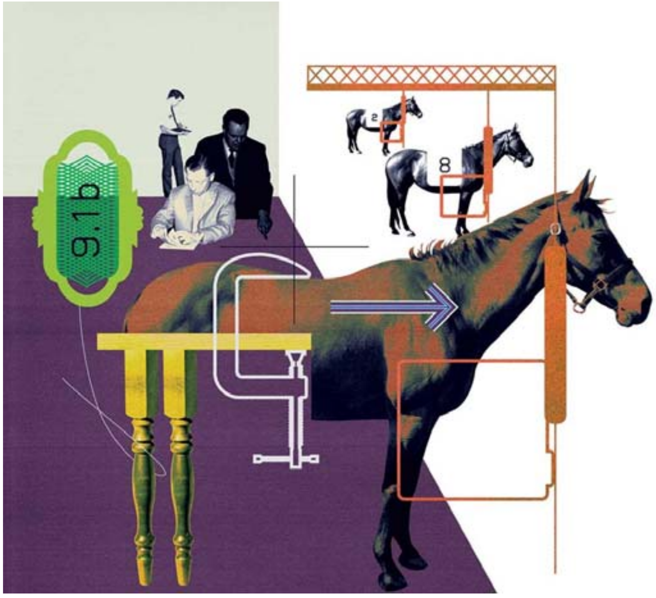

MERGERS & ACQUISITIONS

M&A: The One Thing You Need to Get Right

by Roger L. Martin

FROM THE JUNE 2016 ISSUE

The financial world set a record in 2015 for mergers and acquisitions. The value of such deals eclipsed the previous record, set in 2007, which had surpassed an earlier peak in 1999. This is perhaps not auspicious: It seems (pace the late Prince) that we are partying as if it were 1999—and 2007 to boot. The headiness of those years didn't bode well for either 2000-2002 or 2008-2009.

It's far too early to know how the newer deals will work out, but the seemingly ageless pattern of giant failures continues apace. In 2015 Microsoft wrote off 96% of the value of the handset business it had acquired from Nokia for $7.9 billion the previous year. Meanwhile, Google has unloaded for $2.9 billion the handset business it bought from Motorola for $12.5 billion in 2012; HP has written down

$8.8 billion of its $11.1 billion Autonomy acquisition; and in 2011 News Corporation sold MySpace for a mere $35 million after acquiring it for $580 million just six years earlier.

To be sure, we've seen successes. The purchase of NeXT in 1997 for what now looks like a trivial $404 million saved Apple and set the stage for the greatest accumulation of shareholder value in corporate history. The purchase of Android for $50 million in 2005 gave Google the biggest presence in smartphone operating systems, one of the world's most important product markets. And Warren Buffett's rolling acquisition of GEICO from 1951 to 1996 created Berkshire Hathaway's cornerstone asset. But these are the exceptions that prove the rule confirmed by nearly all studies: M&A is a mug's game, in which typically 70%-90% of acquisitions are abysmal failures.

Why is that so? The answer is surprisingly simple: Companies that focus on what they are going to get from an acquisition are less likely to succeed than those that focus on what they have to give it. (This insight echoes one from Adam Grant, who notes in his book *Give and Take* that people who focus more on giving than on taking in the interpersonal realm do better, in the end, than those who focus on maximizing their own position.)

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For example, when a company uses an acquisition to enter an attractive market, it's generally in "take" mode. That was the case in all the disasters just cited. Microsoft and Google wanted to get into smartphone hardware, HP wanted to get into enterprise search and data analytics, News Corp. wanted to get into social networking. When a buyer is in take mode, the seller can elevate its price to extract all the cumulative future value from the transaction—especially if another potential buyer is in the equation.

Microsoft, Google, HP, and News Corp. paid top dollar for their acquisitions, which in itself would have made it hard to earn a return on capital. But in addition, none of them understood their new markets, which contributed to the ultimate failure of those deals. Other take-based market entry acquisitions, such as Microsoft's $1.2 billion purchase of the social networker Yammer, at 40 times revenue, and Yahoo's $1.1 billion, 85-times-revenue purchase of Tumblr, haven't yet played out—but it's hard to imagine that either will earn a favorable return over the long term.

If you have something that will render an acquired company more competitive, however, the picture changes. As long as the acquisition can't make that enhancement on its own or—ideally—with any other acquirer, you, rather than the seller, will earn the rewards that flow from the enhancement. An acquirer can improve its target's competitiveness in four ways: by being a smarter provider of growth capital; by providing better managerial oversight; by transferring valuable skills; and by sharing valuable capabilities.

Be a Smarter Provider of Growth Capital

Creating value by being a better investor works well in countries with less-developed capital markets and is part of the great success of Indian conglomerates such as Tata Group and Mahindra Group. They acquire (or start up) smaller companies and fund their growth in a way that the Indian capital markets don't.

FURTHER READING

The Big Idea: The New M&A Playbook
MERGERS & ACQUISITIONS ARTICLE by by Clayton M. Christensen, Richard Alton, Curtis Rising, and Andrew Waldeck

It's harder to provide capital this way in countries with advanced capital markets. In the United States, for example, activists often force diversified

Why you should pay top dollar for a "killer deal"—and other new rules for making acquisitions

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companies to break up because the companies' corporate banking activities can no longer be shown to add competitive value to their constituent businesses. Big companies such as ITT, Motorola, and Fortune Brands, and smaller ones such as Timken and Manitowoc, have been broken up for this reason. Even GE has slimmed down considerably. One of the biggest deals of 2015 was the proposed $68 billion merger and subsequent three-way split of DuPont and Dow, which resulted from relentless activist pressure on DuPont.

But even in developed countries, being a better investor gives scope for creating value. In new, fast-growing industries, which experience considerable competitive uncertainty, investors that understand their domain can bring a lot of value. In the virtual reality space, for example, app developers were confident that Oculus would be a successful new platform after Facebook acquired it, in 2014, because they were certain that Facebook would provide the requisite resources. So they developed apps for it, which in turn increased the platform's chances of success.

Another way to provide capital smartly is to facilitate the roll-up of a fragmented industry in the pursuit of scale economies. This is a favorite tool of private equity firms, which have earned billions using it. In such cases, the smarter provider of capital is usually the biggest existing player in the industry, because it brings the most scale to each acquisition (until returns on scale max out). Of course, not all fragmented industries have the potential to deliver scale or scope economies—a lesson learned the hard way by the Loewen Group (Alderwoods after bankruptcy). Loewen rolled up the funeral home business to become the biggest North American player by far, but its size alone created no meaningful competitive advantage over local or regional competitors.

FURTHER READING

The Dubious Logic of Global Megamergers
ECONOMICS MAGAZINE ARTICLE by Pankaj Ghemawat and Fariborz Ghadar
It pays to be big in a global economy, right? Wrong. The rush toward huge cross-border mergers is based on a faulty understanding of economics. There are better ways to address globalization than relentless expansion.
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Scale economies aren't necessarily rooted in operating efficiencies. Often they arise through the accumulation of market power. After eliminating competitors, the big players can charge higher prices for value delivered. If this is their strategy, however, they inevitably end up playing cat and mouse with antitrust regulators, who sometimes prevail—as they did in the intended mergers of GE and Honeywell, Comcast and Time Warner, AT&T and T-Mobile, and DirecTV and Dish Network. For two of the biggest proposed deals of 2015, however, the jury is still out. Dow's merger with DuPont and AB InBev's with SABMiller would represent major consolidations in the companies' key product markets.

Provide Better Managerial Oversight

The second way to enhance an acquisition's competitiveness is to provide it with better strategic direction, organization, and process disciplines. This, too, may be easier said than done. Supersuccessful, high-end, Europe-based Daimler-Benz thought it could bring much better general management to modestly successful, midmarket, U.S.-based Chrysler and learned a painful $36 billion lesson. Similarly, GE Capital was certain it could bring better management to the many financial services companies it bought in the process of ramping up from a small sideline into GE's biggest unit. As long as the U.S. financial services sector was growing dramatically relative to the nation's economy overall, it appeared that GE was right—the company's approach to management was superior and value-adding for those acquisitions. But when that sectorwide party came crashing to a halt during the global financial crisis, GE Capital nearly brought the whole of General Electric to its knees.

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Better management is more likely to result from PE buyouts, such as 3G Capital's acquisitions of Burger King and Tim Hortons and—with Berkshire Hathaway—Heinz and Kraft. Berkshire Hathaway has a long track record of buying companies and boosting their performance through its management oversight, but not many other convincing corporate examples exist. Danaher may be the best one. Since its inception, in 1984, it has made more than 400 acquisitions and has grown to a $21 billion company with a market capitalization above $60 billion. Observers as well as Danaher executives attribute its nearly unbroken record of success to the Danaher Business System, which revolves around what the company calls "the four P's: people, plan, process, and performance" and is installed, run, and monitored in every business without exception. For the system to be successful, Danaher asserts, it must improve competitive advantage in the acquired company, not just enhance financial control and organization. And it must be followed through on, not just talked about. Despite this outstanding growth and performance, Danaher is in the process of splitting into two separate companies under the baleful eye of the activist hedge fund Third Point.

Transfer Valuable Skills

An acquirer can also materially improve the performance of an acquisition by transferring a specific—often functional—skill, asset, or capability to it directly, possibly through the redeployment of specific personnel. The skill should be critical to competitive advantage and more highly developed in the acquirer than in the acquisition.

A historical example is Pepsi-Cola's transfer to Frito-Lay, after the two merged in 1965, of the skills for running a direct store delivery (DSD) logistics system—a key to competitive success in the snack category. A number of PepsiCo DSD managers were assigned to head up Frito-Lay's operations. PepsiCo's 2000 acquisition of Quaker Oats was less fulfilling, however, because the majority of Quaker's sales involved the traditional warehouse delivery method, in which PepsiCo had no skill advantage over Quaker.

Was Pixar a Good Deal for Disney?

The 2006 acquisition of Pixar by Disney for $7.4 billion (actually, a net cost of $6.4 billion, because Pixar came with $1 billion of excess cash) after their joint venture expired is typically regarded as highly successful and credited with turning around Disney's flagging animated film business. A closer examination, however, suggests that thus far it has been a pretty expensive mistake.

As usual, it's hard to calculate the true return, given that an acquisition is reported on as part of a larger business unit—in this case Disney's studio entertainment business, which combines animated and live action movies. That business earned $729 million in 2006 prior to Pixar's integration. Disney's allied consumer business, which licenses and sells merchandise

Google's purchase of Android provides a modern example of successful transfer. As one of the world's greatest software companies, Google could turbocharge Android's development and help turn it into the dominant smartphone operating system—but it fell short with the hardware-centric Motorola handset business.

Clearly, this method of adding value requires that the acquisition be closer to home than not. If the acquirer doesn't know the new business intimately, it may believe that its skills are valuable when they aren't. And even when they are valuable, it may be hard to transfer them effectively, especially if the acquired company isn't welcoming toward them.

Share Valuable Capabilities

based on Disney film characters, earned an additional $607 million in 2006.

Let's make a madcap assumption: that 100% of the incremental operating income for both the studio entertainment and consumer businesses from 2007 to 2015 can be attributed to the Pixar acquisition. That would mean, among other things, that the acquisitions of Marvel Entertainment in 2009 and Lucasfilm in 2012, each for $4 billion, contributed 0%. Furthermore, let's ignore any capital charge Disney incurred for carrying that additional $8 billion of acquisition costs. Even under such laughably unrealistic assumptions, the Pixar acquisition would have destroyed more than $5 billion of Disney shareholder value through 2015.

The only way to imagine it breaking even is to further assume that without Pixar, Disney's combined studio entertainment and consumer businesses would have declined by 25% over the period. A more realistic assessment is that by 2015 Pixar, Marvel, and Lucasfilm had destroyed $10 billion of shareholder value.

Pixar didn't need Disney. It was as hot as a smoking pistol and had many other potential joint venture partners. But Disney needed Pixar:

The fourth way is for the acquirer to share, rather than transfer, a capability or an asset. Here the acquiring company doesn't move personnel or reassign assets; it merely makes them available.

Procter & Gamble shares its multifunctional, colocated customer team capability and its media buying capability with acquisitions. The latter may lower the advertising costs of even large acquisitions by 30% or more. With some acquisitions, it also shares a powerful brand—for example, Crest for the SpinBrush and Glide dental floss. (That approach didn't work for P&G's 1982 acquisition of Norwich Eaton Pharmaceuticals, whose distribution channel and product promotion differed from P&G's.)

Microsoft shared its powerful ability to sell the Office suite to PC buyers by including Visio software in Office after it acquired the company in 2000 for close to $1.4 billion. But it had no valuable capability to share when it bought the handset business from Nokia.

FURTHER READING

M&A Needn't Be A Loser's Game

Its biggest successes in animation in the previous decade were its joint-venture projects with that company. It had little to give and lots to take—and paid an extraordinary price for the pleasure.

CORPORATE COMMUNICATIONS ARTICLE by by Larry Selden Geoffrey Colvin

Most takeovers devour buyers' wealth. But acquirers who understand they're actually buying customers can avoid disastrous deals and find ones that work.

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In this form of "give," success lies in understanding the underlying strategic dynamics and ensuring that the sharing actually happens. In what is hailed as the greatest M&A bust of all time—the merger of AOL and Time Warner for $164 billion in 2001—vague arguments were made for how Time Warner could share its content capability with the internet service provider. But the economics of sharing didn't make sense. Content creation is a highly scale-sensitive business, and the wider a piece of content's distribution, the better the economics for its creator. If Time Warner had shared its content exclusively with AOL, which then owned approximately 30% of the ISP market, it would have helped AOL competitively but damaged itself by shutting off the other 70%. And even if Time Warner had limited itself to giving AOL preferential treatment, the other market players might well have retaliated by boycotting its content.

What's Up with WhatsApp?

All this may lead one to wonder what's up with Facebook's acquisition of the messaging service WhatsApp—perhaps the most shockingly priced deal in recent memory. The original agreement, made in February 2014, was for $19 billion. But because most of that was in the form of Facebook stock, which shot up between February and when the deal closed in October, the actual price was $21.8 billion—this for a company that had just lost $138 million on $10 million of sales.

Let's look at this deal through the giving lens:

- **Was Facebook a better provider of capital?**

  Maybe. But WhatsApp already had a terrific one in the VC heavyweight Sequoia Capital, which led all three funding rounds and had reportedly committed $60 million to the venture. Despite that $138 million loss, it's unclear that WhatsApp would have been capital-constrained without Facebook. This was not like the acquisition of Oculus, in which Facebook conferred singular status on one of a number of virtual reality contenders. WhatsApp was already by far the leader in global messaging, with 465 million users, when Facebook decided to acquire it.

- **Has Facebook provided valuable managerial oversight or transferred skills?**

  Maybe. It is, of course, a monumentally successful company. But by all accounts, it has elected to leave WhatsApp to pursue its own strategy—which is dramatically different from Facebook's. WhatsApp has eschewed advertising and makes its modest revenue on a small subscription fee ($1 a year) after users get the first year free.

- **Has Facebook shared valuable capabilities?**

  No. It could have combined WhatsApp and its own application, Messenger, but it has kept them completely separate.

So what's the logic of this deal? It seems to be based on a fact and a prayer. The fact is simply that WhatsApp is the world's biggest messaging application, with more than one billion users at last count. The prayer is that Facebook will somehow figure out how to monetize those users. That might happen, but the financial bar is staggeringly high. To earn Facebook shareholders a return on the cost of the acquisition, WhatsApp would have to become one of the most profitable software companies on the planet in less than a decade.

Look at the numbers: At a cost of capital of just over 9%, Facebook's acquisition cost of $21.8 billion means that WhatsApp must generate $2 billion a year in additional value—or $2 billion in additional EBITDA. But for a company that lost $138 million in the year prior to acquisition, that won't happen immediately. Facebook shareholders have a right to expect $2 billion of value per year from the start; to them each year's shortfall feels like an addition to the acquisition's initial price. And they need to earn an annual return on the shortfalls as well, so the effective cost to them of the WhatsApp acquisition rises with every year that it contributes less than $2 billion in value.

Why Does the M&A Party Keep Rocking?

The system in which CEOs operate is biased in two ways in favor of playing the M&A lottery. First, with the rise in stock-based compensation since the 1990s, the value of a successful acquisition bet is greatly enhanced for the CEO. If the acquisition gives the stock price a positive "pop," the personal benefit to the CEO is huge. Furthermore, compensation packages are strongly correlated with the size of the company, and an acquisition makes it bigger.

Even failed acquisitions can be personally profitable. The Mattel –Learning Company and HP-Autonomy deals are among the most disastrous in recent memory, and they did cost CEOs Jill Barad and Léo Apotheker their

Let's suppose that after the acquisition, WhatsApp's profitability grows at the same rate that Facebook's did in its first eight years. Facebook lost money for the first five and then ramped up to $2 billion in operating income by its eighth year. If WhatsApp broke even for 2015 –2019 and then achieved earnings growth like Facebook's, Facebook shareholders would see an acceptable return on the investment for the first time in 2022. But to do that, WhatsApp would need the eighth-highest EBITDA in the world of software companies, trailing only Microsoft, Oracle, SAP, Google, IBM, Facebook, and Tencent.

That would be the good news. The bad news would be that on the way to 2022, WhatsApp would accumulate an additional deficit of $18.3 billion in inadequate earnings for the first seven jobs. But Barad left with a $40 million severance package, and Apotheker left with $25 million.

The second bias (at least in the United States) comes from an unlikely source: the Financial Accounting Standards Board. Before the dot-com bubble burst, in 2001, intangible assets were written off over a 40-year period. After the burst, assets valued at billions of dollars were seen to be worthless, so the FASB decided that in future a company's auditors would declare whether or not intangible assets were impaired and, if so, would force them to be written down immediately by the amount of the impairment.

The unintended consequence of this change was to make acquisitions more attractive, because the acquiring company's earnings would no longer be suppressed every year by an automatic write-off. In the modern era of acquisitions, therefore, all a CEO has to do is convince the auditor that the acquired asset isn't impaired and that an acquisition will have no negative impact on earnings, even if it's made at an extraordinary price. Generally, this is fairly straightforward as long as the company's core business is doing well and its market cap is higher than its book value.

years—the equivalent of Facebook's paying $40.1 billion to acquire WhatsApp in 2022. That is a gigantic investment. At last ranking, only 266 public companies in the world were worth more than $40 billion.

Right now, CEO Mark Zuckerberg is hailed as a business genius, Facebook has become one of the most valuable companies in the world, and his shareholders are perfectly happy to watch him fork out $21.8 billion for a company with a handful of engineers and $10 million in revenues. As long as the stock price keeps rising because the base business is prospering, acquisitions don't have to actually make sense. But history shows that when things turn sour for the base business—think of Nortel, Bank of America, WorldCom, Tyco—shareholders start looking more closely at acquisitions and asking, What were they thinking? That's why it pays to have a strong strategic logic for your acquisitions, even when the market isn't asking for it. And what the acquirer puts into the deal determines the value that comes out of it.

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With these two drivers providing the liquid lubrication—and the global financial crisis apparently a distant memory—the party is in full swing.

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JOHN LANDRY 3 days ago

Thanks for this insightful analysis. Expanding on the comment below, the article uses a narrow understanding of shareholder value as the criteria for the success of an acquisition. But shareholders are not as powerful as they once were, and it's hard to believe that companies would keep chasing after acquisitions when so many fail by that criteria. Instead, there's a political dimension: companies make so many acquisitions because it's a way of keeping executives happy. The empire-building of the 1950s and 1960s has come back, to some extent. It's only human nature. The second problem is that this perspective is focused on the short term. As others have argued, Facebook saw WhatsApp as a platform that had the audience around which it could have formed a competitor. So it bought the company for defensive reasons. If Facebook has to "waste" a few billion dollars to preserve its platform in its winner-take-all markets, then it's a small price to pay. Likewise, it's probably no coincidence that acquisitions have increased at the same time that the average size of companies have risen and corporate profits have been stronger than the overall economy. Many acquisitions may not show up as individually profitable, but they may contribute to overall market power. So it's misleading to say that 70+% of acquisitions fail.

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