Managing Risks in Mergers & Acquisitions

Understanding the risks in mergers and acquisitions

A combination of factors - increased global competition, regulatory changes, fast changing technology, need for faster growth and industry excess capacity - have fuelled mergers and acquisitions (M&A) in recent times. The M & A phenomenon has been noticeable not only in developed markets like the US, Europe and Japan but also in emerging markets like India. In 1998, worldwide mergers and acquisitions were valued[1] at $2.4 trillion. In 1999, this figure increased[2] to $3.4 trillion. In 2000, the pace seemed to slow down, with only the Glaxo Wellcome – SmithKline Beecham merger valued at over $50 billion. However, the total value of the deals worldwide crossed $3.5 trillion, much of the activity taking place in the first half of 2000. The recent proposal by HP and Compaq to merge, is a clear indication that merger mania is well and truly alive.

Like capacity expansion, vertical integration and diversification, a large merger or an acquisition is also a strategic move in the sense that it can make or break a company. However, mergers and acquisitions deserve a separate treatment as they involve unique considerations such as the valuation of the company being acquired and integration of the pre merger entities. Valuation is a subjective matter, involving several assumptions. Integration of the pre merger entities is a demanding task which has to be managed skilfully.

Mark Sirower, an internationally acclaimed expert in the field of mergers and acquisitions found two thirds of the 168 deals he analysed between 1979 and 1990 destroyed value for shareholders. When he looked at the shares of 100 large companies that made major acquisitions between 1994 and 1997, Sirower found that the acquirer's stock, on an average trailed the S&P 500 by 8.6%, one year after the deal was announced. 60 of these stocks under performed the market while 32 posted negative returns. Many of the companies acquired were often sold off at a later date and sometimes at a loss.

Consider Kimberly Clark's acquisition of Scott Paper in 1995. This acquisition made Kimberly-Clark the world's largest tissue maker. One year later however, sales were down and profits and operating income had shrunk. By 1999, the merged entity was trailing the S&P 500 Stock Index. When AT&T acquired NCR, several hopes were raised. But after five years of losses amounting to more than $2 billion, AT&T accepted that the acquisition would not work. In 1995, it decided to spin the company off. Similarly the projections made by India's Tata Tea at the time of acquisition of the UK based Tetley have not quite materialised.

Quite clearly, mergers and acquisitions involve heavy risks. In their excitement and enthusiasm to close the deal fast, managers throw caution to the winds. Later, there is a gap between expectations and actual performance and shareholders' wealth is eroded.

Why mergers are risky

Major acquisitions have strategic implications because they leave little scope for trial and error and are difficult to reverse. Moreover, the risks involved are much more than financial in scope. A failed merger can disrupt work processes, diminish customer confidence, damage the company's reputation, cause employees to leave and result in poor employee motivation levels. So the old saying, discretion is the better part of valour, is well and truly applicable here. A comprehensive assessment of the various risks involved is a must before striking an M&A deal. Circumstances under which the acquisition may fail including the worst case scenarios should be carefully considered. Even if the probability of a failure is very low but the consequences of the failure are significant, one should think carefully before rushing to complete the deal.

Top M&A deals in 2001

Target	***Acquirer***	***Value of deal ($ million)***

AT&T Broadband & Internet US	Comcast (US	57,547
Hughes Electronics (US)	Echostar Communications (US)	31,739
Compaq Computer (US)	Hewlett Packard (US)	25,263
American General (US)	American International Group (US)	23,398
Dresdner Bank (Germany)	Allianz (Germany)	19,656
Bank of Scotland (UK)	Halifax Group (UK)	14,904
Wachovia (US)	First Union (US)	13,132
Benacci (Mexico)	Citi group (US)	12,821
Telecom Italia (Italy)	Olivetti (Italy)	11,973
Billiton (UK)	BHP (Australia	11,511

Source: The Financial Times

The strategic implications of a merger should be understood carefully. Otherwise, the shareholders' wealth will be eroded. As Mark Sirower[3] puts it neatly: "When you make a bid for the equity of another company, you are issuing cash or claims to the shareholders of that company. If you issue claims or cash in an amount greater than the economic value of the assets you purchase, you have merely transferred value from the shareholders of your firm to the shareholders of the target – right from the beginning."

There are two main reasons for the failure of an acquisition. They are over enthusiasm about strategic, unquantifiable benefits of the deal which results in over valuation of the acquired company and wrong integration strategies which result in a gap between possible and actually realised synergies.

Many companies are enthusiastic about generating cost savings before the merger, without appreciating the practical difficulties involved in realising them. For example, even if a job is eliminated, the person currently on that job may have to be shifted elsewhere, leaving head count in tact.

Many firms enter a merger hoping that efficiency can be improved by transferring best practices and core competencies between the acquiring and acquired companies. Cultural factors may however prevent rapid diffusion of such knowledge. The 1998 merger of Daimler Benz and Chrysler is a good example. Another important point to keep in mind is that it may take much longer to generate cost savings than anticipated. The longer it takes to cut costs, the lesser the value of the synergies generated.

Revenue growth, the reason given to justify many mergers is in general more difficult to achieve than cost cutting. In fact, growth may be adversely affected after a merger if customer or competitor reactions are adverse. When Lockheed Martin acquired Loral, it lost business from important customers such as McDonnell Douglas, who were Lockheed's competitors. So, companies must look at the acquisition in terms of the impact it makes on competitive forces. The acquisition should be able to put a check on the ability of competitors to retaliate or target the existing markets for the pre merger entities. Some M&A experts look at revenue enhancement as a soft synergy and discount it heavily while calculating synergy value.

The acquisition of Tetley by the Tatas

In mid 2000, India's largest tea company, Tata Tea announced it was buying the UK based Tetley for £271 million in a leveraged buyout. Tetley which earned a net profit of £35 million in 1998 on sales of £280 million was the third largest brand in the global $600 million packaged tea market behind Unilever's Brook Bond and Lipton. Tata Tea looked at the acquisition as a quick way of gaining access to markets in the US, Canada, Europe and Australia. It also looked at the opportunities created by Tetley's estimated weekly purchase of three million kg of tea from 10,000 estates in 35 different countries. Besides, Tata Tea hoped to pick up packaging expertise from Tetley.

Tata Tea did not pay cash upfront. Instead, it set up a special purpose vehicle where it pumped in £70 million of equity. Then it leveraged the equity to borrow £235 million from the market. Tata Tea hoped that cash flows from Tetley would be adequate to pay off the debt. At the time of finalising the deal, there were press reports that Tata Tea was probably overpaying[4], £100 million more than the second highest bid.

To service the debt, Tetley needed to generate cash flows of atleast £48 million per year whereas it generated only

£29 million in 1999. Tata Tea had hoped for a significant increase in the cash flows after the acquisition but unfortunately for it, retail tea prices in the UK market softened. Moreover, the popularity of tea continued to decline in the UK while the market share for natural juices and coffee went up.

By September 2001, the deal was running into short term financial problems. The Tatas announced they would bring in an additional amount of £60 million as equity. The equity infusion would facilitate retirement of expensive debt and reduce interest charges by about £ 8 million per year. If cash flows touch £40 million, the risk of not being able to service the debt will be eliminated. This will however, not be an easy task. Tata Tea Managing Director, R K Krishna Kumar recently admitted[5] that additional investments will be needed to revive demand.

Arriving at the premium

One of the most thoughtful treatments of the premium involved in acquisitions is provided by Porter[6]. Porter points out that an efficient market eliminates the possibility of generating more returns than the pre merger entities are generating currently. If the management of the acquired company is sound and the company itself has a bright future, its market price would already have been bid up. On the other hand, if its future is bleak or the management is weak, the stock price could be low but the infusion of capital and effort required to turn it around could also be massive. As Porter puts it: "To the extent that the market for companies is working efficiently, then, the price of an acquisition will eliminate most of the returns for the buyer… The market for companies and the seller's alternative of continuing to operate the business work against reaping above-average profits from acquisitions. Perhaps, this is why acquisitions so often seem not to meet managers' expectations."

While acquiring a company, firms must be careful about irrational bidders with non profit motives or who are pursuing the deal purely because of the idiosyncrasies of the top management. In the race to the finishing line, companies may end up paying too high a price because of the influence of such bidders. The board should exercise a sobering influence in such situations.

According to Sirower, the acquiring company must consider the following while working out the premium:

- stand alone market expectations about the acquired company
- tangible performance gains from the merger and the management talent necessary to achieve the gains
- impact on competitors and their possible response
- milestones in the implementation plan
- additional investments which will be necessary
- comparison of the acquisition with alternative investments.

Integration

Many mergers fail at the stage of integration. So, it is important to understand carefully the risks involved in integration and how to manage them. All acquisitions must begin with a strategic vision, which serves as a guide for the implementation plans. The vision should be backed by an operating strategy which addresses the issue of how the value chain performance can be improved, whether competitors will react aggressively and if so how they can be dealt with. Vision and operating strategy must be backed by proper systems and processes to align the behavior of managers with corporate objectives. An important point to be noted here is that some operations should be tightly integrated while others should be left alone. What to integrate and what to leave alone is a matter of judgement but there are some useful guidelines, as we will see shortly.

The 1986 merger of Borroughs and Sperry illustrates some of the challenges involved in integration of the pre merger entities. The two computer makers who came together to form Unisys felt that the merger would generate economies of scale, improve efficiencies and boost price competitiveness. The integration of the distribution system was however a disaster. The companies had different order entry and billing procedures. After the attempted integration, equipment orders were executed late and customers regularly frustrated by missing parts. By November 1990, the stock price of Unisys was only $3 per share. About 90% of shareholder value had been destroyed.

The 1986 acquisition of Republic Airlines by Northwest Airlines also ran into integration problems. The two computer systems could not be synchronised. Integration of crew and gate scheduling and human resources ran into serious problems. Republic's employees on an average drew lower salaries compared to those of Northwest. Low morale led to a deterioration in customer service. In August 1987, a Northwest plane crashed after taking off from Detroit. Matters continued to worsen till 1989, when Northwest was bought out by a group of private investors.

Personal chemistry, especially at the top matters a lot during integration of the pre merger entities. In general, it is not advisable to have two bosses. Decisive leadership is best provided by a single individual, not by a two man team or a committee. Indeed, if co CEOs are named after the merger, there will ensue a period of uncertainty during which people wait to see who finally gains the upper hand. In the Citicorp-Travellers Group merger, Sandy Weill of Travellers has taken control, ousting Citicorp's John Reed and in the case of the Daimler Chrysler merger, Jurgen Schrempp has gained the ascendancy over Chrysler's Bob Eaton. In both cases, till the clear leader emerged, things were in a state of flux and employees remained confused.

Case: The AOL Time Warner Merger

On January 10, 2000, America Online (AOL) and Time Warner (TW) announced that they were merging. For all practical purposes, the deal was a reverse takeover by AOL. While the icon of the internet world had just 20% of TW's revenues and only 15% of its workforce, its large market cap made it the senior partner. AOL shareholders received one share in the merged entity while TW shareholders got 1.5 shares for each of their existing shares. AOL shareholders owned 55% and TW shareholders 45% of the new company. Effectively, AOL paid a premium of 71% over the market value of TW. The combined entity was valued at $350 billion.

Even though the two companies were confident of boosting revenues, many analysts expressed concerns about the merger slowing down AOL and robbing it of its entrepreneurial drive. AOL however, remained confident that TW's cable network and content would generate new growth opportunities.

Before the announcement of the deal, TW shares traded at a multiple of 14 times EBITDA while AOL shares traded at a multiple of 55. The immediate market reaction to the deal was negative. By January 12, the combined market capitalisation was actually lower at $260 billion, compared to $270 billion before the announcement. The market value of AOL shares fell by 19% while that of TW shares went up by $22 billion.

AOL which had a strong brand and enjoyed a large customer base was clearly a bellwether in the new economy. However, anticipating that Internet access would turn into a commodity, AOL badly needed the 'pipes' of cable television to carry Internet content. Moreover, AOL did not really have much content of its own. It decided to move fast and make full use of its high market capitalisation before the stock markets moved south. In October 1999, Steve Case, CEO of AOL called TW CEO, Gerald Levin to discuss the merger. Levin sensed an opportunity as his company's stock was not doing particularly well in the market. In December 1998, TW had been worth more than AOL. But by December 1999, AOL was worth 2.5 times TW. Quite clearly, TW was on the decline. Case also sweetened the deal for TW by inviting Levin to be the merged entity's CEO.

After the merger was announced, the Federal Trade Commission (FTC) began to interrogate the senior executives of the two companies to understand the anti trust implications. Case and Levin refused to accept a demand by FTC to regulate the placement of AOL-TW content. However, they agreed to report any complaints from competitors if they were denied AOL-TW content.

"Low hanging fruit" synergies were quickly identified. CNN.comprograms could be featured on AOL, while AOL discs would be bundled with TW product shipments. Warner movies could be promoted on AOL-owned Moviefone. The merged entity had the potential to offer books, movies, magazines and music to customers on TV, paper, PC, cell phone or any of the other wireless devices, to customers.

Even as the FTC was in the process of approving the merger, integration efforts began. Inter divisional committees were set up to facilitate the integration. Efforts to generate cross selling opportunities in the areas of subscriptions, advertising and promotions began. An attempt to sell TIME Inc's magazines through AOL was very successful.

One positive feature of the merger is that the transition at the highest level of management has been smooth. Levin has been clearly in charge of both day to day operations and key strategic and personnel moves. Case has disengaged from day-to-day operations to concentrate on macro level issues. Case explained in an email to *Fortune*[7], that the management set-up in place gave him a sense of what was happening and allowed him to provide his perspective where required, without in any way meddling with the day-to-day operations.

It is now clear that the fortunes of AOL-TW are closely tied to the erstwhile AOL group. Many of the top executive positions had gone to AOL. And most of its senior executives are still around 18 months after the merger was announced. While, AOL has shown good performance in the first quarter of 2001, TW's business continued to struggle in the wake of a week ad market. Moreover, making Hollywood movies remains an unpredictable, low margin business.

A year later, the merger was showing signs of trouble. The projected revenue growth of 12-15% and $1 billion in cost savings looked way off target. According to Merrill Lynch estimates, growth would only be 11% while losses would cross $5 billion due to merger write offs. A slowing US economy and a sharp cut back on ad spending by companies was hitting growth. By early 2001, AOL's stock had dropped by 48% to $37.50.

The markets perceive the integration to be still incomplete. In response to the 2001 second quarter results, the share price declined by 9% even though earnings before interest, tax, depreciation and amortisation had jumped by 20% over the previous year. Cultural differences continue to be a formidable barrier to the integration process. As the *Economist*[8] recently reported: "There is a wide cultural gap between the restless 20 – somethings from AOL and New York institutions such as the 78 year old Time Inc… There is much grumbling among journalists (at Time Warner)… about a new tightness with money and the fears, this has prompted for editorial quality."

The Chief Operating Officer, Robert Pittman feels things are moving in the right direction. As an example, he has cited a recent Madonna world tour arranged by Warner Brother Records, in which AOL subscribers could buy advance tickets and see unreleased photos and videos. Pittman remains confident that the AOL community can be persuaded to buy a range of entertainment products.

Tatenbaum[9] has argued that even before the deal is finalised, a top Human Resources (HR) executive must be involved with a say in the go/no go decision. HR usually enters much later to deal with issues like compensation. Instead, if the HR manager joins the discussions at an early stage and conducts a cultural audit, potential trouble spots can be identified, very early on. Tatenbaum provides seven guidelines for managing the integration process.

- The integration team should build organisational capability by retaining talented manpower. Tatenbaum's research reveals that 47% of the senior managers in an acquired firm leave within the first year of the acquisition and 72% within the first three years.

- Downsizing activities must be managed smoothly, showing sensitivity to the employees concerned. Otherwise, there may be a large scale exodus. A related issue is finding the right roles for the people. Cisco for example tells employees clearly what their new jobs will be after the merger and to whom they will report.

- Systems and procedures must be implemented in line with the strategic intent of the acquisition. For example, bureaucratic procedures can be highly counterproductive if the acquired company is known to have a flexible, entrepreneurial culture.

- The integration team must identify the cultural traits that are consistent with the business goals of the merged entity and take steps to spread them across the two entities. The team can use symbols to project and reinforce the culture. It must manage cultural differences by collaborating with managers throughout the organisation.

- Post merger drift tendencies should be minimised by managing the transition quickly. If decisions and changes are not implemented fast, the acquirer may become focussed on internal issues and lose sight of customers and competitors. Decisions about lay offs, restructuring, reporting relationships, etc must be made within days of the deal being signed and communicated quickly to the employees. However, in an attempt to move fast, people should not be brushed aside. They should be treated with respect and sensitivity.

- Hearing tends be selective during the early days of a merger, when anxiety levels are high. So, some messages may have to be repeated. Besides internal communication, external stakeholders such as customers, vendors and the community must be kept informed.

- When a company has decided to pursue a strategy of growth by acquisitions, clearly defined integration plans can be helpful. It should also identify the team which will conduct due diligence and the team which will plan and implement the merger. Checklists must be prepared to indicate the tasks and suggested deadlines. Cisco, which makes acquisitions at regular intervals, uses a standard business process for managing acquisitions.

Stock Vs Cash deals

The way the deal is financed determines how risk is shared between the buyer and the seller. In general, there are two types of financial risk faced during an acquisition – the fall in share price of the acquiring company from the time of announcement of the deal to its closing and the possibility of synergies not being realised after the deal is closed. In a cash deal, the acquiring company assumes both the risks completely. In a stock swap where a fixed value of the acquiring company's shares is offered to the acquired company, the first risk remains with the acquiring company but the second risk is shared by the two companies. In a stock swap where a fixed number of shares is offered to the acquired company, both the risks are shared between the two companies.

Various considerations dictate the method of financing the deal. If the acquirer feels its shares are undervalued, a cash deal is preferable as any fresh issue of shares would further erode the wealth of existing shareholders. If the acquirer is very confident about actually realising the projected synergies, a cash deal makes sense. Where such confidence is lacking, a stock deal allows the risk to be atleast partially hedged. In general, a fixed value offer is an indication of greater confidence on the part of the acquirer than a fixed number of shares and tends to be better received by the market. A fixed share offer, ironically enough by minimising the pre closing market risk for the acquirer, acts as a kind of self fulfilling prophecy and drives the share price downwards.

Antitrust issues

An important risk in the case of mergers and acquisitions is anti trust attention. Whenever a big merger deal is announced, competition authorities view it with suspicion. If regulators feel that the merger will limit competition, they may impose several conditions. World Com's planned $115 billion takeover of Sprint in June 2000 and the recently announced deal between GE & Honeywell were both blocked by the European Union's competition authorities. When a company is big and enjoys an overwhelmingly large market share, competition authorities tend to view it through a microscope. This is especially relevant in the case of companies like Microsoft. To get around the problem, Microsoft has and by and large concentrated on acquiring small companies or has taken minority stakes in large companies. Image counts when approval of the competition authorities is involved. A company like Cisco, with a very positive, friendly image will be viewed more positively than Microsoft, which is perceived to be a tough no non sense competitor.

Concluding Notes

In this article, we have tried to understand the risks associated with mergers and acquisitions. In their anxiety to close the deal or in their enthusiasm to grow big, companies strike deals of questionable merit. A dispassionate analysis of the potential benefits and pitfalls involved is important before going ahead with a merger or a strategic alliance. Board members have an important role to play here, especially the external directors. CEOs must be thoroughly grilled and asked to explain the benefits of the merger. Once the decision to go ahead with the merger is announced, the focus shifts to integration. This is a task which is underestimated by most companies. In the final analysis, it is the efficiency with which the integration process is managed that decides whether the projected synergies materialise. The difficulties in planning and executing acquisitions make them very risky. Managers should never forget these risks when they strike deals.

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