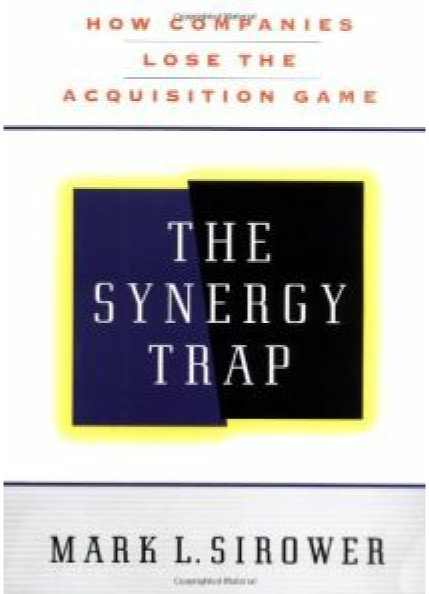

Book The Synergy Trap

How Companies Lose the Acquisition Game

Mark L. Sirower
Free Press, 1997

Recommendation

Mark L. Sirower's thought-provoking and complex book is actually a critically acclaimed academic study that challenges the reasoning behind corporate acquisitions. Pointing out that acquisitions usually devalue the acquiring companies (a loss from which they rarely recover), Sirower delves into management fundamentals and mathematical analyses to get to the bottom of merger and acquisition problems. Three detailed appendices feature plenty of financial calculations, performance measures and data from various corporate acquisitions to back up his assertions. *BooksInShort.com* recommends this book to those involved in mergers and acquisitions and to other readers intrigued by the inside view of this "carnivorous quest."

Take-Aways

- Acquisition is the favorite corporate growth strategy of executives in this generation.
- After most acquisitions, shareholder value drops and doesn't come back.
- Fantasies seduce corporate leaders into the acquisition game.
- The synergy trap is at the center of such fantasies.
- Synergy is defined as the performance increases expected to occur after acquisitions or mergers.
- Rarely is such synergy achieved.
- Achieving synergy is only possible under certain conditions.
- Companies often pay too much when acquiring other companies.
- If you understand management and financial fundamentals, you can undertake a profitable acquisition.
- Human ego is often behind an acquisition that dooms a company.

Summary

The Acquisition Game

Acquisition activity has climbed into the trillions of dollars and remains the favorite corporate growth strategy of this generation of executives, despite the very real fact that shareholder value is a casualty of most acquisitions. Despite decades of research and billions of dollars paid to advisors and consultants, these acquisition decisions continue to destroy the value of the acquiring companies. The big question, given that they don't work financially, is, "Why do these ludicrous acquisitions continue?"

Companies often pay too much in their quest to acquire other companies, and then never see the promised increases in performance and competitiveness. Extensive evidence now shows that the acquisition premium doesn't represent potential value, despite the long-held popular notion that acquisitions are the way to grow and profit.

> "So many mergers fail to deliver what they promise that there should be a presumption of failure. The burden of proof should be on showing that anything really good is likely to come out of one." [Warren Hellman]

Synergy represents the specific increases in performance beyond those already expected for companies to achieve independently. In other words, synergy represents all the performance increases you expect when you put the original company together with the one or more involved in an acquisition or merger. This combination of forces is thought to be more powerful than any of the companies would be independently. Rarely does that become reality, so fantasies of terrific synergy become the synergy trap that seduces corporate leaders into the acquisition game.

Antidote to Seduction

To shine a light on the myths surrounding failed acquisitions, analyze the fundamentals behind the performance of acquisitions, including the standard excuses: Lack of strategic fit or corporate culture conflicts. If you look at the fundamentals, you will be prepared more effectively to avoid the often-predictable losses that come from acquisition decisions. Just because you can acquire another company doesn't mean it would be financially wise to do so.

> "Few, if any, corporate resource decisions can change the value of a company as quickly or dramatically as a major acquisition. Yet the change is usually for the worse."

Acquisitions are a unique business gamble, and certain competitive and organizational conditions must be met and then set in place for synergy to become possible. Precise Required Performance Improvements (RPIs) must be implicitly embedded in acquisition premiums. Without a serious study of these fundamentals, corporate leaders are susceptible to the seductive, and usually dangerous, sophisticated valuation models that highly paid advisors so often use.

Managers have been succumbing to the up-the-ante philosophy in acquisitions, and this has lead to disaster for their shareholders. Before deciding to enter the acquisition game, companies must thoroughly plan for and account for the huge uncertainties that come with any acquisition.

Understanding the Game

Throughout the M&A tidal wave of the past three decades, the fundamentals of acquisition performance have remained a mystery. The walls between finance and strategic management must be broken down. Only then can the foundations of performance be exposed and understood. The walls dividing the fields of finance and strategic management have given rise to unexamined and misleading folklore about the many so-called "keys" to acquisition success. Some of this shortcoming is the direct result of the divisional nature of business schools.

> "Shareholders of acquiring firms routinely lose money right on announcement of acquisitions. They rarely recover their losses. But shareholders of the target firms, who receive substantial premium for their shares, usually gain."

However, in business schools and in the field, the financial side has ignored the competitive and organizational realities of strategic management. Similarly, strategic management perspectives have lacked the financial perspective so essential for a full understanding of the value of investment decisions that include mergers and acquisitions.

> "In management terms, synergy means competing better than anyone ever expected. It means gains in competitive advantage over and above what firms already need to survive in their competitive markets."

The result of this wall is that synergy has remained a vague and even mysterious concept with little financial or strategic meaning. What reasoning is behind the justification of so many predictably bad acquisitions and the destruction of billions of dollars of shareholder value in acquiring firms? The culprit is the use of supposedly sophisticated valuation models, combined with a poor understanding of exactly what synergy is.

Kissing Toads

The excitement level of mergers and acquisitions has led many to forget that these transactions aren't necessary at all - acquisitions are strategic alternatives. CEO's, executive teams and boards of directors all too often choose acquisitions over other, better investment alternatives. They routinely fail to realize that it is incorrect to judge the soundness of an acquisition decision merely on the basis of what it would cost the company to create the particular business from scratch. The soundness of an acquisition should, instead, be judged by its effects on the wealth of the shareholders of the acquiring company. Deciding in favor of an acquisition that can predictably harm the value of the acquiring company's shares would be foolish, and yet, this is precisely what happens every day.

In the 1981 Berkshire Hathaway Annual Report, Warren Buffett wrote, "Investors can always buy toads at the going price for toads. If investors instead bankroll princesses who wish to pay double for the right to kiss the toads, those kisses better pack some real dynamite. We've observed many kisses, but very few miracles. Nevertheless, many managerial princesses remain serenely confident about the future potency of their kisses, even after their corporate backyards are knee-deep in unresponsive toads."

> "The 1990s will go down in history as the time of the biggest merger and acquisition (M&A) wave of the century."

Why do corporate executives, investment bankers and consultants so often recommend that acquiring firms pay more for a company than anyone else on the planet is willing to pay? It's certainly not because so many acquisitions turn out to be a blessing in disguise - they don't. When asked recently to name just one big merger that has lived up to expectations, Leon Cooperman, the former chairman of Goldman Sach's investment policy committee, answered, "I'm sure that there are success stories out there, but at this moment I draw a blank!"

Potential Synergy

The details that make a deal profitable or financially harmful reside in these questions: How can you predict at the outset whether your company is paying too much for an acquisition? How can you use this knowledge to prevent a costly failure? What does the acquisition premium represent? When it is too big? What is the acquiring company actually buying?

> "Saving a company and its shareholders significant wealth by walking away is a very good decision. After all, acquisitions are strategic alternatives. If destroying shareholder value is a manager's best alternative, something is wrong."

An acquisition is essentially a purchase of assets and technologies. But, acquiring companies often pay a premium above the stand-alone market value of these assets and technologies. They're paying the premium for the potential synergy. With dreams of this synergy, companies eagerly, and often stupidly, pay astronomical premiums. The common definition of synergy can be represented by the equation $2 + 2 = 5$ (that's a five, not a four). And that's a pretty dangerous mathematical definition.

The easiest way to lose in the acquisition game is by failing to define synergy in terms of real, measurable improvements in competitive advantage. Ask the specific question, "Will the company have an increase in competitive advantage after the merger or acquisition?" Managers who can analyze the acquisition premium and understand the true concept of synergy will be able to predict the probability and the amount of shareholder losses or gains. When the deal is done, it's too late. Since most major acquisitions are predictably dead on arrival, no amount of managing after the deal is done will help. Do it right from the outset because that's your only chance.

> "Management research on acquisitions consists of two distinct categories: the empirical performance literature and the post-merger integration literature."

Acquisitions and mergers have no room for test runs, trial and error. Other than divesting, there's no way to stop funding during the project. Successful acquirers, including Bestfoods, Cooper Industries and Emerson Electric have learned this over time and understand the fundamentals of the acquisition game. Since most companies make very few acquisitions, they often hire outside advisors to do the acquisition valuations, which are termed fairness opinions.

> "Throughout the 1980s acquisition wave, there was constant concern over the rights of shareholders of the target firm. The concern was, and still is, whether boards of directors are properly exercising their fiduciary duty to their shareholders."

A Boston Consulting Group study found that during the pre-merger stage, eight out of 10 companies didn't even consider how the acquired company would be integrated into operations after the acquisition. It's not surprising, then, that the acquiring company loses the entire premium and plenty more, once the acquisition has taken place. These companies often compound the problem by pouring even more funds into a doomed acquisition, to the detriment of their pre-existing business, which can be destroyed in the process.

Winning and Losing Equations

Achieving synergy means competing better. But in a time of hyper-competitive markets, it's very hard just to achieve the expected performance that's already built into existing company share prices, without an acquisition premium attached. What happens when you raise the bar? Because markets have already priced what is expected from a company, the Net Present Value (NPV) of the company playing the acquisition game can be modeled as follows: "Net present value = synergy minus premium." Companies that don't understand this fundamental equation risk falling into the synergy trap.

Markets attempt to assess the NPV of the acquisition decision - subtracting the premium paid from the expected benefits. The more negative the assessment is, the worse the damage is to the economic balance sheet and the share price.

Sometimes overconfident companies pay too much when they win a bidding contest to acquire another firm. In such scenarios, executive egos run amuck can be blamed for post-acquisition financial downfalls. Sixty-five percent of major strategic acquisitions have been failures. How many of those disasters could have been avoided by paying proper attention to the fundamentals and putting aside executive ego?

> "There is conflicting evidence in the acquisition literature of the management field regarding the effect of the method of payment: the use of cash versus stock as payment in acquisition."

The disastrous Northwest Airlines acquisition of Republic Airlines illustrates a classic failure to understand the fundamentals. In 1986, Northwest (NWA) completed what was then the largest acquisition ever in the airline industry, its $884 million acquisition of Republic Airlines. The acquisition almost doubled Northwest's size, making it the fifth largest U.S. airline. It didn't take long for problems to surface. Within two hours of completion of the acquisition, Northwest's Twin Cities operation was at a standstill.

> "I have presented acquisitions as a unique business gamble. With the fundamentals developed here, we can predict the fate of most acquisitions, no matter how 'strategic' they appear to be."

Federal antitrust regulations had prohibited Northwest and Republic from having any detailed pricing and scheduling discussions prior to the acquisition. Senior management had little knowledge of how the two airlines' computer systems interfaced, and when they put the two systems together, neither pilots nor passengers knew what was going on. Trying to integrate crew and gate scheduling was just the beginning of Northwest's monumental problems.

Because the unions representing Northwest employees were different from those representing Republic, power struggles ensued. Republic's employees came to the merger with lower pay scales than Northwest's employees. At the Detroit hub, outraged baggage handlers tore off destination tags, and employees in Memphis embarked on an unofficial work slowdown that killed on-time performance ratings.

Soon, passengers dubbed Northwest "Northworst." Less than a year after the merger, Northwest topped the government's list for volume of passenger complaints. In 1989, Northwest Airlines was bought out by a group of private investors and its senior management resigned.

About the Author

Mark L. Sirower is a corporate development advisor with The Boston Consulting Group and a visiting professor at New York University's Stern School of Business. He consults with major corporations on merger and acquisition decisions. *The Synergy Trap* is based on his ground-breaking Columbia University doctoral thesis, which first gained national attention when it was cited in *BusinessWeek*. He lives in Manhattan.