LEARNING FROM MERGERS & ACQUISITIONS

Beware of biases

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Measuring performance of transactions is not easy. Let’s look at how companies can learn from experience by focusing on three issues: clearly defining success and failure; avoiding judgmental biases and guarding against the “Halo Effect.”

Defining success and failure

Companies appear to use a number of different definitions of success and failure, leading to very different conclusions. Consider, for example, the abundance of studies about mergers and acquisitions. Many of them claim that most acquisitions fail, and this idea has become a mantra across the business world. Despite warnings, hundreds of companies undertake acquisitions every year. Are these businesses foolish, or merely affected by hubris?

Few acquisitions meet the rosy expectations that are stated when the deal is announced. However, only the most severe definition could conclude that an acquisition not meeting its original goals should be called a failure.

Studies show that the acquiring company suffers an immediate decline in share price, reflecting the capital market’s expectation that the purchase price is likely to be greater than the value that stands to be created.

Over what length of time should we study share price movement in order to capture the true impact of an acquisition? Some acquisitions may initially be greeted negatively by the market, but may be found to add value over time.

What might have happened to the company’s market value had the deal not taken place? Hewlett-Packard did not capture anticipated value through its 2002 acquisition of Compaq, but it does not necessarily follow that HP would have been better off had it remained in its previous position.

Although the acquiring company’s share price may dip, it does not necessarily mean that all acquisitions should be considered a mistake. It is possible, however, that more than half of the acquiring companies would still undertake the deal if they had the chance to do it all over again. This suggests they should not be labelled as failures.

The lesson of these competing and plausible definitions is that in order to learn from success or failure in transactions, managers must have a clear definition of these terms and be sceptical of studies that do not.
Avoiding judgmental biases

Even if we have clear definitions, we might still resist learning from past results because of our judgmental biases. Research by cognitive psychologists has identified a number of biases that shape human thinking, several of which are particularly relevant to measuring the performance of transactions.

One bias is overconfidence. We tend to see ourselves as above average and assume too much about our knowledge and capabilities. To some degree, of course, optimism is healthy and should be encouraged. But such reasoning demands a sober explanation and ought not to be based on bravado. The lesson for managers is to pay attention to base rates of relevant populations’ previous transactions of a similar kind, and to temper natural optimism with past experience.

The Halo Effect

Even if managers follow the steps outlined above, they may face problems when trying to learn from experience. If we believe a company to be successful, perhaps because its sales and profits are growing rapidly, it is natural to infer that it has a sound strategy, a visionary leader, capable employees, efficient organization, and so on.

By the same token, when we believe a company is a poor performer, with slumping sales and shrinking profits, we are quick to infer that its strategy was wrong, its people complacent, its organization inefficient and its customers ignored. Many of the factors commonly held to determine company performance are actually attributions based on performance.

The Halo Effect undermines many studies about business performance, and complicates our ability to learn from transactions. For instance, if we know that an investment or an IPO was successful, we may find that participants often make positive attributions about the leadership and execution involved. They may explain their success in terms of a clear vision. By contrast, if they know that the transaction turned out badly, they may explain that the decision was poorly implemented and leadership ineffective.

A common refrain when it comes to failed mergers is poor leadership. Look at the blame heaped on the executives of the AOL Time Warner merger or on Jürgen Schrempp, CEO of Daimler-Benz, in the wake of the company’s acquisition of Chrysler. It may be true that these executives could have done a better job in leading the acquisitions, but such a judgement must be made independent of outcome. We can always pick an example of failure and infer that the leader was somehow to blame.
The benefits of learning

Some companies capture the benefits of learning and others do not. The successful ones do three things:

- Define success and failure clearly, neither accepting definitions without examining them closely nor altering a definition to achieve desired results
- Pay attention to their past experience and the experience of others
- Guard against the Halo Effect and assess the drivers of success or failure objectively

Philip Rosenzweig is the author of The Halo Effect and the Eight Other Business Delusions that Deceive Managers, to be published in February 2007. He teaches on the Mastering Technology Enterprise (MTE), and the Orchestrating Winning Performance (OWP) programs.

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