TOMORROW'S CHALLENGES

5 GOLDEN RULES OF MERGERS AND ACQUISITIONS

THERE WILL BE LOTS OF M&A DEALS IN 2015. BUT WILL THEY CREATE VALUE OR DESTROY IT?

By IMD Professor Nuno Fernandes – January 2015

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Another busy year of mergers and acquisitions (M&As) lies ahead following a bubbly $3.3 trillion of M&A deals in 2014—the most since before the financial crisis. But how many transactions in 2015 will create value rather than destroying it?

Highlights from last year included Comcast's $71 billion acquisition of Time Warner Cable, the $43 billion merger of cement companies Holcim and Lafarge, and Medtronic's $42 billion purchase of Covidien in the healthcare sector.

The M&A boom reflects several factors. Many industries are changing fast, prompting companies to consolidate. Economic growth is returning, particularly in the US. Companies are sitting on lots of cash, low interest rates reduce the cost of funding, and buoyant stock prices make it easier to buy other companies with shares. In addition, private equity funds are increasingly active and well-financed, driving further M&A deals.

Raising the success rate
M&As are important parts of many companies' growth strategies, and good deals can create a lot of value. In practice, however, more than 60% of M&A transactions destroy it. It's tempting to blame "culture" or "difficult integration" for the high failure rate, but the real reasons lie elsewhere—in mistakes made before, during and after the deal.

Companies could increase their M&A success rate by following these five golden rules:

1] Before and after. Companies must have a continuous process linking the pre-deal phase, the transaction itself and the period afterward. Furthermore, their senior executives need to be involved from the start. Companies that destroy value in M&As often have different teams during and after the deal, and they don't plan the post-merger integration properly.

The initial due diligence is crucial because it provides the rationale for the valuation and deal structure. Due diligence allows companies to see where the merged entity can increase revenues or cut costs, what the main risk factors are, and what roles the respective management teams will play. Brewers InBev and Anheuser-Busch, for example, were clear before their 2008 merger on the joint team that would manage the combined entity.

2] Move fast and communicate. Companies that communicate quickly and constantly during M&A deals keep their focus better and reduce uncertainty among customers and employees—especially those of the target company. Talent exodus is a risk in most M&As, so senior managers must be ready to answer the "What happens to me?" question when employees ask it.

Speed is also crucial during and after the transaction. A prolonged bidding and negotiating period creates additional risks of information leakage, employee departures, and competitors preempting the deal. And if the synergies have not been realized within two or three years of the deal closing, it is because they are no longer there—or never existed.

3] Avoid "strategic" deals. Good, quantifiable reasons for M&A deals include increasing a company's product range, broadening its distribution, improving its manufacturing capabilities, and reducing its unit costs. Bad reasons include boosting a CEO's ego and salary, empire-building, or doing a "strategic deal" when the benefits cannot be quantified. When a CEO says "This is strategic; we'd be stupid not to do it," it's usually a bad sign.

The disastrous $165 billion merger between AOL and Time Warner back in 2000 is a good example. A more recent flop is Hewlett-Packard's $11.1 billion acquisition of Autonomy in 2011, which destroyed billions of dollars. The deal had no financial justification, but it was labeled "strategic" anyway.

4] Think like a financial investor. Companies must be ready to say no to an M&A deal that goes above its "walk-away price." They should not enter into auctions. And they should never fall in love with a deal. CEOs, meanwhile, must control their emotions, because overconfidence and ego can destroy value.

The acquiring company should have a standalone value of the target firm as it is now, and a value with all the projected synergies on top. The purchase price should be somewhere between the two valuations, so that the target company's shareholders also get a premium. But most bidders overpay relative to the value with synergies. Companies should ask "How much is it worth to me?" and then offer less.

5] Never use investment bankers for the valuation. Investment banks are good for roadshows and financing, and market regulators sometimes require public companies to hire banks in M&A deals. But firms should not use them for valuing or negotiating a deal. This is because investment banks get fees for closing the deal, regardless of whether or not it creates value for shareholders after it is completed. A banker is always on the side of the deal, not the company's side.

Companies must have strong in-house valuation skills, from top executives down. Otherwise they will put themselves in the hands of others and will typically overpay. Vodafone's $180 billion acquisition of German company Mannesmann in 2000 is a notorious example. This deal destroyed many billions of dollars, largely because a handful of investment bankers produced a flawed valuation. All employees who are involved in providing estimates that affect the valuation should understand the principles of value creation through M&As, and also basic valuation skills. Otherwise they will not be able to do a proper job in figuring out their individual contribution to the deal's success.

Think quality, not just quantity

M&A success is not random. The most effective companies have many senior executives who understand how M&A deals can create value. These firms do not get that knowledge from external advisers. Nor do they rely entirely on their own finance departments and M&A teams, forgetting about all the other business managers who are involved in the deal, particularly after it closes. If more companies follow the five rules above, then 2015 will be a year of quality as well as quantity in M&As.

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