"ACQUISITIONS: MYTHS AND REALITY"

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ACQUISITIONS: MYTHS AND REALITY

The riskiness of acquisitions as a vehicle for corporate renewal is reflected in both empirical studies of acquisition results and managers' comments about their experiences. Although many factors contribute to acquisition performance, a variety of recurring patterns in the ways in which acquisitions are made offers clues to the disappointing results. We believe that by considering how aspects of the acquisition process affect the results, managers may gain insights into ways to control negative outcomes. In addition, we hope to expand the debate about acquisitions to the domain of corporate strategy. To achieve this end managers must first be willing to adopt a "new" perspective -- one that counters the prevailing truths to which many executives subscribe. This perspective hinges on six observations:

* Acquisitions don't succeed, acquisitive strategies do.
* Shareholders are the least important constituency.
* Managers try to capture rather than create value.
* Strategic analysis plays only a small role in successful acquisition strategies.
* Nothing can be said or learned about acquisitions in general.
* Companies do not learn all they could from their mistakes.
Unfortunately many executives see acquisitions as ends in themselves, not as means to an end. We, however, view acquisitions as an alternative to other equally viable forms of corporate renewal such as internal development, joint ventures, and license agreements. All are means for the firm to secure a capability or a position important to its development and renewal strategy.

Most managers long ago abandoned the practice of judging capital investments solely on a project-by-project basis. Typically, each project is viewed in the context of its contribution to the firm's overall strategy. Acquisitions, however, are still often considered in isolation of that strategy even though their monetary value and strategic importance are usually much greater to the firm than most capital investment projects. This isolation stems from an inevitable element of opportunism in the acquisition process which tends to shift the focus of evaluation immediately to the acquisition prospect and its price, thereby neglecting consideration of the acquisition in its strategic context.

Adequate acquisition analysis goes beyond a study of the candidate firm itself and includes an examination of a potential acquisition's contribution to the firm's corporate development strategy as well as the quality of that strategy. In other words, we suggest that what determines the success of an acquisition is not the acquisition itself, but the acquisitive development strategy that underlies it.
Shareholders Are The Least Important Constituency

Most management literature, statements by executives, and the prevailing theory of the firm imply that shareholders are the most important constituency in an acquisition -- with the key objective being the maximization of shareholder wealth. Yet, the preponderance of empirical evidence from financial economists indicates the acquisitions create value only for the shareholders of the acquired firm, not for those of the acquiring firm.(3)

Compared with managers, employees, investment bankers, commercial bankers, and lawyers, we contend that, in practice, shareholders' interests are often given the least consideration because they are the farthest from the acquisition and therefore have the least influence. To paraphrase Churchill, "Shareholders are the most important constituency in an acquisition, except [for] all the others."

If influence is the most crucial element in the acquisition process, then the senior executives of both firms and key outside advisors (e.g., investment bankers and consultants) end up being the most important constituency. Alternatively, if the criterion is the extent to which one is affected by the transaction, then the managers and employees of both firms (especially the target firm) are surely the most important. In addition, there are indirect constituents -- suppliers, communities, and outside advisors (e.g., investment banks and consultants). All of these groups have a stake in the outcome of an acquisition. The irony, however, is that the constituents least able to make their wishes known are those in whose name the acquisition is often justified, the shareholders.
We do not imply that those parties who are more directly involved in the acquisition decisions (i.e., managers and outside advisors) malevolently neglect the interests of the shareholders for whom they act as agents. Instead we are suggesting that their personal interests are foremost in their minds and often are not congruent with those of the shareholders. This problem is exacerbated by our next point.

Managers Try To Capture, Not Create Value

The ostensible purpose of an acquisition is to create economic value for the acquiring firm's shareholders through a superior combination of the skills, resources, and capabilities of the two firms. Because this intention has proven so difficult to achieve in practice, managers quite often try to capture value at the time of the transaction rather than create value after the acquisition.

We see capturing economic value as a one-time event that is due to the transaction. Examples of this include asset-stripping and the tax benefits associate with a particular acquisition. In contrast we view economic value creation as a long term phenomenon that directly results from managerial actions.¹

The preference for value capture rather than value creation stems from the difference in predictability and timing of the benefits from each. Capturing value via tax benefits or selling off parts of acquired firms offers quick, predictable returns; whereas, creating value is a difficult, uncertain, and time consuming process.
Our arguments about value capture may seem to contradict the fact that most acquisitions are justified on the basis of a list of predicted synergies found in acquisition dossiers. Often though, expected synergies serve foremost to gain support from various groups. However, they rarely represent a realistic appraisal of what the two firms can create together because operating managers play a limited role in the pre-acquisition analysis. Furthermore, although value creation opportunities are emphasized at this stage, the actual deal structuring is geared to capturing rather than creating value because the benefits are more clearly definable.

We are not suggesting that managers should not try to capture the transaction-related benefits from an acquisition, because these can indeed be important. Instead we are arguing for a shift in focus to a longer-term development strategy that has at its core creating economic value through acquisition.

Strategic Analysis Plays Only a Small Role in Successful Acquisition Strategies

The process of making the acquisition--what you do before the agreement--and integrating it--what you do afterwards--determines the success of an acquisition as much as the original purpose, the good intentions of the managers involved, and the quality of the analysis do. Despite the logical advice on what to look for in acquisitions, many firms have experienced disappointing results with their acquisition programs. This suggests that something more than inadequate analysis or a lack of good intentions may be at work. Recent research indicates that the acquisition
process is an important but neglected part of the activity. (5) Three points merit further examination: 1) the acquisition process itself contains impediments to ultimate acquisition success; 2) value creation takes place only after the agreement; and 3) the acquisition process often destroys more value than it creates.

Seeds of acquisition failure are sown in the process. The acquisition process makes it difficult for an acquisition to achieve its intended purpose because of the diversity of people involved, time pressures, and ambiguity of purpose.

The number and variety of specialists working in isolation leads to divergent, unintegrated perspectives. To make matters worse, these experts usually harbor personal agendas and goals, few of which relate to how the acquisition should be managed after the agreement is signed. Severe time and secrecy pressures also come into play in such a way that the acquisition process gathers momentum and assumes a life of its own. These pressures allow the technical, legal, and financial perspectives to dominate negotiations, driving out strategic analysis, as well as considerations of how to integrate the firm afterwards, becomes nothing more than an afterthought.

In addition the process creates a situation where ambiguity during negotiations is endorsed by both parties. In other words, because of dissimilar interests and pressure to reach an agreement, the parties agree to disagree on major points. Thus, key issues that can fundamentally affect the outcome of an acquisition are left unresolved. The situation is likely to worsen after the agreement is signed: neither party is inclined to change his or her position and attempt to resolve these ambiguous issues. The problem is compounded by a buildup of mistrust. Suddenly, constructive
conflict resolution is replaced by the parent firm imposing its will on the subsidiary.

Value creation begins when the agreement is signed. Although the transaction may enable managers to capture economic value, such value is created only after an agreement is signed, and indeed, depends entirely upon the two firms working together over time. Yet often, after an initial flurry of activity, effort, analysis, and communication subsides, senior managers tend to move on to other activities and delegate the integration task to line managers who often were not involved in developing the acquisition's rationale.

Regardless of its presumed merits on paper, the success of an acquisition is fully dependent on the quality of integration and post-acquisition management. The integration process involves combining the skills, capabilities and destinies of the two organizations and may take several years; even then the outcome is difficult to predict. Before integration begins, managers should consider: What should be integrated? Who should be involved? When should integration take place?

Even beyond this integration phase, problems may arise if the acquirer's top management cannot effectively manage a business that has a strategic logic different from the firm's core businesses. The truth about general management is that it is sometimes not always that general.

The acquisition process often destroys more value than it creates. It is important to recognize the distinction between economic and noneconomic value, both of which are present in an acquisition. Economic value can be thought of as benefits which ultimately accrue to shareholders via the stock price. Noneconomic value, in contrast, represents non-monetary benefits which accrue to other constituencies in the acquisition (e.g., managers,
employees, and communities) and include factors such as job security, opportunities for career advancement or the status that comes with belonging to a particular organization. The classical view of acquisitions focuses on creating economic value for the shareholders. Ironically, acquisitions often destroy noneconomic value for those (e.g., managers, employees, communities) who are asked to create economic value after the transaction is made. Creating economic value requires the cooperation and commitment of operating level managers in both firms in order to combine the skills, resources, or knowledge of the two firms. Yet it is precisely this group of managers and their subordinates for whom the acquisition destroys noneconomic value through the loss of job security, status, or career opportunities. Thus, the human cost of acquisitions tends to be very high. We contend that it is unrealistic to expect this group to neglect their own interests in favor of anonymous shareholders.

Nothing Can Be Learned or Said About Acquisitions in General

Although much of the academic research on acquisitions has used large samples to draw general conclusions about success and failure, practicing managers have a right to be skeptical because the issues, reasons, and chances for success vary with the 1) type of acquisition, 2) type of synergy, and 3) degree of integration.

Type of Acquisition. Acquisition managers can consider four questions to help them understand the benefits, risks, and decision-making processes involved in an acquisition.
-- Why are we acquiring? Are our motives defensive, or do we want to capitalize -- in an offensive way -- on underutilized competencies or resources?

-- Who is acquiring? Does the initiative for the acquisition and the responsibility for subsequent management lie with corporate or divisional management?

-- What do we know about the business? Is this an entry into a completely new field? Is it a step-out from our existing business; or is it merely a horizontal acquisition of a competitor?

-- What are we acquiring? How significant a part of our development strategy does the acquisition represent? Are we acquiring just a competence needed for that development strategy; a platform that provides initial entry into a desired business, but which will need major follow-up investment to be viable; or an existing viable business position?

Type of synergy. It is important to note that nothing much can be said about synergies in general. Different synergies correspond to differently types of benefits as well as to different sources of problems. Rather than making the more classical distinctions between related and unrelated acquisitions, we suggest a more subtle view of relatedness which distinguishes among four sources of benefits that accrue from: resource sharing, functional skill transfer, financial transfer, or similarities in strategic logic. (8) Managers can address this issue by asking these questions:

-- Is the relatedness between both firms such that resource sharing is possible? Keep in mind that tangible resources (e.g., distribution systems) as well as intangible ones (e.g., brand names) can be shared.

-- Are the functional competencies in the acquired firm really similar enough to allow for value creation through functional skill transfer? The marketing, manufacturing, or R&D skills possessed by companies are not that general. In fact, competitive advantage is based on a set of much more specific functional capabilities. Successful skill transfer in acquisitions requires an awareness of what these are.
Are the financial requirements of both firms complementary enough to create economic value through financial transfers, that will allow one of the firms to grow at a rate faster than possible using only its own cash generation potential?

Is the strategic logic of both businesses similar enough so that top management can ensure adequate strategic control and improve the general management of the acquired company?

Degree of Interdependence. Examining the nature of relatedness is only the first step in value creation. The realization of benefits depends solely on the extent to which, and the ways in which, the interdependence between the two firms is actually managed. This decision involves a tradeoff between the benefits of integration and the benefits of autonomy. In turn, that tradeoff depends not only on the relatedness and nature of the businesses, but also on the acquiring firm's management approach and its ability to integrate the two firms. In our experience, most firms tend to overestimate the latter.

A common assumption is that the more closely related two companies are, the greater the economic benefits. The evidence, however, is inconclusive. The main reason seems to be that the benefits offering the greatest potential in theory are also more difficult to implement in practice. Resource sharing, for example, implies rationalizing and disposing of assets. This, in turn, implies the destruction of noneconomic value. Indeed, the power, status, and prestige that an employee has built up over a career may be dashed to the rocks by the "economic" rationalization of the workforce. Skill transfer assumes the mobility of people and cooperation among organizational units. But this too may destroy noneconomic value by asking employees to move to a new location. In contrast, the limited benefits of financial transfer require less interaction among parts of the firms and may be more easily realized.
A major reason for the difficulty in gaining the hoped for benefits from a related acquisition is that before the acquisition, analysts rarely consider implementation issues. Instead, they tend to justify acquisitions by adding up benefits they can easily observe. However easy it is to see multiple benefits in theory, successful implementation depends on creating proper organizational conditions and prioritizing objectives. When faced with managing diversity, all firms can structure themselves to achieve one benefit. Some can even handle two dimensions of diversity rather well. But, simultaneously pursuing different types of interdependence across different functions is an illusion. In practice value creation stems from focused and managed interdependence. Thus, the integration phase in an acquisition is the key to value creation because sustainable economic value is created after the transaction.

Companies Do Not Learn All They Could From Their Mistakes

Our final observation is that the experience factor in acquisitions cannot be underemphasized: companies can, in fact, learn general lessons from acquisition activities, especially along the points discussed earlier. They can also learn which company-specific factors impeded success. Based on their experiences, managers can and should draw some conclusions that will influence their firm's future acquisition activities.

However, even in the firms where acquisitions are no longer unfamiliar events, senior managers are not able to capitalize on the valuable and often expensive experience present in their firms. Many firms do not include in the analytical process operating executives who will manage post merger
integration. They thereby forego the best way to provide continuity in a
given acquisition and to thereby consider implementation early in the
process. In the firm's next acquisition, for instance, few managers with
previous hands-on experience are likely to be on the team. Thus, it is not
surprising that the same mistakes are made repeatedly.

Although many firms have put together in-house acquisition teams, these
teams serve more to provide technical, legal, financial, and negotiating
support than to accumulate broad-based acquisition experiences. Few
companies, even those that have acquisition teams, have conducted extensive
post mortems to probe into "what happened" and "why it happened." Instead,
each divisional manager is left to re-invent the wheel at his or her own
risk.

Conclusion

The current debate on acquisitions is encumbered by a number of myths,
several of which have been discussed here. Out of these myths, two extreme
views seem to be emerging. One suggests that acquisitions are a ready-made
solution to managers' problems. The other suggests that shareholders of
acquiring firms never benefit from acquisitions. Neither view is accurate,
and collectively they have the potential to impede a management's attempts
to provide realistic corporate renewal opportunities for its firm.

The first misguided view is that an acquisition by itself can offer
immediate and sweeping solutions to a firm's problems of strategic
redirection and renewal. The argument goes something like this, "Why should
we spend time on internal development activities when both profits and
growth can be more easily and speedily bought outside?" In contrast to this philosophy, we have presented a series of observations that focus on the efforts needed to make an acquisition achieve its strategic purpose and on the difficulties managers often encounter when doing so. These difficulties, which are deeply embedded in the process of analyzing, negotiating, and integrating the acquisition, can be overcome if the specific circumstances of both the parent and target firms are taken into consideration during the acquisition process.

To address these problems, each firm must first consider a series of delicate tradeoffs in its acquisition activities. Commitment and detachment must be balanced before the agreement is reached. In the same vein, the tradeoff between involvement and autonomy after the acquisition must be addressed. Finally, managers, throughout the process, should guard against tendencies toward excessive opportunism and determinism in the final purpose.

The other viewpoint is that acquisitions are essentially driven by managerial motives and never benefit the acquiring firm's shareholders. This view has been fueled by the spectacle of some major hostile takeovers. It appears to have been reinforced by the studies of financial economists, who, observing the immediate impact of an acquisition event on a firm's stock's price, conclude that there is little or no positive impact on the acquiring firm's shareholders.

We should keep in mind that the methodology in these studies relies on large samples and their arguments are made about averages which cover a wide range of outcomes rather than any particular firm's acquisition strategy. More importantly, these outcomes represent the security market's a priori expectations within a narrow time span around the time the acquisition is
announced. As such, they focus on whether the perceived value captured exceeds the price premium paid. We have argued that the real payoff comes from the value creation process which often takes several years to unfold.

Acquisitions often present unique corporate development opportunities, the scope of time frame of which can neither be entirely predicted beforehand nor replicated through internal development alone. This means that for a company to get the most out of an acquisition, managers need to adopt a process view for acquisition decisions and a development view for acquisition integration.

Our observations should not be used as arguments to forego acquisition opportunities. Acquisitions will continue to be an important form of corporate development and strategic renewal. The pressures and opportunities presented by industry restructuring and environmental change point to the need for combining and diversifying firms. Rather, in light of perils and costs associated with acquisitions, we urge managers to systematically examine their own corporate myths about acquisitions and to give more thought to how they manage the acquisition process itself.
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(1) We are grateful to Mal Salter for offering us insights into this distinction during several conversations on the topic.

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