A LIGHTWEIGHT NOTE ON SUCCESS IN MERGERS AND ACQUISITIONS

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Merger and acquisition activity is picking up. The first quarter saw the highest level of global M&A activity since 2000.[1] It may therefore be interesting to review what we have learnt about the science of M&A lately. Perhaps surprisingly, there is growing evidence that making acquisitions is one of the best and safest ways to sustain shareholder value.

Yet should we not have learnt that M&A usually does not make sense? That most acquisitions destroy value? That deal making is prompted by CEO vanity and not by economic reality? Not necessarily. Contrary to popular opinion, the vast majority of M&A deals succeed and add value to shareholders and society.[2]

Conventional wisdom holds that much less than half of all mergers succeed.[3] The facts tell a different story. This story is well known in academic circles, but is at best only anecdotally known among business executives. This review summarizes the most important research findings and explains why executives pursue acquisitions. It is not because of folly, but rather because it is in the interest of their shareholders.

<u>The first lesson</u> learnt is that mergers and acquisitions pay off. That is, the shareholders of the new entity earn their required return or more. Nine studies conducted since 1990 (averaging 190 deals each) report an average return of 5% above the shareholders' opportunity cost.[4]

The mistake we frequently make is to expect extraordinarily high returns. 20–30% of deals show such returns.[5] Maybe this explains the common belief that few deals succeed. But as Professor Bruner at the Darden Graduate School of Business points out: "One should conclude that M&A does pay…The reality is that 60–70% of all M&A transactions are associated with financial performance that at least compensates investors for their opportunity cost."[6]

Within this context, it is not surprising that the shareholders of target companies have high returns. Acquisition premiums are around 20–40%,[7] which is the reward to shareholders for giving up control of their company. The average return reported in 13 studies since 1990 (averaging 324 deals each) was 26%.[8]

Shareholders of the acquiring company break even. That is, they earn their cost of capital. 22 studies conducted since 1990 (averaging 505 deals each) report an average return of 0.5%.[9] Bear in mind though that the bidder usually is larger than the target, so the 0.5% return underreports the actual return (around 2–3%).[10] Interestingly, other classes of investments such as R&D, marketing, and capital expenditures have similar returns above the cost of capital: around 1%.[11]

The table below averages the results from the various studies. We should recognize that the numbers disguise significant variability. For example, deals during the 1998–2001 bubble did less well.

AVERAGE M&A RETURNS

	Return above opportunity cost	Probability of positive return
Combined	5%	68%
Target	26%	86%
Bidder	0.5%	51%

<u>The second lesson</u> learnt is that certain types of deals are more successful than others. An important finding is that "value companies" are more successful than "glamour companies" in M&A. A value company is a company with a moderate or low market-to-book ratio; a glamour company is a company with a high relative valuation where executives are lauded by the business press and analysts. Typically, value acquirers show returns of +3% while glamour acquirers show returns of –6%.[12]

Related to the value and glamour distinction, cash tender offers outperform deals where the acquirer pays with stock. On average, this effect leads to a 4% difference in return.[13] In fact,

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when a glamour company makes an all-stock acquisition, the market views this as a signal that the acquirer is overvalued. Thus, a glamour stock-deal has a high probability of failing and the glamour acquirer on average loses 17% of its value over a three-year period.[14]

Further, related acquisitions are more successful than diversifying deals. The days of conglomerates and diversification as a strategy are long gone, and focusing on the core business is the hallmark of most companies. This is understandable because unrelated acquisitions show negative returns of 14% on average.[15] We also know that geographic expansion is less attractive than product expansion, reducing the shareholder return by 2–3%.[16]

Finally, small acquirers do better than large acquirers. While the shareholders of large acquirers show slightly negative returns, small acquirers show positive returns of 2–3%.[17] This is in part because small acquirers tend to buy private companies or divisions of public companies, while large acquirers often buy public companies;[18] in part because large acquirers tend to overestimate synergies.[19]

The third lesson is that preparation and discipline matter. Pre-deal, it is critical to pinpoint the strategic logic of the deal and the synergies that will be extracted. The market tends to favor hard synergies such as cost cutting more than soft synergies such as cross-selling opportunities.[20] This is rational because, on average, close to 90% of declared cost synergies are realized, but only 60% of declared revenue synergies.[21]

During deal execution, maintaining bid discipline is critical. Many failed acquisitions are the results of unrealistically high bids. However, this does not imply that bids should be accretive. The accretion/dilution distinction is a false issue and it has little or no impact on the market's reaction, while price-versus-value fundamentals do.[22] Further, the use of bulge-bracket investment banks tends to increase the likelihood of closing a deal, but reduces the return to shareholders.[23]

Post-deal, two success factors stand out.[24] First, successful acquirers tend to integrate the targets' operations quickly. An acquirer that lets the target maintain independence is less likely to be successful. Second, it is critical to retain the target's executives. Too often, the executives flee the new company as soon as their incentive programs allow it. If this happens, we can predict that the acquisition will not pay off.

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In sum, M&A often pays off and we have made major strides in turning successful deal making from an art to a science. Indeed, a KPMG survey shows that more than 80% of executives are satisfied with their M&A activities.[25] This does not mean that M&A is easy and, as always, the detail's in the pudding. But we do see the contours of what makes a deal succeed. It is now possible to calculate the value-creation starting point for any prospective deal based on the deal's characteristics. This is in sharp contrast to knowledge only a decade ago.

[1] Thomson Financial, p. 1
[2] Lu, p. 32
[3] e.g., Grubb and Lamb, pp. 9-14
[4] Bruner, p. 21
[5] Andrade et al., p. 27; Bruner, p. 5
[6] Bruner, p. 14
[7] Andrade et al., p. 27; Christofferson et al., p. 1
[8] Bruner, p. 17
[9] Bruner, pp. 18-20
[10] Moeller et al., p. 30; Bruner, p. 6
[11] Andrade et al., p. 20
[12] Lu, p. 11; Rau and Vermaelen, p. 1
[13] Andrade et al., p. 11
[14] Rau and Vermaelen, p. 1
[15] Bruner, p. 9
[16] Canback, pp. 169-176
[17] Moeller et al., p. 29
[18] Moeller et al., pp. 30, 32
[19] Moeller et al., pp. 4, 23-24
[20] Bruner, p. 9
[21] Christofferson et al., pp. 2-3
[22] Andrade, pp. 5-6
[23] Rau and Rodgers, p. 5
[24] Zollo and Leshchinskii, pp. 23, 31
[25] Kelly et al., p. 2

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