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What you need to know before undertaking a takeover or merger

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Overview

The pursuit of growth through takeover or merger has made a small, select group very wealthy while diminishing the wealth of a vast number of shareholders. CFOs and controllers have a moral dilemma here, and only they can decide what is appropriate. In many cases, the forces are huge to transact the takeover. This expert article explores why so many takeovers and mergers, which have been based on perceived synergies and cost savings, fail, and if involved in one, why you need to move on before reality strikes.

It is often quoted, but even great leaders seem to forget that "history has a habit of repeating itself." Company executives, directors, and major institutional investors (whose support is often a prerequisite) need to learn the lessons and think more carefully before they commit to a takeover or merger (TOM).

Reasons for A Takeover Or Merger

To understand the forces at play, you need to look at the various reasons for a takeover or merger (TOM):

- Purchasing future profits from either a related or diversified sector. Here the new subsidiary is left to grow in their way. This method is characterised by successful investment companies like Berkshire Hathaway.
- Purchasing to gain synergy. Here, the argument is 1 + 1 = 3. These are the mergers/ takeovers typically targeted by investment banks and have a history of failure.
- Purchasing for increased market share. Driven by aggressive executives, the cost frequently outweighs the benefits. These also have a history of failure.
- Purchasing to gain access to new channels / new products. The Kraft Cadbury takeover was undertaken so Kraft could access rapidly developing economies such as India, Brazil, and Mexico where Cadbury was well entrenched.
- Purchasing as a defensive move. Used to prevent another aggressive competitor from gaining market share from a company that has become a soft takeover target. These TOMs are often characterised with a duplication of assets that is both costly and time-consuming to rationalise.
- Preventing the newly acquired company from providing services to competitors. Volkswagen purchased the car designer Italdesign Giugiaro.
- Asset swaps. GSK-Novartis deal where each party swapped some operations.

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Some Big Failures

The landscape of mergers and acquisitions is littered with business flops, some catastrophic, highly visible disasters that were often hugely hyped before their eventual doom.

AOL and Time Warner

The media giants American Online (AOL) and Time Warner combined their businesses in what is usually described as the worst merger of all time. In 2001, Time Warner consolidated with AOL, the Internet and email provider, in a deal worth a staggering $110 billion. The merger was seen as a revolutionary partnership between a content owner and a company active in the brave new online world.

AOL and Time Warner parted company in December 2009, after almost nine years of nightmares. In less than a decade, the tie-up had destroyed close to $200 billion of shareholder wealth.

Vodafone/Mannesmann

Vodafone's takeover of German rival Mannesmann is difficult to beat for sheer shareholder value destruction. In February 2000, at the height of millennial dotcom madness, the agreed merger of Vodafone AirTouch and Mannesmann created a telecoms giant. The $160 billion all-share deal to acquire Mannesmann turned the merged group into the world's fourth-largest company, worth $330 billion.

In 2006, Vodafone plunged to massive losses after one-off costs of more than $35 billion connected to the Mannesmann deal.

Glaxo Wellcome/SmithKline Beecham

In December 2000, two of the United Kingdom's largest pharmaceutical companies, GlaxoWellcome and SmithKline Beecham, came together to form global giant GlaxoSmithKline. At that time, GSK's share price was close to $30, valuing the firm at close to $160 billion and putting it in the top three of the FTSE 100.

Fast-forward 15 years, and GSK's share price is around $20, or about a third lower than at the time of the merger, destroying roughly $40 billion of shareholder wealth.

The Driving Forces Behind TOMs

I met an investment banker on a flight who told me about the takeover and merger game that large investment bankers around the world are playing. It never made any sense to me because only one in six mergers breaks even, and many have lost billions off the balance sheet.

The game is called *transactional fees* and involves the study, by the investment bankers, in minute detail of the motivational factors of the key players. They end up knowing more about the private lives of the CFO,

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CEO, board members, and fund managers than they would like their partner to know. Investment bankers go to the CEO and CFO with a proposed merger and acquisition deal, and they often fail. The CFOs and CEOs know that these deals seldom work.

The investment bankers then go to the influential board members, and the CFO and CEO have to fight it out in the boardroom, which they typically will win. The investment bankers, who have now spent hundreds of thousands of dollars in research, are not finished. They go to the fund managers, who are the major shareholders, and say, "The board has lost the plot; they do not recognise the value in this deal!" The fund managers put pressure on the board, whose members, in turn, say to the CEO and CFO, "If we do not do this deal, the fund managers will change the board structure—but before that, we will see that you go first." The CEO says, "What the hell? We will do it." Here is the interesting part. The CEO is offered a big sum to go quietly, and this, along with the investment bankers' fees that are now amortised through poorly thought-out accounting principles, slowly kills the combined company for years to come.

How Takeovers or Mergers Go Wrong

There are many reasons why TOMs go wrong. Set out below are some of the common ones.

Synergy Calculations Are Totally Flawed

My interest in the failure rate of TOMs dates back to the *Economist*[i] series on six major takeovers or mergers (TOMs). In the articles, the writers commented that over half of TOMs had destroyed shareholder value, and a further third had made no discernible difference.

KPMG undertook a cutting-edge study[ii] into TOMs and is a must read for CFOs and controllers involved in a TOM. The study found:

"Only 17% of deals had added value to the combined company, 30% produced no discernible difference, and as many as 53% actually destroyed value. In other words, 83% of mergers were unsuccessful in producing any business benefit as regards shareholder value."

TOM advisers and hungry executives are as accurate with potential cost savings estimates as they are with assessing the cost of their own home renovations (in other words, pretty hopeless). Press clippings are easily gathered with CEOs stating that the anticipated savings have taken longer to eventuate. The reason: It can take up to four years to merge the information technology platforms together, and even when this is achieved, many of the future efficiency and effectiveness initiatives have been put on the back burner.