M&A Research Insights: "Deals from Hell" and Other Surprises

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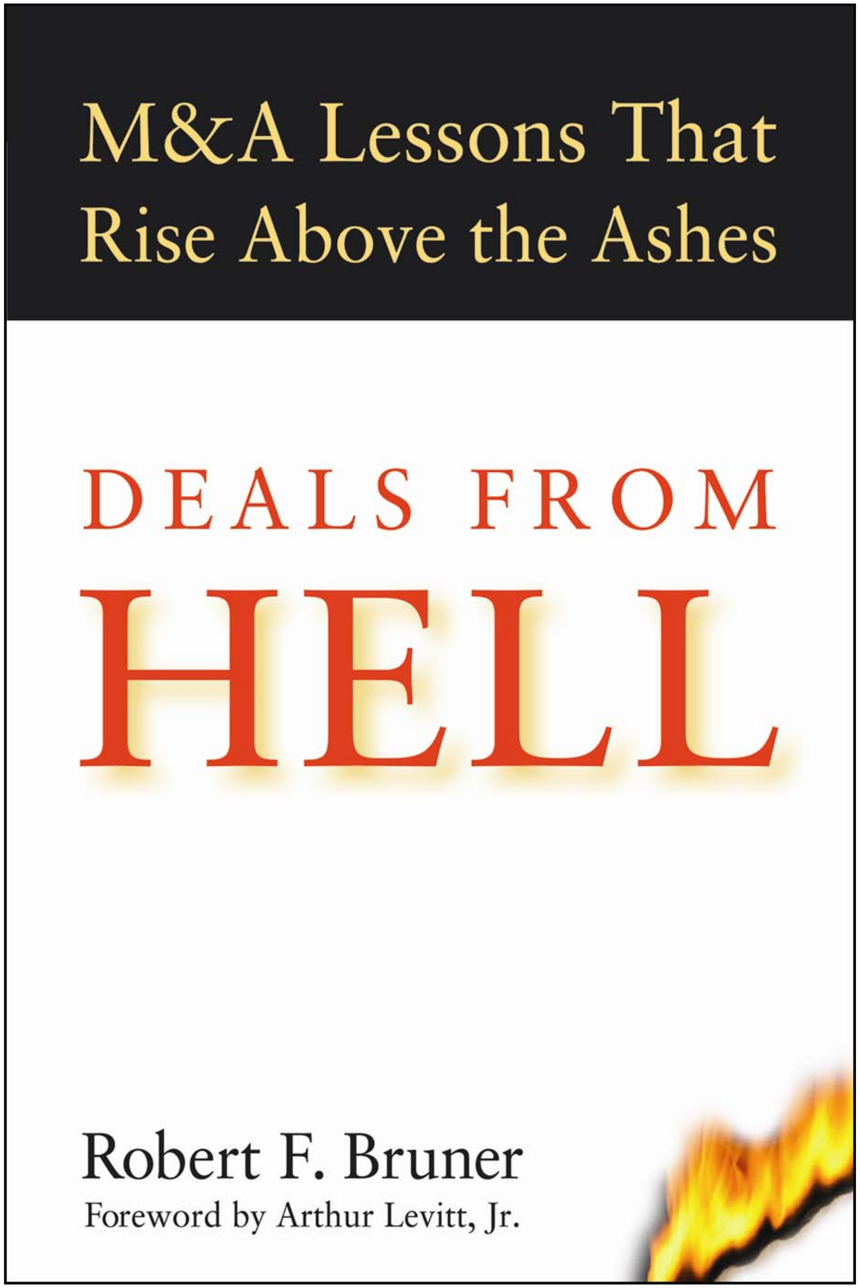
Robert F. Bruner
Dean and Charles C. Abbott Professor of Business Administration
Darden Graduate School of Business Administration, University of Virginia


M&A Lessons That
Rise Above the Ashes
DEALS FROM
HELL
Robert F. Bruner
Foreword by Arthur Levitt, Jr.

The present context

1. New synthesis for understanding managerial action: rationalism, behavioralism, and complexity theory.
2. Deep skepticism about M&A in popular circles.
3. M&A conditions:
   - M&A volume was up ~20% in 2005.
   - Regional consolidations: Europe, Asia, Latin America
   - Protectionist sentiment.
   - Liberalization of entry into emerging markets.
   - Changing rules of the game: hedge funds and private equity players.
   - Hostile and contested transactions.

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Public Policy Concerns about M&A

- Anti-trust/national champions.
- Efficiency of the national economy, the industry, and the company.
- Welfare allocation: who wins? Who loses?

For Example: How to Deal with Hostile Takeover Attempts?

- Most takeovers are not hostile.
  - About 1% of all bids are unsolicited.
  - About a third of unsolicited bids are hostile.
- Most hostile takeover attempts fail.
  - 45% of the time, target remains independent.
  - 30% of the time, a friendly firm buys the target.
  - 25% of the time, hostile bidder succeeds.

Example: Anti-takeover Defenses (Golden Share, Poison Pill, etc.)

- Anti-trust/industrial policy.
  - Golden share: instrument for state intervention.
  - Poison pill: might preserve current industry structure.
- Efficiency.
  - All defenses shelter firms from market forces and thus may reduce efficiency.
- Welfare: Who wins? Who loses?
  - All defenses are costly—mainly to public shareholders.
  - All defenses delegate some degree of control to management.
  - *But* if managers are truly investor-oriented, the benefits of granting management greater control may outweigh the costs.

Key: Are your managers value-creating for shareholders or do they just seek entrenchment for greater personal gain?

Some research questions

- Does M&A pay?
- What can we learn from the really bad deals? How can we avoid them?
- What are the implications for the practice of M&A?

Conventional wisdom about M&A

- *M&A is not comfortable.*
- *M&A is distrusted.*
- *M&A is wasteful.*
- *Big deals seem bad.*

"[T]he sobering reality is that only about 20 percent of all mergers really succeed. Most mergers typically erode shareholder wealth…the cold, hard reality that most mergers fail to achieve any real financial returns…very high rate of merger failure…rampant merger failure… "

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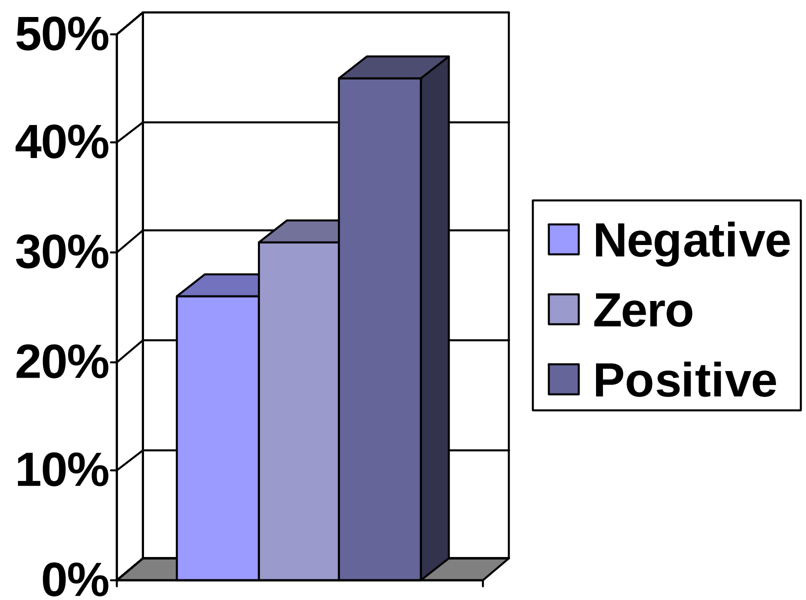
The mass of research paints a different picture

- Large-sample empirical research on M&A.
- Clinical research on M&A failures.
- Clinical research on disasters and organizational failure.
- Case studies.
- Government investigations.
- Bankruptcy examiners' reports.
- Memoirs and journalistic summaries.

Studies of large samples of deals

- Target shareholders gain.
- Buyer shareholders break even.
  - *M&A Pays.*
- But variance among studies bespeaks caution to buyers.
  - *Buyer beware.*
- Research finds "neighborhoods" of profit and loss in M&A.
  - *All M&A is local.*

Distribution of Studies,
Returns to Buyers' Shareholders



All M&A is Local:
Adjusted Returns to Buyers by "Neighborhood"

Returns to buyers likely will be higher if:

- Strategic motivation
- Value acquiring
- Focused/related acquiring
- Credible synergies
- To use excess cash *profitably*
- Negotiated purchases of private firms
- Cross borders for special advantage
- Go hostile
- Buy during cold M&A markets
- Pay with cash
- High tax benefits to buyer
- Finance with debt judiciously
- Stage the payments (earnouts)
- Mergers of equals
- Managers have significant stake
- Shareholder-oriented management
- Active investors
- Big good deals

Returns to buyers likely will be lower if:

- Opportunistic motivation
- Momentum growth/glamour acquiring
- Lack of focus/unrelated acquiring
- Incredible synergies
- Just to use excess cash
- Auctions of public firms
- Cross borders naively
- Negotiate with resistant target
- Buy during hot M&A markets
- Pay with stock
- Low tax benefits to buyer
- Over-lever
- Pay fully up-front
- Not a merger of equals
- Managers have low or no stake
- Entrenched management
- Passive investors
- Big bad deals

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Differentiating the "Best" from the "Worst" Deals

The "Best."

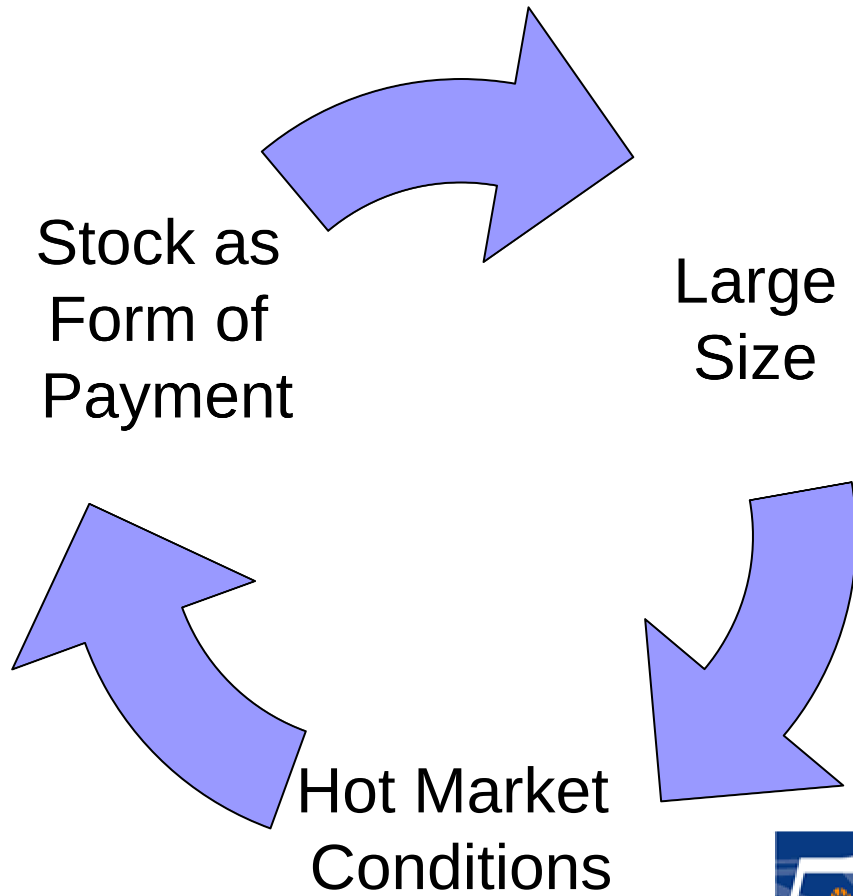
- More strategic relatedness.
- Cooler market conditions.
- Buyer is stronger.

The "Worst"

- Less strategic relatedness.
- Hot market conditions.
- Target is stronger.

Are big deals bad?

- Large size tends to coincide with
  - Stock as form of payment.
  - Hot market conditions.
- Tests find the interaction is significant:
  - Stock and hot markets account for negative return to bidders.
  - Size is an amplifier of these effects.
- Still, no study refutes the private benefits to CEOs from increased size.



Why care about “hot” markets?

- Propensity to over-pay.
- Negative returns to buyer shareholders over 1-3 years after.
- The workshop for big failures.

Attributes of a "hot" M&A market

- Sharp increase in M&A activity.
- Talk of a "paradigm shift."
- Entry by inexperienced, occasional, naive acquirers and investors.
- Higher prices, measured as a percentage premium offered by the buyer. Overvaluation.
- Jumbo deals that redefine the competitive landscape.
- Aggressive financing. Buyers are reaching far beyond their prudent resources to do deals.
- Prominent auctions stimulated by bidders straining to buy the same assets.
- Heavy use of risk management features such as collars, contingent value rights, options, termination fees, and wording of material adverse change clauses. Insiders are worried about something.
- Overoptimism. Buoyant language and synergy estimates that over-reach the benchmarks of best practice and peer deals.

Are we there yet?
No. Warm perhaps, but not hot.

What is a “deal from hell”?

- Wealth destruction.
- Financial instability.
- Impaired strategic position.
- Weakened organization.
- Damaged reputation.
- Violation of ethical norms and laws.

Ten case studies…

- Each chapter: focal case and comparison case.
- Sources:
  - Field interviews
  - Primary documents,
  - Public materials.
- Analysis of motives, actions, and outcomes.
- Synthesis of a framework.
- Implications for managers.

- 1968: Pennsylvania and New York Central Railroads.
- 1986: LBO of Revco Drug Stores.
- **1989: Sony's acquisition of Columbia Pictures.**
- 1991: AT&T's acquisition of NCR.
- **1993: Renault's proposed merger with Volvo.**
- 1994: Quaker Oats' acquisition of Snapple.
- 1999: Mattel's acquisition of The Learning Company.
- 2001: Merger of AOL and Time Warner.
- 2001: Dynegy's proposed merger with Enron.
- 2002: Acquisition program of Tyco International.

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Six factors appear in the "Deals from Hell"

1. **The businesses and/or deals are complicated, making it hard for executives to know what is going on.**

<u>Complexity based on factors such as:</u>

- Size and scope.
- Environment, industry.
- Product or process technology.
- Deal terms and processes.
- Contingencies.

Six factors appear in the “Deals from Hell”

2. Few firewalls or safety buffers. Trouble can spread rapidly. For example:

- Lack of financial or operational flexibility.
- Lack of time to remedy problems or seize opportunities.
- Stuck to a path of action with few alternatives.

Six factors appear in the "Deals from Hell"

3. Management advertently or inadvertently makes decisions that elevate risk. For example:

- Unexpected change of strategy or key people.
- Failure to gain buy-in of key people.
- Accelerated speed.
- Dismissal of due diligence.
- Failure to manage risks.

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Six factors appear in the "Deals from Hell"

4. Cognitive biases: overoptimism, deal frenzy, etc., such as:

- "We succeeded in the last deal. We can do it again."
- "We will carve a new future at the intersection of two industries."
- "We will bet the ranch."
- "We have momentum…"

Six factors appear in the “Deals from Hell”

5. Business is not as usual. Trouble breaks out, such as:

- Bad snow storm.
- Rising interest rates.
- Stock market crashes.
- Consumer tastes change.
- Technology changes.
- Competitors attack unexpectedly.

Six factors appear in the "Deals from Hell"

6. Operational team responds inappropriately, for example:

- Takes too long to react.
- Overreacts, creating other problems.
- Unethical behavior.
- Infighting; the team breaks down due to
  - Old operating rivalries.
  - Cultural differences or misunderstandings.

Implications for practice and policy

M&A failures result from a "perfect storm" of factors.

- Managers, directors, and shareholders need to be storm system spotters.
- No two perfect storms are alike. What matters is recognizing the broad drivers of failure rather than the minutiae of the storm systems.

Attack the *system* of failure. Convergence of the six factors, a "perfect storm." Attack the convergence: Characteristics of the **high reliability organization**:

- A preoccupation with failure. A reluctance to simplify.
- A continuous sensitivity to operations. Excellent monitoring.
- A commitment to resilience of response to problems of differing natures.
- A deference to expertise at the point of trouble.

Implications for practice and policy

Invest through M&A but cover the downside.

M&A *does* pay on average and over time. Intelligent acquiring will seek to limit the negative tail of the distribution of outcomes:

* good strategy: choose the right ‘hoods.

* good process management.

Coda: Where a Research University Can Make a Difference in Professional Life

- Critical examination of conventional wisdom.
- Rigorous assessment of the evidence.
- Synthesis across many studies.
- Induction of new ideas or practices.