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HERIOT-WATT UNIVERSITY

Mergers and Acquisitions

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Mergers and Acquisitions

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Preface

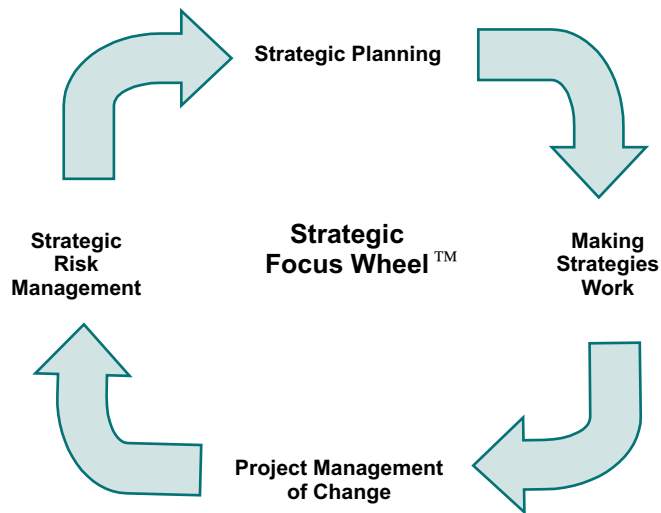
An understanding of mergers and acquisitions as a discipline is increasingly important in modern business. A glance at any business newspaper or business news web page will indicate that mergers and acquisitions are big business and are taking place all the time. Some sectors, such as finance, oil, pharmaceuticals, telecommunications, IT and chemicals, have been transformed since 1994 by the occurrence of very large-scale mergers and acquisitions. The sums of money involved in the really big mergers are truly astronomical. For example, the acquisition of the German company Mannesmann by the UK company Vodafone in 2000 was valued at \$183 billion. This deal created by far the largest company listed on the London Stock Exchange, and the fourth largest company in the world. The Vodafone–Mannesmann deal overshadowed other recent large-scale deals including AOL–Time – Warner (\$181 billion), MCWorld.com – Sprint (\$127 billion), Pfizer – Warner Lambert (\$88 billion) and Exxon–Mobil (\$86 billion). These are enormous sums of money by any standards.

Mergers and acquisitions also take place in relation to much smaller transactions. In an increasing number of countries mergers are now occurring between public sector organisations in areas such as universities and hospital trusts. The indications are that this high level of interest in mergers and acquisitions will continue and if anything increase. As technology continues to develop, and as deregulation and globalisation evolve, the old barriers to trade and national influence become less and less of an obstruction to international trade. In this context, mergers and acquisitions are likely to become an even more important consideration in strategic planning and strategy implementation in the future.

In an article in the *Harvard Business Review*, Joe Bower suggested that most mergers and acquisitions fail. He said that there is a great deal written about mergers and acquisitions, although these writings are largely opinions and are based on one-off cases from which general rules cannot be reliably determined.

In the Edinburgh Business School (EBS) approach, mergers and acquisitions as a discipline are closely related to the *Strategic Focus Wheel™* as developed by Professor Alex Roberts. Mergers and acquisitions represent a major source of organisational change. In relation to change, organisations that can identify the need for change, design the changes required and implement these changes more effectively and efficiently than others are more likely to survive and prosper. Those that cannot adapt to change are likely to perish. The *Strategic Focus Wheel™* was developed by Professor Alex Roberts to address these issues.

The *Strategic Focus Wheel™* covers four interrelated areas as shown below. These four areas form the basis for separate Edinburgh Business School distance learning texts and for the core of the EBS Doctor of Business Administration (DBA) in Strategic Focus programme.



The Strategic Focus Wheel™

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The wheel is used to focus the efforts and resources of organisations on delivering their intended strategic objectives, and has four core elements.

- **Strategic planning** revolves around identifying the options available to an organisation and selecting the most appropriate. If the strategic position selected is poor or inappropriate, even the best implementation capability is unlikely to compensate.
- **Making strategies work** is a process for connecting the high-level strategic plan to the day-to-day activities that are critical to its delivery.
- **Project management of change** ensures completeness and control over the physical realisation of the chosen strategy. Project management provides a comprehensive set of tools and techniques that enable managers to plan and implement change effectively and increase the likelihood of achieving the various objectives of the change process.
- **Strategic risk management** concerns the identification, monitoring and management of the risk profile of the organisation. Strategic risk management covers four primary risk areas or levels. These are *strategic risk*, *change or project risk*, *operational risk* and *unforeseeable risk*.

The complete *Strategic Focus Wheel* offers a representation of some approaches and tool sets that can assist in achieving and maintaining strategic focus. The EBS text in *Mergers and Acquisitions* is one of a series of new advanced-level integrated texts that have been developed in conjunction with the *Strategic Focus Wheel*. In implementing a major merger or acquisition the wheel functions can be used to plan the merger or acquisition and then make the transition work. The immediate and likely long-term performance of the transition can be monitored using strategic risk management tools and techniques. Where specific risks are identified and classified, project management can be used as a correctional tool for reducing the risk to a level where the residual element poses little threat to successful implementation.

The terms ‘merger’ and ‘acquisition’ are used interchangeably throughout the text. Setting the ownership issues to one side, the other characteristics, such as strategic logic, valuation, due diligence and implementation, remain similar.

The Multidisciplinary Approach

Mastery of mergers and acquisitions entails using skills from a wide range of management disciplines. It could be that many mergers and acquisitions fail because the managers leading them have an insufficient breadth of skills and/or experience. In mastering this text readers will have to call upon many disciplines encountered in the core MBA courses. In order to evaluate the strategic logic of a merger or acquisition, readers will need to think like a strategist. The basics of the Strategic Planning course are extended to encompass focus and characteristics mapping. Having evaluated the strategic logic, readers will then be challenged to put a value on the proposed merger or acquisition transaction and, therefore, will need to think like a financier, drawing on the knowledge acquired during the Finance course. Last, but by no means least, readers will be challenged to implement (make it work in practice) the proposed merger or acquisition, drawing on the knowledge acquired in the Project Management and Strategic Risk Management courses.

In *Mergers and Acquisitions*, readers are challenged to think in an integrated manner; like a strategist, financier and project manager, but all at the same time. Few functional managers, with the possible exception of a few CEOs and general managers, are called upon to apply such a wide range of disciplines simultaneously in an integrated manner. It is, however, our observation that many people who lead mergers and acquisitions in practice come from a single functional background. This may be part of the explanation for many of the failures in mergers and acquisitions, and for the recent rise of specialist merger and acquisition project management consultancies, particularly in the US.

As would be expected, there is some overlap between the Mergers and Acquisitions text and the basic MBA courses, particularly the courses in Strategic Planning and Finance. There is also some overlap with the courses in Project Management and Strategic Risk Management. Such overlaps are, however, considered in the specific context of mergers and acquisitions.

Gaining a Swift Overview

Readers have many different learning styles. Some readers prefer to study a stage at a time in depth. Others prefer to read through the text, develop an overview and then fill in the specific detail over a period of time. For readers who fall into the second category it is recommended that they first read the frequently asked questions and common misconceptions at the beginning of each module and the module summaries at the end of each module.

Note also that this text is concerned with risk management from a generic point of view. The text does not refer specifically to financial risk management as there are already two appropriate Edinburgh Business School distance learning texts: *Financial Risk Management 1* and *Financial Risk Management 2*.

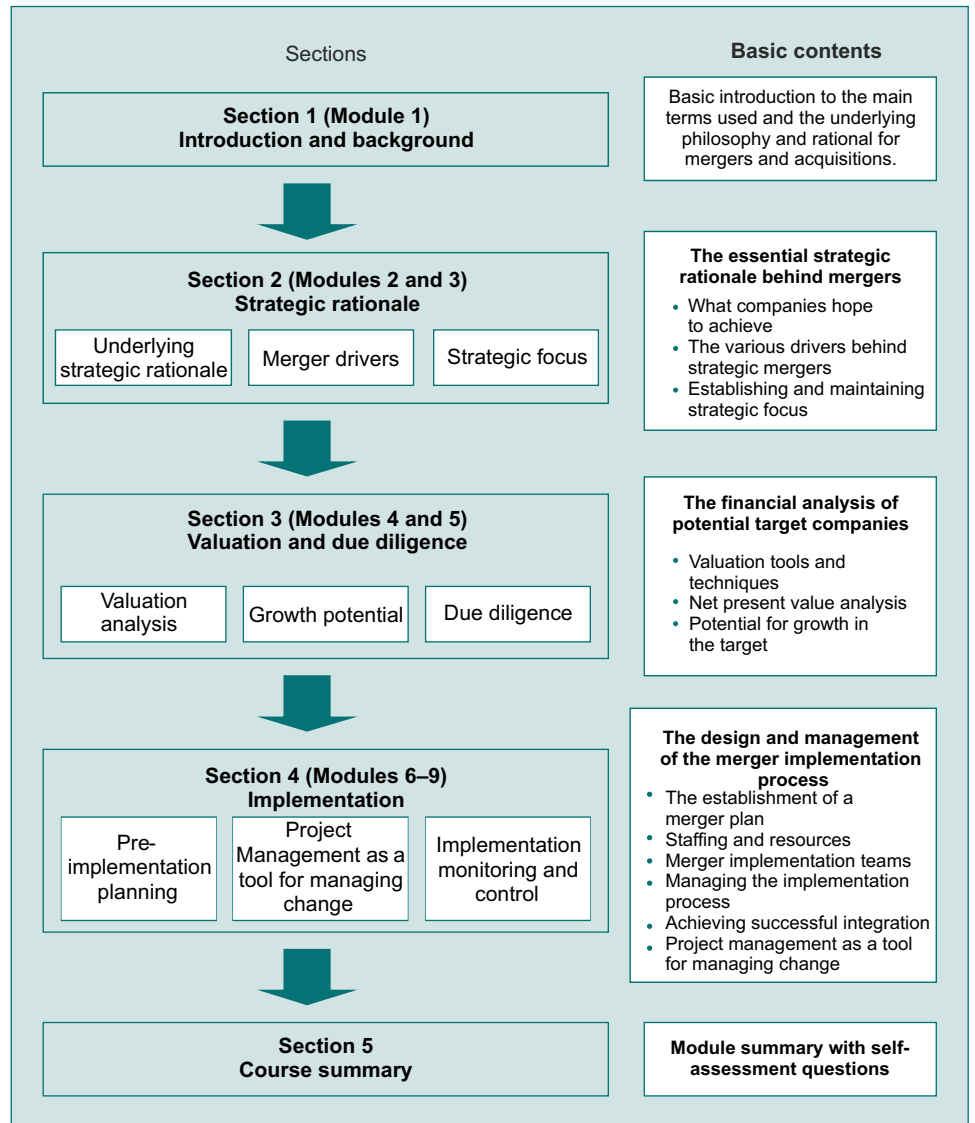
Mergers and Acquisitions is an integrated text. Most textbooks on mergers and acquisitions concentrate on one aspect of the process, such as the financial aspect. This text attempts to consider the whole process, from strategic rationale to implementation. In doing so, the text addresses a combination of strategic, financial and implementation issues. The financial issues are addressed by a financial specialist and adopt a slightly different format and structure to the rest of the course. Candidates may therefore detect structural and content differences between Modules 4 (valuation), 5 (merger tactics) and 6 (due diligence) and the

other modules contained within the text. These differences are intentional, as the financial aspects of mergers and acquisitions necessarily take a different viewpoint from the strategic and implementation aspects.

Candidates may detect that the financial modules (Modules 4, 5 and 6) adopt a more quantitative approach and make use of a smaller number of more detailed end-of-module multi-choice and self-assessment questions. This is because the questions used in these modules address a more narrowly focused and defined area than the strategic rationale and implementation areas. Strategists and project managers (implementers) have to be able to think in terms of a wider range of variables and drivers than financial specialists. Modules 1 through 3 and 7 to 10, therefore, address a wider range of less detailed end-of-module multi-choice and self-assessment questions.

Introduction

As with most EBS advanced integrated texts, *Mergers and Acquisitions* is split into a series of individual modules, structured around five areas whose content and delivery sequence are detailed in the following figure.



The five primary sections of the EBS Mergers and Acquisitions course

Module 1 introduces the primary terms and expressions that are used in the text. It goes on to differentiate between mergers and acquisitions and considers the underlying rationales and drivers. It also considers the concept of integration as a merger goal.

The text is then divided into three sections that reflect the primary components of the course. The three sections are listed below.

- **Strategic rationale**

Modules 2 and 3 are the first of the three main sections of the course. They set out the strategic rationale behind mergers, how mergers can disrupt strategic focus, and how that focus can be maintained throughout the change process.

- **Valuation, merger strategy and due diligence**

Modules 4 to 6 consider the basic tools and approaches available for valuing a potential target company, particularly in relation to its potential for future growth. These modules look in detail at the valuation process, the considerations inherent in the development of a merger strategy and the process to be adopted in conducting a due diligence survey and analysis.

- **Implementation and integration**

Modules 7 to 10 consider the implementation process particularly in the context of using project management as a tool for managing change (see the strategic focus wheel discussion in the preface). Mergers and acquisitions impose a considerable degree of change on an organisation and it is imperative that properly designed procedures and processes are designed and applied. These modules consider the processes involved in the preparation of an implementation plan and in executing and managing this plan through to completion.

Philosophy

This text seeks to establish a process model for mergers and acquisitions. Most people know what a model is or at least are familiar with the concept of modelling.

One definition of a model is:

‘a description, comparison or analogy used to describe that which cannot be seen’.

One definition of a process is:

‘a series of actions or operations in order to achieve a defined objective’.

It is therefore reasonable to suggest that a process model of mergers and acquisitions process is a description or analogy of the action and operations involved in achieving a mergers and acquisitions system. The idea of a process model is to represent the stages and phases involved in a task. A user should be able to look at the process model and be able to use it as a kind of map or guide to assist him or her in developing the outcome of the model. Process models are useful because they are general representations of what has to be done in order to achieve a specified outcome. They are usually generic and therefore also relevant in a range of applications. However, the general nature of the model may restrict the definition and applicability for individual companies and organisations. For specific application, the process model has to be tuned with the detailed company data and information necessary for an accurate and specific analysis.

The text is designed so that it develops an understanding of the processes involved in mergers and acquisitions. The process model ultimately developed will reflect these properties.

List of Abbreviations

ACT	advance corporation tax
ACWP	actual cost of works performed
AIM	Alternative Investment Market
AN	abnormal return
AOA	activity on arc
AOSC	administrative operations steering committee
APV	adjusted present value
ARR	analytical review risk
BAC	budget at completion
BCMT	business continuity management team
BCP	business continuity plan
BCPMT	business continuity plan management team
BCWP	budgeted cost of works performed
BCWS	budgeted cost of works scheduled
BOE	barrels of oil equivalent
BSC	balanced scorecard
BV	book value
CACS	cost account code system
CAPM	capital asset pricing model
CAR	cumulative abnormal return
CBA	critical business activity
CBAM	critical business activity measure
CBS	cost breakdown structure
CCS	change control system
CCS	constant capital structure
CDES	computerised database estimating system
CEP	chief executive officer
CMS	configuration management system
CPM	critical path method
CR	control risk
CSF	critical success factor
CV	cost variance
DBA	Doctor of Business Administration
DCF	discounted cash flow
DDR	due diligence risk
DIY	do-it-yourself
DMS	draft master schedule
DR	detection risk
DTI	Department of Trade and Industry

DVD	digital versatile disc
EAC	estimate at completion
EAIS	enterprise application integration system
EBIT	earnings before interest and tax paid
EBITDA	earnings before interest, tax, depreciation and allowances
EBS	Edinburgh Business School
ECC	European Competition Commission
ECTC	estimated cost to complete
EPS	earnings per share
ESOP	employee stock ownership plan
ETTC	estimated time to completion
EU	European Union
EV	expected value
EVA	earned value analysis
FARM	functional area recovery management
FCF	free cash flow
HR	human resources
IES	intelligent electronic systems
IMS	information management system
IR	inherent risk
IRG	implementation review group
IRR	internal rate of return
IT	information technology
KEI	key environmental indicator
KPI	key performance indicator
LPE	London Petroleum Exchange
LSE	London Stock Exchange
M&A	mergers and acquisitions
MACRS	modified accelerated cost recovery system
ME	monetary error
MIPM	merger implementation project manager
MIS	merger integration survey
MIT	merger integration team
MMC	Monopolies and Mergers Commission
MPT	merger project team
MTF	Merger Task Force
MTT	merger transition team
NAM	net advantage of merging
NCF	net cash flow
NOPAT	net operating profit after tax
NPV	net present value
NWC	net working capital
OBS	organisational breakdown structure

OCE	organisational cultural evaluation
OEM	original equipment manufacturer
OER	organisational effectiveness register
OFFER	Office of Electricity Regulation
OFT	Office of Fair Trading
OPEC	Organisation of Petroleum Exporting Countries
PAPRS	performance assurance plan and review system
PC	personal computer
PCCS	project cost control system
PERT	programme evaluation and review technique
PLE	project logic evaluation
PMS	project master schedule
PPB	party political broadcast
PPU	price per unit
PVAR	project variance analysis reporting
R&D	research and development
RC	replacement cost
REC	regional electricity company
ROV	real option valuation
SBU	strategic business unit
SCC	strategic change campaign
SFRT	specialised functional response team
SGA	sales, general and administration
SIT	specialist integration team
SOW	statement of work
SPP	strategic project plan
SR	sample risk
SV	schedule variance
SWOT	strengths, weaknesses, opportunities and threats
TQM	total quality management
TRM	task responsibility matrix
VCA	value created by acquisition
VO	variation order
VOR	variation order request
WACC	weighted-average cost of capital
WAP	wireless application protocol
WBS	work breakdown structure

Introduction

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Learning Objectives

By the time you have completed this module you should understand:

- what a merger is and how it differs from an acquisition;
- some of the reasons why companies merge;
- the underlying merger rationales;
- what a merger driver is;
- what the primary merger drivers are;
- the difference between horizontal integration, vertical integration and conglomeration;
- the basic merger lifecycle and lifecycle phases;
- some basic measures of success for mergers;
- the difference between long-term and short-term measures of success;
- the basic scenarios for failure;
- the concept of merger waves and the major waves that have occurred since 1900.

This module acts as an introduction to the EBS text in *Mergers and Acquisitions*.

Note that most of the areas discussed in this module are developed in more detail in subsequent modules. This module provides an introduction and overview to some of the main issues and considerations relating to mergers and acquisitions.

I.1 The Concept of Mergers and Acquisitions

I.1.1 Introduction

This section introduces the concept of mergers and acquisitions. The section assumes no prior knowledge of the subject.

It should be appreciated at the outset that mergers and acquisitions are affected by a number of influences that are very much specific to the individual country where they take place. Typical regional factors with a direct impact on mergers and acquisitions include:

- company law;
- employment law;
- community law;
- regulations and regulatory powers;
- community codes of practice and standards;
- custom and embedded practices;
- protectionism.

For example, in most European countries and the US there are government controls on mergers and acquisitions where the combination of two or more companies can have an impact on the overall level of competition within a particular market. This applies particularly where the merger or acquisition would give the new company the ability to alter or fix prices in a particular sector. In the UK the Competition Commission considers proposed mergers between large companies in the same sector to determine whether there is any possibility of such price control being an outcome. Several large proposed mergers have been blocked on these grounds in the UK over the past few years.

Employment law can be a major consideration in some EU countries. There are significant differences in the level of employee rights in the various member states. Germany, for example, has much more stringent employment law than the UK. A UK company wishing to merge with a German company may find itself dealing with powerful, legally protected employee 'commissions' or representative groups. In some cases such groups can influence government bodies and can make the difference between the proposed merger being accepted or being blocked.

In considering mergers and acquisitions it is not possible to allow for the multitude of different restrictions and laws that apply in the numerous different countries where such actions take place. This text attempts to develop a generic overview of mergers and acquisitions. The main areas and sections covered are intended to provide a general overview of what is involved and how the process works. The individual regulatory and legal details are generally omitted.

I.1.2 Mergers and Acquisitions

A **merger** or an **acquisition** in a company sense can be defined as the combination of two or more companies into one new company or corporation.

The main difference between a merger and an acquisition lies in the way in which the combination of the two companies is brought about.

In a merger there is usually a process of negotiation involved between the two companies prior to the combination taking place. For example, assume that Companies A and B are existing financial institutions. Company A is a high street bank with a large commercial customer base. Company B is a building society or similar organisation specialising in providing home loans for the domestic market. Both companies may consider that a merger would produce benefits as it would make the commercial and domestic customer bases available to the combined company. There will obviously be some complications and difficulties involved but there are also some obvious potential **synergies** available. For example, company B might be able to use its home loans experience to offer better deals to potential and existing mortgage customers of company A. The two companies may decide to initiate merger negotiations. If these are favourable, the outcome would be a merger of the two companies to form a new larger whole.

In an acquisition the negotiation process does not necessarily take place. In an acquisition company A buys company B. Company B becomes wholly owned by company A. Company B might be totally absorbed and cease to exist as a separate entity, or company A might retain company B in its pre-acquired form. This limited absorption is often practised where it is the intention of company A to sell off company B at a profit at some later date. In acquisitions the dominant company is usually referred to as the **acquirer** and the lesser company is known as the **acquired**. The lesser company is often referred to as the **target** up to the point where it becomes acquired.

In most cases the acquirer acquires the target by buying its **shares**. The acquirer buys shares from the target's shareholders up to a point where it becomes the owner. Achieving ownership may require purchase of all of the target shares or a **majority** of them. Different countries have different laws and regulations on what defines target ownership.

Acquisitions can be **friendly** or **hostile**. In the case of a friendly acquisition the target is willing to be acquired. The target may view the acquisition as an opportunity to develop into new areas and use the resources offered by the acquirer. This happens particularly in the case of small successful companies that wish to develop and expand but are held back by a lack of capital. The smaller company may actively seek out a larger partner willing to provide the necessary investment. In this scenario the acquisition is sometimes referred to as a **friendly** or **agreed** acquisition. Alternatively, the acquisition may be **hostile**. In this case the target is opposed to the acquisition. Hostile acquisitions are sometimes referred to as **hostile takeovers**.

One tactic for avoiding a hostile takeover is for the target to seek another company with which it would rather merge or be acquired by. This third company, if it agrees, is sometimes referred to as a **white knight**, as it 'comes to the rescue' of the threatened target.

In hostile takeovers the acquirer may attempt to buy large amounts of the target's shares on the open market. The problem with this action is that the target's share price will tend to increase in value as soon as any large-scale purchases are detected. In order to minimise share price rises, the acquirer may attempt to buy as much stock as possible in the shortest possible time, preferably as soon as the markets open. This practice is sometimes referred to as a **dawn raid**, as it attempts to take the market (insofar as is possible) 'by surprise'.

In both friendly and hostile takeovers the decision on whether or not to sell shares in the target lies with the shareholders. If all or a large proportion of target shareholders agree to sell their shares, ownership will be transferred to the acquirer. Shareholders generally will agree to a merger if they are recommended to do so by the board of directors and if they

stand to make a profit on the deal. The acquirer may offer either cash or its own shares in exchange for target shares. Cash transactions offer shareholders an immediate potential profit, whereas shares offer a longer-term investment. Share transactions tend to be more attractive to shareholders in a buoyant market as the value of the shares is likely to increase more rapidly than in a stagnant market.

1.2 Why Companies Merge and Acquire

1.2.1 Introduction

There are numerous reasons why one company chooses to merge with or acquire another. The literature suggests that the underlying motivation to merge is driven by a series of **rationales** and **drivers**.

Rationales consist of the higher-level reasoning that represents decision conditions under which a decision to merge could be made. Drivers are mid-level specific (often operational) influences that contribute towards the justification or otherwise for a merger. As an example, company A might decide to acquire company B. The underlying **rationale** could be that of **strategy implementation**. In order to achieve one or more strategic objectives it may be necessary for company A to acquire company B because, at present, there is over-capacity in the sector in which company A and company B operate. This is an example of a **strategic rationale**. The underlying **driver** for acquiring company B is the desire to control capacity in that sector.

An understanding of the various rationales and drivers behind mergers and acquisitions is very important in developing command of this text.

1.2.2 Some Underlying Rationales

There are several primary rationales that determine the nature of a proposed merger or acquisition. These rationales are:

- **Strategic rationale.** The strategic rationale makes use of the merger or acquisition in achieving a set of strategic objectives. As discussed above, a merger to secure control of capacity in the chosen sector is an example. Mergers and acquisitions are usually not central in the achievement of strategic objectives, and there are usually other alternatives available. For example, company A might want to gain a foothold in a lucrative new expanding market but lacks any experience or expertise in the area. One way of overcoming this may be to acquire a company that already has a track record of success in the new market. The alternative might be to develop a research and development division in the new market products in an attempt to catch up and overtake the more established players. This alternative choice has obvious cost and time implications. In the past it has only really been achieved successfully where the company wishing to enter the new market already produces goods or has expertise in a related area. As an example, an established producer of electronic goods might elect to divert some of its own resources into developing a new related highly promising area such as digital telephones. A large scale example is the electronics giant Sony in taking the strategic decision to create a research and development facility in electronics games consoles in order to develop a viable competitive base in this area despite there being a relatively small number of very powerful and established competitors in the area.

The strategic rationale may also be fundamentally defensive. If there are several large mergers in a particular sector, a non-merged company may be pressured into merging with another non-merged company in order to maintain its competitive position. This strategic scenario tends to happen in sectors dominated by relatively large players. In the UK, all of the major high street banks were engaged in merger activity between 1995 and 2002. In the global oil production sector, all of the major oil producers were involved in merger activity in the same period. In some cases three or more major producers merged into **super-companies**. In both industries the merger wave was driven by a need to respond to the merger activities of competitors.

- **Speculative rationale.** The speculative rationale arises where the acquirer views the acquired company as a commodity. The acquired company may be a player in a new and developing field. The acquiring company might want to share in the potential profitability of this field without committing itself to a major strategic realignment. One way to achieve this is to buy established companies, develop them, and then sell them for a substantial profit at a later date. This approach is clearly high risk, even if the targets are analysed and selected very carefully. A major risk, particularly in the case of small and highly specialised targets, is that a significant proportion of the highly skilled people who work for the target may leave either before, during or immediately after the merger or acquisition. If this does happen the actual (rather than apparent) value of the target could diminish significantly within a very short time.

Another form of speculative rationale is where the acquirer purchases an organisation with the intention of splitting the acquired organisation into pieces and selling these, or major parts of them, for a price higher than the cost of acquisition.

The speculative rationale is also high risk in that it is very vulnerable to changes in the environment. Apparently attractive targets, purchased at inflated (premium) cost, may soon diminish significantly in value if market conditions change.

- **Management failure rationale.** Mergers or acquisitions can sometimes be forced on a company because of management failures. Strategies may be assembled with errors in alignment, or market conditions may change significantly during the implementation timescale. The result may be that the original strategy becomes misaligned. It is no longer appropriate in taking the company where it wants to go because the company now wants to go somewhere else. Such **strategy compromises** can arise from a number of sources including changing customer demand and the actions of competitors. In such cases, by the time the **strategy variance** has been detected, the company may be so far off the new desired **strategic track** that it is not possible to correct it other than by merging with or acquiring another company that will assist in correcting the variance.
- **Financial necessity rationale.** Mergers and acquisitions are sometimes required for reasons of financial necessity. A company could misalign its strategy and suddenly find that it is losing value because shareholders have lost confidence. In some cases the only way to address this problem is to merge with a more successful company or to acquire smaller more successful companies.
- **Political rationale.** The impact of political influences is becoming increasingly significant in mergers and acquisitions. In the UK between 1997 and 2002, the government instructed the merger of a number of large government departments in order to rationalise their operations and reduce operating costs. Government policy also encouraged some large public

sector organisations to consider and execute mergers. These policies resulted in the merger of several large health trusts (hospitals financed by central government but under their own management control). By 2002 several large universities were also considering merging as a result of changes in government funding policy. In Australia, some of the 'big four' banks embarked on an aggressive overseas acquisitions policy because legislation in Australia directly prevented them from merging with each other.

1.2.3 Merger Drivers

Some typical merger drivers are considered below.

- **A requirement for specialist skills and/or resources.** A company sometimes seeks to merge with or acquire another company because the company is keen to acquire a specific skill or resource owned by the other company. This type of merger or acquisition often occurs where a smaller company has developed high-value specific skills over a number of years and where it would take an acquiring company a long time and a great deal of investment to develop these same skills.
- **National and international stock markets.** Variations in share prices can act as powerful drivers for mergers and acquisitions. A stock market boom tends to make acquisition activity more attractive because it becomes easier to use the acquirer's shares as the basis for the transaction rather than cash. Alternatively a falling stock market can lead to potential targets being valued lower, and therefore they become more attractive for a cash purchase.
- **Globalisation drivers.** Increasing globalisation, facilitated to a considerable extent by the growth and development of IT, tends to encourage mergers as the geographical separation between individual companies becomes less of an obstacle to organisations working together as single entities, both within the same countries and across international boundaries. In the UK several large high street banks have been successfully acquired by a major Australian bank.
- **National and international consolidation.** This type of driver occurs where there are compatible companies available for merger or acquisition within the same general geographical area(s).
- **Diversification drivers.** A company may want to diversify into new areas or sectors as a means of balancing the risk profile of its portfolio. Diversification was a primary driver of many mergers and acquisitions in the 1960s, 1970s and 1980s. More recently there has been a discernible move away from diversification as a risk-management strategy. Numerous researchers and practitioners have argued that diversification and non-related acquisition does not in fact reduce the risk profile faced by an organisation. This argument is supported by the assertion that the more diversified an organisation is, the less it has developed the specific tools and techniques needed to address individual problems relating to any one of its range of business activities.
- **Industry and sector pressures.** In the 1990s, mergers became very commonplace in some sectors. Large-scale mergers were particularly popular in the oil exploration and production sector. In one notable case British Petroleum Amoco merged with Exxon Mobil on the same day that Total and Petrofina also merged.

- **Capacity reduction.** The total production in a given sector may exceed or be near to demand so that the value of the product is low. In some cases it may be desirable for a company to merge with or acquire a competitor in order to secure a greater degree of control over total sector output. If company A acquires company B, company A has achieved greater control over total sector production and also has the opportunity to maintain more of its own production facilities and employees within the new company at the expense of company B.
- **Vertical integration.** Integration is discussed in Section 1.3. A company may attempt to integrate vertically with (for example) a supplier of a key supply in order to reduce the risk profile associated with that supplier, and therefore ensure continuity of supply.
- **A drive for increased management effectiveness and efficiency.** A particular company may have a deficit in management expertise in one or more key areas. Such areas may be 'key' because they are central to a new growth area the company is seeking to develop, or because they relate to the achievement of new strategic objectives that have just been established.
- **A drive to acquire a new market or customer base.** A merger or acquisition can often provide a fast-track route to new and established markets. If a large high street bank merges with another bank, each bank acquires the customer base of the other bank. In some cases the acquired customer base may represent a market that was previously unavailable. For example one bank may have previously specialised in business customers and the other bank in domestic customers. The new arrangement provides a more balanced customer base.
- **A drive to buy into a growth sector or market.** Companies sometimes use mergers or acquisitions as a way to enter a desirable new market or sector, particularly if they expect that market or sector to expand in the future.

1.3 Integration and Conglomeration

1.3.1 Introduction

The various merger waves that have taken place since the 1890s (see section 7) have generated three basic types of merger. In the literature these are referred to as follows:

- vertical integration;
- horizontal integration;
- conglomeration.

Vertical integration is characterised by forward or backward integration along the **supply chain** (see Module 3). Horizontal integration is characterised by the practice of one company acquiring another company that is active in the same general areas or sectors. Conglomeration is characterised by the acquisition of unrelated companies that continue to produce in unrelated sectors. This section briefly introduces these three basic types of merger.

1.3.2 Vertical Integration

Mergers and acquisitions are often used in the pursuit of **vertical integration**. In its simplest form, vertical integration is the process of manufacturers merging with suppliers or retailers. Major production companies obtain supplies of goods and raw materials from a range of different suppliers. Vertical integration is basically an attempt to reduce the risk associated with suppliers. Note that vertical integration can run in both directions, as shown in Figure 1.1.

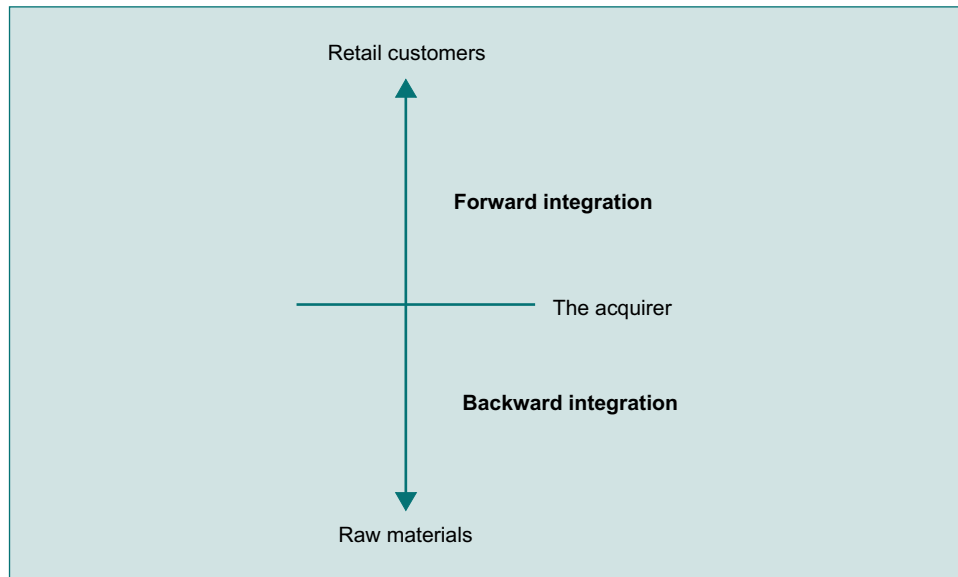


Figure 1.1 The concept of vertical integration

Forward integration refers to vertical integration that runs towards the customer base, whereas backward integration refers to vertical integration that runs towards the supplier base.

Vertical integration offers a number of obvious advantages. Some of these advantages are listed below.

- **Combined processes.** The production processes of most organisations carry fixed price overheads. Typical examples include human resources and IT support. Where integration allows these overhead functions to become combined, there is, theoretically, the prospect of increased support function efficiency.
- **Reduced risk and/or enhanced risk management.** Vertical integration allows some of the risk associated with suppliers to be removed. Obvious examples are sudden supply price increased and late and/or defective deliveries. In many ways, the control of supply products and raw materials passes to the acquirer.
- **Configuration management.** The concept of configuration management is covered in the EBS text *Project Management*. Configuration management is primarily concerned with the efficient and effective flow of information both within and outside an organisation. Information is generally much more easily and effectively controlled within an organisation and vertical integration, therefore, acts to enhance the configuration management system operated by a given organisation.

- **Quality management.** This is an increasingly important consideration for most organisations. A fully integrated production system provides the opportunities for an enterprise wide quality management system covering everything from raw materials, through production to sales. As with risk management, quality management is more easily executed where supplies, production and sales are contained in-house rather than externally.
- **Reduced negotiation.** As suppliers are acquired the necessity for complex and competitive negotiations decreases. The acquiring company is no longer required to negotiate the best deals with suppliers as the suppliers become part of the parent organisation. The obvious downside is that the acquired suppliers may lose their competitive edge as they now have a guaranteed market and no longer need to compete at the same level.
- **Proprietary and intellectual property protection.** This can be an important consideration in sectors that are characterised by rapid change and innovation. Organisations that operate under these circumstances have to give away a certain degree of their organisational knowledge when specifying exactly what they want suppliers to produce. In some cases, such specifications can be very revealing, and an uncontained supplier could release proprietary and intellectual property to a third party.
- **Individualisation.** Complete control of suppliers and customers can lead to a particular classification of trading known as brand. In order to achieve and maintain brand status, organisations have to achieve and maintain a close degree of control over all aspects of production and sales so that quality and image can be maintained. The evolution of a brand allows organisations to charge a premium rate for their products.

Vertical integration also implies some disadvantages. By acquiring suppliers the acquirer also eliminates the direct competition that existed previously in the supply market. This can be addressed to some extent by **partial vertical integration**, where selected key suppliers are integrated while remaining non-key suppliers remain outsourced and open to competitive pricing. There are also **brand** implications in vertical integration. Some companies have successfully integrated along all sections of the production and distribution process. In fast food, for example, a company might integrate all outlets and then award outlets operation to selected and approved subcontractors through a system of **controlled franchises**. This practice protects the brand from the point of manufacture through distribution and right up to the point of sale to the consumer.

Vertical integration is sometimes extended beyond suppliers to include customers as well. Examples of this are particularly pronounced in the interaction between the entertainment and fast food industries. It is common practice for manufacturers of fast foods and drinks to integrate with outlets such as cinemas and fast food restaurants so that only their particular brand of food or drink is offered for sale in that outlet. This practice, if successful, more or less guarantees a steady and dependable outlet for the food or drink product concerned.

1.3.3 Horizontal Integration

Mergers and acquisitions can also be used in order to achieve horizontal integration. Horizontal integration occurs where two companies engaged in essentially the same product or service merge to improve their combined value. As discussed above, horizontal integration has been widespread in the global oil production sector over the past few years. Another example is where automobile distribution companies buy other companies with distribution franchises for ranges of vehicles from other manufacturers.

1.3.4 Conglomeration

Conglomeration mergers occur where the merging companies continue to operate in different sectors and industries. Conglomeration can be a useful approach in spreading business risk across a range of different areas. As conglomerates grow and expand, however, they run the risk of becoming unfocused as their senior management team may be unfamiliar with the new products, services and markets that are introduced as unrelated companies are acquired. In effect, the risks increase rather than decrease.

1.4 The Merger and Acquisition Lifecycle

1.4.1 Introduction

Most mergers and acquisitions progress through a clearly identifiable **lifecycle**. In this context, the word 'lifecycle' is taken to refer to the *changes that take place during the life of an entity*. In this context the word 'entity' means *something that exists in its own right, and has its own existence*. A merger can be regarded as consisting of two or more entities progressing through a series of identifiable changes or lifecycle points until the merger is complete. More correctly, most mergers and acquisitions do not have a clearly defined completion point. Most organisations, however, do establish a point at which the merger or acquisition is regarded as being complete. After this point the process usually receives no separate resources or funding. Any longer-term costs are simply absorbed into the overall operational expenses of the organisation.

This section considers a simplified view of the lifecycle phases of a typical merger. The lifecycle phases involved in the implementation process are considered in more detail in Modules 7–10.

I.4.2 Typical Lifecycle Phases

A typical set of merger lifecycle phases is shown in Figure 1.2.

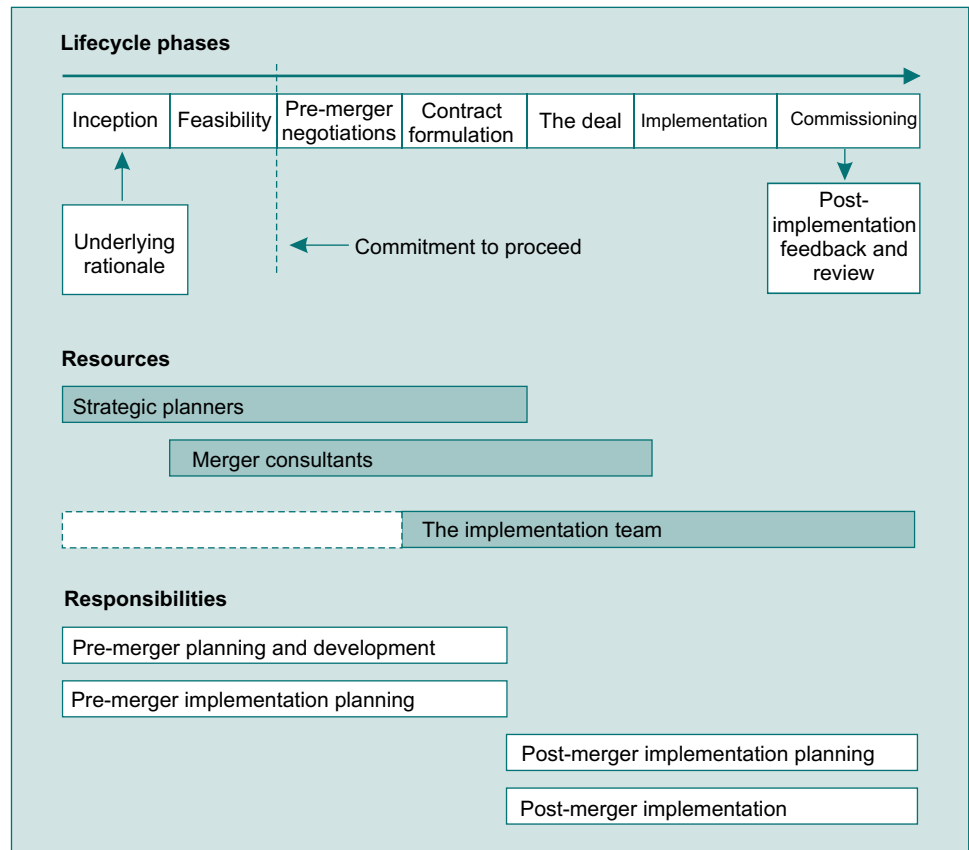


Figure 1.2 The merger lifecycle (simplified)

Most mergers commence with an inception phase. In this phase the senior managers of an organisation initiate the process. Inception is usually followed by a feasibility stage where the underlying financial and logistic areas are considered. The merger may be initiated to improve financial performance or for numerous other reasons (see Section 1.2.3). Most feasibility phases include a detailed analysis of the financial characteristics of the proposed merger together with considerations of likely timescales, synergy generation and other variables.

At some point during, or on completion of, the feasibility phase a firm commitment is made to proceed. At this point the organisation commits itself to the merger and allocates funding and resources as necessary.

The pre-merger negotiation phase usually starts right after the commitment to proceed. In this phase the senior managers of the two organisations enter into negotiations in order to reach agreement on the structure and format of the new combined organisation. The negotiation phase often involves external professional consultants such as specialist contract lawyers. In many cases (especially in the US) specialist merger project management consultants are used as negotiation drivers and facilitators.

Once the negotiations are complete, the deal itself takes the form of a detailed merger contract. The contract sets out the rights and obligations of each party (organisation) under the terms of the deal. Merger contracts can be extremely complex and are usually developed and finalised by specialist external consultants working with in-house specialists.

The implementation process starts as soon as the contract is in place. Implementation includes the mechanics of actually making the merger happen. In the UK, implementation is often carried out by in-house project teams, whereas in the US there are growing numbers of external project management implementation consultants who offer integrated services that take implementation through from inception to completion. There is usually some point at which implementation is designated as being complete, at least from an independent project point of view. This point is usually followed by a longer-term phase in which the new organisation acclimatises to the new organisational structure. This phase is usually referred to as commissioning. In some cases the commissioning phase can continue for several years.

In reality, merger lifecycles can be considered in much more complex terms. In practice, in order to have sufficient control and response it is usually necessary to subdivide each lifecycle phase into relatively small components. For example, pre-merger negotiations might be considered in terms of several different sub-phases, each of which may be separated by control gateways. Each phase of negotiation may have to be concluded and agreed before the negotiation process can move through that gateway and on to the next phase. It is common practice to establish precise performance achievements before each gateway can be passed. It is also common for merger implementation managers (*see* Module 9 and Module 10) to establish detailed reviews and associated reporting procedures for each phase. These procedures can be very useful in ensuring that the entire merger remains focused and on track.

Figure 1.2 shows the various specialists that are involved in each stage of the lifecycle. The early stages tend to be dominated by the strategic planners (or equivalent), who are responsible for initiating the merger and for making a strategic evaluation of the decision. Once the decision to merge is made and the commitment to proceed is given, the involvement of the strategic planners diminishes, to be replaced by an increased input from the implementation team and the various specialist consultants who may be involved. The external consultants are usually primarily involved in setting up the contracts and the remaining aspects of the deal. Their involvement diminishes when the deal is signed although they often have a long-term lesser involvement. The post-deal work is largely dominated by the integration team. These variations in responsibility involvement are summarised in Figure 1.3.

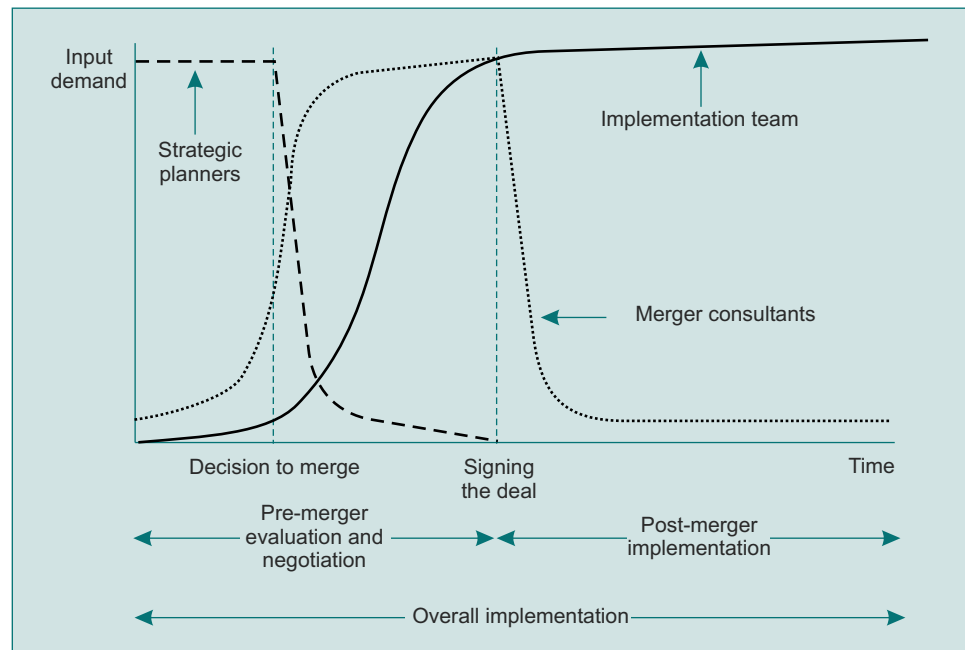


Figure 1.3 Typical people involvement before and after the deal

Where possible the integration team should be involved at the earliest possible time. In general terms, the greater the involvement the implementation people have in planning the merger, the greater the impact they can have on the development of the plans and the more easily they can actually implement the plans after the deal is signed.

The integration team consists largely of operational people. Their early involvement is likely to provide a clearer view of the work required to implement the merger. This clarity contributes significantly to understanding the timescales and magnitude of cost involved, and will in turn lead to more accurate estimates of the true value of the net benefits to be derived. It also militates against over-optimism on the part of the strategic planners and financial advisors.

There is a risk involved in this approach in that there is always a possibility that the early negotiations may be unsuccessful and the deal could fall through. If this does happen, the work that the implementation team have put into the early merger planning may be abortive. There is generally a balance or trade-off between reducing merger risks and unknowns by involving the integration team early and accepting the risk of potentially high, abortive implementation planning costs.

1.5 Measuring the Success of Mergers and Acquisitions

1.5.1 Introduction

There are numerous ways in which the relative success or failure of a merger can be defined. If the consideration is taken to extremes, such as mergers that directly result in the post-merger company going into liquidation, the success rate is high. Alternatively if the merger is considered in purely short-term financial terms, such as a significant increase in net income

or significant return on capital employed, the success rate is low. If success is defined in the generation of synergies that add long-term value to the merged organisation, success rates appear to be mixed. It therefore seems logical to consider the success or otherwise of mergers in terms of short-term and long-term measures.

1.5.2 Short-term Measures of Success

There are several well-documented short-term effects of a merger announcement. In most cases, when the announcement is made the value of the target company shares will increase while the value of the acquiring company shares will remain static or fall. In many cases the prices of the target company shares will increase prior to the announcement because of **pre-announcement rumours**. The tendency for the target share price to rise has important implications for the short-term financial success of the acquisition. In many cases the typical share price behaviour discussed can result in the acquirer paying an inflated price for the target. The difference between the pre-rumour value and the merger bid value represents the **inflationary premium**. As a result, acquired companies are often overvalued at the time of acquisition, particularly where more than one bidder exists.

Shareholders may therefore have two different views of success in the context of an acquisition. Target shareholders who sell shares to the acquirer at the premium rate make more money than they otherwise would have done in selling the shares. For target shareholders who sell, the short-term view of the acquisition may be one of success. Shareholders who remain with the target and continue to hold shares of the merged company may have a different long-term view.

1.5.3 Long-term Measures of Success

The longer-term view tends to be more complex and less clearly defined. The literature suggests that long-term performance can depend on a wide range of variables. In straightforward financial terms the long-term success of the merger appears to depend on two main areas:

- payment method;
- implementation.

The merger deal itself is generally financed either by a cash deal, or by a share deal, or by a combination of the two. In a cash deal, existing shareholders sell their shares for a cash sum. In a share deal, existing shareholders receive new shares for their existing ones. In some cases the deal may use a combination of both in what is sometimes referred to as a combined deal. Generally, in a buoyant economy more deals will be done through shares as the value of these shares is likely to increase over time. However, companies paying in shares are more likely to have overvalued shares, particularly in the period immediately before the deal. After the deal, the true value of the stock becomes apparent and the value generally falls. As an alternative, companies paying in cash tend to have higher debt levels and undervalued stock. There is evidence to suggest that, in the long term, mergers paid for in shares will perform less well from a shareholder's point of view than those paid for in cash so long as the economy remains depressed. In a buoyant economy better long-term performance can be expected from companies that have paid for the deal in shares.

The other major long-term problem indicated by the literature is ineffective implementation. Numerous mergers continue the implementation process for much longer than was originally intended. In addition it is common to find that the original implementation plans

are changed during the integration process as it becomes apparent that the implementation plans were not sufficiently well thought through, or that the problems associated with full integration were not fully appreciated during the planning stages.

Merger implementation and integration are considered in more detail in the final four modules of this course.

1.5.4 Some Scenarios for Failure

It should be clear that it can be very difficult to say clearly whether a merger or acquisition has been successful, either in the short term or in the long term. The degree of success involved depends on the point of view of the observer, the timescale being considered and determinants of success being used for evaluation.

The literature contains many examples of studies carried out on merger success and failure. Some of the literature is contradictory, while other areas of the literature lack clear outcomes and conclusions. There are, however, key issues frequently quoted in the literature upon which there is more or less common agreement. The primary reasons for a relatively unsuccessful outcome appear to be those listed below.

- **An inability to agree terms.** In some cases the proposed merger may never even be implemented because the senior managers in the two companies are unable to agree terms for the merger. In such cases the merger has to be classified as a failure because of the cost involved and time wasted. There have been several examples in the UK between 1995 and 2002 of potentially very large mergers that failed to materialise because the senior managers could not agree on the management and organisational structures of the proposed new organisation. An example of such a failure was the proposed UK merger between *Abbey National* and *Bank of Scotland*.
- **Overestimation of the true value of the target.** Acquirers often pay more for the target than it is actually worth. In the short term this could result from pre-merger target share price rises as discussed earlier. In the longer term the problem could result from an inaccurate assessment of the value of the target, either through poor valuation and due diligence or because the sector within which the company operates is subject to potential large-scale changes. Over-optimistic assessments, particularly where there is more than one bidder, are also common.
- **The target being too large relative to the acquirer.** The literature suggests that the difficulties associated with a merger or acquisition increase as a function of the relative size of the target. This tends to happen because the target becomes more and more difficult to absorb as it becomes relatively larger. A target equal in size to the acquirer can only be effectively absorbed in a merger of equals.
- **A failure to realise all identified potential synergies.** The underlying rationale behind mergers and acquisitions is often influenced by the potential to generate and exploit synergies. These potential synergies may seem achievable during the planning stage, but actually realising and exploiting them can be significantly more difficult than anticipated.

External change. Mergers and acquisition logic is sometimes superseded by events. Even the best strategic planners can occasionally fail to see sudden and large scale changes in the external market. Where such changes do occur, the whole rationale behind the merger or acquisition can quickly dissipate, sometimes with disastrous results. Examples include companies that acquired dot.com targets just before the relative global collapse in this sector in the late 1990s.

- **An inability to implement change.** A large-scale merger or acquisition generates a considerable amount of change. In a merger of equals all sections of each organisation may be subjected to change of varying degrees. Some companies are better than others at designing and implementing change. In some cases there may be a basic inability to plan and manage change effectively. In other cases there may be a deep-rooted cultural opposition to change.
- **Shortcomings in the implementation and integration processes.** Poor implementation frequently shows up in the literature as a primary scenario for failure. The most common reason for poor implementation is inadequate planning and control. In mergers and acquisitions generally, the most common specific cause of poor implementation is the lack of an implementation driver. Most implementation processes appear to be carried out without an overriding driving force behind them. The result is that they take longer than originally expected, and the opportunity for generating and exploiting synergies may be lost as a result.
- **A failure to achieve technological fit.** Technological fit and the failure to achieve it are very common problem areas in mergers and acquisitions. Companies tend to develop their own technologies and technological approaches to production over a number of years, and each system tends to be highly individualistic. It can be extremely difficult to merge two entirely different technological systems. In some cases the costs of doing so fully would be prohibitively expensive.
- **Conflicting cultures.** The incompatibility of corporate cultures is another classical scenario for failure. Cultures, like technologies, tend to evolve over a long period of time and are highly individualistic. It is very common to observe the formation of conflict when two corporate cultures are thrown together with inadequate preparation.
- **A weak central core in the target.** Targets may be unfocused or there may be problems with the central or core elements in the company. In such cases the acquisition may turn out to be less valuable than was originally thought. Typical examples were the acquisitions of the apparent high-growth dot.com companies of the late 1990s.

1.6 A Brief History of Mergers and Acquisitions

1.6.1 Introduction

Mergers occur in waves. There have been five clear waves since the end of the nineteenth century. Each wave had different characteristics and was generated by different combinations of events. However, there are remarkable similarities between the first wave and the current fifth wave. It is important to be able to understand merger wave patterns because they provide a valuable insight into how the current fifth wave may evolve.

1.6.2 Merger Waves

It is important to understand that mergers and acquisitions are very much driven by external forces. In addition, a cursory examination of the history of mergers and acquisitions reveals that they tend to occur in waves. There appears to be a direct relationship between merger activity and external economic forces such as national events of major significance and variations in the global economy.

- **The railroad wave (approximately 1895–1905).** In the United States there was a first major wave of mergers between 1890 and 1910. This wave was fuelled by the completion of the transcontinental railway system that linked cities across the entire US for the first time. This continental transport system created an integrated national market in the US. Rail links provided the opportunity for local or regional companies to evolve into fully national companies. This wave is sometimes referred to as the **railroad wave**. It was characterised by both vertical and horizontal integration mergers. Some global brand names were established through the horizontal integration of leading producers during this wave. Examples include *Coca-Cola* and *General Electric*.
- **The automobile wave (approximately 1918–1930).** The next major merger wave in the US was generated by the expansion in the general availability of automobiles in the 1920s and early 1930s. Whereas the railway system had linked cities together across the continent, the widespread availability and affordability of automobiles allowed local customers to gain access to a larger number of local and regional outlets. Automobiles also enabled companies to make much more use of professional sales teams. The widespread use of trucks and delivery vans stimulated companies based particularly in food and food processing. This wave is sometimes referred to as the **automobile wave**. It was again characterised by a high level of vertical and horizontal integration. The most prominent feature was perhaps the level of horizontal integration among secondary (as opposed to primary) producers in heavy industry and the financial sectors.
- **The conglomerate wave (approximately 1955–1970).** The 1920s wave was followed by the 1960s wave. This wave is sometimes referred to as the **conglomerate wave**. Legislation in the US at that time made it difficult for companies to integrate horizontally or vertically. At the same time the dynamic US economy provided the incentive for rapid growth. This induced companies to form mergers and acquisitions with other companies operating outside the acquirer's normal sphere of operations. This wave was characterised by a large number of management problems as acquirers experienced difficulty in managing their newly acquired assets, and there were numerous problems and failures.

- **The mega-merger wave (approximately 1980–1990).** The 1980s was a decade of rising share prices and a very buoyant economy. Relatively low interest rates made acquisition finance readily available. This fuelled a considerable number of cash-financed acquisitions of firms that were relatively low performers. There were examples of so called **mega-mergers**, which were indeed carried out on a very large scale by the standards of that time. The wave itself is sometimes referred to as the *mega-mergers* wave. Successive US and UK governments deregulated numerous sectors and relaxed anti-merger and merger-control legislation. These actions actively encouraged large-scale horizontal mergers. In the US competition was significantly reduced in a number of industries, including oil production and chemicals.
- **The globalisation wave (approximately 1994 to the present).** The current globalisation wave started in the mid 1990s and expanded rapidly through the last few years of the twentieth century and into the early years of the twenty-first century. These relatively few but extremely important years were characterised by a number of very significant facts.
 - Market growth was slow. Mergers and acquisitions allowed companies to grow in otherwise slow markets.
 - Interest rates were very low. Companies were able to take out relatively large loans at much lower interest rates than would have been possible just a few years previously. The relatively low cost of finance made mergers and acquisitions more of an economic reality for a wider number of companies.
 - Supply exceeded demand in most industries, putting pressure on prices and generating a necessity to reduce costs. One way of achieving this was through the scale economies that could be generated by successful mergers and acquisitions.
 - By the late 1990s many industries were mature or close to being mature; they realised that scale economies through mergers and acquisitions provided a viable way of reducing costs and increasing competitiveness.
 - The growth of computers and IT made an increasing impact on company operations. Geographical separation and international frontiers became less important as the Internet expanded and crossed traditional trade borders.
 - Companies began to realise that the global marketplace opens up access to both buyers and sellers of products and services. The increase on the supply side places a downward pressure on prices and therefore on costs.

The current wave is sometimes referred to as the **globalisation** wave. It is characterised by very high growth in new technologies and new communication media including the Internet. In generating the fifth merger wave it can generally be said that companies were exposed to global competition; many of the old trade barriers weakened or disappeared all together. In many countries public utilities were privatised, and global competition generated pressures for deregulation in many areas. The net result was a blurring of traditional trade boundaries and sectors. The result was an increasing pressure on companies to change. Companies generally had to reduce costs and produce higher-quality, more customer-oriented products. These factors combined to produce a generally favourable environment for mergers and acquisitions.

The fifth wave is ongoing and is remarkably similar in many ways to the first wave. It will be recalled that the first wave was propagated by the completion of the railroad network. This was effectively the result of new technology opening up a nationwide market for goods. In the globalisation wave, new technology in the form of computers, IT and the Internet is

opening up global markets. The globalisation imperative is assisted by a number of associated initiatives, such as:

- the increasingly global view taken by companies;
- the expansion of the internet and electronic communications;
- the privatisation of previously state-owned bodies;
- the development of common currencies such as the euro;
- the deregulation of financial institutions;
- the relaxation of regulations relating to mergers and acquisitions;
- the increasing liberalisation of world trade and investment;
- the formation of trading blocs such as the EU.

International mergers create companies with an international scale and effectively link the world capitalist system more firmly together.

Learning Summary

The text has considered the following areas that candidates should now be familiar with

- what a merger is and how it differs from an acquisition;
- some of the reasons why companies merge;
- the underlying merger rationales;
- what a merger driver is;
- what the primary merger drivers are;
- the difference between horizontal integration, vertical integration and conglomeration;
- the basic merger lifecycle and lifecycle phases;
- some basic measures of success for mergers;
- the difference between long-term and short-term measures of success;
- the basic scenarios for failure;
- the concept of merger waves and the major waves that have occurred since 1900.

It should be appreciated that mergers and acquisitions are complex high-risk operations. Even very large companies with previous experience of mergers and acquisitions face dangers during the merger/acquisition process, with the probability that the eventual outcome cannot be classified as entirely successful.

In the preceding sections, the text has sought to provide an overview of the key influences. As in most areas of management, there will be exceptions to the general ‘rules’. However, these tend to be small in numbers.

The Concept of Mergers and Acquisitions

- Mergers and acquisitions vary widely between countries.
- In most European countries and the US there are government controls on mergers and acquisitions where the combination of two or more companies can have an impact on the overall level of competition within a particular market. This applies especially where the merger or acquisition would give the new company the ability to alter or fix the price in a particular sector.

- Employment law can be a major consideration in some EU countries. There are significant differences in the level of employee rights that are recognised between the various member states.
- For some reason, mergers and acquisitions appear to be mainly an Anglo-Saxon phenomenon. They are far more frequent in Anglo-Saxon countries than they are in non Anglo-Saxon countries.
- **A merger** or an **acquisition** in a company sense can be defined as the combination of two or more companies into one new company or corporation.
- The main difference between a merger and an acquisition lies in the way in which the combination of the two companies is brought about.
- In a merger there is usually a process of negotiation involved between the two companies prior to the combination taking place.
- In an acquisition, the negotiation process does not necessarily take place.
- In most cases the acquirer acquires the target by buying its **shares**. The acquirer buys shares from the target's shareholders up to a point where it becomes the owner. Achieving ownership may require purchase of all of the target shares or a **majority** of them. Different countries have different laws and regulations on what defines target ownership.
- Acquisitions can be **friendly** or **hostile**. In the case of a friendly acquisition the target is willing to be acquired. The target may view the acquisition as an opportunity to develop into new areas and use the resources offered by the acquirer.
- In the case of a hostile acquisition, the target is opposed to the acquisition. Hostile acquisitions are sometimes referred to as **hostile takeovers**.
- In hostile takeovers the acquirer may attempt to buy large amounts of the target's shares on the open market. The problem with this action is that target share prices will tend to increase in value as soon as any large-scale purchases are detected.
- In both friendly and hostile takeovers the decision on whether or not to sell target shares lies with the shareholders. If all or a large proportion of target shareholders agree to sell, ownership will be transferred to the acquirer.

Why Companies Merge and Acquire

- Companies sometimes merge or acquire in order to try and improve long-term competitive advantage in support of strategic goals.
- The strategic rationale makes use of the merger or acquisition in achieving a set of strategic objectives.
- The strategic rationale may also be fundamentally defensive. If there are several large mergers in a particular sector, a non-merged company may be pressured into merging with another non-merged company in order to maintain its competitive position.
- The speculative rationale arises where the acquirer views the acquired company as a commodity.
- Another form of speculative rationale is where the acquirer purchases an organisation with the intention of splitting the acquired organisation into pieces and selling these, or major parts of them, for a price that is higher than the cost of acquisition.
- Mergers or acquisitions can sometimes be forced on a company because of management failures. Strategies may be assembled with errors in alignment, or market conditions may change significantly during the implementation timescale. The result may be that the original strategy becomes misaligned. It is no longer appropriate in

taking the company where it wants to go because the company now wants to go somewhere else.

- Such **strategy compromises** can arise from a number of sources, including changing customer demand and the actions of competitors. In such cases, by the time the **strategy variance** has been detected the company may be so far off the new desired **strategic track** that it is not possible to correct it other than by merging with or acquiring another company that will assist in correcting the variance.
- Mergers and acquisitions are sometimes required for reasons of financial necessity. A company could misalign its strategy and suddenly find that it is losing value because shareholders have lost confidence. In some cases the only way to address this problem is to merge with a more successful company or to acquire smaller more successful companies.
- Government and other public sector bodies may sometimes be instructed to merge as part of long-term government initiatives.
- Merger drivers are underlying events or characteristics that act to drive companies towards mergers or acquisitions. Typical examples include:
 - a requirement for a specific skill or resource;
 - the stock market;
 - globalisation;
 - geographical consolidation;
 - diversification;
 - sector pressures;
 - capacity reduction;
 - vertical integration;
 - increased management efficiency;
 - a desire to acquire a new market or customer base;
 - the need to buy into a growth sector or market.

Integration and Conglomeration

- The various merger waves that have taken place since the 1890s have generated three basic types of merger. In the literature these are referred to as:
 - vertical integration;
 - horizontal integration;
 - conglomeration.
- Vertical integration is characterised by forward or backward integration along the **supply chain**.
- Horizontal integration is characterised by the practice of one company acquiring another company that is active in the same general areas or sectors.
- Conglomeration is characterised by the acquisition of unrelated companies that continue to produce in unrelated sectors. This section briefly introduces these three basic types of merger.
- Vertical integration offers a number of obvious advantages. Some of these advantages are:
 - combined processes;
 - reduced risk;
 - reduced negotiation and shopping around;
 - proprietary knowledge protection.

The Merger and Acquisition Lifecycle

- Most mergers and acquisitions progress through a clearly identifiable **lifecycle**. In this context, the word 'lifecycle' is taken to refer to the *changes that take place during the life of an entity*.
- Most mergers commence with an inception phase. In this phase the senior managers of an organisation initiate the process.
- Inception is usually followed by a feasibility stage, where the underlying financial and logistic considerations are considered.
- At some point during or on completion of the feasibility phase a firm commitment is made to proceed. At this point the organisation commits itself to the merger and allocates funding and resources as necessary.
- The pre-merger negotiation phase usually starts right after the commitment to proceed. In this phase the senior managers of the two organisations enter into negotiations in order to reach agreement on the structure and format of the new combined organisation.
- Once the negotiations are complete the deal itself takes the form of a detailed merger contract. The contract sets out the rights and obligations of each party (organisation) under the terms of the deal.
- The implementation process starts as soon as the contract is in place. Implementation includes the mechanics of actually making the merger happen.

Measuring the Success of Mergers and Acquisitions

- A significant proportion of mergers appear to fail in terms of short-term financial value creation.
- There is some evidence to suggest that merger success or failure should be measured in longer-term variables.
- Many mergers appear to fail because of poor implementation.
- Typical reasons for merger failure include:
 - an inability to agree terms;
 - overestimation of the true value of the target;
 - the target being too large relative to the acquirer;
 - a failure to realise all identified potential synergies;
 - an inability to implement change;
 - shortcomings in the implementation and integration processes;
 - a failure to achieve technological fit;
 - conflicting cultures;
 - a weak central core in the target.

A Brief History of Mergers and Acquisitions

- Mergers occur in waves. There have been five clear waves since the end of the nineteenth century.
- Each wave had different characteristics and was generated by different combinations of events.
- The first wave was the railroad wave. It was driven by the development of the transcontinental railway line network in the US between 1850 and 1905.
- The second wave was the automobile wave. This wave was driven by the widespread availability and use of automobiles between 1918 and 1930.

- The third wave was the conglomeration wave. This was driven by a combination of legislation and the dynamic US economy.
- The fourth wave was the mega-merger wave. This wave reached its peak in the late 1980s. It was largely driven by the maturity of a number of large industries coupled with over-capacity and a need to reduce costs.
- The current wave is the globalisation wave and is driven largely by IT.

Review Questions

These questions are designed to allow you to evaluate your general understanding of the subject areas quickly. You should attempt these questions as quickly as possible. You should be able to answer the majority of them correctly if you have developed a reasonable knowledge of the subject areas.

True/False Questions

The Concept of Mergers and Acquisitions

- 1.1 This text is primarily concerned with mergers and acquisitions from a strategic point of view. T or F?
- 1.2 The underlying rationale behind mergers and acquisitions is often affected by the actions of regulators. T or F?
- 1.3 Employment law can critically affect mergers in some countries. T or F?
- 1.4 The main difference between a merger and an acquisition lies in the way in which the combination of the two companies is brought about. T or F?
- 1.5 In an acquisition there is usually a process of negotiation involved between the two companies prior to the combination taking place. T or F?
- 1.6 Mergers are usually hostile. T or F?
- 1.7 Most acquisitions are financed using cash. T or F?
- 1.8 Acquisitions can generally be classified as friendly or hostile. T or F?

Why Companies Merge and Acquire

- 1.9 The strategic rationale is only one of a series of alternative rationales. T or F?
- 1.10 The strategic rationale is always less risky than the speculative rationale. T or F?
- 1.11 Merger drivers are characteristics or events that drive companies towards mergers or acquisitions. T or F?
- 1.12 The stock market could be an example of a merger driver. T or F?

Integration and Conglomeration

- I.13 Vertical integration is characterised by forward or backward integration along the *supply chain*. T or F?
- I.14 Horizontal integration is characterised by the practice of one company acquiring another company that is active in the same general areas or sectors. T or F?
- I.15 Conglomeration is characterised by the acquisition of unrelated companies that continue to produce in unrelated sectors. T or F?
- I.16 In its simplest form, vertical integration is the process of manufacturers merging with suppliers or retailers. T or F?
- I.17 Vertical integration can be both forward and backward. T or F?

The Merger and Acquisition Lifecycle

- I.18 Most mergers and acquisitions can be considered as projects with identifiable lifecycle stages. T or F?
- I.19 The commitment to proceed usually comes right after the pre-merger negotiations. T or F?
- I.20 The implementation team should not be involved in the planning process until the latest possible time. T or F?

Measuring the Success of Mergers and Acquisitions

- I.21 There is no single method for evaluating the success or otherwise of a merger or acquisition. T or F?
- I.22 In purely financial terms most mergers are a success, at least in the short term. T or F?
- I.23 Mergers never fail because of an inability to agree terms. T or F?
- I.24 The actual value of targets is often overestimated, resulting in the payment of an inflationary premium. T or F?

A Brief History of Mergers and Acquisitions

- I.25 Mergers appear to happen in waves. T or F?
- I.26 The first wave was the automobile wave. T or F?
- I.27 The current (globalisation) wave is the fourth wave. T or F?
- I.28 One driver of the current (globalisation) wave was the growth and spread of IT. T or F?

Multiple-Choice Questions

The Concept of Mergers and Acquisitions

- I.29 In most EU countries there are:
- A. no controls on mergers and acquisitions.
 - B. some controls on mergers and acquisitions.
 - C. general rules subject to individual application consideration.
 - D. precise and clearly defined rules on mergers and acquisitions.
- I.30 The degree of board–board negotiation in a hostile acquisition is generally:
- I. less than in a friendly acquisition.
 - II. largely non-existent.
 - III. extensive and varied.
 - IV. about the same as in a merger of equals.
- Which of the above is/are true?
- A. I only.
 - B. I and II.
 - C. I, II and III.
 - D. III and IV.
- I.31 In many cases, as soon as a major acquisition is announced the target's share prices:
- A. double or treble in value.
 - B. increase significantly.
 - C. remain static.
 - D. decrease.
- I.32 Hostile takeovers can be funded by:
- I. cash only.
 - II. shares only.
 - III. cash and shares.
 - IV. other incentives.
- Which of the above is/are true?
- A. I only.
 - B. I and II.
 - C. I, II and IV.
 - D. I, II, III and IV.

Why Companies Merge and Acquire

- I.33** Companies often merge or acquire on the basis of an underlying
- I. strategic rationale.
 - II. speculative rationale.
 - III. management failure rationale.
 - IV. financial necessity rationale.
- Which of the above is/are true?
- A. I only.
 - B. I and II.
 - C. I, II and IV.
 - D. I, II, III and IV.
- I.34** Mergers and acquisitions conducted under the strategic rationale are usually carried out with the objective of:
- I. adding long-term competitive advantage.
 - II. increasing the value of the target with the intention of future resale.
 - III. responding to the demands of immediate financial shortcomings.
 - IV. complying with regulator requirements.
- Which of the above is/are true?
- A. I only.
 - B. I and II.
 - C. I, III and IV.
 - D. I, II, III and IV.
- I.35** The following are examples of strategic merger drivers:
- I. enhanced vertical integration.
 - II. acquisition of a new customer base.
 - III. increased management efficiency.
 - IV. increased short-term resale profit.
- Which of the above is/are true?
- A. I only.
 - B. I and II.
 - C. I, II and III.
 - D. I, II, III and IV.

Integration and Conglomeration

- I.36** Vertical integration offers advantages based on:
- Which of the above is/are true?
- A. I only.
 - B. I and II.
 - C. I, II and III.
 - D. I, II, III and IV.

- I.37 Generally conglomeration is now:
- A. becoming increasingly popular.
 - B. becoming marginally more popular.
 - C. becoming less popular.
 - D. more or less as popular as it always has been.
- I.38 One of the main reasons for de-conglomerisation is to
- A. reduce business risk.
 - B. increase business risk at a premium.
 - C. increase strategic focus.
 - D. decrease strategic focus.

The Merger and Acquisition Lifecycle

- I.39 Generally major mergers have
- A. no definable lifecycle.
 - B. clear lifecycle stages although with random events.
 - C. random lifecycle phases with no consistent sequence of events.
 - D. clear lifecycle phases with a standard set of sub-phases and work packages.
- I.40 In terms of lifecycle phases
- I. inception usually comes right after feasibility.
 - II. feasibility comes right before the deal.
 - III. implementation comes right before commissioning.
 - IV. contract formulation comes right after the deal.
- Which of the above is/are true?
- A. I only.
 - B. I and II.
 - C. III only.
 - D. IV only.

Measuring the Success of Mergers and Acquisitions

- I.41 In terms of short-term financial gain by the acquirer, most mergers or acquisitions
- A. are very successful.
 - B. are somewhat successful.
 - C. break even.
 - D. fail.
- I.42 Generally, in terms of short-term financial gains
- A. acquirer shareholders make the most.
 - B. target shareholders make the most.
 - C. acquirer and target shareholders do equally well.
 - D. acquirer and target shareholders both lose small amounts.

A Brief History of Mergers and Acquisitions

- 1.43 Most analysts would agree that in business history (including the present wave) there have been
- A. two major merger waves.
 - B. three major merger waves.
 - C. four major merger waves.
 - D. five major merger waves.
- 1.44 The current globalisation wave is driven largely by the continued evolution of
- A. transport systems.
 - B. language compatibility.
 - C. population growth.
 - D. information technology and the Internet.
- 1.45 The current globalisation wave has a number of drivers including
- I. sustained low interest rates.
 - II. sustained low growth.
 - III. supply exceeding demand in many industries.
 - IV. the continued sustained development in computers, IT and the Internet.
- Which of the above is/are true?
- A. I only.
 - B. I and II.
 - C. I, II and III.
 - D. I, II, III and IV.