Abstract

This study explored three key areas of merger and acquisition (M&A) strategy. These were: the link between corporate vision and M&A strategy; the importance of the due diligence process; and the impact of experience in completing successful M&As.

The study found that there was a clear alignment between corporate and M&A strategic objectives but that each organisation had a different emphasis on individual criterion. Due diligence was critical to success; its particular value was removing managerial ego and justifying the business case. There was mixed evidence on the value of experience, with improved results from using a flexible framework of assessment.

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INTRODUCTION

In 2004, worldwide merger and acquisition activity increased by over 40% to $1.95 trillion resulting in the highest merger and acquisition activity levels since the year 2000 (Thomson, 2005). This growth in activity is interesting to note considering that research has shown that, historically, approximately half of all mergers and acquisitions have proven unsuccessful (See Covin, Kolenko, Sightler and Tudor, 1997; Gadiesh & Ormiston 2002; Gadiesh, Ormiston & Rovit 2003; Kaplan 2002; Stanwick & Stanwick 2001; Weber, Shenkar & Raveh 1996; Schneider 2003).

In contrast to previous research, a recent Australian study found that for the first time shareholder value was increased as a result of mergers and acquisitions more frequently than it was reduced (KPMG, 2003). It was established that 34% of the deals enhanced shareholder value, 32% reduced value and 34% had no effect. This was a significant improvement from the first survey carried out in 1999 where 53% of mergers and acquisitions reduced shareholder value (KPMG, 2003).

Given the conflicting research results and in light of the large increase in cross-border mergers and acquisitions, this approach to organisational growth appears worthy of review. This exploratory research had three main objectives: (1) to identify the link between corporate strategic planning and merger and acquisition (M&A) strategy; (2) to examine the due diligence process in screening a merger or acquisition; and (3) an evaluation of experience in the successful completion of M&As.

LITERATURE REVIEW

Corporate Strategy and Mergers and Acquisition Strategy Alignment

In a study conducted by Harding and Rovit (2004) the importance of aligning corporate strategy to planning for mergers and acquisitions was examined. They reviewed more than 1,700 mergers and acquisitions and interviewed 250 Chief Executive Officers (CEOs). It was found that less than one in three CEOs interviewed had a clear strategic rationale for the M&A, or understood the contribution the deal would make to their company’s long-term financial future. This study also found that over half of those companies with a clear rationale underpinning their M&A activity came to a post-M&A conclusion that their rationale had been wrong.

A number of authors have discussed the different growth strategies available to CEOs (Gulati, Freeman, Nolan, Tyson, Lewis and Greifeld, 2004; Lynch and Lind, 2002). Lynch and Lind (2002) describe mergers and acquisitions as being one of the central techniques for organisational growth, whilst Hurtt, Kreuze and Langsam (2000) go further and suggest growth is the primary reason for M&As. Perry and Herd (2004) emphasise the critical role of strategic planning when using M&As to grow an organisation. They suggest that in the 1990s companies shifted the focus for undertaking M&As from a cost saving perspective to using M&As as a strategic vehicle for corporate growth, which the authors regarded as an inherently more difficult challenge.

Harari (1997) lists several reasons given by CEOs to justify a merger or acquisition. These include: to obtain synergies, economies of scale, cost savings, increased products and rationalisation of distribution channels. Selden and Colvin (2003) highlight the way companies focus on the potential return on capital. They also suggest that the most common reason companies buy one another is to acquire customers. The authors note the pressure on CEOs to use their excess cash and increase earnings by mergers or acquisitions even if that may not be an appropriate strategy for the company. Albizzatti and Sias (2004) identified that the reasoning for an acquisition needed to be more strategic than simply the use of excess cash. The strategic
reasons they identified for acquisitions were: (i) acquire new products, capabilities and skills; (ii) extend their geographical reach; (iii) consolidate within a more mature industry; and (iv) transform the existing industry or create a new industry.

Whilst many CEOs appear happy to share the virtues of their latest acquisition it appears few are keen to highlight their failed M&As. Harari (1997) questions why so many M&As fail after CEOs extol their strategic rationale. This author suggests the reason for failure is the lack of vision by short sighted executives, who take the safe route and buy current competitors to gain market share. Harari recommends that instead companies should boldly redefine themselves and their market place.

Balmer and Dinnie (1999) identified a number of reasons for the failure of M&As. It was found that there was an over-emphasis on short term financial and legal issues, at the neglect of the strategic direction of the company. This neglect included failure to clarify leadership issues, and a general lack of communication with key stakeholders during the merger or acquisition process.

Some studies have focused on identifying the specific reasons for the failure of mergers or acquisitions. For example Gadiesh and Ormiston (2002) list five major causes of merger failure:

- Poor strategic rationale.
- Mismatch of cultures.
- Difficulties in communicating and leading the organisation.
- Poor integration planning and execution.
- Paying too much for the target company.

Of these five causes of merger failure Gadiesh and Ormiston (2002) believe that having a clear strategic rationale for the merger is most important problem to overcome, as this rationale will guide both pre and post merger behaviour. They emphasise that this issue alone may result in the other four causes of merger failure occurring. Lynch and Lind (2002) list other reasons for merger failure such as: slow post merger integration, culture clashes and lack of appropriate risk management strategies.

**Due Diligence: Screening of Potential Merger or Acquisition Targets**

Sinickas (2004, p12) defined due diligence as ‘…where each party tries to learn all it can about the other party to eliminate misunderstanding and ensure the price is appropriate’. Angwin (2001) identified due diligence as critical in the merger and acquisition process. This author points out that effective due diligence should be a comprehensive analysis of the target company’s entire business, not just an analysis of their cash flow and financial stability as has traditionally been the case.

Perry and Herd (2004) identified that as the complexity of mergers and acquisitions has increased, the issue now is the scope and effectiveness of due diligence. This view is supported by Jensen (1982) who noted that the majority of acquisitions in the 1960s came from referrals through investment and commercial bankers, whereas in the 1970s a more proactive screening process was utilised to identify candidates. Jensen suggests that potential candidates have become well exposed to many potential suitors and it can be difficult to determine if they are the best candidates available for M&As.

To overcome the danger of entering a bidding war amongst suitors, Carey (2000) advises that a potential buyer of a company needs to set clear criteria when considering a potential merger or acquisition. Jensen (1982) stated that it is essential to test the business case by examining operational and management strengths and weaknesses. Carey (2000) goes further and recommends that this examination should include full financial information, candour about the company’s operating performance and problems, its corporate culture plus an honest assessment
of management talent. Carey suggests this can be achieved by building relationships with target companies.

Learning From Past Merger and Acquisition Experience

Hayward (2002) states that while people undertaking mergers and acquisitions have a great opportunity to learn from their experience, they seldom do. This author found that firms who have small losses in prior acquisitions are stimulated to learn from their performance and outperform on subsequent acquisitions. On the other hand, firms that have had great success or great failure find it difficult to learn from that experience.

Rovit and Lemire (2003) established that frequent buyers, regardless of economic cycles, were 1.7 times more successful than those firms who were not as frequent, (i.e. between 1 - 4 deals). Consistent purchasing was found to increase the chances of success, as was being prepared to walk away from deals that are considered too risky.

By contrast, Hayward (2002) found that acquisition experience was not enough to generate superior acquisition performance, however, firms were more successful when they acquired companies that were in a moderately similar business. This author also found that acquirers, who made acquisitions one after another in quick succession, did not outperform companies that acquired infrequently. The best outcomes came from those organisations who took a modest break in their acquisition process to allow the lessons learnt from acquisitions to be processed, i.e. a break long enough for management to consolidate key lessons, but not so long that those lessons are forgotten.

Guest, Cosh, Hughes and Conn (2004) found that having a successful first merger is a predictor of declining performance in subsequent acquisitions. This is in contrast to Hayward (2002), who found that acquirers that have an unsuccessful first merger learn from their mistakes and improve their subsequent performance. Even though these acquirers do learn from their mistakes, they never quite catch up with the organisations successful in their first acquisition. Guest et al (2004) concluded that if your first merger doesn’t succeed, it is not worthwhile pursuing future mergers. Overall, the body of literature on the usefulness of prior experience in undertaking M&As has shown mixed results.

RESEARCH DESIGN AND METHODOLOGY

A qualitative research approach was adopted in this study. The benefit of qualitative research is its ability to allow the investigator to gain depth and detail (Patton, 1990), and to address how and why questions (Yin, 1994). This methodological design is particularly useful in expanding our understanding and knowledge of mergers and acquisitions in terms of strategic planning and the issues surrounding the due diligence process. Datta (1991) supported the utilisation of a qualitative approach in the study of mergers and acquisitions on the grounds that previous studies in this area provided limited insight as to the reason around half of these transactions have failed.

This exploratory research consisted of six semi-structured interviews undertaken with experienced senior managers and CEOs of Australian listed companies and Australian based US subsidiaries. The participants had a diverse spread of experience, competence and skills. They operated in different industries and in companies of varying size and revenues.
Table 1: Description of Participants Interviewed

<table>
<thead>
<tr>
<th>Org</th>
<th>Organisation Description</th>
<th>Participant /Position</th>
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<tbody>
<tr>
<td>A</td>
<td>A multi national beverage company.</td>
<td>A Manager – group strategies</td>
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<tr>
<td>B</td>
<td>A leading global information technology company</td>
<td>B President/CEO</td>
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<tr>
<td>C</td>
<td>Global consulting firm, consulting across all industries with a focus on results.</td>
<td>C Senior Manager</td>
</tr>
<tr>
<td>D</td>
<td>A leading manufacturing company operating in Australia, New Zealand, Asia and the US.</td>
<td>D Senior Business Analyst</td>
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<tr>
<td>E</td>
<td>A transport and logistics provider.</td>
<td>E Chief Financial Officer</td>
</tr>
<tr>
<td>F</td>
<td>A diversified manufacturing and service company</td>
<td>F CEO</td>
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RESULTS

The Link Between Corporate and Merger and Acquisition Strategy

In line with Harding and Rovit (2004), participants in the current study emphasised the need for alignment between corporate strategy and M&A strategy. Some participants lamented that they did not always link their merger and acquisition strategy with their corporate plan. For example, Participant A indicated ‘We had a history of bankers and the like presenting us with transactions rather than us being absolutely on top of the landscape ourselves and deciding that is the area that we should be pursuing’.

After initially adopting an ‘ad hoc’ approach to acquisitions Organisation A, at the time of interview, was undertaking a more focused, detailed strategic planning process. As Participant A stated ‘It has (in the past) been transaction driven; it is now more driven by strategic merit’.

In line with their corporate strategy, Organisation D’s strategic planning process identified downstream value added products, ‘focusing on complementary rather than diversified opportunities’.

Organisation E had a clear alignment between their corporate strategy and merger and acquisition strategy. Participant E suggested that ‘they’re one and the same, almost’. Similarly, the M&A strategy adopted by Organisation B closely aligned with their strategic plan, in that it aimed to fill identified strategic gaps. Organisation B emphasised how M&As were essential to growing market share in emerging markets. ‘We will get substantial growth in emerging markets, China and India, through acquisitions’. They also identified acquisitions as a strategy to quickly position themselves for change that occurred in the information technology market and to reduce product time to market.

Participant C, a management consultant, identified that the planning process is quite CEO driven: ‘I find that in most corporations I deal with, mergers and acquisitions are not at the forefront of their strategic planning process, but rather a way of addressing issues or achieving objectives’. Similarly, Participant F stated ‘you’ve got to make sure there is no emotion in it, particularly the CEO’s ego because a company is usually driven by the direction they provide’.

Due Diligence: Screening a Merger and Acquisition Target

As suggested by Cullinan and Holland (2003), the majority of participants evaluated M&As on the basis of their fit with the organisation’s strategy. Financial criteria were seen as secondary; as issues to be satisfied once the strategic benefits of the proposed merger or acquisition had been
confirmed. In contrast, however, Organisation A discussed how in their current growth phase, they were looking for new opportunities within the context of financial and strategic criteria. The first step was to meet their financial criteria: ‘every project must from year one beat WAC (Weighted Average Cost of capital)’. At the time of interview, Organisation A was seeking a post tax WAC of around 9%, resembling Selden and Colvin’s (2003) criterion which focused on the return of capital employed. In this particular case, once the accretive impact of the merger or acquisition had been identified, fitting the strategic imperatives became more important. With further probing it was identified that each acquisition was assessed on merit, however if the WAC was not likely to be met in the first year, it made the business case difficult to get up.

Participant E identified additional capability, scale, and geographical presence as the three major criteria to screen M&As. Although ‘there is a whole bunch of financial metrics that sit behind that but if they don’t pass one of those three then we don’t look any further’. This finding is comparable with the views of Albizzati and Sias (2004) who suggested that M&As should be used to acquire capability and extending the businesses geographical presence.

Organisation D’s initial focus was on the strategic fit of the acquisition relative to its corporate strategy. After attaining this fit, the company then analysed the accretive value of the acquisition, the impact on earnings per share, and the investment cost ratio.

Participant B discussed two ways to look at an acquisition. They looked for complementary companies that can provide strong revenue generation with a quality customer base or organisations with unique technology where they can capture new technical skills.

In line with previous research (Balmer & Dinnie, 1999; Sinckas 2004) the majority of participants in this study identified due diligence as a key phase in M&As. More specifically, participants highlighted the notion that effective due diligence required an assessment of the total target business operations. For example, Participant D divided due diligence into two parts, understanding the risks of the business, and thinking through the implementation process. As he stated, ‘The focus is really about understanding the risks’. Taking a slightly different tangent, Participant F, offered a sellers perspective regarding due diligence. He suggested that leaders of the potentially acquired company might operate differently if they know the company is being acquired. For example, the company may undertake a range of strategies to positively impact on their sales or profitability. As Participant F asserted, ‘They will build their backlog with low margin work so it looks good’. Participant F went on to suggest that the due diligence process is ‘to get a feel for what’s really happening in the organisation’.

Organisation B emphasised that due diligence must cover cultural issues. Participant B discussed a previous merger and how its success was due to the focus on cultural integration. At the time of the merger, Organisation B had five major geographical regions. After the merger, however, two of the five geographical regions had been fully integrated, and ‘three (geographical regions) for a period of about 12 -18 months, were kept separate side by side’. Participant B went on to compare the culture between the two companies describing the cultures as ‘effectively, …diametrically opposed’. A ‘very flexible open company, very empowering’ versus a ‘very policy driven, very hierarchal company’ and the challenge was to get the best of both cultures. The three regions where the merged organisation operated multiple sites were only integrated once customer data, operations, and services had become fully integrated, roles clearly delineated, and identified overlaps eliminated.

As noted by Participant C, the fulfilment of due diligence is not without its pitfalls. He commented that ‘a very focused strategic due diligence is critical, one that tries to get the testosterone out of the deal’. This participant was concerned that those involved in M&As can get carried away with the negotiation such that their egos affect the outcomes. Participant C suggested that the danger is that everyone wants to be seen as a key to the process often at the expense of effective due diligence.
There was also evidence of the utilisation of external professionals in the M&A process. For instance, Organisation A ensured that the business case was tested at all levels of the organisation. This organisation was not averse to bringing in professionals who have operated similar businesses or were familiar with the industry under question. Participant A cited an example of a recent acquisition within the water industry where experienced industry professionals were brought in. He stated ‘they come in and say there’s no way they are getting $8 a case for water, so then you start to get some flags raised’. The issue underpinning this acquisition was the identification of the cost per cent on a litre of water and appropriate ratios for cost of goods sold on bottles of water. A key issue identified by Organisation A was the formulation of the ‘right team’ to carry the acquisition process through to completion. As such, the team may include a mix of internal specialists or external consultants. Participant A contended that this strategic focus on good team formulation facilitated a comprehensive list of due diligence issues and the formulation of appropriate responses from the target company. Participant A argued that this approach ‘gives you a sense of how well the business is run or what they actually know about the business’.

Of particular importance was the strategy adopted by Organisation A to require the target acquisition management to prepare a business review detailing what their views were on how the business could grow and how the two businesses could be best brought together. This gave Organisation A an opportunity to observe key employees in action and to examine the issue of cultural fit. Moreover, attainment of a good level of cultural fit was identified by Organisation A as a critical feature to their success. Participant A’s company is one with a ‘very strong and distinct culture and it’s one of those things where you can see this culture isn’t changing and the brutal fact of life is that things have to mesh or they’re not going to work’.

Employee involvement was another issue identified as a core component of successful acquisitions. For instance, Participant B emphasised ‘how critical the people component is, as it is the people who make it work’. Similarly, Participant A identified communication with people as a vital aspect, ‘because I haven’t seen any acquisition that we’ve done to date where employees haven’t been the number one priority’.

Experience in Mergers and Acquisitions

There was a divergence of opinion on the value of experience in the M&A process. Half the participants interviewed in this study felt that experience in undertaking a M&A assisted with the success of the process. However, there was a codicil. They argued that it was important that the experienced leaders in the M&A process employed a flexible, yet defined framework. For instance, Participant A felt experience ‘absolutely’ helped. Both Participant A and C agreed with Guest et al’s (2004) view that people must learn from these experiences and set up disciplines to assist with success. Participant C went on to state that experience helps organisations to ‘focus on the sources of value, identify the need for speed and importantly continue to run the business’. Taking a slightly different tangent, Participant E felt the main lesson of experience was to ‘ensure that we do the due diligence correctly and thoroughly enough to make sure that we don’t miss anything’.

Interestingly, the other respondents interviewed for this study felt attempting to capitalise on past experience was futile. Their assertion was that the variance in circumstances of M&As meant that past experience did not generalise across situations. For example, Participant D argued that experience offered little benefit and stated ‘Having done one doesn’t always make you any better. The risks are always different, the businesses are always different…you have a good system but it actually doesn’t make it any easier to do’. This contention was supported by Participant B who took the view that as M&As were all different, the lessons learnt from each would not necessarily translate to other companies. Participant B was particularly concerned with the difficulties associated with the use of models, ‘I don’t think there is any one exact recipe. In fact I think the more closely you follow supposed models the more trouble you can get into’.
DISCUSSION AND CONCLUSION

This exploratory study examined the link between corporate strategic planning and M&A strategy, the due diligence process used to screen targets, and the impact of experience on the success of M&As. Although each company interviewed had differing criteria for assessing potential merger or acquisition targets, they were all aligned with their corporate strategic objectives. Past research has identified the importance of this alignment but provides only a broad overview of the various criteria for assessing potential M&As. However, this study found organisations do not just focus on ensuring strategic alignment across a variety of criteria. They each have differing criteria priorities and weightings.

Balmer and Dinnie (1999) found an over-emphasis on financial issues and it appears Organisation A took this approach. For example, unless a financial target is likely to be met they are less inclined to consider the opportunity based on strategic rationale. This response could be due to their history of failed acquisitions, often with these opportunities being presented to them by financial institutions. Their reaction to past failures has been to tighten their assessment process and focus on financial objectives as well as strategic fit. This more proactive approach to seeking out acquisitions is more in line with that recommended by researchers (Harding and Rovit, 2004; Gopinath, 2003; Gadish and Ormiston, 2002).

In line with previous research, participants identified due diligence as critical in screening potential M&A targets (Sinicks, 2004, Perry and Herd, 2004). This research identified that participants did not see due diligence as simply a financial assessment but a detailed investigation that tests the viability of the proposed merger or acquisition. The key issues identified were strategic fit, cultural alignment, assessment of people skills and attributes and meeting financial objectives. All of these aspects have been identified as important in previous research; however two more issues arose that these Australian companies highlighted as important. These were the importance of extracting managerial ego and its associated hype out of the process, and getting the target organisations to prepare a business review detailing their vision for the new entity.

Hayward (2002) found that there was mixed evidence as to whether experience in mergers and acquisitions was useful. This research concurred with Hayward’s findings, however, for different reasons. This study found that participants saw each merger or acquisition as unique. This meant their experience was difficult to exploit, however using a flexible framework for analysis provided a more holistic overview for each business case. This helped overcome any bias that could arise using the rigid application of any defined assessment models.

This Australian study sets an outline on which to build further research. Other issues identified in this study worth further investigation include: differences between cross cultural and domestic M&As, challenges in post merger or acquisition integration, M&A team member roles, and the overall process of M&As including the process of negotiation.
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