



Local Authority
Pension Fund
Forum

Which Deals Create Value?

Mergers and Acquisitions through the Lens

LAPFF Trustee Guide
December 2007

www.lapffforum.org

The Local Authority Pension Fund Forum, which was set up in 1991, is a voluntary association of 44 public sector pension funds based in the UK. It exists 'to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest.' The Forum's members currently have combined assets of £85 billion.

Stuart Imeson
LAPFF Secretariat
Bradford City Council
Britannia House
Hall Ings
Bradford
West Yorkshire
BD1 1HX
Tel +44 (0)1274 43 23 17
Fax +44 (0)1274 43 77 00
info@lapfforum.org

Published by LAPF Forum
© LAPF Forum December 2007

Acknowledgements

This guide has been compiled by Ebba Schmidt of PIRC Ltd, LAPFF's research and engagement partner. We gratefully acknowledge the assistance of Dr. Nancy Hubbard, Associate Fellow at Templeton College, Oxford University, who has many years of consultancy experience on acquisition strategy and implementation, and James O'Loughlin, a consultant with over 23 years' experience in the investment management industry, who has written widely on the subject of corporate governance and M&A. For further information, please contact EbbaS@pirc.co.uk or TessaY@pirc.co.uk

Structure of guide

Trustees can choose to base their assessment of a proposed merger and acquisition (M&A) deal on a set of twelve core questions (chapter 3) or use the full set of questions on strategy (chapter 4) and implementation (chapter 5) for an in-depth assessment, which may also involve engagement with acquirers.

- **Twelve core questions**

The core questions aim to uncover whether an acquisition is prone to failure, i.e. whether a proposed acquisition is characterised by those traits that have been associated with past acquisition success or acquisition failure. Trustees can use the core questions for an initial assessment as to whether a proposed deal raises any concerns. If any concerns arise, the assessment can be extended to the full set of questions in order to decide whether or not to support a proposed deal, or whether active engagement with the acquirer may lead to more information, and possibly bring about some change.



- **Strategic considerations**

These revolve around the acquirer's approach to M&A strategy: does the proposed transaction fit with the acquirer's understanding of its own business model?; how large is the acquisition in relation to the size of the acquiring firm?; is the deal part of a series of deals that the acquiring firm has engaged in or whether it represents occasional activity?, and does it serve to increase the acquirer's focus in existing businesses or diversify the firm's activities into other areas?

Successful acquirers consider such issues carefully. So too should trustees. While there is some evidence that a well thought out implementation process can overcome flaws in strategic considerations, such strategic underpinnings are likely to have considerable influence over the ultimate success of any deal. Investors therefore need to be sure that these considerations do not expose acquisitions to factors that predispose them to failure.

- **Planned implementation.**

Suitable implementation plans and processes can mitigate risks arising from strategic considerations; particularly in respect of the realisation of available (expected) synergies and in the integration of the combined firms. Nevertheless, very limited information is typically available to investors on implementation plans and processes, and the guide has been designed to illuminate the factors that careful acquirers are aware of, which trustees should seek to ensure that management pay attention to.

Each section within chapters 4 and 5 sets out risks and opportunities arising from a specific issue. This is further illustrated by an example, followed by a set of assessment criteria in the form of questions, which are designed to highlight the likelihood that an M&A proposal will generate long-term value or lead to value destruction.

Benefits for the fund

The guide will enable fund trustees, officers or fund managers to review proposed M&A deals, in order to:

- Introduce corporate governance and CSR thinking into the assessment of M&A deals.
- Develop an understanding of issues surrounding M&A that include those most commonly cited as contributing to the failure of deals to add value.
- Conduct an assessment of the value that the proposed acquisition will have in the long-term.
- Identify opportunities for active engagement with the acquirer to ensure that M&A deals enhance value in the long-term, and
- Come to an informed decision on whether or not to support the proposed deal.



Contents

Chapter 1	5
Mergers and Acquisitions and Value	
Chapter 2	7
Background to the Trustee Guide	
Chapter 3	12
Core Questions	
Chapter 4	16
Strategic Considerations	
4.1. Acquisition process	16
4.2. Acquisition objectives	19
4.3. Acquisition type and acquisition success	21
4.4. Due diligence	25
Chapter 5	27
Planned Implementation	
5.1. The written implementation plan	27
5.2. Track record	28
5.3. Implementation resources	30
5.4. Top team selection	31
5.5. Synergy assessment	33
5.6. Integration, culture and communication	36
Chapter 6	39
Engagement Opportunities	

Chapter 1 – Mergers and Acquisitions and Value

It is generally accepted that two thirds of M&A deals do not create value for shareholders¹. The presence of local authority pension funds in acquirers, however, can make a difference: a recent study in the US concluded that acquirers with large public pension fund presence perform relatively better in the long-term than those without.

The reason for this, the study finds, is that public pension funds in the US are effective monitors of corporate M&A activity, and thus reduce the likelihood of value-reducing M&A deals.²

The Local Authority Pension Fund Forum agrees with these findings. Mergers and acquisitions are a capital-consuming strategy that carries a high risk of failure both pre- and post-deal. The data on M&A shows that around two thirds of deals do not enhance value. Specifically, 31% of M&A transactions have been found to destroy value for the acquiring firm; 34% neither create nor destroy value, and 35% create value for the acquiring firm.³

In light of this data, and in respect of the fact that M&A routinely accounts for a substantial proportion of the use of shareholders' capital, trustees should be concerned to determine as far as possible whether a proposed transaction is likely to enhance or destroy value. LAPFF recognises that if trustees are to do this, and if they are to take a long-term perspective on value, some guidance is required.

The requirement for value enhancement of pension fund investments in the long-term warrants close monitoring and active engagement with companies on their acquisition activities. But what does effective monitoring mean in the



context of a proposed M&A deal, and what are the issues to look out for?

To answer this question, the Forum is issuing this Trustee Guide on Mergers and Acquisitions. Depending on resource and time limitations, trustees have the choice of concentrating on twelve core questions, which allow the rapid assessment of the likelihood that a proposed deal will enhance value; or the use of the full guide, which allows a comprehensive analysis of risks and opportunities of the proposed deal. In either case, the guide will enable trustees to come to an informed decision on what steps to take, i.e. supporting or rejecting the deal, and/or engaging with the acquirer's management on issues of concern.

The opportunity for trustee engagement should, in the Forum's view, not be neglected. Worldwide spending on deals reached \$1.5 trillion in 2004, and a strategy of fast growth through acquisitions dominates organic growth in many deals today. With two thirds of deals not adding value, this represents a serious concern for pension fund investors.



¹ KPMG, *Unlocking shareholder value: the key to success*, 1999

² Qiu, L., *Which institutional investors monitor?*, Dept of Economics, Brown University, June 2006

³ Robert F. Bruner, *Deals from Hell: M&A Lessons That Rise Above the Ashes*, John Wiley & Sons, 2005

Chapter 2 – Background to the Trustee Guide

The LAPFF Executive Committee agreed in April 2005 that:

“...Institutional investors may need a simple framework by which to assess M&A deals being proposed by companies. ...Key issues that would form part of such a framework [would be]...in particular the question of what constitutes a good strategy, from an institutional shareholder perspective...”

The LAPFF Trustee Guide provides trustees with such a strategic assessment, which takes into account the corporate governance and CSR aspects that are most commonly cited as reasons for failure of M&A transactions. It also includes recommendations on circumstances leading to intervention.

The guide is based on an M&A disclosure framework developed by the Forum, which defines activities that are typical of successful acquirers, such as thorough pre-acquisition planning, early top team selection or conducting a formal post-acquisition review⁴.

In order to translate this framework into a set of questions that trustees should ask when assessing proposed M&A deals, further consideration was given to:

- The likelihood that questions will furnish answers that will allow trustees to determine whether a proposed deal is likely to create or destroy long-term shareholder value
- The access that trustees have to the information that the questions are designed to elicit
- Prior statistical analysis of M&A success and failure, drawn from a variety of sources, which, in turn, draw upon extensive academic and professional research into the subject.

The views contained in this guide on what constitutes a good M&A strategy and successful implementation are largely in line with the general debate on how mergers and acquisitions can add value in the long-term and have been drawn from diverse studies on success and failure.

⁴ LAPFF, *M&A Disclosure Framework, June 2006* (unpublished)

How to Use this Guide

This trustee guide aims to assist local authority pension fund trustees in assessing proposed M&A deals with a view to identifying value creation in the long-term.

It addresses a number of strategic and implementation issues, which in our view give rise to risks, which may contribute to the failure of a merger or acquisition to create long-term value.

The guide highlights both risks and opportunities for each strategic or implementation aspect. The guide illustrates by examples, and sets out pertinent questions to ask acquirers in the run-up to a merger or acquisition, in order to come to an informed view on the proposed deal, and to decide on a way forward, by supporting or opposing the deal, and/or engaging with the acquirer on issues of concern.

In recognition of the fact that local authority pension funds are facing resource and time constraints, a set of 12 core questions out of the total of 37 contained in the full guide have been identified which should enable the rapid assessment of the likelihood that a proposed deal will enhance value. Where resources are too

constrained to achieve this in the run-up to an M&A transaction, or where the assessment is outsourced to fund managers, trustees can fulfill their fiduciary duty by gaining an understanding of the main strategic and implementation aspects that affect success or failure of M&A transactions, and to engage with their fund managers on the degree to which these factors are considered in their decision-making processes. This trustee guide should equip trustees with sufficient insight to help promote the relevant issues.

When using the full trustee guide, trustees or their agents should bear in mind that asking these questions is an exercise in probability assessment, not an exercise in certainty. In other words, if on the basis of the questions suggested in this guide, an acquisition looks prone to failure, this is only an indication of possible failure rather than proof of likely failure.

The factors identified in this guide should therefore not be considered individually in isolation, and the decision on the way forward requires some degree of judgement. If, for example, there is insufficient information available on a number of issues, with individual concerns being moderate, they could collectively trigger opposition to the deal or intervention because of a serious lack of communication by the acquirer.

Obviously, trustees or their agents should also consider the overall value of the acquisition at hand, and the level of investment that the fund has in the companies involved.

Where trustees or their agents decide that engagement with an acquirer is warranted rather than simply opposing a deal, trustees are advised to consider additional, precursor questions to be answered either prior to or during engagement. These are:

- Does the company have an independent board?
- Can the company evidence board independence in prior capital allocation decisions?

- Can management evidence that it acts like an owner, measuring its use of capital against all other possible uses of capital, including returning cash to shareholders through dividends or share repurchases?

While it is the trustees' right as shareholders to be given sufficient information pre-deal, including views on the acquirer's stated intentions towards the company and its employees⁵, the full guide suggests a number of areas that trustees or their agents should explore which will not normally be readily disclosed by acquirers in offer documents or shareholder circulars. In many cases, obtaining information on these areas will require additional research or contacting the acquirer directly, which in many cases will go beyond the resources available to trustees. Therefore, this guide provides a subset of twelve questions as an alternative: the answers to the twelve core questions should in general be readily available in an acquirer's offer documentation, without necessitating further research from other sources or contacting the acquirer.

However, if the answers to the core questions raise concerns, trustees should seek to obtain answers to the full set of questions, and also consider engaging with management.

The Forum believes that investors need more information on risks and opportunities, mitigation and long-term prospects than acquirers are currently required to provide. This is particularly the case for issues surrounding implementation. The Forum considers it part of the fiduciary duty of trustees to raise pertinent questions with acquirers, in order to ensure that they receive all the information necessary for the offer assessment.

If monitoring and engagement has been outsourced to fund managers, trustees may want to impress upon their managers the importance of these key issues to be considered. In fact fund managers may be better placed to obtain the desired information from company boards, given their responsibility for company monitoring.



⁵ LAPFF, *M&A Procedures in the UK, 2005* (unpublished)

Chapter 3 – Core Questions

Question	Commentary
What is the company's track record in M&A with respect to value creation?	One of the clearest indicators of a company's ability to make successful acquisitions is its record of having done so in the past. The way to establish whether or not a past acquisition was successful is to ascertain whether it met the objectives set out by the management team pre-deal.
Has the company transformed its acquisition strategy into a core competence?	Successful acquirers treat M&A as a core capability, which forms an integral part of a pre-planned growth strategy. Such companies standardise their approach around learned lessons and experience as they go and have been found to outperform companies that engage in M&A episodically and less systematically.
Is the valuation of the acquirer at the upper end (top decile/top quartile) of its long-term valuation range?	Companies that do not think about M&A as a planned process tend to engage in acquisitions periodically – often during periods in which the share prices of their companies (and the valuations of target companies) are elevated. Acquiring in such 'hot markets' is normally an indicator of value destruction.
Is the operating performance of the acquiring company superior or inferior to the operating performance of the target?	Successful acquirers tend to acquire with a view to improving the operating performance of a target with weaker operating performance through the skills, knowledge and process transfer. Acquirers that achieve poor returns from M&A tend to buy from a position of weakness, seeking to import operational skills from the target firm.

Question	Commentary
To what extent does the proposed deal increase or dilute the company's focus on existing business?	While diversification by acquisition is not necessarily a bad thing, it has been shown that acquisitions which increase a company's focus in existing businesses outperform those that dilute a company's focus on existing business. Successful acquirers tend to increase their focus, for example, by moving into new geographic regions, or by adding new distribution channels for existing products and services.
How large is the market capitalisation/value of the target firm in relation to that of the acquiring firm?	Companies that enjoy the highest returns from M&A are those that systematically buy companies that are a small fraction of their own size, i.e. target firm is 15% the size of the acquiring firm or less. Acquisitions in which the target firm is 30% as large as the acquiring firm, or greater, can lead to poor returns.
Is the acquisition of a listed company or of a private company?	The pre-bid valuation of listed targets is likely to be closer to their true worth than it is for private entities. The acquisition of listed companies tends to take more time than the acquisition of private companies. In most deals in which a private company is acquired, the private company sells to a preferred acquirer which generally makes integration easier.
What proportion of the deal is financed with cash and equity?	Deals that are financed with cash tend to outperform those that are financed with equity. Using stock to finance a deal is considered by some as an indication that incumbent management perceive their equity to be overvalued. Equity financed M&A transactions may also be a marker

Question	Commentary
What proportion of the deal is financed with cash and equity? (continued)	for higher risk deals. Debt service requirements impose a discipline on the acquirers to extract the identified value of the target company. Also, debt-financed M&A transactions are subject to the additional scrutiny of lenders.
Is executive management rewarded for creating long-term shareholder value (return on capital employed, for example) or simply for growing the acquirer's sales, earnings or other volume related metric?	In setting acquisition objectives, the interests of management can often diverge from the interests of shareholders. The underlying reason why acquiring companies overpay for acquisitions and thus destroy shareholder value is in part due to inappropriate incentives for management. Executive management is often rewarded based on earnings per share (EPS) growth and/or the company's size (sales, assets or number of employees) – and M&A deals may provide a quick and easy way to boost these two metrics.
What proactive steps has the acquirer taken to identify and address cultural issues arising from the transaction?	Cultural issues are often considered late in the acquisition process. Culture pervades the entire business from top to bottom and is manifest in different languages, working practices and procedures, employee legislation, management styles, employee attitude, and communication. Especially in acquisitions that entail fuller integration, when systems are introduced that are new to all employees, the acquirer runs the risk of alienating both acquired and acquiring employees; with it comes the increased risk of losing key staff.

Question	Commentary
Are the strategic benefits of the transaction based on initiatives that carry a high probability of success or upon initiatives with low or varying probabilities of success?	Acquisitions in which, for example, acquired firms are granted a large degree of post-deal autonomy may be considered simple in respect of the fact that such acquisition benefits have proven to be relatively easy to obtain in a large sample of M&A transactions. Acquisitions in which success is premised on a number of initiatives with a low probability of success, e.g. the subsequent development of a new technology, the creation of a new market and the acquisition of licences to operate at reasonable cost, face a greater risk of failure.
What was the initial stock price reaction to the announcement of the deal?	The stock market's initial reaction to a deal serves as an excellent indicator of the share price performance of the acquiring firm one and five years out.



Chapter 4 – Strategic Considerations

KPMG's latest survey of M&A activity found that 67% of deals enhancing value resulted from the identification of a suitable target in advance, compared with 28% that were opportunistic or where the strategy was unclear.⁶

Every deal that a company does should be premised on a clear understanding of how that deal will create value for the company. Trustees need to consider whether or not an acquirer and its chosen target company are suitable businesses for an M&A transaction from this strategic perspective.

Considerations include whether the proposed transaction fits with the acquirer's understanding of how it makes money and competes; how large the acquisition is in relation to the size of the acquiring firm; whether the deal is part of a series of deals that the acquiring firm has engaged in or whether it represents occasional activity, and whether it serves to increase the acquirer's focus in existing

businesses or diversify the firm's activities into unrelated areas.

Acquirers need to consider such issues carefully and trustees need to be sure that these considerations do not lead to acquisition failure.

4.1. Acquisition process

A pan-European study by KPMG in 1997 found that, of the CEOs interviewed, the most commonly cited 'lesson learned' in M&A transactions was not having done adequate pre-acquisition planning, nor allowing sufficient time for it.⁷

Additional studies confirm that successful acquirers treat M&A as a core capability, which forms an integral part of a pre-planned growth strategy.⁸

Such companies standardise their approach around learned lessons and experience as they go and have been found to outperform companies that engage in M&A episodically and less systematically.⁹

The most successful acquirers plan their acquisitions meticulously.¹⁰ They create a list of potential acquisition candidates. They screen these candidates for strategic fit with the way in which they make money and compete. And they develop a detailed profile of the target companies' industries, their competitive position, their operating performance and their management teams.

4.1.1. Risks and opportunities

Companies that enjoy the highest returns from M&A tend to build permanent deal teams that work closely with relevant operating managers to appraise deals.¹¹

They engage in deals through market cycles in a proactive process that creates acquisition opportunities and which responds rapidly and systematically to opportunity.

Conversely, more than 50% of executives confirm that their companies have not been able to transform their M&A experiences into a core competence, which would enable them to think about M&A as a planned process.¹² Such companies tend to engage in acquisitions periodically – often during periods in which the share prices of their companies (and the valuations of target companies) are elevated. Acquiring in such 'hot markets' is normally an indicator of value destruction.¹³

It has also been found that the stock market's initial reaction to a deal serves as an excellent indicator of the share price performance of the acquiring firm one and five years out.¹⁴

⁶ KPMG, *Beating the Bears: Making global deals enhance value in the new millennium*, June 2003

⁷ Quoted in Nancy Hubbard, *Acquisition Strategy and Implementation*, Palgrave MacMillan, 2001

⁸ David Harding and Sam Rovit, *Mastering the Merger: Four Critical Decisions That Make or Break the Deal*, Harvard University Press, 2004

⁹ Bruner, op cit

¹⁰ Harding and Rovit, op cit

¹¹ Harding and Rovit, op cit

¹² Harding and Rovit, op cit

¹³ Bruner, op cit

¹⁴ Mark Sirower in David Henry, *Mergers and Acquisitions: Why Many Big Deals Don't Pay Off*, Business Week, October 14, 2002; reported in Bruner, op cit

4.1.2. Example: Types of acquisition processes

Objective/reason	Explanation
Acquisition teams	Certain acquirers employ permanent M&A staff who are tasked with searching for suitable acquisition candidates and for codifying the acquisition process around learned lessons.
Line managers	Acquisitions benefit when managers who have responsibility for post-deal integration and operations are involved in due diligence and planning.
Senior level veto	In order to remove possible bias, many companies ensure that deals are signed off by senior managers who are not part of candidate appraisal or due diligence.
Pricing discipline	Successful acquirers often demonstrate a willingness to walk away from deals and certain acquirers build a robust pricing discipline into the acquisition process.
Remuneration	Certain acquirers are careful to ensure that remuneration of senior staff is not tied to M&A execution.

4.1.3. Key questions

1	Has the company transformed its acquisition strategy into a core competence?
2	Does the acquirer employ permanent M&A staff?
3	At what stage did/will line managers become involved in the deal?
4	Is the remuneration of senior staff involved in the transaction tied to the execution of the transaction or to the success of the transaction?
5	What was the initial stock price reaction to the announcement of the deal?
6	Is the valuation of the acquirer at the upper end (top decile/top quartile) of its long-term valuation range?

4.2. Acquisition objectives

The acquirer's objectives for the acquired business should be compatible with the acquirer's strategy of either maintaining or increasing the returns made on a growing capital base. In particular, the acquirer's objectives should reflect an understanding of how it creates value for shareholders on a sustainable basis.¹⁵

4.2.1. Risks and opportunities

Companies that enjoy the highest returns from M&A tend to buy from a position of strength.¹⁶ With a view to improving the operating performance of the target firm through the transference of skill, knowledge and process, they acquire or absorb companies with weaker operating performance than their own in related businesses that are underperforming. They also tend to do deals that increase their focus in the industries or sectors in which they operate: often with the aim of increasing market share - by consolidation; by moving into new geographic regions, or by adding new distribution channels for existing products and services.¹⁷

Conversely, companies that experience poor returns from M&A tend to buy from a position of weakness; seeking to import operational skills from the target firm. They also tend to do deals that diversify their businesses into industries or sectors in which they have no particular prior competence. That does not mean that diversification by acquisition is necessarily a bad thing. But it has been shown that acquisitions which increase a company's focus in existing businesses outperform those that dilute a company's focus on existing business.¹⁸

In addition, in setting acquisition objectives, the interests of management can often diverge from the interests of shareholders. Research by Stern Stewart concludes that the underlying reason why acquiring companies overpay for acquisitions and thus destroy shareholder value is related in part to inappropriate incentives for management.¹⁹ Executive management is often rewarded based on earnings per share (EPS) growth and/or the company's size (sales, assets or number of employees) – and M&A deals may provide a quick and easy way to boost these two metrics.

¹⁵ Harding and Rovit, op cit

¹⁶ Bruner, op cit. See also Harding and Rovit, op cit

¹⁷ McKinsey, *Deals That Create Value*. Reported in Harding and Rovit, op cit

¹⁸ Bruner, op cit

¹⁹ Dennis Soter, *Why Most Winners Lose*, Stern Stewart Research, Volume 3, Issue 4, April 2001

4.2.2. Example: Types of acquisition objectives	
Objective/reason	Explanation
Financial synergies	For example, an acquisition in a certain location can be used to gain tax efficiencies, to take advantage of transfer pricing, or to secure more attractive financing terms or rates.
Diversifying	Entering either into a new geographic area or a new industry. In most cases, the acquirer has little experience in the new industry or geographic area.
Focusing	An acquirer buys another element of its channel of distribution, either in securing parts or resources, or in distributing its own product. An acquirer may also buy a direct competitor in an existing market. The two entities share knowledge of industry in which both operate.
Asset potential	Using acquirer skill and knowledge to improve target assets to improve target performance. Using target assets, skill and knowledge to improve acquirer returns. For example, venture capital houses provide resources necessary to improve a target's performance, with the intention of selling on the improved company.
Economies of scale	Partial or whole merging of the target and acquiring organizations, for example, by combining of operating sites, head offices and functions.
Growth	Companies in which senior management is rewarded on the basis of metric growth (EPS or sales, for example), may be more eager to pursue acquisitions than companies in which senior management is rewarded on the basis of the creation of shareholder value. While most acquisitions grow sales and many grow EPS, only a minority of acquisitions increase shareholder wealth.

4.2.3. Key questions	
7	How does the investment thesis behind the deal fit with the acquirer's understanding of how it makes money and competes?
8	Is the operating performance of the acquiring company superior or inferior to the operating performance of the target?
9	To what extent does the proposed deal increase or dilute the company's focus on existing business?
10	Allowing for cannibalisation of existing business, what effect will the acquisition have on the acquirer's market share?
11	Is executive management rewarded for creating long-term shareholder value (return on capital employed, for example) or simply for growing the acquirer's sales, earnings or other volume related metric?

4.3. Acquisition type and acquisition success

The data on M&A support the view that acquisition type and acquisition success are related. Acquisitions vary by type across several measures; including deal size, means of payment, and listed versus private target firms.

4.3.1. Opportunities and risks

Companies that enjoy the highest returns from M&A are those that systematically buy companies that are a small fraction of their own size; that is; acquisitions in which the target firm is 15% the size of the acquiring firm or less.²⁰

Conversely, companies that experience poor returns from M&A tend to engage in large transactions: that is; acquisitions in which the target firm is 30% as large as the acquiring firm, or greater. There are three principal reasons for the poor returns from this type of acquisition. First, the complexity of a deal increases with deal size, which means that an acquirer's implementation abilities may be overstretched (see below). Second, when large deals fail they naturally have greater consequential effects upon the performance of the acquiring firm than small deals that fail. Third, firms that make large acquisitions tend to be

²⁰Harding and Rovit, op cit

strategically challenged in relation to those that make smaller acquisitions.²¹

Acquisitions that are part of a serial acquisition strategy tend to be more successful than one-off or periodic acquisitions.²² When an acquisition is part of a serial process it is usually indicative of the fact the acquirer has a well thought out and robust acquisition process.

Agreed takeovers tend to be more successful than contested, or hostile, takeovers. In cases with more than one potential suitor, the target usually provides less information to the acquirer in its due diligence process, as it must do so to all potential acquirers. In cases of hostile acquisitions, the ability to gather accurate information pre-deal can be impaired, as the target may not grant access to internal information. In addition, in hostile transactions, employees may be less welcoming of the acquisition, decreasing their willingness to cooperate or to stay on post-acquisition. Each of these considerations has implications for the ability of the acquirer to successfully implement the acquisition post-deal.

Acquisition success rates are higher in those instances in which the acquirer buys a private company versus those instances in which the acquirer buys a publicly listed company.²³ This is most likely because the pre-bid valuation of listed targets is closer to their true worth than it is for private entities. It is also because the acquisition of listed companies tends to take more time than the acquisition of private companies. Finally, in most deals in which a private company is acquired, the private company sells to a preferred acquirer which generally makes integration easier.²⁴

Deals that are financed with cash tend to outperform those that are financed with equity.²⁵ Using stock to finance a deal is considered by some as an indication that incumbent management perceive their equity to be overvalued. Once this is signalled to the stock market through the use of stock as a means of payment, the stock market usually takes notice and downgrades its estimation of the valuation of the acquirer.²⁶ Equity financed M&A transactions may also be a marker for higher risk deals.²⁷ One of the reasons

cited for the better performance of cash-based deals is that debt service requirements impose a discipline on the acquirers to extract the identified value of the target company.²⁸ Also, debt-financed M&A transactions are subject to the additional scrutiny of lenders.

Time delays increases the likelihood that acquisitions will fail pre-deal. The timetable for public deals in the UK is a minimum of 60 days, but there is much potential for delays as outlined below.

4.3.2. Example: Acquisition types	
Objective/reason	Explanation
Public or private target	UK public deals face the potential for delays if there are multiple bidders, or if the transaction is referred to the Competition Commission. Publicly listed firms are also priced in a very competitive market place. Neither of these factors applies to private deals.
Agreed or contested	Agreed acquisitions: target board of directors agrees with terms and price being offered. Contested or hostile acquisitions: board of directors rejects the offer.
Requirement for industry approval	Regulated industries (e.g. airlines, utilities) require the industry ombudsman's approval. This can delay the transaction or even make it fail.
Requirement for regulatory approval	Acquisitions may need approval by national Competition Commissions. May result in substantial delays and/or conditions for the deal to protect competition.
Target small compared to acquirer	Acquisition teams (internal employees and/or consultants) may lack adequate resources for successful implementation. Unlikely to damage the business unduly going forward, but represents a missed opportunity.

²⁵ *Cash is King*, Financial Times, 21 February 2005

²⁶ James Montier, *Behavioural Finance: Insights into Irrational Minds and Markets*, John Wiley & Sons, 2002

²⁷ *Cash is King*, op cit. See also Montier, op cit and Henry, op cit

²⁸ Soter, op cit., p.10. See also *Cash is King*, op cit

²⁸ Soter, op cit., p.10. See also *Cash is King*, op cit

4.3.2. Example: Acquisition types	
Objective/reason	Explanation
Target large compared to acquirer	A too large target can lead to acquisition indigestion. Worst outcome: destruction of the acquirer, or the combined business if they are merging.
Merger of same-size targets	Target and acquirer in combination create a much larger entity. Management, while competent to run a medium sized enterprise, does not have the skills necessary to run the enlarged group.
Means of payment	Acquisitions can be financed using cash, equity or debt or some mix of each. The means of payment in an acquisition can have a strong bearing on post-deal governance.

4.3.3. Key questions

12	How large is the market capitalisation/value of the target firm in relation to that of the acquiring firm?
13	Does the acquisition form part of a planned serial acquisition policy?
14	Is it an agreed or hostile deal?
15	Is the acquisition of a listed company or of a private company?
16	What proportion of the deal is financed with cash, debt and equity?
17	How quickly is the deal likely to go through?

4.4. Due diligence

Acquirers use due diligence to evaluate a potential target pre-acquisition. It is often restricted to issues and major risks that could make the deal fail rather than the implementation after the deal. Due diligence should extend beyond the traditional financial or legal boundaries, because other factors such as management team characteristics, or differing employment or environmental standards between acquirer and target can be of importance when it comes to acquisition implementation or integration of two entities.

4.4.1. Opportunities and risks

Acquisition type (section 4.3) has a large bearing on the accessibility and amount of information available to an acquirer. In cases of limited access to target information, due diligence must be more creative but remains absolutely critical to the transaction's overall success.

Information pertaining to 'hard' issues, such as understanding a target firm's customer base, is relatively easy to obtain. Successful acquirers distinguish themselves, however, by analysis of

softer issues. An effective risk management and due diligence process will identify all political, regulatory and environmental risks at an early stage as well as any potential employee issues.²⁹ For example, a KPMG survey on environmental due diligence found that for some companies, starting to consider the health, safety, social and environmental (HSSE) issues during an M&A transaction can significantly decrease unpleasant post-deal surprises.³⁰ An additional consideration is whether there is evidence of due diligence in areas which the acquirer has identified as risk factors for the deal.



²⁹ International Federation of Accountants (IFAC). *Enterprise Governance: Getting the Balance Right*, February 2004

³⁰ KPMG, *Impact – A survey on environmental due diligence*, May 2004

4.4.2. Example: Types of due diligence

Types of DD	Explanation
Commercial/ marketing	For example, names of key clients and future order confirmation; understanding the target’s customer base. Target will often not grant access until heads of agreement or a conditional offer have been accepted.
Human resources	Can uncover any outstanding tribunals, employee-related law suits or pension obligations that the acquirer may be liable for in the future. Lower degrees of integration: assessment of key employees, and existing succession plans. Higher degree of integration: differing employee policies and standards.
IT systems	Important in acquisitions with heavy expenditure in IT going forward (for example, migration of one system to the other in merged business), or where IT is a major reason for acquiring the target.
Health and safety, social, environmental issues	Can uncover competitive strengths and weaknesses that pertain to future target firm performance, its appropriate valuation and the availability of expected synergies. For example, understanding of medium- to long-term environmental risks to the acquirer, i.e. regulatory, physical and financial risks arising from environmental issues.

4.4.3. Key questions to ask your fund manager or yourself

18	What factors, beyond traditional financial and legal issues, has the acquirer taken into consideration in its due diligence?
19	In the acquirer’s opinion, what weight do these factors carry in their contribution to deal success or failure?
20	What health, safety, social and environmental (HSSE) issues have been uncovered in the due diligence process?

Chapter 5 – Planned Implementation

KMPG found in 1999 that all successful acquirers included in its study undertook at least four key implementation activities:

- Active synergy paper assessment.
- Internal employee communication.
- Dealing proactively with cultural differences.
- Picking the top management team quickly.

These should be the elements of successful implementation planning, which would result in the written plan of how the acquirer is to proceed once the target is acquired (section 5.1). Sections 5.2 to 5.6 outline practice issues that acquirers are likely to face, and will need to address as part of their implementation plan.

5.1. The written implementation plan

Thorough implementation plans can mitigate risks arising during acquisition implementation. Acquisitions regardless of their size and complexity should be accompanied by a written implementation plan. Once the acquisition process is rolling, acquirers without a written implementation plan may well run out of time.

Elements	Section in this guide
Acquisition process	Section 4.1
Strategy for the combined business	Section 4.2
Senior management team	Section 5.4
Timing and type of planned changes	Sections 5.3, 5.5
Communication plan	Section 5.6

Table 1. Elements of a written implementation plan.

5.1.1. Opportunities and risks

Many purchasers underestimate the complexity of an acquisition.

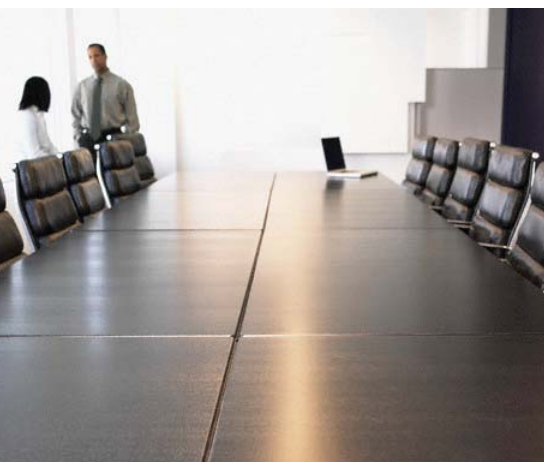
All transactions bring with them their own implementation issues. In larger deals, it is difficult for acquirers to understand the complexities and

interdependencies especially when considering differences in operating procedures, languages, and cultures.

In smaller acquisitions, senior management's limited time is being pulled in multiple directions, often meaning that planning is neglected.

5.1.2. Key questions

- | | |
|----|--|
| 21 | Has the company set down a written implementation plan? |
| 22 | Does the thinking that underpins the implementation plan evidence that the acquirer is seeking to mitigate the integration, cultural and communication risks of the transaction? |



5.2. Track record

One of the clearest indicators of a company's ability to acquire successfully is its success of having done so in the past. The way to establish whether or not a past acquisition was successful is to ascertain whether the acquisition met the objectives set out by the management team pre-deal. In order to do that, the management team will need to conduct a post-acquisition review.

5.2.1. Opportunities and risks

Some serial acquirers have an in-house implementation process honed over years of acquiring. Others buy in the requisite skills using consultants to help with the process. Whichever is the case, all acquisitions bring with them their own implementation issues, and hence previous acquisition experience is no guarantee for future implementation success.

An indication of valuable acquisition experience is seen in those companies who run a formal post-acquisition review in which they assess any deals for elements that went well or could be done better next time. Without this formal review, acquirers run the risk of overestimating their M&A skill and of making the same

mistakes in any future acquisition. However, only approximately 45% of companies in the UK do conduct some sort of post-acquisition review of how well the company met its objectives, leaving over half that do not.³¹

Any acquirer that moves into another sphere in which they have not previously made acquisitions requires additional caution and forward planning to address the increased complications. If the acquirer moves into unfamiliar territory, steps should be taken to mitigate the risk: hiring local experts or consultants to help with the implementation or regulators, having a robust internal process and personnel to support the process, and demonstrating that they are prepared for the increased complexities of the acquisition.

5.2.2. Example: Activities of the successful serial acquirer

- | |
|--|
| Conducts a formal, periodic post-acquisition review |
| Codifies learned lessons into acquisition process |
| Treats acquiring as a core competence |
| Mitigates risk when moving into unfamiliar territory |

5.2.3. Key questions

- | | |
|----|--|
| 23 | What is the company's track record in M&A with respect to value creation? |
| 24 | Can the company evidence that it conducts systematic reviews of acquisition success and failure? |

³¹ Source

5.3. Implementation resources

The types and scope of resources needed for successful acquisitions are significant and should be considered prior to the acquisition.

5.3.1. Opportunities and risks

If acquirers do not consider their time, skills and costs before an acquisition, i.e. if they are not planning for resources, the acquirer may as a result be overstretched in the implementation

phase. Consultants may then be called in at the last minute to ease some of the time pressure, which in turn raises the cost. In extreme cases this can cause a downward spiral of related issues leading to acquisition failure, i.e. the acquisition objectives are not achieved because the implementation costs are much higher than previously allocated and reduce synergy to an unacceptable level.

5.3.3. Key questions

25 What is the company's estimate of acquisition resource cost as a proportion of total transaction value?

26 What proportion of this resource will be supplied internally?

5.4. Top team selection

Acquisitions that rely on a greater degree of integration often have a surplus of senior management. In businesses where the acquirer maintains a lower degree of integration, acquired management is not being merged into a new structure, and therefore management talent may be at a premium.

5.4.1. Opportunities and risks

Surplus management in merger situations is not necessarily a problem (the acquirer should, however, be announcing, as part of their implementation plan, how they plan on selecting and retaining key managers); losing managers may well be if crucial organisational knowledge about the target is lost. Acquirers should therefore assess the risk of losing key managers pre-acquisition. Cases where a founder is still involved or executive options vest upon takeover deserve special

consideration because the risk of wealthy senior management leaving is increased, and retention and succession planning is crucial. Also, where current management, in both acquirer and target, does not bring the skills necessary for the intended implementation, for example, because they have the skills to run a medium-sized entity, but not those required to run a large organisation that would be the result of a merger, the acquirer should consider top team requirements pre-acquisition. Companies are most vulnerable to talent poaching in the period immediately after an M&A announcement. Competitors will approach the best employees of a company involved in an M&A deal in the hope of leveraging their uncertainty.³³ Consequently, it is important to develop an effective retention strategy at an early stage to identify and retain key employees.³⁴

³³ Kristen Donahue, *How to Ruin a Merger: Five People-Management Pitfalls to Avoid*, Harvard Management Update, September 2001

³⁴ Roger Pudney, *2 + 2 = 5*, The Ashridge Journal, Summer 2003. See also Kristen Donahue, op cit., p.4 and IFAC, op cit., p.45

5.3.2. Example

Types of resources	Explanation
Financial	Advisor fees (investment banks, due diligence providers, lawyers, PR firms, acquisition planning specialists, etc.) and ongoing or additional costs (capital expenditure and the rise in the combined wage bill) can add substantially to the actual purchase price. ³² There are also significant costs associated with redundancies or closing sites.
Management time	Management working on the implementation teams usually do so initially on a full-time basis, meaning that others have to perform their job responsibilities for the immediate 100 days following an acquisition.
Management expertise	The acquirer's management expertise to successfully manage implementation: successful track record in acquiring, in-house acquisition process and team. Note that the skills needed for merging two entities differ from those required for a low-level acquisition.

³² Source

5.4.2. Example: Risks	
Items	Explanation
Top team not determined early	Management in both target and acquisition may worry about their positions going forward; they may be approached by competitors, and politics may distort perspectives. Impact on productivity and retention.
Hostile acquisitions	Potential resignations of key senior staff: immediate management vacuum. For example, Focus DoltAll's 2000 acquisition of Wickes in which the entire Wickes board of directors resigned upon transaction completion. Morrisons, when acquiring Safeway, had identified two executive directors of Safeway which it intended to retain because of their experience, without indicating how it would attract them into the role, or what succession plans they had in place should the directors step down along with the rest of Safeway's board; both directors decided to step down prior to the final offer in January 2004.
Options vest upon takeover/founder still involved	In cases where a founder is still involved or executive options vest upon transaction, senior management is often wealthy enough that they can retire or resign from the business

5.4.3. Key questions	
27	Has the acquirer selected its top team for the combined entity and put retention plans in place for these individuals?
28	Has the company developed a succession plan in the event of losing key staff?

5.5. Synergy assessment

In order to determine an appropriate offer price for the target, the acquirer must ascertain what synergies exist between the acquirer and target. It is difficult for outside observers to assess the quality of thinking behind a company's synergy assessment. Nevertheless, from a shareholder's perspective, the proper definition of a synergy is any benefit that arises from the combination of two firms that would not otherwise be available to the shareholder.

5.5.1. Opportunities and risks

Unrealistic synergy assessments may well result in acquirers paying more for the target than it is actually worth to them and, given the nature of synergy appraisal, a general rule of thumb is that, the higher the expected synergy in a deal, the higher the risk that the deal will fail to live up to expectations.

Bain & Company reports that two-thirds of acquiring company executives admit to overestimating synergies and that their prospective exaggeration had been an important factor in an ultimately disappointing deal outcome.³⁵

In addition to positive synergies, negative synergies attach to some deals. For example, up to 42% of acquiring companies lose ground in respect of organic post deal growth compared to non-acquiring peers.³⁶ Many combined entities lose market share early post M&A transactions.³⁷ And companies commonly experience an increase in the number of customer complaints in the period after an M&A deal.³⁸

According to a study by KPMG, which measured the degree to which acquirers captured expected synergies, some synergies are easier to obtain than others.³⁹ KPMG's general finding is that synergies available from the cost reduction benefits of M&A tend to be realised more fully than those available from the business expansion benefits of M&A (see the table below for details).

'Simple' deals in which the success of an acquisition is predicated on initiatives with a high probability of success (based on large sample size data from similar initiatives) tend to outperform more complex deals in which success rests upon favourable outcomes from (a

³⁵ Harding and Rovit, op cit

³⁶ Harding and Rovit

³⁷ Hubbard, op cit

³⁸ Donahue, op cit

³⁹ KPMG, *Unlocking Shareholder Value: The Keys to Success*

possibly large number of) initiatives to which a low probability of success attaches (based on large sample size data from similar initiatives).⁴⁰

Especially in complex acquisitions, or those where the acquirer pays a large premium, trustees should be mindful of the synergy calculations provided.

One of the main weaknesses of the offer document relating to the takeover of BAA by Grupo Ferrovial in 2006, for example, was the lack of disclosure on implementation plans and synergy expectations, leaving investors fully in the dark as to the justification of the 54% premium paid for the target.

Cost reduction	Success rate synergies	Business expansion	Success rate synergies
Head count reduction	66%	New customers	45%
Buying and merchandising	60%	New markets	42%
Supply chain	60%	Marketing	34%
Procurement	48%	New product development	34%
Manufacturing	35%	Cross-selling	25%

5.5.2. Example: Synergy initiatives (continued)

Items	Explanation
'Simple'	The strategic benefits of the transaction are based on initiatives that carry a (proven) high probability of success. Acquisitions in which, for example, acquired firms are granted a large degree of post-deal autonomy or in which acquired products and services are plugged into existing distribution channels may be considered simple in respect of the fact that such acquisition benefits have proven to be relatively easy to obtain in a large sample of M&A transactions.
Complex	The strategic benefits of the transaction are based a possibly large number of initiatives with (proven) low or varying probabilities of success. Acquisitions such as Vodafone's purchase of Mannesmann may be considered complex in respect of the fact that acquisition success was largely premised on: <ul style="list-style-type: none"> (i) the subsequent development of a new technology; (ii) the creation of a new market, and (iii) the acquisition of licences to operate at reasonable cost – all of which comprise initiatives with a low probability of success based on large sample evidence. The greater the number of interdependent events in such acquisitions, the greater the risk of failure.

5.5.3. Key questions

29	What is the break down between synergies that are available from expanding sales through the deal, and those that are available from reducing costs?
30	What is the break down of expected synergies under the headings of sales expansion and cost reduction?

5.5.2. Example: Synergy initiatives

Items	Explanation
Redundancies	The Transfer of Undertakings Protection of Employment (TUPE) requires that acquirers consult with employees prior to any changes affecting their jobs. While this is a costly process, non-compliance can be even more costly as well as damaging to employee relationships.
Cross-sell potential, market share	For example, bank/insurance mergers (the bank is seen as distribution channel for insurance products). Ability to cross-sell after acquisition stymied by a variety of circumstances. Most acquisitions result in a drop of market share for the combined business: for example, Royal Bank of Scotland/Natwest: offer document cited market share cannibalisation of up to 5% of the combined group, an assumption that proved to be relatively accurate.

⁴⁰ Principal concept: Bruner, op cit

5.5.3. Key questions (continued)

- | | |
|----|--|
| 31 | Is the transaction simple or complex, i.e. are the strategic benefits of the transaction based on initiatives with a high probability of success, or a (possibly large number of) initiatives with a low or variable probability of success? |
| 32 | In the case of an acquisition of a listed company, what is the size of the premium paid in relation to the total value of the combined entities? |

5.6. Integration, culture and communication

In order to achieve the acquirer's objectives (section 4.2), the acquirer has four basic options in terms of how far, if at all, it integrates the target; from the granting of effective autonomy to fully absorbing the acquired firm into parent company oversight and managerial practice (see below).

During integration, acquirers need to be acutely aware of the respective cultures of target and acquirers, and the communication needs that result from the proposed acquisition.

Culture pervades the entire business from top to bottom and is manifest in different languages, working practices and procedures, employee legislation, management styles, employee attitude, and communication. Especially in acquisitions that entail fuller integration, when systems are introduced that are



new to all employees, the acquirer runs the risk of alienating both acquired and acquiring employees; with it comes the increased risk of losing key staff. Whether or not cultural differences between the two organisations exist, effective communication, i.e. that employees are kept up to date on issues and events as they happen, is crucial. A very high correlation has been found in the ability of acquirers to manage employees' expectations and overall acquisition implementation success.

Especially important is the information given to employees on the day the acquisition is announced, the plan for Day One (the day the acquirer officially takes control of the target), and those announcements designed for communicating key decisions.

5.6.1. Opportunities and risks

The further an acquirer integrates the target, the greater the potential cost savings, but the greater the risks. Implementation of a higher degree of integration is more time consuming and complicated and requires a different skill set to that needed for a lower degree of integration. Companies that are experienced at low integration acquisitions may not have the skills necessary for full mergers.

In a study carried out by KPMG in 1998 executives reported that they had not considered cultural issues enough in their acquisitions and had done so late in the acquisition process.⁴¹ The executives also agreed that such issues should be addressed in the planning phase of an acquisition rather than in the implementation phase.

⁴¹ Hubbard, op cit

⁴² Harding and Rovit, op cit. See also IFAC, op cit

⁴³ KPMG, *Beating the Bears*, op cit



Acquirers that opt for a lower degree of integration will face less cultural implications. This is simply because fewer employees are affected by the changes that are inherent to any acquisition: the introduction of new systems, working practices, colleagues and management. The risk of reduced productivity or losing staff is common to both the failure of addressing culture and communication issues early on.

There is weak evidence that deals that involve significant cultural issues underperform those in which cultural issues are not significant. However, there is strong evidence that companies which identified cultural issues in due diligence and addressed them in integration, regardless of the complexity of cultural issues significantly outperform those companies which do not do this⁴² – and there is some evidence that according a higher priority to integration planning appears to have a favourable impact on the outcome of the deal.⁴³

Chapter 6 – Engagement Opportunities

Worldwide spending on deals was at \$1.5 trillion in 2004, and a strategy of fast growth through acquisitions currently dominates over organic growth. With two thirds of deals not adding value, this trend represents a serious concern for shareholders.



Therefore, if a material concern over a proposed deal has not been adequately addressed in offer documents, trustees need to act.

Whether it is a single overriding concern that triggers intervention (for example the acquirer is engaging in a large one-off acquisition with limited prior acquisition experience), or a number of concerns collectively, the assessment of issues on the basis of this guide should enable trustees, their officers or

fund managers to prioritise concerns and make a decision on whether intervention would add value. While the ultimate means of expressing concerns is by way of an oppose vote at the EGM, there can be value in raising questions with the acquirer in the run-up to the deal. This may uncover useful additional information on the acquirer’s approach, but may also be an opportunity for pension funds to influence acquirers’ approach to M&A positively.

5.6.2. Examples	
Levels of integration	Explanation
Autonomy	Target not physically integrated with the acquirer, but financial controls ensure that it is meeting financial targets set by the acquirer.
Restructuring/financial controls	Target is given an influx of a needed resource (money, management talent), is restructured, and then left to run stand-alone under financial controls.
Centralising key functions	One or more key functions of acquirer and target are combined to achieve cost savings.
Full integration	Two businesses are fully brought together into one new operation.

Impact on culture

- Geographic location (different languages, working practices)
- Company’s history
- Departmental rules, procedures
- Industry
- Degree of integration

5.6.3. Key questions

- 33 What proactive steps has the acquirer taken to identify and address cultural issues arising from the transaction?
- 34 Does the acquirer’s communication strategy evidence that it has taken steps to manage employees’ expectations in an effective manner?
- 35 What mechanism has the acquirer put in place to measure the cultural impact of the deal on the combined firms and their subsequent corporate climates?
- 36 What degree of integration does the acquirer intend with the target firm?
- 37 What evidence is there that prior integration plans of this type have been successful?



www.lapfforum.org

info@lapfforum.org