Local Authority
Pension Fund
Forum

TRUSTEE GUIDE
MERGERS & ACQUISITIONS

The Case for Engaging on M&A:
Raising Standards of Corporate Governance
by Asking the Right Questions

HOW TO USE THIS GUIDE

This Trustee Guide aims to assist local authority pension fund trustees in assessing the quality of the M&A processes that companies use to inform their approaches to M&A, and in assessing whether proposed M&A deals are likely to create or destroy shareholder value in the long-term.

- It updates the Forum's prior guide on M&A (*Which Deals Create Value: Mergers and Acquisitions Through the Lens*), which was published in 2007;
- It argues the case for analysing M&A in its own right as a highly material form of capital allocation;
- It makes the investment case for M&A, whilst also highlighting the financial risks to members that can emanate from M&A, and
- It delineates the Forum's understanding of what good M&A looks like in order to inform engagement on this subject (with investee companies and with the Takeover Panel).

LAPFF considers it part of the fiduciary duty of trustees towards their pension fund members to raise pertinent questions with companies that engage in M&A in order to ensure that they receive all the information necessary to assess particular M&A offers; to play their part in raising standards of corporate governance around M&A, and to extend their stewardship duties to embrace engagements that explore the quality of board-level strategic decision making within investee companies. This Guide therefore articulates a number of questions that fund trustees, officers or appointed fund managers can ask of companies in order to meet these objectives.

HOW LAPFF CAN USE M&A ANALYSIS TO IMPROVE STANDARDS OF CORPORATE GOVERNANCE

Pension fund trustees face a considerable challenge in respect of monitoring and improving standards of corporate governance in the companies in which pension fund members invest:

- LAPFF has recognised that the quality of a Board's decision making process is critical to good governance;
- It has a working model of what a good Board decision making process looks like, which is underpinned by observation, experience and by decision science,
- Yet, whilst Board *policies, processes and prodedures* are generally visible to third parties such as the the trustees that are associated with the Forum, the *behaviours* that comprise a Board's decision making process are not.

The Governance Code's solution to this challenge is to require boards to undertake an annual evaluation of their performance, and that an evaluation of the board of FTSE 350 companies should be externally facilitated at least every three years.

This solution is not ideal. The Forum believes that board self-evaluations can be subject to bias, and it has noted strong reservations about the quality of external evaluation service providers. Many external Board evaluations emphasise policies and procedures - such as gauging whether board members received meeting papers on a timely basis – rather than behaviours. In addition, they frequently feature data gathering by survey which, once again, invites self-evaluation.

The Local Authority Pension Fund Forum is a voluntary association of 69 public sector pension funds based in the UK which manages assets of over £175 billion. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders while promoting corporate social responsibility and high standards of corporate governance among the companies in which they invest.

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In contrast, the Forum has identified the opportunity to analyse more readily observable board behaviours such as remuneration, succession planning, and M&A in order to judge what these behaviours may mean for corporate performance *and* for more general standards of governance within relevant companies.

This guide focuses on one of these behaviours: M&A practice.

WHY NOW?

LAPFF's work to improve standards of corporate governance in the companies in which its members invest has earned it a valuable reputation, which has provided the Forum with improved access to key individuals in this regard. The Forum's thought leadership in the area also gives it the option of mobilizing additional capital behind its initiatives in the shape of reaching out to like-minded institutions for collaboration purposes.

Nonetheless, LAPFF competes with other shareholders for the attention of the companies in which its members invest, and to gather the support of other investors for its engagement initiatives. Corporate directors have a finite capacity to attend to, and engage with, their shareholders, and institutional investors that wish to improve standards of governance in investee companies frequently gravitate towards those collaborations that are most likely to attract the biggest 'players.'

Assets under management by activist vehicles grew from approximately $30 billion in 2008 to over $100 billion in 2014, for example.[1] In 2014 alone, these funds raised $14 billion of new money which represented 20% of all the inflows into the hedge fund market. Indeed, activist investors may now control close to 8% of total hedge fund capital. By their very nature, such funds frequently take a more aggressive approach towards commanding board attention than the Forum, and the mere threat of an activist approach can effectively make boards resistant to messages conveyed by other investors and/or investor bodies.

Using M&A Analysis and Engagement to Enhance LAPFF's Strategic Focus

At the same time, asset owners and institutional investors are being pressed to raise their own standards of corporate stewardship. The Kay Review of UK Equity Markets and Long-Term Decision Making (2012) in particular asserted that traditional forms of shareholder engagement focus disproportionately on corporate governance matters, leading to a vacuum in respect of shareholders' willingness and capacity to engage with investee companies in respect of their strategic decision making.

This is likely to be a critical omission. When Cesare Mainardi of PwC Strategy& analysed the performance of the world's largest companies and singled out those whose market capitalisation had dropped by more than 10% between 2002 and 2012, he found that 80% of the value destruction in these companies resulted from poor strategic choices made at board level.[2]

An informed approach to M&A analysis and engagement has the capacity to address this gap by enabling the Forum to deepen the dialogue it has with investee companies in a subject matter that lies at the heart of strategy and competitive advantage, and which frequently plays a material role in business and stock price performance.

Using this approach to M&A as an engagement platform, LAPFF also has an opportunity to respond to contextual changes that threaten its ability to command the attention of investee companies; which may impede its ability to mobilise the support of other interested parties, and which call upon it to enhance its own approach to stewardship.

THE INVESTMENT CASE FOR M&A

The data presented in *Which Deals Create Value* was of the type that maintained[3]:

- 30% of M&A transactions create shareholder value for the acquirer;
- 39% are value neutral, and
- 31% destroy shareholder value.

Observation suggests that the nature of M&A governance in many acquiring firms has changed since 2007: from one that was dominated by financial opportunism at the time the last Trustee Guide was written to one that is more strategically focused today.[4]

Corporate governance is generally more transparent, and boards now appear to be more engaged in relevant M&A strategies, a fact which may be forcing acquiring firms to do their homework more thoroughly and to report back on M&A performance using quantitative measures.[5] In addition, the 'M&A lessons' taught by business school professors and consultants now have a greater profile - and it appears that leading acquirers at least are paying more attention to empirically sourced descriptions of what a good M&A process looks like, and embedding these within dedicated in-house M&A teams.

Indeed, a relatively new study by Intralinks Holdings Inc. and the Mergers and Acquisitions Research Centre (MARC) at Cass Business School may have picked up on some corporate M&A process developments that were invisible to prior studies.[6]

Whereas most previous academic studies on shareholder value creation from M&A have focused on the impact of individual deals over relatively short time periods, the Intralinks/Cass study analysed the effect of M&A on companies' performance in the context of their overall M&A activity across multiple time periods – for 25,000 global companies during rolling three-year periods over 20 years (from 1994 to 2013).

The study found that a company's Total Shareholder Return (TSR) performance increases with increasing frequency of its acquisition activity. Specifically (and as shown in Figure 1, below):

- Companies outperform the market by 2.0% per annum during periods when they announce three to five acquisitions, and by 3.4% per annum during periods when they announce six or more acquisitions.
- By contrast, during periods when firms are merely "active" (one to two acquisitions announced over a three-year period) they perform on average in line with the market, but underperform the market by an average of 0.4% per annum during periods when they announce no acquisitions.

This result is repeated across all major geographical regions and, in the study's opinion "provides strong evidence that companies that do not undertake any M&A activity may not be maximizing returns for investors."

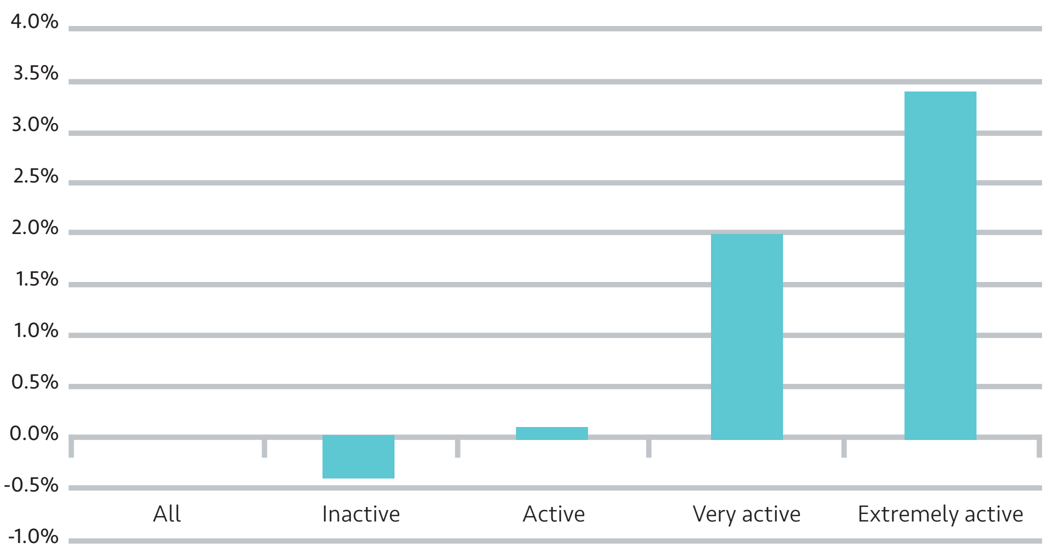
THE STOCK MARKET IS TAKING NOTICE

Improved approaches to M&A are also showing up in the way in which the stock market responds to deal announcements.

In the past, the stock market typically 'rewarded' the announcement of an M&A deal by marking the share price of the acquiring company down. Indeed, the long-term average market-adjusted decline in the share price of an acquiring firm (as a percentage of the transaction value) was 4.4% between 1999 and 2013[7] – meaning that the stock market's verdict on M&A was that (on balance) it would destroy shareholder value for the acquiring firm.[8]

- When the last Trustee M&A Guide was being drafted the same measure of value destruction through M&A was approximately 11.5%.[9]
- By 2013, however, the stock market's reaction to deal announcements had turned positive to the tune of circa 3.8%.
- In addition, whilst the share price of the acquiring firm typically declined 58% of the time between 1999 and 2013 (and indeed declined 59% of the time in 2007), the share prices of acquiring firms went up 55% of the time in 2013 – a new record high in the period under measurement.[10]

Figure 1: The relation between acquisition frequency and returns



Specific data in the US supports the general finding that shareholder reactions to M&A announcements are becoming more positive. Figure 2 below shows, for example, the average one-day price reaction of acquiring firms measured against the performance of the S&P 500 in every year since 2002.

Some may be tempted to write these share price movements off as short-term reactions to M&A deal announcements – but that may do the stock market a disservice. In the past, the stock market's initial reaction to a deal has been found to serve as an excellent indicator of the share price performance of the acquiring firm one and five years out.[11]

This should come as no surprise. M&A deal announcements frequently concentrate the minds of investors in a way that attracts considerable analytical resource, and the market's job is calculate the net present value of the consequences of such capital allocation and reflect it in prices today: on announcement.

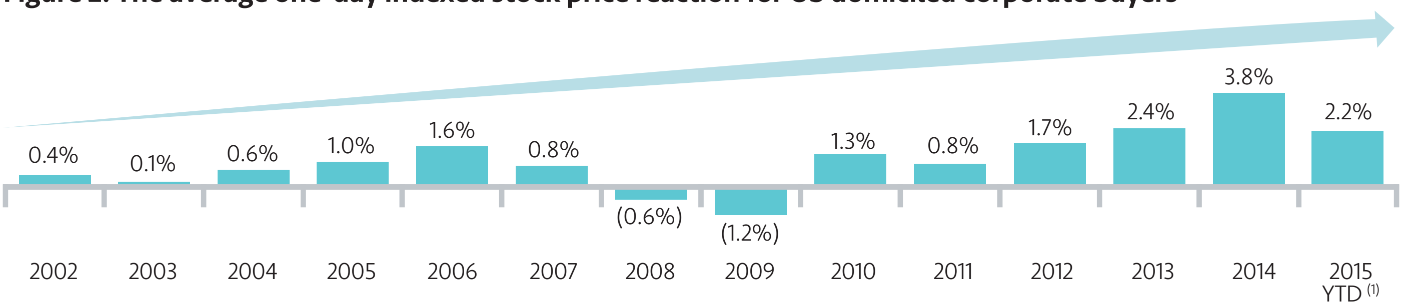
WHAT GOOD M&A LOOKS LIKE

The shareholder funds that firms invest in M&A have exceeded those allocated to all other major uses of capital since the early 1980s (see Figure 3, below), and is reaching new peaks in this cycle.

Indeed, the value of global M&A amounted to approximately $3.2 trillion in 2014, with the volume of M&A in the first half of 2015 (at $2.2 trillion) surpassing that in the first half of 2014 by 40%.[12] That full year 2014 number equates to roughly the size of the UK economy (measured in GDP) and dwarfs the $1.2 trillion that global companies paid out in dividends in that year.[13] (For comparison purposes, UK companies paid $135bn in dividends in 2014, whilst companies in North America and Europe ex-UK paid out $393bn and $250bn, respectively).

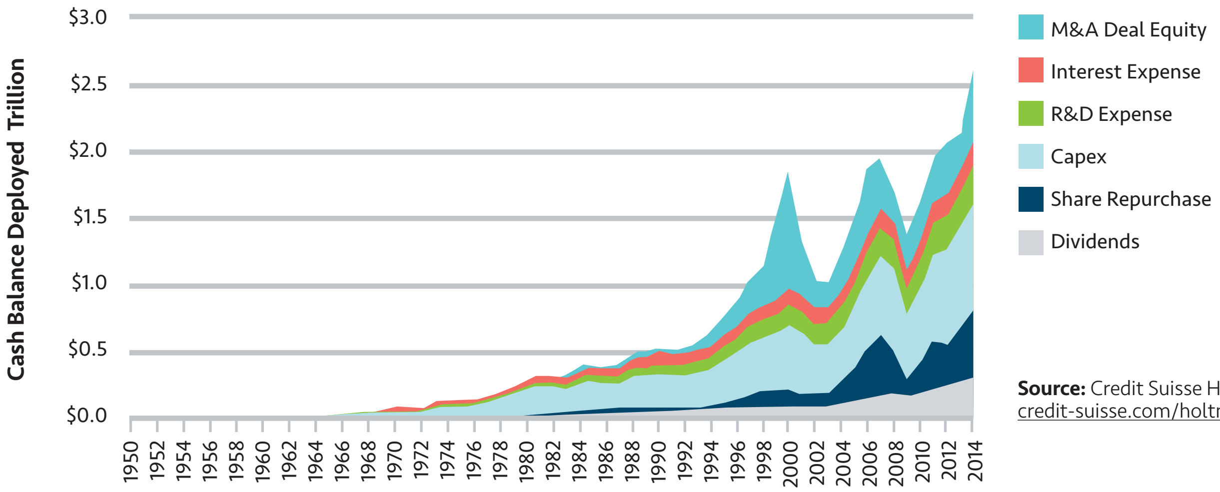
At a macro level M&A clearly represents a critical form of capital allocation. At the micro level, it can also make a highly material difference to corporate growth; to strategic success, and to the creation of shareholder value. Indeed, the average large company gets nearly a third of its growth (or 3.1 percentage points a year) from M&A[14], where the larger a company becomes, the more it relies on M&A to grow.[15]

Figure 2: The average one-day indexed stock price reaction for US domiciled corporate buyers



Source: Credit Suisse HOLT, credit-suisse.com/holtmethodology

Figure 3: Uses of corporate capital



Source: Credit Suisse HOLT, credit-suisse.com/holtmethodology

Yet growth is difficult to achieve. Research conducted by Bain & Company suggests that, on average, listed companies set targets to grow revenues at twice the rate of their industry, and to grow profits at four times the rate of their industry. Nonetheless, when Bain studied the performance of 2,000 companies with a market capitalisation in excess of $500m between 2001 and 2011 it found:

- Just 19% of the sample were able to grow real sales in excess of 5.5% per year in that ten-year period;
- Only 13% were also able to grow profits at that rate, and
- A scant 11% of the sample generated annual growth in real sales and profits in excess of 5.5% whilst also creating shareholder value at the same time.

HOW THE BEST COMPANIES 'PLAY THE GAME'

> *"We have a repeatable M&A playbook. We have done 27 acquisitions in the last 3 years, and only one was sourced from an investment bank. Our line managers find and source these targets... This is sort of a hidden asset that we had because of the fact that our people had a direct line of sight on these targets given their understanding of our strategy."*

***Sunny Verghese**, Group Managing Director and CEO, Olam*[16]

Bain suggests that size has very little bearing on a company's ability to generate sustainable, profitable growth and shareholder value.[17] For companies that excel in this regard, nor is growth determined by the industries in which they operate. Indeed, a company's relative competitive position within an industry was found to be *more than four times as significant* than the choice of industry in determining its economic returns: In Bain's words, "it's how you play the game that matters, not which game you play."

Additional research conducted by Bain on the minority of companies that defy the odds and deliver growth in revenues and profits over the long-term, whilst also creating shareholder value showed that they relied on a combination of organic growth *and* M&A to do so:

- Indeed, when Bain studied the stock market performance of 1,600-plus companies from around the world between 2000 and 2010, it found that companies that did not engage in M&A delivered compound annual growth in total shareholder returns (TSR) of just 3.3%;[18]
- The whole sample delivered a 4.5% average annual TSR growth,
- *But a subset of companies that made frequent acquisitions that were material in relation to their pre-existing size, generated average annual rate total shareholder returns at a rate of 6.4% per annum.*

Successful M&A begins long before a company engages in any transactions

Successful M&A is premised on the deep insights that some companies possess into the nature of their strategic advantage – so that M&A becomes an extension of that advantage.[19]

Booz & Company's Cesare Mainardi and Paul Leinwand maintain that companies derive these insights into the nature of their strategic advantage using three factors:[20]

1. An understanding of how the company competes in a way that differentiates it from its competitors.

   Many companies resolve to position themselves in growth markets, and seek to design a way of winning in those markets. In contrast, companies with a developed sense of how they compete spend more time understanding where they have the right to win - where this is defined in respect of their *distinct* capacity to meet customers' needs - so that they can look for markets in which they will thrive on that basis.

2. A system of (usually three to six) mutually reinforcing capabilities that deliver the company's ability to compete.

   A capability is a key strength of a company's business that customers value and competitors cannot beat. It is not a generic activity (like HR, or supply chain management), but a specific combination of people, knowledge, IT, tools, and processes, which delivers a central aspect of its right to win.

3. Products and services that are aligned with how the company competes, and with the critical capabilities that enable it to do this differently from any other company.

   Richard Rumelt tells us strategy involves focus and, therefore, choice, and that choice means setting aside some goals in favour of others.[21] (A nice illustration of this principle comes from Nike CEO, Mark Parker, talking of the conversation he had with Steve Jobs who was then CEO of Apple.[22] "Do you have any advice?" Parker asked Jobs shortly after his appointment at Nike. "Well, just one thing," said Jobs. "Nike makes some of the best products in the world. Products that you lust after. But you also make a lot of crap. Just get rid of the crappy stuff and focus on the good stuff." Parker said Jobs paused and Parker filled the quiet with a chuckle. But Jobs didn't laugh. He was serious. "He was absolutely right," said Parker. "We had to edit.")

   Companies that understand the nature of their strategic advantage therefore resist the temptation to emulate how competitor firms operate, and resolve to confine their product and service offerings to those that their strategic advantage is set up to deliver.[23]

Leveraging and Enhancing Deals versus Limited Fit Deals

Research performed by Mainardi and Leinwand has found that when companies that exhibit the characteristics described above engage in M&A, they frequently use their insights into the nature of their strategic advantage to enter into transactions that either *leverage* their distinctive capabilities systems, or *enhance* those capabilities systems, or do both. (See table 1).

As a consequence, the M&A deals executed by such companies have (on average) generated 14.2 percentage points more in shareholder return than M&A deals by other buyers in the same industry and region (measured during the two years after the closing of each deal).[24]

Figure 4 (on page 8) elaborates on these findings. It shows the differential returns from M&A strategies (for deals made between 2001 and 2012) that either enhance or leverage the acquirer's distinctive capabilities systems versus the returns from "limited-fit" transactions, conducted by other companies, which largely ignored capabilities. (PricewaterhouseCoopers reports that the worst-performing deals are those in which companies acquire targets whose capabilities are a poor match with their own. Those deals tend to destroy value).[25]

HOW COMPANIES TRANSFORM M&A INTO A CORE COMPETENCE

"That was our biggest transaction so far, but also one or our quickest in execution... we had just 11 days to come up with a counterbid and a full financing package... Because we wanted to expand our health-care business, we had started looking for potential targets specifically in pharmaceuticals and OTC... when the Schering opportunity came up, we didn't have to do any deep analysis. It was already on our list."

***Klaus Kuhn,** CFO Bayer on the acquisition of Schering in 2006*[26]

The gold standard in M&A performance is a *repeatable model that improves with learning over time.*[27]

Companies that engage in frequent and material M&A transactions typically generate higher returns from M&A than companies that engage in only occasional transactions.[28] But it is not the frequency that counts: It is the M&A model that *enables frequency* and which *benefits from frequency* that distinguishes the winners from the losers.

Table 1: Leverage, Enhancement and Limited-Fit Deals Explained

Type of deal	Description	Examples
Leverage	The acquirer applies its already advantaged capabilities systems to incoming businesses, products, and services, generating performance improvements and giving them an environment in which to thrive.	When Reckitt Benckiser acquired Boots Healthcare in 2006, Reckitt was able to leverage its capabilities system for building global brands (R&D, innovation, brand development and distribution) by adding three major products to its portfolio that played to these capabilities (Neurofen, Strepsils, and Clearasil).
Enhancement	The acquirer adds new capabilities to fill a gap in its existing capabilities system or to respond to a change in its market.	Pixar's innovations in digital animation expanded Disney's core capability in stop-frame animation and motion pictures, and enabled Disney to better access the adult and teenage markets that Pixar's content embraced.
Limited-Fit	The acquirer largely ignores capabilities and does not seek to improve upon or apply the acquiring company's capabilities system in any major way. (These deals often bring the buyer a product or service that requires capabilities the buyer does not have).	Morrisons' acquisition of Safeway in 2004 sparked a multi-year period of underperformance for the acquirer largely because the operating models of the two firms were not compatible and because Morrisons had not built any capabilities around customers from Safeway's socio-economic background.

Source: PwC Strategy&, PIRC

In a world where more than 50% of executives confirm that their companies have not been able to transform their M&A experiences into a core competence that would enable them to think about M&A as a planned process, the most successful acquirers work hard to make M&A a core competence.[29] Such companies typically emphasize two types of thinking: strategic and tactical.

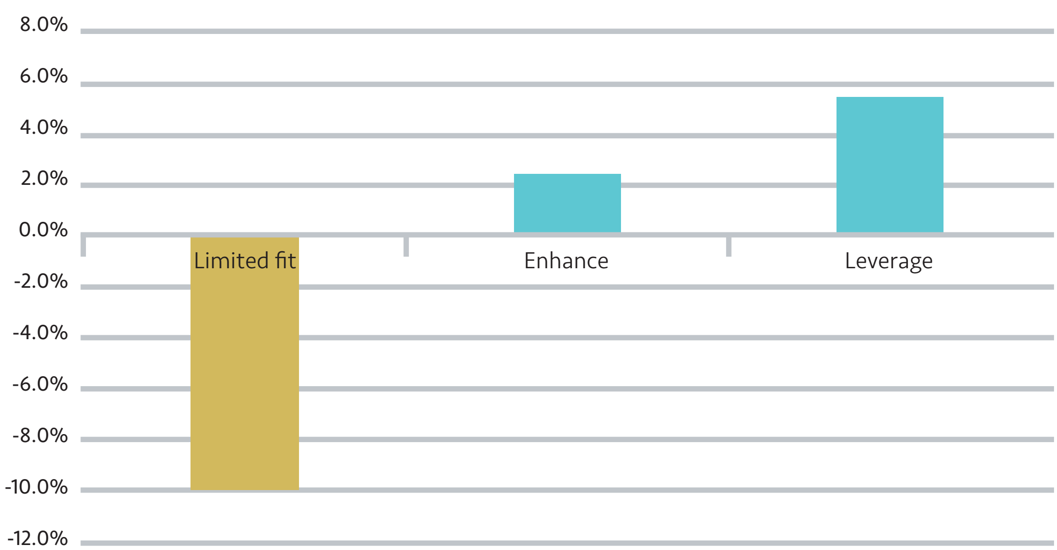
STRATEGIC THINKING

- Successful acquirers create a list of potential acquisition candidates and screen them for a fit with their strategic advantage (as in Table 1). Acquisition candidates that do not exhibit such fit are culled from the list and not revisited (no matter how opportune an acquisition may be, the price it might be obtained at, or whatever it might add to the top line and/or EPS).[30]
- They generate a detailed profile of the remaining target companies' industries, their competitive position, their operating performance, their management teams, and how competitors are likely to respond to any prospective transaction.[31]
- Thereafter, they develop a deal thesis based on how they will exploit or enhance their strategic advantage in every transaction, which spells out how the deal will create value.[32]
- They empower leaders of business units (rather than members of the permanent deal team) to gauge a potential acquisition's strategic and cultural fit, identify potential business synergies, and establish the road map for delivering expected outcomes.[33]
- Using large sample data from similar deals conducted in the past, they take care to ensure that expectations in respect of synergies (such as market share gains, for example) are consistent with competitive realities.[34]
- They conduct detailed analysis of how customers will react to the deal.[35]
- They ensure acquirer and target IT platforms are compatible.[36]

TACTICAL THINKING

- Successful acquirers build permanent deal teams that work closely with relevant operating managers and business units to facilitate and execute the details of the transaction.[37]
- They ensure a distinct (internal) body prices the deal in case the negotiating manager becomes too personally invested in the deal and overpays.[38]
- They set a price ceiling before negotiations begin; which establishes the price at which they will walk away from the deal.[39]
- They make significant adjustments to their M&A strategies to take account of market conditions and take advantage of valuation opportunities. That is; successful acquirers significantly reduce the value of acquisitions relative to divestments during periods when stock market valuations are high, and significantly increase the value of acquisitions relative to divestments immediately following sharp stock market downturns.[40]

Figure 4: Relative returns from enhancement and leverage deals vs. limited-fit deals



Finally, since experience does not equate to expertise unless acquiring companies take the time to codify the lessons they learn from prior successes and failures,[41] successful acquirers monitor transactions to track how well they perform relative to expectations,[42] and they institutionalize the learning from this process into their 'M&A playbook.'

THE ROLE OF THE BOARD IN SUCCESSFUL M&A

> *"Our thinking is never 'How do we ram this through the board?' Quite the contrary: Many of our board members are very experienced in acquisitions, and we regard their thinking as one of our best process checks."*

Bruce Nolop, *CFO, Pitney Bowes*[43]

McKinsey & Company point out that boards are well placed to take a long-term view of prospective M&A performance versus CEOs or business-unit leaders that may have tenures that are shorter than the time needed to fully realize the benefits of M&A.[44] This may explain why:

- Higher standards of corporate governance have a positive effect on operating performance changes in companies that are combined through M&A, and why the stock market appears to anticipate this operational improvement upon the announcement of the deal.[45]
- Acquisitions of firms with poor corporate governance by firms with good corporate governance generate higher total gains.[46]
- Independent boards promote necessary restructuring in transactions that investors perceive to be prospectively value destroying.[47]

A board's perspective on M&A works in two principal ways to further the interests of shareholders:

1. Some CEOs have an inflated sense of their ability and these overconfident CEOs have been found to make poor capital allocation decisions.[48]

   A useful antidote to such overconfidence is the presence of an independent and effective board: One that brings an objective 'outside view' to bear on an executive's naturally occurring 'inside view.' In the same way that many successful acquirers do not allow the negotiating manager to price the deal for fear that he or she will become too personally invested and overpay, companies that are good at M&A have found that a final check at board level can deliver the same detached perspective.

2. Dan Lovallo maintains that many executives feel reluctant to pursue M&A because they incorrectly believe it is riskier than organic growth.[49]

   Accordingly, too many firms never avail themselves of M&A growth possibilities – or do too few deals. They may also be inclined to revise (or even abandon) M&A strategies that are robust, and which are likely to succeed in the long-term, simply because they have an overly aversive reaction to the volatility that all short-term results contain. In contrast, boards are frequently better positioned (than CEOs) to take more of a portfolio perspective.

In successful acquirers therefore:[50]

- The board plays its part in agreeing the role M&A will play in a company's growth strategy and in its strategy for creating shareholder value (how material that role should be).
- It understands the company's approach to M&A at the same strategic level as management, so that it can challenge the M&A screening process and the company's prospective deal pipeline.
- It puts itself in position to challenge the specific details of particular transactions in respect of whether the company is complying with the tenets of its M&A playbook.
- And it asks the ultimate question: *Are we the best owner of this asset?* In other words, does this acquisition exhibit such a good fit with our strategy that we can add more value to the target company than *any other* acquirer?

M&A AS INVESTMENT RISK

> *"M&A activity tends to be greatest when the economy is doing well, the stock market is up, and access to capital is easy. As a result, companies frequently do deals when they can, rather than when they should."*

Michael Mauboussin, *Credit Suisse*[51]

Whilst it seems apparent that some companies are getting better at M&A, that cannot be said for all companies. The stock market still marks down the share price of the acquiring company in something like 45% of M&A deals, and the list of deals that have famously destroyed shareholder value continues to grow.

Equally, as Michael Mauboussin infers, with economies generally doing well; stock markets up and the cost of capital down, history also suggests companies may be at risk of doing deals because they can, rather than because they should – and that Forum members should be on their guard.

Figure 5 shows the value of M&A deals from January 1990 to January 2015 measured against a cost of capital measure – the market implied discount rate – calculated by the HOLT division of Credit Suisse, as an example. It demonstrates how M&A activity tends to fall off when the cost of capital is high/when stock markets are depressed, and how it tends to rise when the cost of capital is low/when stock markets are elevated.

Of even greater concern is that the majority of companies that are *poor* at M&A are still *almost as likely* as companies that are good at M&A to do subsequent deals.[52]

LAPFF's research suggests four primary M&A investment risks to be aware of:

1. The acquiring company uses M&A to expand outside of core markets
2. The premium paid for control of the target is justified by business expansion synergies
3. The acquirer announces a large deal but has limited or no previous M&A experience
4. The success of the deal is dependent on melding two distinct cultures into one

1. The acquiring company uses M&A to expand outside of core markets

Most companies tell their shareholders how proposed deals fit with their business and/or strategy. But successful acquirers understand the term 'fit' at a different level than companies that are poor at M&A.[53]

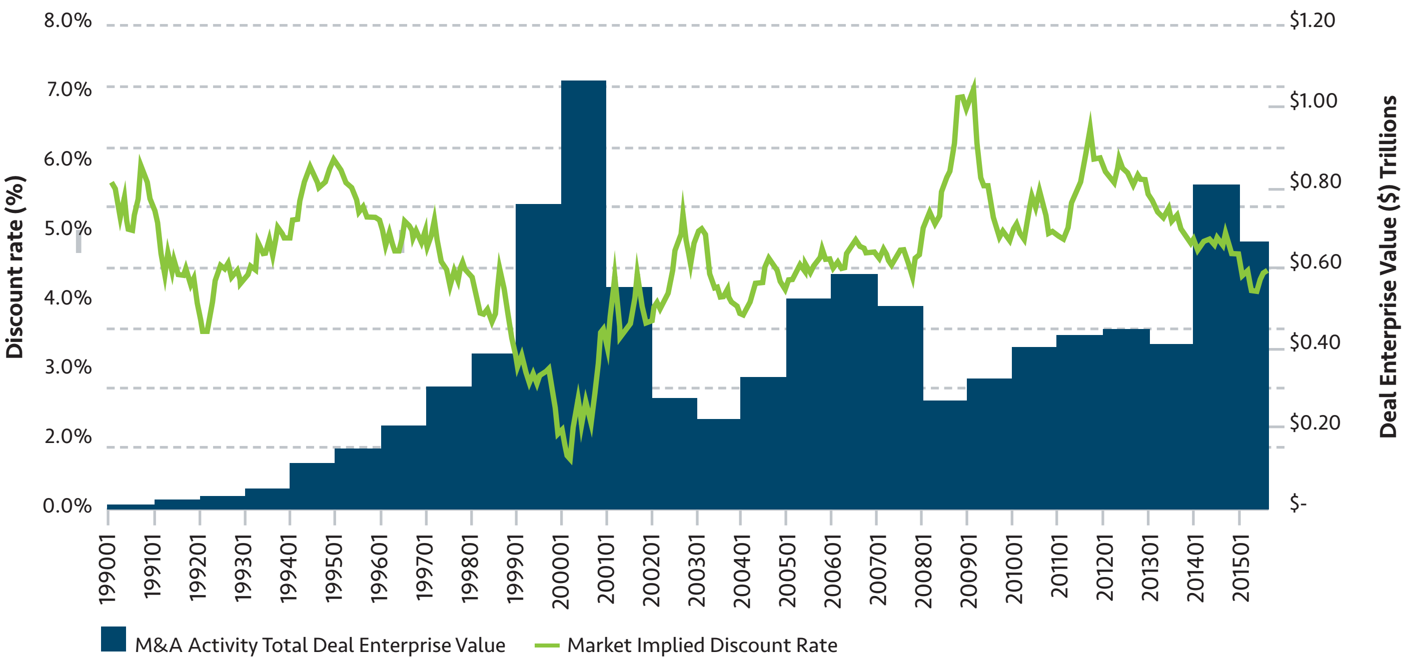
When M&A losers say 'fit' they frequently mean adjacent. That is, they tend to believe that an acquisition makes sense when it matches "the type of product or service we sell" rather than "what sets us apart."

Acquisitions justified on the basis of fit with 'what we sell' often fail – simply because the acquiring company has not ensured it has the right to win in the target company's business, where the right to win is defined in respect of the degree of fit between the acquirer's strategic advantage and the strategic advantage that works in the target company's business.

Gauging Whether a Deal Takes a Company outside its Core Markets

Chris Zook has found that 70% of M&A deals that take companies into unrelated markets fail. (He has also found that 80% of "adjacent" growth initiatives that take companies into new geographies, channels, or customer segments fail).

Figure 5: The relationship with M&A activity and the cost of capital



Source: Credit Suisse HOLT, credit-suisse.com/holtmethodology

Five dimensions have been identified as being critical to the success or failure of moves away from a company's core into adjacent markets. These are: Customers, Competitors, Cost structure, Channel, and Brand.

- Changing only one of the dimensions in an adjacent move is usually associated with a 37% chance of success, which is high in comparison to most other growth initiatives;
- Changing two dimensions, however, is associated with a 72% chance of failure,
- And with three dimensions changes, the failure rate rises to 90%.

Mitie's Use of M&A to Expand Outside its Core

"We've come to the conclusion over the last two years that we needed to do something which gave us the platform for more growth and the home care market is a very good place to start."

Ruby McGregor-Smith, *Mitie CEO*[54]

"At a high level Mitie had pinned its colours to the mast of delivering 10% p.a. EPS growth that as not possible to achieve without taking more risk by diversifying into areas they did not know much about."

Joe Brent, *Head of Research, Liberum Capital*[55]

Mitie announced the £110.8m acquisition of Enara Group, the fourth largest provider of home care in the UK, in October 2012: a significant acquisition that was designed to enhance Mitie's rate of growth by transporting its expertise in workforce management into a new market.

Three years later the acquisition has been condemned as a managerial mistake that has led to several profit warnings and the destruction of shareholder value at the acquiring company.

At the time of the acquisition MITIE was a support and building services company that provided services such as mechanical and electrical engineering and maintenance, cleaning, catering, landscaping, pest control, and security to organisations in the public and private sector. Enara, on the other hand, operated in the domiciliary care market - providing help with personal hygiene and dressing; assistance getting into and out of bed; plus administration and assistance with medication.

Although the stock market greeted the announcement of the acquisition by marking Mitie's share price down by 1%, in general, analysts were favourably disposed to the deal: balancing the full price they considered Mitie had paid for Enara with the prospect of Mitie repeating its ability to use the acquisition as a platform that would thereafter allow it to expand into adjacent healthcare markets.

None of the analysts appeared to ask the questions: How far outside the core markets in which Mitie operates is Enara, and therefore how risky is this deal?

MITIE had a reputation for engaging in rigorous due diligence prior to making any acquisitions, and we have no reason to question the rigour of its due diligence ahead of the Enara deal. However, Bain's central point is that companies that (use M&A) to expand outside their core markets frequently do not know enough about the new markets in which they will operate to ask the right questions in a due diligence process.

Table 2, on page 12, examines the Enara deal from this perspective and suggests that the value destruction that emanated from the transaction was an accident that was waiting to happen.

As developments in the healthcare market came to back to bite Mitie, the degree to which Enara represented a move away from Mitie's core market is likely to explain much of what management failed to see when they put the deal together:

- Sharp cuts to rates paid by local authorities and the NHS mean that the services that Mitie provides to these two customers are now far less profitable than management expected at the time of the deal.
- Recent revenue is running at least 10% below pre-acquisition levels, and costs have been elevated above expectations due to much higher rates of staff turnover in the healthcare business than Mitie is accustomed to (which has had a knock-on effect in training costs), and greater need to resort to the use of agency workers.
- At the same time, with inspection scores from The Care Quality Commission deteriorating, any recovery in revenues and profits has been made all the more difficult by the extent to which Mitie's brand has been tarnished in this market.

2. The premium paid for control of the target is justified by business expansion synergies

McKinsey & Company has found evidence to suggest that unless synergies are realized within, say, the first full budget year after consolidation, they risk being overtaken by subsequent events and wholly fail to materialize.[56]

The 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 2 on page 12 for details).[57]

In fact, revenue enhancement synergies are considered by some acquiring companies as being so difficult to predict that they do not include them when calculating synergy value.

3. The acquirer announces a large deal but has limited or no previous M&A experience
According to a BearingPoint study of 2,500 European mergers over a ten-year period, companies that were most likely to create value through M&A averaged about two deals a year, while those that were more likely to destroy value averaged one deal every ten years.

Unless a company's M&A capabilities have been developed over numerous transactions it is unrealistic to expect it to be good at M&A. Equally, we know that managerial (and board) overconfidence is likely to be most pronounced in projects never attempted before.[58]

4. The success of the deal is dependent on melding two distinct cultures into one
Cultural considerations clearly do not come into play when a deal is premised on leaving the target as a standalone entity, but they do when the acquiring company seeks to integrate the target in its approach to business.

In spite of the fact that executives consistently rate cultural incompatibility as the greatest barrier to successful integration, CEOs and CFOs attest that research on cultural factors is least likely to be an aspect of due diligence.

There is also strong evidence that companies which identify cultural issues in due diligence and address them in integration, regardless of the complexity of cultural issues significantly outperform those companies which do not do this.[60] (Mike DeCesare at McAfee expresses it thus: "It is one hundred percent about the culture... At McAfee, every decision I make about an acquisition in the first 12 months is through the eyes of the acquired company... We're not just buying their technology; we're buying their culture. So I have to make decisions within the business that absolutely send a signal that I respect their culture, that I'm not looking to kill it, and that I want the best of what McAfee can bring to their business, but not in an overwhelming or suffocating way")[61].

Table 2: Appraising the extent to which Mitie's acquisition of Enara expanded outside the core

	Comment
Same Customers?	Mitie and Enara shared some local authority customers, and some sell side analysts believed the acquisition afforded Mitie the opportunity to build on a number of existing relationships. In reality the majority of Enara's customers were unique to that company and the individual end buyers within those customers that overlapped with Mitie were significantly different – meaning that Mitie had no relationships to leverage.
Same Competitors?	The second largest competitor to Enara in a small element of its healthcare business was Mears Group plc - a company that Mitie also competed against in its core business. However, Mitie had no overlap with Enara's largest competitor (Allied Healthcare) and it would be fair to say that it had little experience of the different players in the healthcare market.
Same Cost Structure?	Whilst Mitie and Enara were both engaged in labour intensive industries in which staff costs played a major role, Enara's healthcare business was characterised by very high levels of staff turnover, which generated higher recruitment costs, higher training costs and higher (last resort) agency worker costs.
Same Sales Channel?	Mitie's sale process was premised on delivering value for a client in one area of its service proposition in order to use that relationship to encourage the client to buy a more comprehensive bundle of services under a single agreement in the future. No such channel existed within Enara -where the opportunity to meet or exceed client expectations in the delivery of basic services such as providing assistance in getting into and out bed could never lead to Enara being retained for meeting more sophisticated community care requirements.
Same Brand?	Mitie had created a brand around the concept of being a trusted partner to its customers where customer intimacy with what Mitie stood for (its values, its culture and how it invests in and trains its people) became an important component of its sales process. In contrast, Enara existed as the product of a four-year long, Private Equity backed, 'M&A spree' that featured around 50 acquisitions, which resulted in a collection of 29 different brands, where even the better parts of the business were tarnished by poor customer outcomes.

ASKING THE RIGHT QUESTIONS OF M&A

This Trustee Guide aims to assist Forum members identify those companies that engage in M&A where engagement is likely to be valuable and/or to identify those M&A deals where further questions require answering before a full appraisal of a proposed deal can be made.

Having highlighted opportunities and risks to value creation from M&A it also sets out pertinent questions to ask acquirers, which are designed to enable forum members engage with the companies in which they invest on matters of strategic importance with a view to making a long-term difference to outcomes from M&A.

WHAT TO ASK COMPANIES THAT ENGAGE IN M&A

1. How does your use of M&A leverage or enhance the capabilities that set your company apart from the competition?
2. To what extent have particular M&A transactions in the past either leveraged or enhanced these capabilities?
3. What evidence can you share with us in respect of how you have used your M&A experience to transform M&A into a core competence?
4. In your view, what are the critical components of your M&A process that elevate the chances of creating shareholder value through M&A?
5. What evidence can you share with us that non-executive directors on your board understand the company's approach to M&A at the same strategic level as management, so that they can challenge the company's M&A screening process and its prospective deal pipeline; where they also put themselves in position to challenge the specific details of particular transactions in respect of whether the company is complying with the tenets of its M&A playbook?

WHAT TO ASK ABOUT PARTICULAR M&A DEALS

1. To what extent does this transaction seek to leverage an existing capability that the acquirer possesses; enhance the acquirer's capabilities, or do neither of these?
2. To what extent is the acquirer using this transaction in order to expand outside of its core markets?
3. Measured in terms of the value of the target in relation to the market capitalisation of the acquirer, if this is a large deal does the acquirer have sufficient M&A experience to elevate its chances of success?
4. To what extent is the acquirer justifying the premium paid for control of the target by business expansion synergies as opposed to cost reduction synergies?
5. To what extent is the success of this transaction dependent on melding two distinct cultures into one?
6. To what extent does a gap exist between low standards of governance in the target company and high standards of governance in the acquiring company, which this transaction can close?

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We would also like to thank Credit Suisse HOLT for the provision of certain data; Joe Brent at Liberum Capital for his assistance with the analysis of Mitie's acquisition of Enara, to Adam McConkey at Henderson Global Investors for suggesting this transaction for analysis.

Table 3: The Probabilities of Capturing Synergy Benefits in M&A Transactions

Cost reduction synergies	Success rate	Cost reduction synergies	Success rate
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%

1 http://www.strategyand.pwc.com/media/file/Shareholder-activism.pdf

2 http://www.strategy-business.com/blog/Becoming-a-Capable-Company?gko=9deea

3 https://community.dur.ac.uk/p.j.allen/kpmgm&a_survey.pdf. For each deal, a relative measure of change in equity price was taken pre-deal and then a year later. This was compared with the overall trend in the relevant industry segment to arrive at an assessment of whether or not shareholder value had been created.

4 http://www.strategyand.pwc.com/global/home/what-we-think/multimedia/podcasts/mm-mergercast_display/decade-of-mergers-and-acquisitions

5 http://www.accenture.com/SiteCollectionDocuments/PDF/Accenture-Outlook-Who-says-MA-doesnt-create-value.pdf

6 http://img.en25.com/Web/IntraLinks/%7B1aa707fb-3a46-4c53-a26b-6373a989e54c%7D_Masters_of_the_Deal_Part_1_FINAL_%281%29.pdf

7 Measured from the two days prior to an M&A announcement to the two days following the announcement

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[28] Harding, Shankar and Jackson, Op. cit.

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

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[38] Eccles, Lens and Wilson, Op. cit.

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