

Six rationales to guide merger success

Management feature



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Succeeding at mergers and acquisitions has never been easy. Several well-structured studies prove that more than half of acquisitions actually destroy shareholder value instead of achieving cost or revenue benefits. Causes of failure abound: overpayment for overestimated value, inadequate integration planning, lack of communication, cultural mismatch, to name a few. But topping the list is poor strategic rationale. And getting the strategic rationale right when merging or acquiring is crucial, both for pre- and post-merger activities.

The late 1990s saw both an increase in M&As and a fundamental shift in their motivation. None of the largest acquisitions were merely about swapping assets: each had a stated strategic rationale. Some were conceived to improve competitive positioning such as TotalFinaElf or Axa/Royale Belge. Others, such as Deutsche Post/DHL/ Danzas or Belgacom/Skynet let acquirers push into highly related businesses. In all these instances, the leaders first considered the strategic rationale behind the deal then tailored their plans to address the particular challenges associated with achieving their stated goals.

The following rationales lie on a continuum, from deals that play “by the rules” of merger transactions and integration, to those that transform the rules:

1. Growing scale

Mergers most often aim to grow scale, which does not mean simply getting larger. Rather, success requires gaining scale in specific elements of a business and using these elements to become more competitive overall. For instance, if materials cost drives profit, then purchasing scale will be key. If customer acquisition is more important, then channel scale will be critical. Getting scale-based initiatives right requires the correct business definition and correct market definition. This can be difficult since, over time, the definition of scale in an industry can change dramatically. For example a sea change in the economics of pharmaceuticals led to the mergers of Pfizer with Warner-Lambert, and of SmithKline

Beecham with Glaxo Wellcome. For decades, pharmaceuticals were national (in some occasions regional) businesses. Regulatory processes were unique to each country and there were barriers rendering drug introduction to foreign markets difficult. Distribution and regulatory costs needed to be spread across local markets. Today, many of those barriers have diminished, while the costs per successful drug have risen exponentially. R&D can and should be spread across the entire global market, covering more countries, more products, and more types of diseases.

2. Building adjacencies

The next most common impetus for mergers and acquisitions is to expand into highly related or adjacent businesses, as in the IBM/PWC example. This can mean expanding business to new locations, new products, higher growth markets, or new customers. But most importantly, the additions should be closely related to a company’s existing business. In *Profit from the Core: Growth Strategy in an Era of Turbulence* authors Zook and Allen provide empirical evidence that expanding into closely related businesses through acquisitions drove the most impressive stories of sustained profitable growth in the 1990s: such as Emerson, GE, Charles Schwab, or Reuters. When Travelers Insurance acquired Citicorp Bank, the merger gave the two companies a complete array of financial services products to cross-sell to their combined customers across a broad range of global markets.

3. Broadening scope

In mergers geared to broaden the scope of products or technologies, a serial acquirer systematically buys specific expertise to either accelerate or substitute for a traditional new business development, or technology R&D function.

We have witnessed several serial/scope acquisition models played out successfully across a number of industries: in financial services (GE Capital), Internet hardware (Cisco), and chip manufacturing (Intel). For these firms, major ongoing investment

to scan for new product concepts or technologies is an integral part of their growth strategy. For most, organic development would be too expensive, too slow and/or would dilute the focus on their existing businesses.

4. Redefining the business

Deployed strategically, mergers and acquisitions can at times redefine a business. This is an appropriate strategic rationale, when an organisation's capabilities and resources grow stale very suddenly due to, for example, a major technological change. In such cases, a firm cannot quickly refresh its technology or knowledge by making internal investments and incremental adjustments.

When telecommunications equipment provider Nortel embarked on a strategic shift towards Internet provider-based working infrastructure, Nortel transformed its business model through a series of acquisitions. Since January 1998, the company has acquired 21 businesses—including Cisco's competitor Bay Networks—to refocus from supplying switches for traditional voice communication networks to supplying technology for the Internet. Nortel utilised the mergers strategically to take what CEO John Roth calls the company's "right-angle turn". While hit hard in 2001 by a downturn in fibre optics, Nortel has nevertheless become Cisco's chief rival.

5. Redefining the industry

Sometimes a bold, strategic acquisition can redefine an entire industry, changing the boundaries of competition and forcing rivals to re-evaluate their business models. For example, the AOL/Time Warner merger could potentially rewrite the rules for communication and entertainment just as Vivendi/Universal had hoped to do. Beyond creating new distribution channels for content, the merger could allow the newly formed company to propose wider content to meet customers' requirements, which would not have been possible otherwise.

6. Platform for success

A clear, strategic rationale for an acquisition is critical, but not enough to guarantee a successful deal and merger integration. Remember: over half of acquisitions destroy shareholder value. The rationale helps identify the right target and set boundaries for negotiations, but the hard work remains bringing two companies together effectively. Nonetheless, the "why" informs the "how". The right strategic rationale will inform the preparation and valuation of the merger, and should also inform what leadership and communication style to adopt and how to plan for post-merger integration.

In acquisitions seeking to gain scale, pre-merger planning can be done "by the numbers." One can forecast goals for combined market share and cost reduction, plan steps to achieve them, and create measures of performance improvement. This type of merger places great demands on a chief executive's ability to cope with complexity. The task may not be easy, but at least the leader can craft a plan before the transaction and execute it after the merger.

In bolder mergers, where parties seek to redefine their industries, the numbers may not be as precise and the odds more uncertain. Obviously the companies involved will have a post-merger model for operations, but that model will fluctuate as industry rules change. In such a profoundly uncertain environment, vision is critical and must come from the top. A strong leader must cope with flux by confidently and effectively communicating the strategy and vision. The post-merger integration plan will have to be much less detailed and much more flexible than that of a scale transaction, leaving room for leadership to adapt its message to a rapidly evolving competitive environment. Having a strategic rationale constitutes the bedrock for capturing the value that spurred your acquisition. And remaining a member of that value creating minority.