L.E.K.

EXECUTIVE INSIGHTS

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Buying Trouble: Avoiding Acquisition Pitfalls

Most studies suggest that when it comes to the M&A game, acquirers generally lose. Studies that have looked at the success rate of acquisitions conclude that buyers would enjoy better odds by placing their corporate funds on "black"on a spin of a roulette wheel. If the odds of success are so poor, why do acquisitions remain such a core component of corporate growth strategies?

Many managers rightfully respond that, unlike roulette, M&A is a highly complex game of skill, so the opportunity to "beat the odds" is greater for the superior acquirer. Unfortunately, many managers delude themselves into believing that they are in the minority of superior performers, when studies show that in all probability they are not.

The following discussion breaks down the acquisition process and demonstrates the many requirements for success. Each element is necessary but insufficient alone to reliably create value through acquisitions. We will focus on the most dangerous acquisition pitfalls and explore ways to avoid them. Awareness of these hazards will help you develop a more realistic understanding of the challenges and result in improving your organization's chances to "beat the odds."

Categorizing Acquisition Pitfalls

When an acquisition goes wrong, managers should look to three root causes:

Analytical Drivers

The most obvious problem area may lie in the analysis employed in completing an acquisition and integrating the target company. We find that analytical failure is what executives point to most often as the cause of underperforming deals. Common epitaphs to this situation include: "We made revenue assumptions that later proved false" or "The market trends were not necessarily what we thought they would be"or "The margin improvement that we thought we could achieve was harder to realize. Even though analytical failure can certainly ruin a deal, many common pitfalls lie in the two less obvious areas.

Process Drivers

There are few management processes where the stakes are higher or that involve more complex executive interactions than the acquisition process. Every business function is represented, and the coordination of activities can be daunting. Even though companies routinely spend millions to re-engineer processes such as procurement and product design, relatively few have made a serious study of their acquisition process.

Behavioral and Cultural Drivers

A third problem source lies in a litany of factors that introduce biases into the process. For example, a CEO who announces the financial goal of acquiring companies with combined sales of $1 billion by 2005 risks introducing a bias. The message may be construed as "buy growth" rather than "create value through acquisitions." Emphasis on filling the revenue gap can lead to an underemphasis on validating strategic fit and value creation.

We will expand on each of these themes and offer some suggestions to guard against the most common acquisition pitfalls.

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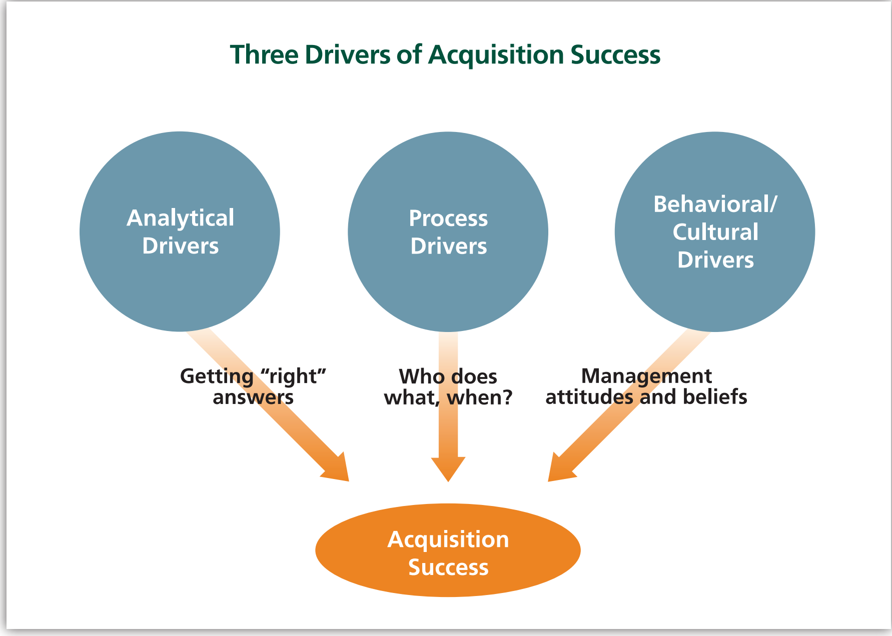


Analytical Drivers – Valuing Strategic Fit

Though acquisition analysis can break down at any stage in the process, it most frequently occurs at the very beginning. This is when the level of strategic fit of the target and the value associated with that fit are determined. Mistakes at the start are common because it is possible to develop scenarios of strategic fit that seem plausible on paper but are rooted in erroneous assumptions. The results are often fatal, because even flawless deal execution and integration can rarely overcome a bad strategic rationale.

There are generally three sources of strategic fit. First, deals may create value because they add **scale** in activities where scale economies can be realized. Second, they may add or take advantage of **skills** that can improve the combined entity's competitive position. Finally, a deal may broaden the **scope** of products, enabling customers to "one-stop shop," or expand geographically to grow the customer base. Regardless of the source, strategic fit must translate to more revenue, lower costs or lower capital requirements in order to create value.

Scale Economies

These are often considered by buyers to be the most attainable and lowest-risk sources of value creation. This is because scale economies are achieved by combining assets or operations where hard data exists to assess the efficiency potential. On the other hand, skill – and scope – related benefits are often realized through revenue expansion, which managers consider more speculative.

Scale benefits can still be easily overstated. One reason is that the buyer concludes that the buyer's and target's operations seem more alike than they really are. Management might then erroneously assume that assets or activities can be combined when substantial obstacles exist. The following brief examples illustrate this point:

- An electrical products manufacturer assumes that the target's product can be made in its facilities but later learns that the target's products are much more customized and therefore require a dedicated plant to meet individual customer needs
- A health care products manufacturer believes that the target's products can be sold through the acquirer's sales force but then learns that the two sales forces target very different buying points in the hospital and that one is a commodity sale while the other is a consultative sale
- A building products manufacturer counts on consolidating warehouses but then learns that increased transportation costs offset the warehouse savings

These are obvious problems that buyers should have foreseen and avoided. What is surprising is that these examples are from otherwise superior-performing companies with competent and well-intentioned managers.

The simple truth is that increased scale comes in multiple forms with different potential benefits. For example, L.E.K. was asked to assist a company to seek out a target in a specific energy sector. In Example I, our findings showed that there was a wide range of potential scale benefits depending on the sector type and geographic adjacency of the target.

Even when scale economies are valid, they may not be value creating. This is because scale is the most common strategic rationale and many companies in a sector can realize similar benefits with a target. Since scale benefits are not unique to a specific buyer, in a competitive M&A environment buyers are more likely to be forced to pay full value of the scale synergies to avoid losing the target to a competitor.

Questions to Ask When Assessing Scale Opportunities

- Are buyer and seller operations similar enough in their products, processes and other dimensions to determine that credible scale economies exist?
- Has the buyer demonstrated a pattern of reduced unit costs as their scale has increased?
- What barriers exist to realizing scale savings and what scale-related risks should be considered?
- How explicitly will these economies be generated? What operations will be combined? What labor or other cost savings will result?
- How long will it take to realize these savings? How much will it cost to implement?
- How unique is the buyer's ability to generate economies? How much of these savings will likely be bid away in a competitive sale process?
- Does the acquirer have the managerial capacity and talent to successfully integrate the target?

Leveraging Skills

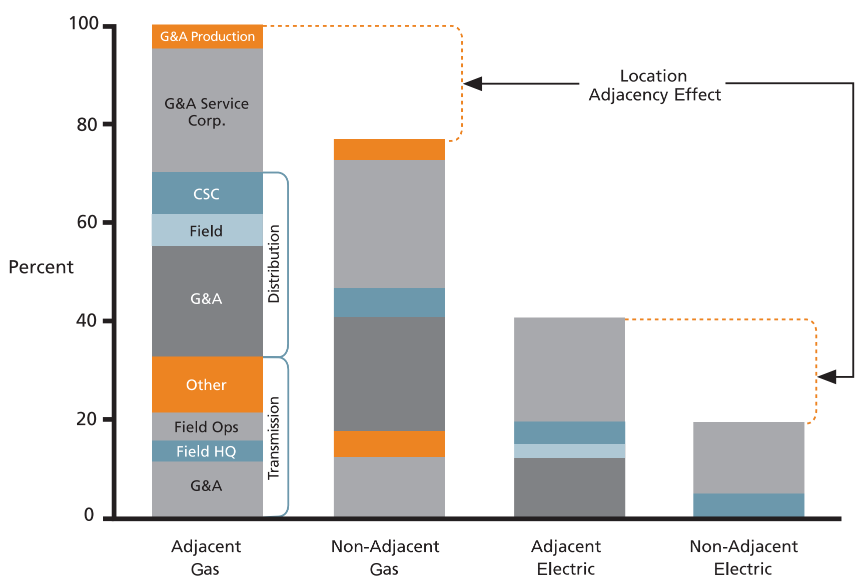
Identifying a unique core competency that the buyer or seller has can be used to strengthen the combined company's competitive position. Skill deals come in countless varieties. Commodity companies may strive to offer more "value added" products and services. Technology companies may look to expand or maintain a competitive advantage. Industrial manufacturing companies may seek cost saving processes or industrial marketing skills.

The key challenge is that skills are often difficult to quantify and can be overstated. To determine if credible value creation prospects exist, two questions must be addressed:

- Does the buyer or target have the desired skill in sufficient quantities?
- Can the skill be applied to either the buyer's or target's operations to create greater value?

Validating that certain skills exist presents a variety of challenges. For example, management skills are often intangible. One must take care to identify tangible manifestations of these competencies such as cost advantages, market share gains, staff retention, etc. Buyers also fall prey to perceptual biases regarding their own skills. L.E.K. has worked with buyers who refer to skills they believe can be applied to the target to create value. However, an unbiased review often reveals that these skills fall short of competitive levels. If superior skills do exist, they should manifest themselves in better operating performance.

Example I: Synergy Potential Varied Greatly Depending on Specific Sector and Location



Even when skills are proven, barriers to realizing expected benefits may yet exist. Key managers may resign post acquisition. Cultural clashes can undermine skill sharing. Applying skills in new areas may result in neglecting the needs of existing operations. These and other problems can erode the value creation anticipated in attractive skill-related acquisitions.

Broadened Scope

With broadened scope, companies view geographic expansion, product expansion or vertical integration as a route to creating value. Product or service expansions are often pursued by acquirers that feel a broader offering will be attractive to customers. They believe that customers wish to "one-stop shop" and will favor suppliers that offer this breadth. Suppliers to GM, Ford and Chrysler have been grappling with this issue for years as the automakers have sought to consolidate their purchases.

However, acquirers risk presuming product scope advantages where none exist. Customers may attach no value to one-stop shopping for very clear reasons:

- Customer buying points or purchase processes for the target's products are very different from products offered by the acquirer
- The target's product requires a highly consultative sales approach that is incompatible with the acquirer's capabilities or other products
- Customers may perceive broad-line suppliers as "jack of all trades and master of none"

For example, one company was pursuing a broad-line strategy in a commercial infrastructure services sector. To confirm the merits of their strategy, they completed market research to determine the value that customers attached to one-stop shopping. This research, as shown in Example II, found that product breadth was the least important driver of new customer generation or retention.

How do you defend against these types of analytical foot faults? The following are three recommended lines of defense:

Give Yourself Time

Being proactive in searching out targets that offer the best strategic fit buys you time to do an adequate assessment. Typically when an investment bank solicits your interest in a target, you have a matter of a few weeks to complete your analysis. This allows little time for comprehensive research. Instead, if you have actively searched for quality targets, the chances increase that you will be better prepared when one of these targets decides to sell. Then you will also be able to make better use of the limited time available.

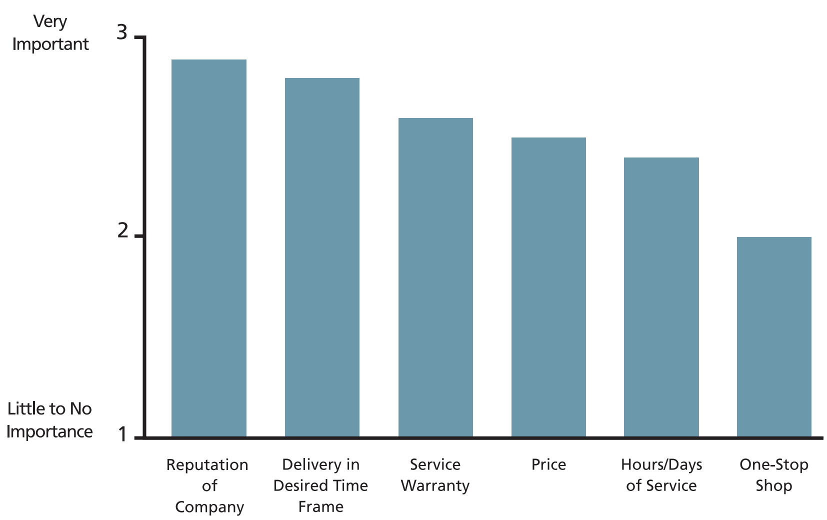
Use Primary Data

Often, for lack of time or resources, managers rely too heavily on secondary information. Using generic market research reports to estimate market growth often means relying on old data that is not focused on the target's specific market segment. As a rule, companies should expect to base 50%–70% of their analytical inputs on primary research directed at the target, their customers, competitors and suppliers. This is an area where many successful buyers look for outside assistance.

Answer First

At L.E.K., we advise scripting out the deal presentation before conducting research on the target. This enables an acquirer to clearly present hypotheses and information gaps so that the research can be focused on the most critical issues. Time is restricted enough without wasting it by boiling down an ocean of facts that may not bear directly on key issues.

Example II: Product Breadth Is Not Always Most Important Driver of First–Time Selection Criteria



M&A Processes Drivers – Who Does What, When

Many companies complete less than one acquisition per year. Because of this, the machinery to process deals can be rusty. Inexperienced people may be asked to learn as they go, and operators are often pulled away from their full-time responsibilities to try to manage the process. It is no wonder that the following common process failures occur:

Waiting for the Phone to Ring

One of the more destructive process sins is being reactive to deals. For example, a salesperson hears that WidgetCo is for sale. WidgetCo may never have been considered as a target in the past, but since it is "on the block," ProductCo assembles a team of people to consider it.

There are two difficulties in this scenario. First, companies that are being actively marketed for sale are often the least attractive to acquire. WidgetCo could be an excellent target, but a selection bias does exist that makes least attractive targets most available for purchase. The second issue is that the deal consideration process is starting off flat-footed. If the target is at all attractive, ProductCo may have only weeks to assemble an indication of interest. Analysis and internal consensus building may be rushed and poor decisions can result.

Contrast this with the following scenario: In the context of developing a strategic plan, ProductCo has conducted a screening exercise to determine optimal targets. The effort was time consuming and resource-intensive, but resulted in 10 companies deemed most attractive, including WidgetCo. ProductCo approaches each company and expresses interest in an acquisition. A year later, WidgetCo calls indicating it may be interested in a deal. ProductCo has already conducted the analysis and built consensus so that when the deal becomes live, ProductCo can move quickly and decisively.

Wrong People, Wrong Roles

It is not uncommon to see corporate development managers of small and midsize companies have less than one year of experience in that role. The position is sometimes considered a "way station" en route to other assignments, and it is not given the status or access to top management that other positions have. The result can be a corporate development manager who does not have the experience to slow "runaway trains" before they gather momentum or the clout to challenge biases, beliefs and assumptions held by other executives.

Communication breakdowns can be an issue as well. Many companies put too much organizational distance between the deal makers and the integrators. A manager mentioned to L.E.K. that he was suddenly notified by the acquisition group that a purchase agreement had been reached and that he was now responsible for integrating operations. Holding managers accountable for delivering results is more effective when they are actively involved in valuing synergies and agreeing that they are achievable.

Failing to Manage M&A as a Process

In our experience we have found that companies create detailed processes for core activities like new product development, but leave the acquisition process under-examined. In many cases,far more value can be destroyed by M&A process faults than by other business processes. Recognizing this, some companies have requested a process audit to document M&A best practices and are adapting these to their organizations. Tangible results include documents that specify roles, responsibilities and approval-stage gating.

Underestimating the Value of Integration Planning

Deals go awry for many reasons, but perhaps the most common cause is poor integration. This is because integration is a highly complex process typically led by managers who have little experience in the task. The following are common integration process failures:

- *Integration leader involved too late in the process* – If the integration leader is not involved from the beginning, confirming the key operating assumptions of the deal, he or she should not be held accountable for an integration that does not meet expectations.

- *Integrating too quickly or too slowly* – The pace of integration is determined by the nature of the deal. Scale-driven deals, where the objective is to consolidate operations, should be integrated quickly so that uncertainty and disruption is minimized. Skill-driven deals are often guided by the desire to transition employees smoothly so they do not look elsewhere. In this case, a more gradual integration process may be warranted.

- *Deferring difficult choices* – Acquirers sometimes leave critical issues, such as who will lead the newly combined business units, unresolved far too long. Good managers depart as a result.

- *Failing to bridge the cultural divide* – Cultural differences between acquirer and target can destroy a good strategic fit. Synergies are delayed or lost, managers resign, and operations are disrupted, all because of cultural clashes between the organizations.

Recognizing these and other problems, companies are investing more resources in integration planning. Some have tasked specific managers to ensure that best practices are identified and adopted throughout the organization. Others have conducted post-acquisition interviews with acquired management to discern process improvements.

Behavioral/Cultural Drivers

Many corporate executive decisions are based on seasoned judgment that is supported by impeccable analysis and guided by best-practice processes. The bad news is that this judgment is also vulnerable to inherent human biases that can be counterproductive to a desired result.

Consider the following story: The CEO falls in love with a deal and pulls together an acquisition team of senior managers who normally do not have M&A responsibilities. Quickly, members on the team conclude that opposing the deal may mean abandoning their career aspirations in the company. Thus the deal is recommended.

Another example involves a deal team that has spent six months pursuing a transaction. Suddenly it becomes apparent that the deal may not create all the hoped-for value. However, each member of the team looks at the hard work they have done and is reluctant to render their effort wasted by walking away from the deal. Thus the deal is made.

Behaviorists contend that people establish expectations that are not always supported by an independent and objective review of capabilities and track record. Paradoxically, we are often most confident about subjects that we know the least about. Several biases or behavioral effects that are relevant to M&A decisions have been documented:[1]

- *Irrational Escalation of Commitment:* For a variety of reasons, we are prone to continue on a path that objective credible evidence suggests is suboptimal. This is called "falling in love with the deal."Executives can become so wedded to the chase that they ignore evidence that they are pursuing value destruction.

- *Confirmation Bias:* We tend to look for information that confirms prior assumptions and pay less heed to information that conflicts with these assumptions.

- *Groupthink:* A highly cohesive group less prone to question each other or raise differing points of view has the potential to make erroneous assumptions and less objective decisions.

- *Overconfidence:* People have a tendency to overstate their ability to estimate in the face of uncertainty. This overstatement increases with the level of uncertainty. Put another way, we often underestimate the true level of uncertainty associated with decisions. This leads us to assume, for example, that a market will grow at a rate consistent with historical growth rates even though that rate of growth is extremely uncertain. This is perhaps because of commodity cycles or the threat of substitution.

To defend against these biases, some companies build explicit review points into the deal evaluation process to kill transactions before they gather unwarranted momentum. Others assign managers the explicit task of challenging key deal assumptions without unduly interfering with the deal process. Perhaps the best defense is to recognize that we are all vulnerable to these biases and to be vigilant for warning signs that they are overtaking reasoned decision making.

Behavioral issues are not only limited to pre-deal decision making. They often interfere with integration and are typically expressed as "cultural differences." Cultural conflict is an all-too-common epitaph for failed acquisitions. It arises in all types of deals but can be most intense in:

1 *For a useful review of biases in managerial decision making, see* Judgment in Managerial Decision Making, *Max Bazerman, published by John Wiley 1994.*

- Cross-border mergers and acquisitions
- People-intensive service industry consolidations
- Small acquisitions by very large buyers
- Low-growth buyers of high-growth targets (or vice versa)

Recognizing this, acquirers are taking greater care in assessing cultural differences before deal closure. Some have gone so far as to complete cultural audits to determine the greatest differences between buyer and seller cultures. Other companies assign managers the explicit role of managing interactions between acquirer and target. These gatekeepers help to ensure that cultural integration can occur with minimal friction.

Steps Toward Better M&A Performance

The ability to consistently create value through acquisitions is perhaps one of the most significant challenges facing management. So what should you do to improve M&A performance at your company? L.E.K. has been asked by many clients to help them improve their acquisition success. We recommend four tangible steps:

- *Re-examine the targeting criteria and search process* – Is your definition of strategic fit sufficiently clear and valid? Are you being proactive enough in looking for targets?
- *Review the quality of information and credible external market research* – Acquiring a company is not a time to rely on the most convenient or available data. Examine the extent that your organization solicits quality information through primary research about the health of the target, customer relationships, market growth, competitor strategies, or industry economics.
- *Audit current practices and past deals* – It is important to know what the organization does well and what practices can be improved. Reviewing past deals and talking to employees from acquired operations can provide extremely useful insights.
- *Identify M&A process improvements and communicate within the organization* – Many companies have begun to clearly define best practices in M&A while also defining roles and responsibilities. Like any other management process, a clear understanding of "who does what, when" is critical.

In summary, increased knowledge of the most common pitfalls in all aspects of the acquisition process can form the basis for M&A process improvement. Overconfidence can then be replaced by informed appreciation of M&A opportunities and a greater likelihood of "beating the odds."

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded more than 25 years ago, L.E.K. employs more than 900 professionals in 20 offices across Europe, the Americas and Asia-Pacific. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns. For more information, go to www.lek.com.

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