Executive Summary

- Mergers and acquisitions (M&A) are two broad types of restructuring through which managers seek economies of scale, enhanced market visibility, and other efficiencies.
- A merger occurs when two companies decide to combine their assets and liabilities into one entity, or when one company purchases another.
- An acquisition describes one company’s purchase of another—for example, the absorption of a smaller target firm into a larger acquiring firm.
- The nature and scope of M&A activity has changed over time, with a growing trend to cross-border transactions.
- M&As are motivated by the expectation of financially rewarding synergies in terms of reduced fixed costs, increased market share, cross-sales, economies of scale, lower taxes, and more efficient resource distribution.
- At the individual level, executives may pursue M&As because of psychological drivers such as empire-building, hubris, fear, and mimicry.
- There are five broad types of strategic fit: overcapacity, geographic roll-up, product or market extension, research and development, and industry convergence.
- M&A execution can be hampered by incompatible corporate cultures, with failure to achieve synergies, high executive turnover, and too much focus on integration at the expense of customers.
- Before the deal, managers should formulate a clear and convincing strategy, preassess the deal, undertake extensive due diligence, formulate a workable plan, and communicate to internal and external stakeholders.
- After the deal, managers should establish leadership, manage culture and respect employees, explore new growth opportunities, exploit early wins, and focus on the customer.

Introduction

Mergers and acquisitions are two broad types of restructuring through which managers seek economies of scale, enhanced market visibility, and other efficiencies. A merger occurs when two companies decide to combine their assets and liabilities into one entity, or when one company purchases another. The term is often used to describe a merger of equals, such as that of Daimler-Benz and Chrysler, which was renamed DaimlerChrysler (see case study). The term “acquisition” simply refers to one company’s purchase of another—as when a smaller target firm is bought and absorbed into a larger acquiring firm.

Patterns

The worldwide M&A market topped US$4.3 trillion and over 40,000 deals in 2007. Figure 1 depicts the growth of M&A activity, quarter by quarter, over the last five years.

Figure 1. Global M&A activity 2002–07. (Source: Thomson Financial, Bain & Company analysis)
The nature and scope of M&A activity has changed substantially over time. In the United States, the Great Merger Movement (1895 to 1905) was characterized by mergers across small firms with little market share, resulting in companies such as DuPont, Nabisco, and General Electric.

More recently, globalization has increased the market for cross-border M&As. In 2007 cross-border transactions were worth US$2.1 trillion, up from US$256 billion in 1996. Transnational M&As have seen annual increases of as much as 300% in China, 68% in India, 58% in Europe, and 21% in Japan. The regional share of today’s M&A market is shown in Figure 2.

![Figure 2. Global M&A market 2007—share by region. (Source: Thomson Financial)](image)

**Motives**

Mergers and acquisitions are often motivated by company performance, but can also be linked to executive decision-makers’ empire-building, hubris, fear, and tendency to copy other firms.

The dominant rationale used to explain M&A activity is that acquiring firms seek improved financial performance through synergies that enhance revenues and lower costs. The two companies are expected to achieve cost savings that offset any decline in revenues. Then Hewlett-Packard CEO Carly Fiorina justified the merger with Compaq at a launch effort on September 3, 2001: “This is a decisive move that accelerates our strategy and positions us to win by offering even greater value to our customers and partners. In addition to the clear strategic benefits of combining two highly complementary organizations and product families, we can create substantial shareowner value through significant cost-structure improvements and access to new growth opportunities.”

The formula for the minimum value of the synergies required to protect the acquiring firm’s stockholder value (i.e. to avoid dilution in earnings per share) is:

\[
\frac{(\text{Pre-M&A value of both firms} + \text{Synergies})}{\text{Post-M&A firm number of shares}} = \text{Pre-M&A firm stock price}
\]

Managers may be motivated by the potential for the following synergies:

- Reduced fixed costs: Duplicate departments and operations are removed, staff often made redundant, and typically the former CEO also leaves.
- Increased market share: The new larger company has increased market share and, potentially, greater market power to set prices.
- Cross-sales: The new larger company will be able to cross-sell one firm’s products to the other firm’s customers, and vice versa.
- Greater economies of scale: Greater size enables better negotiations with suppliers over bulk buying.
- Lower taxes: In some countries, a company that acquires a loss-making firm can use the target’s loss to reduce liability.
- More efficient resource distribution: A larger company can pool scarce resources, or might distribute the technological know-how of one company, reducing information asymmetries.

At the individual decision-making level, M&A activity is also linked to the following:
• Empire-building: M&As may result from glory-seeking, as managers believe bigger is better and seek to create a large firm quickly via acquisition, rather than through the generally slower process of organic growth. In some firms, executive compensation is linked to total profits rather than profit per share, creating an incentive to merge/acquire to create a firm with higher total profits. Furthermore, executives often receive bonuses for completing mergers and acquisitions, regardless of the resulting impact on share price.

• Hubris: Public awards and increasing praise may lead an executive to overestimate his or her ability to add value to firms. CEOs who are publicly praised in the popular press tend to pay 4.8% more for target firms. Hubris can also lead executives to fall in love with the deal, lose objectivity, and overestimate expected synergies.

• Fear: Managers’ fear of an uncertain environment, particularly in terms of globalization and technological development, may lead them to believe they have little choice but to acquire if they are to avoid being acquired.

• Mimicry: If leading firms in their industry have merged or acquired others, executives may be more likely to consider the strategy.

Executives may overpay for a target firm. Microsoft has acquired more than 128 companies, but recently withdrew a US$44.6 billion offer of cash and stock for Yahoo. Microsoft CEO Steve Ballmer commented on the logic of the decision: “Despite our best efforts, including raising our bid by roughly $5 billion, Yahoo! has not moved toward accepting our offer. After careful consideration, we believe the economics demanded by Yahoo! do not make sense for us, and it is in the best interests of Microsoft stockholders, employees, and other stakeholders to withdraw our proposal.”

Strategic FIT

Regardless of their category or structure, all M&As share the common goal that the value of the combined companies will be greater than the sum of the two parts. M&A success depends on the ability to achieve strategic fit. Harvard Professor Joseph Bower identifies five broad types of strategic fit, based on the relationship between the two companies and the synergies sought: overcapacity M&A, geographic roll-up M&A, product or market extension M&A, M&A as R&D, and industry convergence M&A.

Overcapacity M&A

In this horizontal M&A, the two companies often competed directly, with similar product lines and markets. The new combined entity is expected to leverage synergies related to overcapacity by rationalizing operations (for example, shutting factories). This often one-time M&A can be especially difficult to execute as both companies’ management groups are inclined to fight for control.

Geographic Roll-Up M&A

In a geographic roll-up the new entity seeks geographic expansion, but often keeps operating units local. For example, Banc One purchased many local banks across the United States in the 1980s. Banc One was, in turn, acquired by JPMorgan Chase & Co. in 2004.

Product or Market Extension M&A

Market-based roll-up focuses on extending a product line or international coverage. Often the two companies sell similar products but in different markets, or different products in similar markets. Brands are often a key motivation. Philip Morris purchased Kraft for US$12.9 billion—four times its book value. Philip Morris CEO Hamish Marshall justified the premium: “The future of consumer marketing belongs to companies with the strongest brands.”
M&A as R&D
A fourth type of strategic fit is research and development. Companies may acquire or merge with others to access technologies. Microsoft has aggressively pursued this strategy, acquiring smaller, entrepreneurial firms such as Forethought, which had presentation software that would eventually be known as PowerPoint.

Industry Convergence M&A
Finally, the new entity may be motivated by a “bet” that a new industry is emerging and the desire to have a position in this industry. For example, Viacom purchased Paramount and Blockbuster in the expectation that integrated media firms controlling both content and distribution were the wave of the future.

Case Study
The Failed Merger of DaimlerChrysler
Germany’s Daimler and the United States’ Chrysler merged in 1988, creating the world’s largest commercial auto manufacturer. At the time of the merger, Daimler’s CEO claimed that the merger of a luxury car maker (Daimler) with a mass-market brand (Chrysler) would become the world’s most profitable auto manufacturer due to new economies of scale and scope across brands, product niches, manufacturing expertise, and distribution networks. For example, it was hoped Daimler’s high-end manufacturing expertise and worldwide network would help to distribute Chrysler products and compete successfully against increasingly strong Asian competitors, especially Toyota and Honda. However, at the time, not all executives were positive. One DaimlerChrysler executive was quoted as saying, “It is unthinkable for a Chrysler car to be built in a Mercedes-Benz factory, and as long as I’m responsible for the Mercedes-Benz brand, only over my dead body will a Mercedes be built in a Chrysler factory.”

By the end of 2003 DaimlerChrysler’s market capitalization was just US$38 billion, significantly lower than the pre-merger US$47 billion in 1998. Despite product costs, DaimlerChrysler was unable to realize expected synergies. Furthermore, many competitors followed Chrysler’s lead, introducing minivans, pickup trucks, and SUVs that eroded Chrysler’s formerly attractive market share. Further barriers to success came with management and national cultural differences: Daimler’s mostly German management used approaches that did not go down well with Chrysler managers. By early 2003 most of Chrysler’s top executive team had left the firm.

Seven years after the merger the picture became more positive, with Chrysler contributing one-third of the company’s earnings in the first half of 2005. Dieter Zetsche was promoted to chairman of DaimlerChrysler’s board. By August, market capitalization reached US$54 billion and worldwide sales of the newly launched Mercedes were up 9%. Still, the American market proved difficult, with the three major American auto manufacturers experiencing significantly declining sales. Meanwhile, Toyota and Honda sales were up 16% and 10% respectively, gaining in the upscale market DaimlerChrysler had hoped to dominate.

In the summer of 2006, DaimlerChrysler sought to make a positive out of a negative in its US television advertisements, with Zetsche presented as an amusing cultural misfit to America. Still the company faced high labor and health care costs and soaring fuel costs. By April 2007, DaimlerChrysler confirmed that buyers were being sought, as German investors declared “this marriage made in heaven turned out to be a complete failure.” In fact, some suggested that Daimler could itself become a takeover target if it did not sell Chrysler. By May, DaimlerChrysler had paid Cerberus Capital Management, a private equity investment firm, US$650 million to end its exposure to health care and other costs as well as to ongoing operational losses.

Conclusion
Mergers and acquisitions can be accretive in that they increase financial performance, or dilutive in the reverse case, where a measure such as earnings per share (EPS) actually falls. It is a fact that 70% of mergers and acquisitions actually destroy value.

In implementation, M&As typically face the following critical issues:
Mergers and Acquisitions: Patterns, Motives, and Strategic Fit

- Incompatible corporate cultures: The cultures of the two companies may be inconsistent, resulting in resources being diverted away from the focal synergies.
- Business as usual: The target company may allow redundant staff and overlapping operations to continue, thwarting efficiency.
- High executive turnover: The target company may lose critical top management team leadership. A recent study reports that target companies lose 21% of their executives each year for at least ten years following an acquisition (twice the turnover experienced in nonmerged firms).
- Neglect business at hand: A recent McKinsey study reported that too many companies focus on integration and cost cutting, and neglect the daily business at hand and customers.

Making It Happen

Despite the grim statistics, several companies are skilled M&A executors. For example, General Electric has integrated as many as 534 companies over a six-year period, and Kellogg’s delivered a 25% return to stockholders after purchasing Keebler. The following are key steps to facilitating a successful process before and after a merger:

Before the Merger

1. Begin by formulating a clear and convincing strategy. Strategists must first develop a compelling and sustainable strategy. Key questions include: What is your firm’s strategy? What role does the M&A play in this strategy? What is the vision of the strategy of the new entity?

2. Preassess the deal. Prior to signing a memo of understanding, managers should examine operational and management issues and risks. Seek answers to the following questions: Is this the right target? What is the compelling logic behind this deal? What is the value? How would we communicate this value to the board of directors and other key stakeholders? What will our strategy be for bidding and negotiations? How much are we willing to spend? If we are successful, how can we accelerate integration?

3. Do your due diligence. Executives must acquire and analyze as much information as possible about potential synergies. In addition to managers across key functional areas in the firm, outside experts can be brought in to help appraise answers in the preassessment, and especially to challenge assumptions, by asking questions such as:

   Are our estimates of future growth and profitability rates reliable? Are there aspects of the company history/culture or of the environment (for example, legal, cultural, political, economic) that should be taken into account?

4. Devis a workable plan. Formulate plans that take into account some of the following: What is our new entity’s organizational structure? Who is in charge? What products will be taken forward? How will we manage company accounts? What IT systems will we use?

5. Communicate. M&A transactions tend to be viewed favorably when executives can convincingly discuss integration plans, both internally and externally. Managers should be prepared to answer the questions identified above, as well as: How can we prepare our people psychologically for the deal? What value will be created? What are the priorities for integration? What are the primary risks? How will progress be measured? How will we address any surprises?

After the Deal

6. Establish leadership. The new entity will require the quick identification and buy-in of managers, especially at top and middle levels. Ask: Who will lead the new entity? Do we have buy-in and support from the right people?

7. Manage the culture and respect the employees of the merged/acquired company. An atmosphere of respect and tolerance can aid the speed and ease of integration. Executives should formulate plans that address the following concerns: How can we encourage the best and brightest employees to stay on in the new entity? How can we build loyalty and buy-in?
8. **Explore new growth opportunities.** Long-run performance is linked to identifying and acting on both internal and external growth opportunities. Managers should seek out any untapped growth opportunities in the new entity.

9. **Exploit early wins.** To build momentum, the new entity should actively seek early wins and communicate these. To identify them, consider whether there early wins in sales, knowledge management, or the work environment.

10. **Focus on the customer.** To survive, firms must create value for customers. Managers must continue to ask: Are we at risk of losing customers? Are our salespeople informed about the new entity? Can our salespeople get our customers excited about the new entity?

**More Info**

**Books:**

**Websites:**
- Google Scholar articles—search on terms “mergers and acquisitions” or “M&A”: scholar.google.com
- Yahoo! Finance M&A news: biz.yahoo.com/topic/m-a

**Notes**


2. Quoted on ThinkExist.com: thinkexist.com/quotatation/this_is_a_decisive_move_that_accelerates_our/346964.html


**See Also**

**Best Practice**
- Acquisition Integration: How to Do It Successfully
- Mergers and Acquisitions: Today’s Catalyst Is Working Capital
Checklists

- Why Mergers Fail and How to Prevent It
- Acquiring a Company
- M&A Regulations: A Global Overview
- Planning the Acquisition Process
- The Rationale for an Acquisition
- Structuring M&A Deals and Tax Planning

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