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Why (Most) Mergers and Acquisitions Fail: The Causes, The Effects, and How to Lessen the Risk of Failure

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WHY (MOST) MERGERS AND ACQUISITIONS FAIL -- THE CAUSES, THE EFFECTS, AND HOW TO LESSEN THE RISK OF FAILURE

SHELDON R. CHESKY, B.S.

An Abstract Presented to the Faculty of the Graduate School of Lindenwood College in Partial Fulfillment of the Requirements for the Degree of Master of Science

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Most mergers and acquisitions fail to meet the original goals set forth for engaging in the merger. Merger failure is the failure to meet these goals in a reasonable time frame, usually five years. As a result, most mergers and acquisitions fail.

There are several causes of merger failure which are described in detail. The most significant causes are that most corporations merge or acquire for the wrong reasons, and that they fail to do adequate strategic planning before and during the merger process. As a result, up to ninety percent of the mergers and acquisitions consummated during the current "merger wave" have or will fail.

This paper described the forces which drive mergers and acquisitions, the cause and effect relationships of merger failure and identifies several key steps which can be taken to offset the likelihood of merger failure.

WHY (MOST) MERGERS AND ACQUISITIONS FAIL -- THE CAUSES, THE EFFECTS, AND HOW TO LESSEN THE RISK OF FAILURE

SHELDON R. CHESKY, B.S.

A Culminating Project Presented to the Faculty of the Graduate School
of Lindenwood College in Partial Fulfillment of the
Requirements for the Degree of
Master of Science

1989

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DEDICATION

This project is dedicated to my family for the sacrifices they made in foregoing my participation in many family functions during the preparation of this work, and all the time taken to study and learn prior to writing. It is also dedicated to those men and women in the business environment that possess the intelligence to realize that attempting a merger or acquisition will provide the greatest challenge of their business careers. It will affect them, and it will change them. It is the hope of this author that they will learn from this work to help avoid the pitfalls of corporate mergeritis.*

*A business disease which drives normally sane business professionals to actively pursue mergers for the wrong reasons.

ACKNOWLEDGMENTS

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In addition, I would also like to thank all the present and former employees of Vestal Laboratories, Calgon Corporation, DePree Pharmaceutical Corporation, Chattem Drug & Chemical Company, Inc., and the Kendall Company for their openness, candidness and insights or their personal experiences from being involved and affected by mergers and acquisitions.

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I. INTRODUCTION

"Corporate Disease" -- an abnormal set of business conditions causing a detrimental effect which can infect the most stable, well-run companies...usually associated with a merger or acquisition.

"Most mergers turn out rotten" according to Morty Lefkoe of Lefkoe and Associates, a Connecticut-based consulting firm that specializes in helping corporations reshape their corporate culture.[1] Between thirty and ninety percent of all mergers and acquisitions fail based upon the definition of 'failure' as not meeting the criteria originally used to justify the acquisition.[2,3] The significance of having such a wide range of reported failures is that this range includes many mergers between small, privately-held companies which occur at a far greater frequency than the merger and acquisition activities of publicly held corporations or large, visible privately held companies, and that 'good' reliable data is not present. What is equally significant is that even though there is a wide range in the merger failure rate, it clearly points out that there is a

real risk of merger failure.[4] Mr. Mark Feldman of the Hay Consulting Group has indicated that at least one-third of the companies that are acquired get sold off within the first five years after being acquired, and at least 90% of the mergers and acquisitions consummated may never live up to the expectations of the acquiring company.[5] By Mr. Feldman's definition, the realistic failure rate of corporate mergers and acquisitions is 90%, since the expectations of the acquiring company usually are the goals set forth for justifying the acquisition or merger to begin with. If the failure rate is so high, why is there so much merger and acquisition pressure present in today's corporate society?

The purpose of this study is to identify the significant causes of merger and acquisition failure based on the hypothesis that there are clearly identifiable causes which doom most mergers and acquisitions to fail after all the financial data has been analyzed, the due diligence information has been scrutinized, and the deal still looks good (on paper) to the buyer. The second goal of this study is to identify the effects of these causal factors on both acquirer and acquiree. The third and final goal is to

construct a functional set of parameters for corporations to use as a 'road map' to help avoid these causal factors and their effects, thus providing a greater likelihood of success once the merger or acquisition is consummated.

This study does not address the critical financial analyses, the due diligence investigation (with some exceptions and suggestions), the legal issues and appropriate consent to merge provisos from the Securities and Exchange Commission (SEC) or the Federal Trade Commission (FTC) and other federal agencies. Pre-merger acquisition analysis of those issues normally occupy, and more times than not, engross the buyer's management group responsible for the acquisition. The structure of the deal is the central issue on the minds of most buyers, not what happens after the deal is consummated. Looking for financial synergies, enhancement of tax benefits, fiscal reporting, the financing of debt and the mechanics of implementing the merger are of paramount importance to the acquirer. Numerous studies, articles, opinions and books have been published on the 'proper' way to handle these issues. This study does not deal with these elements.

This study focuses on the forces that motivate a company to seek a merger or acquisition, and on what can happen after the "best laid plans..." become reality and the purchaser discovers that "Now that we bought a company, what are we going to do with it?"

Very little has been written on how to effectively reduce the overwhelming risk of merger/acquisition failure. This study has been organized to provide the reader with a comprehensive overview of why companies get corporate mergeritis, a new term which describes the current "business disease" of seeking out a merger or acquisition for the wrong reasons, and why corporate mergeritis is often fatal. It focuses on the cause and effect relationships which trigger merger failure. In addition to the data reported in the literature, results from interviews conducted with several employees and former employees involved in several mergers and acquisitions form both the buyers' and acquirees' positions have been incorporated in the causal factors, effects, and the risk reduction recommendations. Finally, the author's personal experiences working for three corporations before, during and after being acquired, being

involved in one divestiture, and witnessing and participating in the purchase of two additional companies provide in-depth observations of what transpires before, during and after mergers and acquisitions which destine failure.

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II. MERGERS AND ACQUISITIONS - DEFINITIONS AND HISTORY

"Etiology - The conditions present that result in visible symptoms. If enough are present, it is referred to as epidemiologic risk."

"Mergers have not increased profitability, have not improved efficiency, have not expanded sales and, in fact, do not seem to yield sufficient benefit to anyone -- consumer and company alike." This was one of the conclusions reached by researchers for the International Institute for Management and Administration after studying 765 mergers in the United States and Europe from 1975 to 1985.[1] Similar conclusions are not uncommon in the literature on mergers and acquisitions. There is an overwhelming propensity for merger failure according to most sources.[2] Even the U.S. government attempts to keep track of merger activity, divestitures, spin-offs, sell-offs, and business failure of the major corporations since it has such a far reaching effect on the economy.[3] Are mergers and acquisitions bad? Do any of the deals made really work long-term? What really constitutes a successful merger?

In order to answer these questions, it is necessary to understand the forces driving merger and acquisition pressure. To do this effectively, it is essential to define what mergers and acquisitions are, to identify the distinguishing characteristics between them and identify the forces behind the earlier "waves" of merger activity.

Mergers and acquisitions represent the combination of two or more businesses into a single enterprise.[4] Both terms have been used interchangeably as will be the case in the balance of this text. However, a distinction between the two terms needs to be made. Reid refers to this distinction as the "form of the merger."[5]

A true merger is the combining and blending of two or more succinct organizations into a single new organization which is characteristically different than both previous companies. Even though specific features of each of the previous organizations may be present, the newly formed company rapidly blends these characteristics and assumes a new identity not present in the prior organizations. Most 'mergers' do not meet this definition since the organization that usually initiates this activity becomes the dominant partner in the newly formed company.

An acquisition is the purchase of one or more companies' assets by a buyer. This definition allows for the inclusion of the so called "corporate raider". Generally the acquiring company keeps its inherent characteristics and, in many instances, attempts to interject these characteristics on the acquired organization. The acquired company rarely keeps its internal identity. However, generally, some of the external identity of the acquired company is maintained for 'appearance' to assure customer awareness and loyalty.[6] Acquisitions, not mergers, are the most frequent type of activity and are one of the prime sources of significant corporate growth.

Mergers and acquisitions can be classified into three separate groups according to the Federal Trade Commission. The FTC defines these groups as:

"1. <u>Horizontal Mergers</u>: the companies involved produce one or more of the same, or closely related, products in the same geographical market.

2. <u>Vertical Mergers</u>: the companies involved had a potential buyer-seller relationship prior to the merger.

3. <u>Conglomerate Mergers</u>: (which) are classified into three subcategories: Product extension, market extension and other.

<u>Product Extension Mergers:</u> The companies involved are functionally related in production and /or distribution but sell products that do not directly compete against each other.

<u>Market Extension Mergers:</u>

The companies involved manufacture the <u>same</u> products, but sell them in different geographic markets.

<u>Other (or "pure") Conglomerate Mergers:</u>

The companies involved are essentially unrelated."[7]

Throughout "legal" history, there has been a general belief that internal growth stimulates expansion competition and thus, our economy; whereas mergers and acquisitions remove suppliers and competitors or customers from the market without an increase in net investment or production.[8] As a result, several antitrust laws have been enacted to estimate internal corporate expansion versus growth by acquisition and mergers. The Sherman Act of 1890 prohibited some forms of monopoly activity. "The Clayton Act of 1914

allowed corporations to grow at will through asset acquisitions"[9]... but restricted stock acquisitions. It was the enactment of the Celler-Kefauver Act in 1950 that changed the ground rules for merger activity by severely restricting the acquisition of assets of another firm, particularly in the area of horizontal mergers. Basically, the Celler-Kefauver amendment to Section 7 of the Clayton Act was passed into law to prevent most restrictive acquisition mergers that would limit, lessen or destroy competitive forces in a given market.

Two other recent laws have given the Federal Trade Commission the power to seek an injunction to prevent a merger, and that advance notification of mergers <u>must</u> be given if one or more of the parties in the merger has at least $100 million in yearly sales or assets of $100 million and the other party at least $10 million.[10]

Several mergers or acquisitions have been prevented or restricted as a result of these laws. It is evident that there has been and there continues to be a substantial concern over the impact of mergers and acquisitions in our

federal laws. However, changes in the enactment and interpretation of these laws have created waves of merger and acquisition activity.

From 1895 until the present there have been four "waves" of merger/acquisition activity, each as a result of different business pressures. The first wave, from 1895 to 1903-04, focused on a combination of vertical concentration and horizontal mergers.[11] Merger activities concentrated on industries where manufacturers wanted to control the sources of their raw materials and other components of their products to permit domination in a particular industry. An example of this type of domination can be traced to the iron and steel industry. Firms in this industry sought to own their own ore mines, coal mines and shipping concerns. This type of merger/acquisition activity effectively "got around" the Sherman Act.

The second wave of merger/acquisition activity occurred during 1918 to 1929 which created large holding companies.[12] During this period, a great number of mergers were entered into to enhance product differentiation

and to help companies compete in an expanding U.S. and world market. The depression of the 1930's put an abrupt halt to the second merger/acquisition wave.

The third wave from about 1955 through the 1960's, was caused by the desire to expand into other, non-related businesses. During this time, large conglomerates were assembled. Large conglomerates such as Grace and Co., Inc. actively pursued companies in both related and non-related areas and would end up with as many as 158 businesses under its corporate umbrella at one point.

The present wave of merger/acquisition activity started in the mid-1970's when interest rates began to skyrocket and real growth began to slow down. During this period many companies began to search for recession resistant, or inflation-protected companies and new growth industries.[13]

The pressure to expand because of these forces still exists in today's business environment. Many corporations are investing in business expansion by purchasing outside enterprises rather than investing in internal development and expansion.[14] The average real size of the purchase

price of mergers and acquisitions have been increasing yearly since 1980 as have the total dollars paid, as shown on Table Number 1 below:

Mergers & Acquisitions By Year

Year	No. of M/A	Total $ (in Billions)	No. Over $100 Million
1980	1889	44.3	94
1981	2395	82.6	113
1982	2346	53.8	116
1983	2533	73.1	138
1984	2543	122.2	200
1985	3001	179.8	270
1986	3336	173.1	346

Source: U.S. Bureau of the Census, Statistical Abstract Of the United States: 1988 (108th edition), Washington, D.C., 1989.

Table No. 1 also points out that the average number of 100 million dollar plus mergers/acquisitions are increasing further supporting the fact that significant merger pressure is coming from large corporations buying other large corporations, thus involving even larger corporations.

Dalton and Kesner indicate a portion of this growth may be attributed to the "...increased leniency on the part of the antitrust division of the Justice Department (and), perhaps more significant is the underlying desire by corporate management to expand and grow. Size is associated with success; consequently, growth becomes an end in itself."[15] What Dalton and Kesner fail to emphasize is that this type of growth would not be possible if the Federal agencies were not lenient. Many acquiring companies would be forced to invest in their own companies, thus developing assets, not purchasing them.

Prokesch and Powell reported in a 1985 "Business Week" cover story that one out of every three of these mergers will be undone and that in the past five years, the rate of divestiture has jumped to 35%.[16] Their estimate is low. Since 1980 the number of divestitures has jumped from 666 to 1259, reflecting an 89% increase in divestiture activity, while mergers and acquisitions had a 76.6% increase during the same time frame.[17]

The current wave of merger activity has increased concerns on behalf of many corporate advisors even before the advent of the corporate raider. Some business consultants have stated that recent mergers are "...ill conceived, inadequately planned, and overpriced...the primary objectives sought in mergers -- greater economics of scale and productivity, increased profitability and improved stock performance -- are not being attained to any significant degree."[18]

Mergers and acquisitions can be classified based upon the dynamics of the business arrangement. There are four general categories of mergers and acquisitions. They are:

1. Mutually Friendly Mergers
2. Hostile Takeovers
3. "White Knights and Dragons"
4. Corporate Raiders

Leveraged employee buyouts may be classified as a fifth type of acquisition but will not be addressed since the causal factors and failure of these ventures are not directly related to merger and acquisition failure.

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A mutually friendly merger is one in which both corporate parties agree that the combination of the businesses will result in mutually obtained benefits for the stockholders. These benefits would generally not be achievable in a reasonable time frame if each company were to continue operating independently of each other.

Mutually friendly mergers and acquisitions provide the source for diversification for both buyer and acquiree. One firm may be weak in Research & Development (R&D) in a specific area, while being strong in marketing, production, sales or distribution areas. The other firm may possess the R&D expertise, but not be strong in marketing, sales or distribution. When a merger occurs between these two companies, this type of merger is complimentary since both gain "synergies" that benefit shareholders, customers or society. The IBM/Rolm and Champion/St. Regis mergers represent two prime examples of mutually friendly acquisitions which have provided synergies.[19]

Recent examples of mutually friendly mergers/acquisitions are General Electric taking over RCA, Sperry & Burroughs

joining forces to become Unysis and TWA acquiring Ozark Airlines. Major corporations may acquire small privately-held companies under friendly terms to obtain new technology or protect existing technology from competition. Merck & Co., Inc. the giant pharmaceutical company, acquired BritCair (a small privately-held company) in October, 1989. Merck did so to obtain BritCair's new patents in alginate technology and wound management products which could have adversely affected its Kelco Company subsidiary whose main enterprise is alginate technology. In addition, another Merck subsidiary, Calgon Corporation, has a business group developing wound management products, and BritCair had new wound management products, i.e., a good strategic fit. BritCair lacked the resources to develop these innovations and Merck wanted to protect its businesses, so a mutually beneficial, friendly acquisition was structured.

Not all mutually friendly mergers/acquisitions work. The Mobil Oil purchase of Marcor (Montgomery Ward), Exxon's purchase of Reliance Electric and Fluor's acquisition of St. Joe Minerals are just a few examples of numerous friendly (mutually consenting) mergers which have failed.

Hostile takeovers are exactly what the term implies. The acquired company is taken over by another firm in a hostile way. This can occur through a tender offer for the purchase of stock of the acquired company at higher than fair market value against the advice and consent of the management, or it may be caused by the reduction in availability of raw materials to force a company to sell itself to stay in business, law suits and other hostile actions by organized minority stockholders.

Hostile takeover activity may be triggered by several factors -- not all revolving around money. Hostile takeover threats force companies to come to the merger bargaining table.[20]

"Unfriendly tender offers often are more than the result of only market forces. They are frequently driven by other motivations. Ego may drive these deals...A hostile offer might be motivated by a defensive action. An executive might be concerned that his company is vulnerable to a takeover. How might he avoid it? Make a move on somebody else."[21]

Hostile takeovers waste resources - time, energy, assets -- and create unemployment according to most people involved in a 1986 survey on mergers. The results indicated that 70.3%

of the respondents surveyed stated that hostile takeover attempts don't benefit the economy.[22]

The "White Knight" is a term used to describe a more suitable acquirer, than a corporation attempting a hostile takeover. Much like the medieval stories where the White Knight appears to save the damsel from being devoured by the dragon, many acquiring firms assume the same role "rescuing" corporations from being acquired by either a hostile suitor *or the "wrong" suitor, by purchasing the corporation* "in distress." In many instances, the company under siege by the "dragon" actively seeks out a more suitable buyer usually with better terms of acquisition.

This type of acquisition strategy was employed by John Pietruski, the former Chairman and CEO of Sterling Drug, Inc. when F. Hoffman-LaRoche & Co., attempted a hostile takeover of Sterling. Roche submitted a tender offer of $72.50/share of common stock. Since this would result in a great deal of debt, Pietruski felt that Roche planned to play down this debt by capitalizing on the "synergies" generated by the acquisition. He further indicated that

this would create havoc among employees, vendors, customers and the communities where Sterling had facilities because "achieving those synergies could result in shutting down manufacturing facilities, closing corporate headquarters, combining marketing and distribution, and selling off parts of the business" according to Pietruski.[23] As a result, Pietruski actively sought a 'white knight' to rescue Sterling from the 'dragon'.

Sterling sought an organization to buy the firm for strategic reasons, not synergetic reasons. Strategic mergers are complimentary mergers, much like the "mutually friendly" mergers and acquisitions with both firms gaining something that the other didn't have previously. In Sterlings' case, Kodak was actively seeking a route into the pharmaceutical industry as a logical extension of its medical existing business, principally in imaging films and equipment. Sterling had the product line, manufacturing and distribution capabilities and Kodak had an existing sales force.

Corporate raiders are the terrorists of the business world using whatever tactics they can get away with legally to manipulate mergers and acquisitions for personal gain, generally at the expense of all other affected parties: employees, customers, whole communities and the general economy. Corporate raiders "look at things differently...(raiders are) willing 'to break apart a company' to achieve perceived values" according to Dean LeBaron, head of Thackery March Financial Management.[24] Ronald O. Proman, a corporate raider who chairs the Revlon Corporation, also made the following statement, "we are not passive security owners. When we start buying a stock, it is our intention to end up owning the company."[25]

Corporate raiders operate under the premise that the shareholders gain from these types of hostile takeovers. T. Boone Pickens, Jr. refers to shareholders as the "forgotten people" who aren't considered by the management of the corporations insulating themselves from any takeover activity. Executives "are worried about losing their jobs and have adopted some questionable practices" according to Pickens in a recent "Journal of Business Strategy" article on the subject.[26]

Mr. Pickens indicated that when companies are under pressure to operate as if they were potential takeover targets, they will operate far more efficiently than when they are not under such pressure. Mr. Pickens quotes a recent study by Professor Michael Jensen in the "Harvard Business Review" which showed that on average, shareholders gain 30% on their investment at takeover. However, Mr. Pickens fails to point out that these profits are paper profits coming from the rise in stock value generated by acquisition "fever" rather than by increased productivity which represents true gain.

Corporations have attempted to insulate themselves from corporate raiders like T. Boone Pickens, Ronald O. Perleman and Sir James Goldsmith, Jr. and others by adopting a "poison pill". The poison pill essentially is a way of a company making itself less attractive by adopting a provision to issue a new class of stock in the event that an acquirer accumulates a given percentage of outstanding shares. The acquirer then is forced to pay as much as twice as much as they would to control the company. Several firms, including Household International, Owens-Illinois, Colgate-Palmolive and Crown Zeller Pack have adopted this poison pill philosophy.

Corporate raiders have made a considerable amount of money through the use of legalized blackmail. This type of blackmail is referred to as greenmail. Greenmail is a way of overvaluing the stock ownership position of an investor who is threatening to takeover the company. Companies not wanting to give up their independent positions and will pay off the corporate raider by repurchasing the stock held by the raider at a price range in excess of what the going market price per share offers. This premium to market price has plunged many profitable companies into debt forcing these organizations to use the profits generated from their traditional business activities to pay off this premium rather than reinvesting this money in business expansion. Corporate raiders have done an excellent job of forcing companies to restructure which has accounted for approximately one-third of the stock market's rise in value since 1984 according to a November 24th, 1986 article in "Business Week."[27] Because of the steep prices corporate raiders are willing to pay for companies which are "under valued" and the aggressive buy back by the corporations from the raiders using greenmail tactics, the stock market has "all but abandoned the traditional way of valuing stocks."

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"Many of the transactions create a company with imposing amount of debt, challenging management's ability to find new ways to generate cash to serve as interest payments."[28] Because of this new debt structure, companies are being forced into restructuring which includes the scrambling and redeploying of assets to enhance shareholder value in a given corporation.[29] The 1987 Tax Reform Act which resulted in a jump in the capital gains taxes stimulated this restructuring. Spinoffs, divestitures and other tactics used to generate cash and boost shareholder values such as corporate stock buy backs have created additional demands on long-term corporate investment. A new term, called "Nuclear finance, has been created as a result of restructuring using junk bonds. Junk bonds provide the key ingredient of alchemy for restructuring -- leverage."[30] The buying and selling of corporate assets is nothing new in corporate America, but what is critically different now is that "corporate restructuring is completely finance-driven."[31] The creation of what Felix G. Rohatyn, a partner in Lazard Ferres & Co., calls "nuclear finance" or high power debt, allows raiders to capture huge companies. Raiders and CEO's that act like raiders have shown that they are able to redeploy undervalue corporate assets and cut

costs. This short-term synergy rings out a quick flow of cash to the shareholders and then enforces a "lean and mean" organization on their companies...nobody is focusing on future growth."[32]

Michael C. Jensen of Harvard University and the University of Rochester sees this takeover wave as a goad to managers who have allowed their companies to "get fat and inefficient because they are mature industries that generate high cash flow but can find few profitable places to put it. With low growth prospects, they should be paying all that money out to stockholders and letting them invest it, but instead, the U.S.X.'s, Carbides, oil and tobacco companies, and a host of others diversified into industries with the same problems." Jensen argues that having a company in debt forces a company to operate more efficiently. Jensen, however, worries that "a major recession could bring checkouts and defaults. It is astonishing that there have been few so far."[33] Jensen still feels that leveraging corporate America is highly beneficial in that even under the 1987 tax law changes, debt is still a less expensive form of finance than equity since interest costs are deductible and dividend payouts are not. In effect, leveraging is an efficient way

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of turning cash flow into tax deductions and "the company that isn't highly leveraged is not doing its job in maximizing its return to shareholders."[34] Can Dr. Jensen be the vector of "corporate mergeritis?"

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III. THE FORCES BEHIND MERGER AND ACQUISITION PRESSURE

"Corporate mergeritis" -- a highly contagious disease that affects companies searching for mergers and acquisitions for the wrong reasons. It is sometimes fatal and always results in change."

The current wave of mergers and acquisitions has been referred to as the era of unprecedented uncertainty by Tom Peters in his text titled, Thriving On Chaos. Peters describes the current phenomena of merging and de-merging as a "shuffle for shuffle sake" and states that "madness is afoot in reference to mergering and demerging."[1] Joseph A. Schumpeter refers to this era as the "era of creative destruction."[2] Still other people refer to this era as the deal-mania era or merger-mania era. Why is there so much concern about all of the acquisitions, mergers, leverage buy outs, spin-offs, sell-backs, corporate raiders, recapitalizations and other terms which apply to mergers and acquisitions?

Andrew C. Sigler, Chief Executive of Champion International Corporation, summed up these concerns in a November 24th, 1986 Business Week article on the subject where he stated, "there is intense pressure for current earnings, so the message is: don't get caught with major (long-term) investments. And the leverage the hell out of yourself. Do all the things we used to consider bad management."[3] Structural economist, Frederick Scherer, stated that, "on average, mergers decrease efficiency."[4]

Most studies suggest that generally mergers and acquisitions don't work. Business strategist, Michael Porter of the Harvard Business School, concluded a study of merger behavior among thirty-three big U.S. firms from 1950 through 1980. His study indicated that as a group, these firms sold 53% of all of their acquisitions during this time frame, and sold off 74% of their acquisitions in unrelated fields.[5]

McKenzie & Company, merger consultants, also studied the impact of mergers between 1972 and 1983 that involved 200 of the largest publicly-held corporations. They reported that only 23% of these acquisitions were successful using an increase in value to the stockholder as the barometer of success. Their study also reported that the highest success

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rate was 33%, and this occurred with small acquisitions made in related field. Whereas the acquisitions of firms in unrelated field had only an eight percent success rate.[6]

If the merger and acquisition success rate is only ten percent, the logical question which needs to be answered is: What are the driving forces behind merger and acquisition pressure in today's corporate environment, especially with such a high failure rate?

Many of the forces behind merger pressure are, in fact, responsible for the cause and effect relationship of merger and acquisition failure. The forces behind merger and acquisition pressure can be divided into offensive and defensive pressures. Offensive pressures are those that attempt to capture economic value through the purchase of another firm's assets. Hostile takeovers, corporate raider activity and, in some instances, White Knight mergers and acquisitions may be viewed as offensive forces. The assets of the acquired company are normally stripped and, in many instances, sold off to pay down the debt acquired in obtaining the acquisition. In addition, tax benefits are

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capitalized. The preference for 'value capture' rather than 'value creation' essentially stems from the difference in predictability in timing of the benefits according to Haspeslagh and Jemison. They indicate that capturing value via tax benefits, or selling parts off from the acquired firms, offers the acquirer a quick, predictable return rather than trying to create value from the acquisition which is a more difficult and uncertain process.[7]

Offensive merger forces place an additional burden of debt on most corporations in one of two ways. If the company under siege manages to avoid the takeover attempt, it has given into either greenmail tactics or incorporated a poison pill which would have loaded the firm with an inordinate amount of debt. This leaves the company more susceptible to competitive activities. On the other hand, if the acquired company does get purchased via a hostile takeover, it's a sure bet that restructuring will take place. Restructuring is the magic word of the mid-1980's according to Tom Peters. Peters states, "they cure all ills, excuse all past mistakes and justify huge write-downs and assets."[8]

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The problem with loading a company with this type of debt structure is that it forces companies to spend their time servicing the debt, not operating the company for growth, market expansion or new market exploration and development.

Most of the current literature referenced conclusively indicates that when corporate raiders use these offensive forces to takeover companies, the first thing that is usually done is selling off the most productive assets to pay down the takeover debt, and then auctioning off the remaining assets to recuperate their investments. The net result is the destruction of a reputable organization which, for many years, may have been profitable and productive and a source of competition and ends up getting cut to pieces.

Defensive merger activity, although completely opposite of offensive activity, operates in much the same way since it, too, saddles companies with the burden of significant debt.

The driving forces behind current merger and acquisition pressure can be identified as one or more of the following:

1. The desire to expand
2. The desire or need to diversify
3. Short-term gains
4. Tax benefits
5. Risk of government intervention
6. Power
7. Recapitalization
8. Undervalued asset activity
9. Competitive forces
10. Stock market price surges and the institutional trader
11. The Cheaper-to-buy-than-build Syndrome
12. Synergies
13. Foreign investments.

All of these forces have a direct relationship as part of the current merger wave.

Economics is the driving force behind most merger and acquisition activity. Most firms engage in merger and acquisition activity with the sole purpose of generating additional revenue for the stockholder. Expansion into similar businesses via the acquisition of firms that have complimentary products, distribution channels or geographical advantages is a principle offensive form of merger pressure which is engaged in to add value to the acquiring firm. These types of acquisitions may be looked at as either complimentary or supplementary types of acquisitions.

Diversification is generally an offensive force. The Boston Consulting Group has a prime source of growth for mature firms. Kenneth Davidson refers to the Boston Consulting Group's matrix as a strategic investment theory. Davidson states that, "strategic investment theories that justified mergers rested on a series of premises: successful firms have a life cycle." During their "mature" phase, the firms generate excess earnings which should be used to acquire

other firms. Appropriate, non-mature acquisition targets can be identified.[9] Davidson indicates that the use of the Boston Consulting Group matrix fails to take into account that even though diversification may be the direction desired by a firm in the acquisition mode, it best not be managed by the numbers alone. Familiarity with the business is just as essential as applying the Boston Consulting Group matrix in diversification decisions. Diversification can bring added value to a company on the acquisition trail, but only if the acquisition is successful. As cited earlier, the increase in the rate of divestiture versus acquisitions indicates that diversification forces are a high-risk venture.

Diversification can be an offensive force that can add value to corporations. An example of this is the takeover of Pet Company by Illinois Central in the early 1980's. What began as a hostile takeover with Pet Foods initially attempting to fight the takeover turned into an excellent example of what can happen when senior management begins to work toward the common goal of making the acquisition work. Illinois Central avoided imposing its will on Pet Foods and asked Mr. Boyd Schenk to stay on as Pet's president. Mr. Schenk

ultimately became the Vice-Chairman of Illinois Central, and in an interview with Mr. Schenk and the Chairman of the Board of Illinois Central, Mr. Johnson, both agreed that it took working together to make the merger work - and keeping all of the top management committed in place.[10]

Short-term gains are the goal of the hostile takeover and of the corporate raiders. The desire to obtain short-term gains is a strong force behind the current merger and acquisition wave. Hostile takeovers and corporate raiders have turned into "greenmail junkies," actively seeking out undervalued companies which can be acquired, broken up and sold off at recovery value significantly greater than the original purchase price. The raider turns a quick profit and scurries off to the next "deal." In most instances, the company under siege is a stable, growing, profitable, dividend paying concern that is undervalued because it hasn't been in the "news," is not a "high" growth company -- just a company that has been managed to make a profit for its stockholders. Michael Jensen thinks this type of

takeover activity is good business. His constant referral to "companies that get fat and inefficient...that generate high cash flow"[11] forgets that these same companies pay dividends to their owners -- the stockholders. Jensen wants these companies sold off because he feels that its a "...huge waste of resources that makes society worse off."[12] His philosophy of 'corporate debt is better than stockholder returns' is what motivates the short-term "takeover junkies."

The T. Boone Pickens, Jr. 1984 raid on Gulf Oil is the first example of "short-term" merger pressure. His "raid" on Gulf Oil was driven by short-term profit motives, "but not just his own." Pickens has always taken the position that these raids are good for the stockholder. He claims that it is the shareholders that gain financially from these takeovers, and cites Michael Jensen's study "that showed that on average, shareholders gain 30% on their investment in a takeover."[13] Neither Pickens nor Jensen point out that this is a one time gain, at the expense of a viable company. They also neglect to mention that it is the

investment bankers "advice plus financing business" that provide "...the astonishing lucrative business of combining investment banking advice with takeover financing to give corporate raiders one-stop shopping."[14] It was Drexell Burnham Lambert, the Wall Street Investment Banking Company, that provided Pickens the necessary "tools" for his "unsuccessful" raid on Gulf Oil and then Phillips Petroleum all for <u>short-term</u>, <u>large profits.</u>[15]

Since 1984, all the large investment banking concerns have entered this arena for the short-term gains. Kidder Peabody & Company provided advice to the Dart Groups' attack on Supermarkets General, Merrill Lynch advised and financed Sir James Goldsmith's attack on Goodyear Tire & Rubber, and First Boston Corp. helped Canpeau Corporation attack the Allied Store Chain. American Express has taken a slightly different approach to generating short-term gains. "American" Express says that while it eschews hostile takeovers, Amex subsidiary, Shearson, helps clients do them...Shearson provides a broad spectrum of investment banking services...and advising and financing hostile takeovers is one of them."[16] Investment bankers make

money by putting the deal together, or financing the deal and by selling the pieces off once the deal is consummated. It's clear that the investment banking community is a principle force causing short-term merger and acquisition pressure, not just the corporate raider.

Federal government short-sightedness is an equally important cause of the latest flurry of merger activity. It is much more advantageous to leverage a corporation with debt than to operate from a positive equity position. Federal tax laws allow, and, in fact, encourage indebtedness by corporations since interest paid on that debt is tax deductible. Profits made from being "cash rich" get taxed twice if they're paid out in dividends to the stockholder. During the current merger wave, U.S. tax laws rewarded the use of "junk bond" financing for acquisitions. Henry Kaufman, a noted Wall Street economist, recently stated that this type of activity "decreases the Federal Government's revenue and thus increases the budget deficit."[17]

The relaxation of the antitrust laws has also allowed for many mergers and acquisitions of questionable volume to occur. Horizontal mergers which would not have occurred ten years ago are not commonplace. A prime example is the acquisition of Vestal Laboratories (formerly owned by Chemed, Inc.) a prime supplier of hospital use soaps, disinfectants and housekeeping chemicals by Calgon Corporation, a subsidiary of Merck & Co., Inc. Calgon Corporation and Vestal Laboratories individually occupied the number one and number two market share positions in hand soaps for hospital use. When they were allowed to merge, a dominant, almost noncompetitive oligopoly was established in this market. The Justice Department's Antitrust Division essentially ignored this reduction in competition.

Another dominant force driving mergers and acquisitions is the "cheaper-to-buy-than-build" syndrome of undervalued assets. When depressed stock market prices prevail, many firms are worth more in "hard assets" than the value the stock market places on the firm. Real estate, production facilities, patents, a trained sales force and a

distribution system in place may entice a competitor to actively pursue a merger or acquisition because acquiring might well be less costly than having to invest the time, money and productivity to achieve similar goals. The Kodak purchase of Sterling Drug provided Kodak with the product mix, distribution and sales organization selling pharmaceuticals. Kodak was beginning to invest in this market when it became the "White Knight" for Sterling, at a substantially lower investment cost than attempting to enter the pharmaceutical market alone.

In tandem with the route of least cost is the competitive pressure present in the merger environment. Many mergers and acquisitions are initiated because of competitive pressure in the marketplace. The "if you can't beat them--then buy them" attitude is more prevalent now than ever before, it is due to the laxity in enforcing the antitrust laws. The Burroughs/Sperry merger, Delta Airlines' acquisition of Western Airlines and Piedmont Airlines being absorbed by U.S. Air not only provided market expansion, but eliminated either a potential, or real, competitor.

In most friendly mergers and acquisitions, "synergies" are given as one of the primary driving forces behind the acquisition. Synergy is the total being greater than the sum of the individual parts making up the total. Even under the best of conditions, the simple fact that a merger brings together two or more different companies should alert the most casual observer that obtaining synergies is extremely difficult due to the differences.

Mergers and acquisitions take place because of various pressures. According to Kenneth Davidson, Attorney for the Federal Trade Commission, over one trillion dollars have been spent on acquisitions in the last decade and that "pro-merger sectors of the business community claim that the takeover premium paid to shareholders rewards the acquired business for a success that has been ignored by the stock market." However, it is Mr. Davidson's contention that these rewards don't find their way back into the investment community.[18] He further states that mergers have diverted the 40% profit margin made by stockholders of the acquired company from more to less productive uses. Many companies have leveraged themselves to the point of bankruptcy

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as a result of acquisitions during "good times" and according to Davidson, may be likely to go under during bad times.

Do mergers and acquisitions work? - - - Sometimes; but most mergers ultimately fail.

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IV. THE CAUSES OF MERGER AND ACQUISITION FAILURE

Infective agents - the infection agents which cause corporate mergeritis.

Do mergers and acquisitions really work? What constitutes a successful merger or acquisition? What are the causes of merger and acquisition failure? Why don't most mergers and acquisitions pursued in today's current merger wave provide the results sought after?

The low level of success for mergers and acquisitions is not just a present day occurrence. During the first wave of merger activity, fifty percent of the acquisitions eventually were failures. The definition of a successful merger (and therefore one that is not successful) is one where the investment (merge) results in producing adequate earning power; i.e., providing a sufficient return on investment over and above all alternate, more secure investments such as interest income earned on certificates of deposit.[1]

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"A 1960, Booz, Allen & Hamilton study surveyed management in 128 acquiring companies and learned that over one-half of these mergers resulted in less than favorable results with those companies they acquired."[2]. As cited earlier, up to 90% of mergers or acquisitions never fulfill their original promise. With such high risk of failure, mergers and acquisitions should be considered a high-risk venture.

There are many reasons why most mergers and acquisitions don't work. When a merger fails to provide adequate results along with the desired benefits sought after, the source of this failure can usually be traced back to the inception of the idea to acquire or merge; and caused by several factors.

The single-most dominant cause of merger and acquisition failure is the lack of adequate planning, specifically the lack of sufficient strategic planning before and during the merger/acquisition process, along with developing a tactical implementation plan. Malekzadeh, et al, states that

> "In the rash of takeover fever, the balance sheets take on an exaggerated importance and become a paramount consideration to the negotiating parties. Little consideration is given to the congruence between the culture of the two firms and how each department and each employee might react to the merger. However, two

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> organizations with two distinct identities and cultures need to merge, and human resource and cultural factors are essential to the success of any merger. It is simply assumed and stated that takeovers are beneficial and healthy. Again, escalating stock prices are presented as evidence of the effectiveness of the takeover, and once again, long-term performance and human resource and cultural matters are quietly ignored."[3]

Malekzadeh's comments exemplify the failure to do any serious strategic planning before and during the merger.

Dane Shrallow, Assistant General Counsel for Leaseway Transportation, indicates that there are many reasons why acquisitions may fail to produce desired benefits. He points out that the sellers may misrepresent the strengths or future prospects of their companies. "In other incidences, the acquirer may have failed to understand the business of the acquiree, or asked enough of the right questions. Significant undisclosed claims or liabilities may surface after closing, and different management philosophies of the acquirer and acquiree can lead to a falling out and resentment, thus effecting the vigor and dedication of the operation's management." Shrallow goes on to say that for these and many other reasons, corporate marriages frequently result in estrangement and divorce. Shrallow states that, "in his opinion, the money and

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time invested in putting the acquisition together should be continued during the transition process...and that management should continue to direct attention to the new acquisition by implementing a strategy designed to successfully integrate and operate the newly acquired business."[4]

Shrallow's comments are valid. However, his recommendation on developing and implementing a strategy post-integration is the essence of what causes so many mergers and acquisitions to fail --- the failure to preplan prior to the merger or acquisition. Pekar and many others point out that acquisition strategy places an overwhelming dependency on financial advisors, negotiation strategies, antitrust laws and the need for swift decisive action without prior planning.[5] Planning, both strategic and tactical, before, during and after the merger are the keys to success.

Most mergers are doomed from the beginning because the acquiring company fails to define why the acquisition should be pursued at all. Acquiring companies need to define the

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purpose, goals and objectives of any acquisition plan in order to engage in any activity. This should include a detailed analysis of the current state of affairs of the acquirer including size, market definition and projected market growth, market diversity, competitive structure and profitability as compared to the industry. It should also include any environmental impact and other factors relating to the environment, technological strengths and weaknesses, defined company differentiation and competitive analysis including descriptions of the marketing, sales, distribution and degree of profitability as it relates to comparable firms within the industry.

Most mergers fail because companies acquire or merge for the wrong reasons. Most shareholders find mergers attractive and desirable if they add value to the corporation. However, many investors look for a high immediate return without consideration for the corporation's future.[6] Corporate raiders are examples of the latter where they are first likely to sell off the most productive assets of the acquired firm to pay off the debt and then auction off the remaining balance to recuperate their investment.

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As a result, according to Nahavandi, a reputable organization with many years of productive service is cut to pieces. Its managers, who might have spent many years nurturing the business, are fired, and many of the executives who do leave are from the acquired businesses that then lose momentum. The damaged company is quietly phased out or, if salvageable, sold off.[7]

Fray, Gaylin and Down state that the failure to adequately strategically plan prior to an acquisition is the primary cause of merger and acquisition failure. These observers have also indicated that the failure to integrate different corporate styles, corporate goals and corporate cultures of the two organizations are reasons for failure as are the personal agendas of the key executives and the general economic environment.[8] They recommend that firms that meet "sound strategic and economic criteria -- not what is available -- offer the least risk. Too many firms become impatient or 'love struck' unwisely abandoning their screening activity in the heat of the chase."[9] They recommend that the business being purchased should only be acquired for a strategic set of goals, nothing else.

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The failure to acquire for the right reasons discloses the clash between short-term/long-term investments. Most corporations need long-term investments to provide future growth for their organizations. These long-term investments are supported by short-term earnings which may, in fact, reduce stock prices. When the stock prices become depressed, the company becomes a logical takeover threat since it is undervalued. Business today is pegged to immediate earnings, and if management engages in long-term planning and investment, they create a target for hostile takeovers as well as corporate raiders.

Most mergers are initiated to enhance the earnings power, yet most acquisitions are financed with high debt. Professor Jensen wants high debt to put the fear of bankruptcy in corporate managers. However, if debt financed corporate acquisitions and stock buy backs are the prescriptions for a healthier economy, and thus, healthier companies, why did U.S. companies increase their debt by $170 billion in 1987 while their equity positions declined by $110 billion.

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The failure to retain earnings which are then available for capital investment is a result of mergering for the wrong reasons. Money in the capital market that is paid to shareholders tends to go one of three places: to secondary security markets, to fund new corporate or government debt or to personal consumption. However, only a tiny portion gets reinvested on new equity issues. When money goes into the secondary securities markets, it tends to bid up the price of shares, but at the expense of future growth.[10]

Another reason for mergering for the wrong reasons can be traced back to one of the primary forces of merger and acquisition pressure; competition. When one firm purchases another firm because of their competitive position within a given market, the acquiring firm effectively eliminates a major competitor. Many management teams make the mistake that since the acquired firm was a competitor within 'their' marketplace, it possesses the same style and management characteristics of the acquiring company. Little attention is paid to the skills portion of business - which means understanding the kinds of skills that a business has

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and identifying the major strengths and weaknesses of the organization.

Another cause of merger and acquisition failure is the failure to communicate to employees and telling corporate "white lies." The lack of communication during the merger process to the employees of both organizations allows "the rumor mill to churn at full speed." When target firms formalize communications and operate on a "need-to-know" communication mode, a lot of misinformation and rumor mongering takes place. According to Mirvis and Marks, this type of misinformation creates problems for organizations that find it difficult if not impossible to overcome once the merger or acquisition is complete and integration takes place. When formal communications on a "need-to-know" basis occur, it is generally interpreted that management has something to hide and employees become suspicious of management plans and intentions.[11] The lack of trust present during and after a merger is heightened. This creates "Merger Syndrome" according to Mirvis and Marks. When acquiring companies tell employees all jobs are secure, that no one will be adversely affected and that no

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changes will occur, they begin to "lie" to their employees since some changes are inevitable. This miscommunication does more to damage employee relations, employee trust and employee loyalty than most other actions and is a source of merger failure.[12]

The lack of corporate culture or chemistry is another principle cause of merger and acquisition failure. Merger partners need to insure that as many of the cultural differences between both the acquiring as well as the acquired organizations are overcome. Corporate culture or corporate chemistry is essentially a compatibility question of how individual companies do things. This integrating of corporate cultures is not easy. The merger of two corporations sometimes can produce a clash of different cultures and values. Integration must be managed to insure that the combined organization maintains its operations in a positive, highly motivated state even though there may be differences in blending corporate cultures during the post-acquisition process. The failure to do so has been responsible for numerous merger failures.[13]

In Paul Hirsch's recent article titled, "Happy Endings To Mergers,"[14] he strongly emphasized that corporate culture should never be down played. The acquiring company should function as partners in building the combined company. This includes keeping all the physical trappings of companies that were acquired, rather than "ripping up the carpet" and rearranging the organization to impose the presence of the new owners.

The IBM/Rolm acquisition almost failed when an IBM manager inadvertently decided to cancel the free coffee being given to Rolm employees. Rolm employees interpreted this as a total change of corporate culture which reflected poorly on IBM, and IBM began to lose credibility and support from the acquirees. When the free coffee was reinstituted, the corporate culture issue dissipated.

Mr. Johnson learned this first hand when ICI acquired Pet, Inc. Johnson was able to quickly absorb Pet because of his philosophy of "by keeping the trappings of this proud, once independent company status, (he) showed their managers that he respected their judgment, honored their dignity and

valued their management skills. Even more significant, Johnson's strategy worked to reduce the acquired managers' fear that ICI bought their company to milk their assets and harvest their well-known brand names.[15]

Differences in corporate "chemistry" can serve as a tell tale barometer of future merger failure. These are:

1. When management of the acquiring corporation establishes goals for the acquired company without concern for or consulting with the acquired staff (lack of interplay and communication).
2. When management by the numbers becomes the only source of measure without regard of actual resources, skills or limitations.
3. When the acquiring company starts short-terming the profitability of the acquired business.
4. When new operational guidelines for the acquired company are established without telling what they are.
5. When quality assurance and quality standards change.
6. When performance appraisals and compensation plans get changed in an arbitrary fashion.

7. When there is corporate indifference which represents the lack of a systematic attempt to utilize the resources of the acquired company.
8. When dictatorial management styles occur; i.e., "Do it my way or else....We bought you!"

These tell tale signs are indicative of what could be described as a "We-They" attitude and develop due to the lack of planning, goals and objectives and priorities which should have been established by the purchasing company at time of acquisition.

Differences in management style and management philosophy are another culprit leading to the destruction of a merger or acquisition. When an entrepreneurial-type company which is used to networking gets acquired by an autocratic top-down decision making organization, the acquisition is doomed almost from the start. The loss of decision making is a prime force for driving away managers who previously enjoyed the responsibilities. When St. Joe Minerals was acquired by the Fluor Corporation, St. Joe enjoyed that entrepreneurial-type of work environment. In less than a

year, even the most senior St. Joe employee had requested permission and approval for even the most meaningless decisions from Fluor's management. Some authorities refer to this as a clash of corporate cultures which sparked an exodus by key personnel.[16]

A key cause for merger failure is the inordinate debt assumed by the purchasing company with most of the mergers and acquisitions done today. Servicing this debt consumes the funds which would normally be invested in new business development and expansion. "...the new debtors are not borrowing in the traditional way to put up a new plant," says Harvard University economist, Benjamin Friedman. "They're borrowing to retire equity. That doesn't do anything to increase cash flow, it just increases obligations."[17] Friedman goes on to state that corporate debt is historically high and pre-tax profits are flat and interest costs are eating up more than 50% of pre-tax earnings. In the 1970's, interest cost was approximately 40%, and in the 1960's, it was less than twenty percent.[18]

This new corporate debt forces executive focus increasingly on boosting cash flow -- fast. That often means laying off employees, sacrificing research or capital investment and selling lackluster divisions or units that no longer fit corporate strategy according to some authorities.[19]

When T. Boone Pickens attempted his raid on Gulf Oil, Gulf Oil took on four billion dollars in debt. The chairman of Gulf (now Unocil Corporation) was quoted as saying that, "everyday we open the door up, we spend two million dollars for interest,...think what that would have done for the U.S. if it had been put into job creation."[20]

Dr. Jensen, a Harvard professor, has repeatedly stated that operating a company bordering on the brink of bankruptcy due to corporate debt stimulates a company to produce returns. However, the Gulf Oil incurrence of debt is just one of many different examples which can be used to indicate that debt can destroy a company along with a merger.[21]

Another example of merger debt can be seen when Owens Corning Fiberglas Corporation was pursued by the Wickes Corporation in 1985. Owens successfully fought off the hostile takeover bid, but had to close two major plants and

began to cut the salaried work force by forty percent. Owens also dismantled its research facility which could have developed new products or opened new markets and the capital expenditures were cut in half.[22]

Union Carbide incurred significant debt when GAF Corporation attempted to take it over, and the same phenomena occurred when Sir James Goldsmith began his raid on Goodyear. Goodyear's chairman at the time, Robert E. Mercer, sent the following note to his employees once Goldsmith began his attack: "Once a company's stock has been put into play as a result of a raid attempt and the accompanying speculation, it is necessary to sacrifice both our long-term plans and our current assets, to narrow our business focus and shorten the time frame for stock performance." What Mercer did was put up for sale more than a billion and one-half of Goodyear's assets to buy back twenty million shares of stock, cut the staff working for Goodyear and closed plants. The impact of the high bet is much like 'throwing the baby out with the bath water.'[23]

Unions, work stoppages, raw material shortages, strikes and "acts of God" can also cause a merger to fail.

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V. THE EFFECTS OF CORPORATE MERGERITIS

Clinical (Persona) - Sympton of corporate mergeritis most seen -- What's going to happen to me????

When an acquisition or merger fails to provide sufficient return, a significant number of changes can be anticipated. Even at the start of a merger, the signs of failure can be observed. Sometimes there is significant number of jobs lost and closing of plants and offices.

Shortly after an acquisition is made, many companies look for places to sell-off assets to quickly pay down debt encountered as a result of the acquisition. As a result, many companies lose their ability to compete effectively in the marketplace because they do not have the funds necessary to support new product development or be competitive. Paul Choat refers to this "dicing, chopping and reassembling of American business" as the inevitable downfall of the U.S. business competitiveness. Choat goes on the say that "corporate managers are so busy trying to preserve themselves, that they entire focus of business has turned to short-term payoffs. They're too busy fighting

Wall Street to fight Japan. How can anyone concentrate on doing what's needed for the long-term competitiveness -- spending for plant and equipment, R&D and job training when they're so busy battling for survival?"[1] Conclusion: Mergeritis can destroy the strong U.S. position in the marketplace.

Mergeritis does not create wealth or value. Michael Drury indicated that "great expectations of wealth are being created, but this could be a leap of fate. Unless acquirers can sell goods for higher prices or more make production more efficient, there won't be a real wealth effect. Until then, we are seeing a transfer. Somebody is getting rich only because someone else is liquidating assets to pay for higher priced stock." Drury refers to this as the great reshuffling or a "zero sum gain -- someone else gains only because someone else loses." He also supports this by pointing out that in 1985, the U.S. economy fell to 0.8% even during the time of high merger and acquisition fervor.[2]

Jeff Binghaman, Democratic Senator from New Mexico, has repeatedly warned that the big wave of takeovers is creating an unstable situation for the economy. Those with a stake in restructured and reorganized businesses are essentially placing a huge bet on the continued economic growth to feed cash flows. The major question is, 'what happens if there is an economic downturn?'[3]

The "buzz" word for mergers and acquisitions to work is restructuring which consists of a shuffling and reorganization and redeployment of company assets to provide a lean aggressive organization. According to some experts, Wall Street's magic is no longer an earnings growth, dividend increases or low price earnings ratios, but in restructuring which has accounted for approximately one-third of the market's rise since 1984. The market has essentially abandoned its traditional way of valuing stocks. Some call restructuring a "frenzied blur of buy backs and spin-offs, mergers and acquisitions, leverage buy outs and recapitalizations."[4]

Mergeritis may affect future economic prosperity. The rules of restructuring call for rediscovering hidden assets which are undervalued. According to Bruce Nussbaum, an author for Business Week, the stake in the restructuring game is the future economic prosperity of the United States. This is particularly important since the restructured tax reforms which took place on January 1, 1987. Restructuring opens the door for foreign raiders. It has been the corporate raiders who set the restructuring force in motion. Nussbaum and others indicate that "to evade raiders, managers are restructuring their companies with a vengeance. They are doing deals everywhere to get stock prices up. The most common tactic is to simple order a stock buy back, and according to these experts, buy backs work."[5] Buy backs work, but at a premium price as evidenced by the dollars made by raiders in their unsuccessful bids to acquire companies. T. Boone Pickens made eighty-four million dollars on the Gulf Oil raid.

Spin-offs and divestitures are other tactics which have been borrowed from raiders to generate cash and boost shareholder value. In addition, cutting out layers of management is a prime goal to reduce operating costs and pass through more

profit to the shareholders. "In the last three years, nearly a half a million people have been asked by their companies to walk -- some politely, some through retirement programs and others more bluntly" according to Bruce Nussbaum.[6] Mergeritis is creating unemployment.

Mergers can cause high debt. The cost of restructuring has been debt. Junk bonds have provided the key ingredient for restructuring in the form of leverage. Corporate restructuring today is being finance driven rather than the buying and selling of assets which has been the traditional source of merger and acquisition activity. Professor Jensen feels that this type of nuclear finance is healthy for the U.S. economy, but "what the Jensen argument seems to ignore is the effect of an acquisition in the years between purchase and divestiture."[7]

When profitable companies pay dividends to their shareholders (and are investing in the growth of the organization) all parties contribute to supporting the U.S. economy by paying taxes. When ill conceived mergers and

acquisitions occur, the entire U.S. economy suffers and there is lost tax revenues. Once a merger or acquisition takes place, there usually is an eventual loss of jobs. This reduces the amount of money spent in a community which immediately reduces the tax base for local community taxes as well as the federal tax base. In addition, by removing a profitable organization paying dividends, and thus, taxes, to the federal government (through both corporate and individual taxes paid on earnings by the stockholders), the government can lose twice; first on the earnings tax and second, because most of the current deals are financed with high debt which don't get taxed.

Are mergers and acquisitions good? Yes, if they are well planned, done for the right reasons and managed properly with little or no debt.

ENDNOTES

[1]N. Jones, J. Berger and K. Pennar, "Do All These Deals Help or Hurt the U.S. Economy?", Business Week, (November 24, 1986), pp.86-88.

[2]S. Prokesch and W.J. Powell, "Do Mergers Really Work?", Business Week, (June 3, 1985), p. 88.

[3]N. Jones, J. Berger and K. Pennar, "Do All These Deals Help or Hurt the U.S. Economy?", Business Week, (November 24, 1986), pp.86-88.

[4]J. Dobrzynski, Z. Schiller, G. Miles, J. Norman, "More Than Ever, It's Management for the Short-Term," Business Week, (November 24, 1986), p. 92.

[5]B. Nussbaum, "Deals, Deals, Deals," Business Week, (November 17, 1986), pp. 74-76.

[6]Ibid.

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VI. MAKING MERGERS AND ACQUISITIONS WORK -- STEPS FOR SUCCESS

Since engaging in a merger/acquisition is a high-risk venture, the recurrent question that surfaces is the following: Are there steps which can be taken to reduce the risk of merger failure? Are there techniques that can help a merger be more successful? The answer to both questions is, "yes." The steps that can be utilized will be discussed in detail in this chapter.

Although there are no guarantees of successful merger and acquisition activity, the following points represent critical steps which can lessen the risks of merger failure. The single most important element in an successful merger or acquisition is having a set of written, flexible plans for implementing strategic acquisitions. Detailed plans for post-merger integrations need to be developed and should include several elements:

1. How will the new acquired business be managed?
2. How will the transition be handled?
3. How will employee concerns about job security, career advancement, communications in general, and other

questions relating to human resources be handled?

Unfortunately, there is a recurring theme with mergers that fail:

"...the preconceived notions held by the acquiring company of what is best for the (to be) acquired or merged firm -- without the latter's input -- and sometimes ending with the divestment of what could have been a valuable asset. The lack of concern for the human/organizational factors of a merger or acquisition, and the lack of a collaborative effort to make a corporate marriage work, often scuttle the best of intentions and paper plans. Economic and financial extrapolations can sway judgment and clog the basic human and organizational issues that all too often sabotage the 'ship of hope'."[1]

The failure to involve management from both the acquiring as well as acquired company in planning post-merger activities is one of the cardinal sins that must be avoided if a merger is to be successful. Involving managers in the merger process at the pre-combination phase develops a working rapport which allows different management styles to be combined when the organizations are at different developmental stages or ages.[2] This also sets the stage for establishing personal commitment and a high priority to insure that interest and involvement at the highest levels set a friendly and caring tone that is continued during the first critical year once the merger is consummated.[3]

Including acquired managers emphasizes a commitment to making a merger work. It has been generally suggested that a merger management task force composed of equal numbers of senior executives from each company be established. When Bendix was merging with Allied, managers virtually from all sectors of both companies met with their counterparts to devise ways to incorporate the strengths of each of the organizations so the systems were essentially made one. This also allowed an opportunity for team building to take place early in the post-merger process.[4]

Involving managers from the acquired corporation offsets the time of insecurity often referred to as the time just after the company is acquired, and the question of "Where do I fit in?" gets asked over and over. Involving management of the acquired company in building the company during the post-acquisition process provides a way for the newly acquired employees to demonstrate their values and skills to new superiors. According to Mitchell Marks and Philip Mirvis in their article, "The Merger Syndrome; Stress And Uncertainty," a merger/acquisition changes people's accustomed work arrangements and demands more time. It poses countless uncertainties and can threaten people's jobs

as well as their self-esteem. Mergers create stress, and by involving managers from the acquired corporation in the planning process, the "merger syndrome" is avoided." Marks and Mirvis describe "merger syndrome" as

> "a combination of uncertainty and the likelihood of change, both favorable and unfavorable, that produces stress, and ultimately affects perceptions and judgments, interpersonal relationships and the dynamics of the combination itself. In companies, the syndrome is manifested by increased centralization and lessened communication that leaves people in the dark about the combination and fuel rumors and insecurities."[5]

The authors candidly indicate that stress can make or break a management team during a combination, so working in a friendly manner is essential.

Communication is a prime area of concern. Open channels of communication which provide an accurate flow of information to all members of both acquired, as well as acquiring, organizations offsets the rumor mill. Employees who stay receive a message from the new management that it really cares, and "good will is an important investment because nothing contributes mightily to the credibility of another message ... and that is that the acquirer can be trusted" according to Edward Hennessey, Jr., the CEO of the Bendix-Allied Corporation.[6]

Equally important to offsetting problems when merging companies is the development of a new corporate identity. This can be reinforced by a distinctive name and progressive positioning to set the stage for planned growth according to some experts. Identity is more than just descriptive, and sometimes leads to future development by serving both as a compass and an engine for the acquisition of new businesses, entry into new markets, and introduction of new products. Corporate identity has an economic value to the owners of the new enterprise, and it needs to be cultivated and managed especially when its new.

Developing a new corporate culture is a necessity. It can set the stage to distinguish and communicate the substance of the newly formed corporation.[7] What is important, however, even though a new identity may be established, is making sure that the remnants of the earlier corporations are still kept. This is particularly true as it relates to the culture of the acquired organization. Corporate culture is an intangible that needs to be gently changed over time, and it is important to keep the trappings of once independent company status of the acquired company as a way of showing newly acquired employees that not everything has

been changed. It is unfortunate that there is a recurring theme of preconceived notions held by most acquiring companies. The notion the buyer's management "thinks it knows what's best for their (to be) acquired firm without the latter's input, which sometimes ends with a divestment of what could have been a valuable asset, exists. This lack of concern for human/organizational factors including the corporate culture can create problems.[8]

There are four predictable trouble spots in managing corporate culture. It is essential that care be paid to avoid these trouble spots. Acquiring organizations often find that the culture of an acquired organization is being poorly managed. The trouble spots that can be created are: The absence of a clear, internally coherent set of values, overrelevant, indirect methods of communicating values, a dysfunctional conflict between espoused values of top management and the values being inferred from the actual practices of the firm and finally, the existence of pockets of ignorance or resistance. Clashes between cultures of acquiring and target companies can and do create problems and will lead to merger failure if they aren't worked out.

In many instances, it becomes imperative to build a new culture, gently, over time so that "the carpets are kept and the coffee is kept" without sending signals to the acquired company's employees that everything has been changed.[9]

Equally important in assuring that mergers and acquisitions work smoothly is the orderly transition of authority. Several experts have indicated that care should be taken that there is no "strutting" or assumed dominance by those managers in the acquiring firm. By establishing a basis of mutual respect and concern, care should be taken to avoid insensitive, brutal talk or actions that could be self-defeating, especially strutting.[10] Partnerships do work. A position power--the dominant recessive behavior can target a merger for failure.

Fair treatment of employees who will lose their jobs due to duplication of positions should be mandatory in assuring merger success. By emphasizing dignity, incentives and rewards rather than insults and punishment, the termination process becomes significantly easier. By being open and

honest, indicating that duplication of services could not be handled, loyalty of essential employees who could easily leave or sabotage a company, can be maintained. Ample notice should be given to all employees who will be departing. "Insuring that departing executives leave with their pride in tact is a value investment. A shared sense that the decision is regrettable, but fair, boosts the morale of everyone who is directly involved as well as interested onlookers."[11]

Avoid housecleaning! -- which is the replacement of acquired personnel with the acquiring company's personnel without rhyme or reason. In most mergers, reduced productivity among employees at all levels, due to the changes that come with mergers and acquisitions, can be anticipated.[12] Staff reductions, transfers and other cross consolidation efforts should be postponed until personnel can be effectively evaluated. An unexpected employee benefit can result if this is done. By holding off the "budget axe," managers can work in a "safety zone" in which they can work and plan their futures. In addition, they might work harder for the firm while feeling far less threatened. Employee

morale will remain higher since executives at the new parent company have the opportunity to gain time to evaluate personnel.[13]

Perhaps the most difficult concept for the deal makers to grasp is related to the apparent lack of concern for the employees of the acquired company. In many cases, the essence of what makes the company worth acquiring is the people who not only run the organization, but all the employees that make it productive. Unfortunately, little attention is given to this most valuable asset. Many acquirers, especially corporate raiders and hostile takeover companies view these employees as replaceable, or eliminatable commodities. People are any company's most important assets, and should not be treated as if they were corporate human fodder.

One of the cardinal sins of merger and acquisition activity is overpaying for an organization. By overpaying, especially with the use of leverage debt, the acquired organization may be treated as 'cash cows' to help service the debt, and profitable segments of the acquired corporation may be sold off to help pay down the debt. The use of stock

transfers and cash, rather than debt, to acquire is strongly recommended.

Mergers that work have several other characteristics in common. Usually they are in closely related businesses so the acquiring company does not have to take time to learn and understand the business.[14] This avoids having to create value since both the economic and non-economic value of the company being acquired is recognized by the buyer.[15] Lawrence A. Bennigson, an executive of Management Analysis Center, Inc. Business Consultants, stated, "if you don't understand what you've got your arms around, it's damn hard to manage it."[16]

Compensation programs and systems should be dealt with during pre-merger negotiations. Both acquirer and acquiree should recognize that compensation is a critical issue, and should deal with this early in the post-merger integration process. Compensation should be fitted to business strategy, and be used as a motivator to reward and provide incentives for all parties to maintain superior performance.

Any disparities between organizations should be effectively resolved so that neither the acquirer or acquiree discovers shortly after the post-acquisition process that the compensation program becomes a demotivator.[17]

Departmental blending of departmental activities after acquisitions creates special challenges. Care should be taken to blend sales forces with cross training as rapidly as possible to avoid both sales forces competing against each other for individual positions or to effectively drive sales people to the competition. In general, a post-merger drop or slowdown in sales can be attributed to the failure to blend sales force adequately early in the post-merger scenario.[18]

Essentially, there are many steps that can be taken to lessen the risk of merger failure. One expert, John Callahan, President of the Callahan Consulting Corporation, does an excellent job of summing it up:

"Do your homework. Identify the character of the company you are interested in. There are many companies with reputations as being great places to work, full of good people, and run by management with high integrity, but there are many that aren't. Given the choice of paying a premium for a company that has a high ethical quotient versus one that doesn't, you are better off paying the premium and getting one with a good name in the marketplace. Companies don't get a good name without having the management teams to back them up.[19]

Do mergers work? Can they work? The forces behind merger and acquisition pressure are constant. A stimulus to grow and expand organizations and increase the flow of profit to the stockholders is essential for survival. Most mergers don't work because most people involved in mergers and acquisitions don't bother putting together a plan that will effectively overcome the hurdles that always surface during the integration process. Some of these hurdles, such as merger stress, may take several months or even years to surface. Can they be avoided? In most instances, "yes" and "no." Yes, because the severity of the problems can be lessened considerably if the acquiring company does its homework, treats people with dignity and fairness and takes the time necessary to effectively develop a strategic and tactical plan for the integration process. No, because some of the problems cannot be avoided since they are part of

human nature, especially the "what's going to happen to me" syndrome. Mergers and acquisitions naturally create distrust. Trust is rebuilt only over time. Should mergers and acquisitions continue to be pursued? Yes, but on a much more selective basis and effectively without overloading the acquiring company with inordinate debt. Above all, for any merger or acquisition to be successful, corporate mergeritis, the desire to merge or acquire for all the wrong reasons, should be avoid at all costs. If it isn't, it most certainly will be costly.

ENDNOTES

[1]G. Olive, "Post-Merger Performance of Dun's Well-Managed Companies," Mergers & Acquisitions, (Spring, 1983), pp.42-58.

[2]P. Mirvis and M. Marks, "Managing Human Resources, " Mergers & Acquisitions, (Summer, 1982), pp.38-44.

[3]P. Hirsch, "Happy Endings to Mergers," Across The Board, Vol. 25, No. 2, (February, 1988) pp.14-21.

[4]Ibid.

[5]P. Mirvis and M. Marks, "Merger Syndrome: Stress & Uncertainty," Mergers & Acquisitions, (Summer, 1985), pp.50-55.

[6]P. Hirsch, "Happy Endings to Mergers," Across The Board, Vol. 25, No. 2, (February, 1988) pp.14-21.

[7]K. Halloran, "The Impact of Merger and Acquisition Programs on Company Identity," Mergers & Acquisitions, (Spring, 1985), pp.60-66.

[8]G. Olive, "Post-Merger Performance of Dun's Well-Managed Companies," Mergers & Acquisitions, (Spring, 1983), pp.42-58.

[9]C. Siehl, G. Ledford, R. Silverman and P. Fay, "Preventing Culture Clashes From Botching a Merger," Mergers & Acquisitions, (March/April, 1988), pp.51-57.

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[10]P. Hirsch, "Happy Endings to Mergers," Across The Board, Vol. 25, No. 2, (February, 1988) pp.14-21.

[11]Ibid.

[12]P. Pritchard, After the Merger: Managing the Shockwaves, (Dow, Jones Irwin, 1985).

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[14]S. Prokesch and W.J. Powell, "Do Mergers Really Work?", Business Week, (June 3, 1985), P. 90.

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[18]J. Huguet, "Blending Sales Forces After the Acquisition," Mergers & Acquisitions, (Summer, 1984), pp.52-56.

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