Chapter 7: Merger and Acquisition Strategies

Overview:
- Why firms use acquisition strategies
- Seven problems working against developing a competitive advantage using an acquisition strategy
- Attributes of effective acquisitions
- Restructuring strategies
Merger and Acquisition Strategies
Introduction: Popularity of M&A Strategies

- Popular strategy among U.S. firms for many years
- Can be used because of uncertainty in the competitive landscape
- Popular as a means of growth
- Should be used to increase firm value and lead to strategic competitiveness and above average returns
- The reality is that returns are typically close to zero for acquiring firm
Merger vs. Acquisition vs. Takeover

- **Merger**
  - Two firms agree to integrate their operations on a relatively co-equal basis

- **Acquisition**
  - One firm buys a controlling, 100 percent interest in another firm with the intent of making the acquired firm a subsidiary business within its portfolio.

- **Takeover**
  - Special type of acquisition strategy wherein the target firm did not solicit the acquiring firm's bid
    - Unfriendly acquisition
Reasons for Acquisitions

**Increased market power**

- Exists when a firm is able to sell its goods or services above competitive levels or when the costs of its primary or support activities are lower than those of its competitors.

**Sources of market power include**

- Size of the firm
- Resources and capabilities to compete in the market
- Share of the market

**Entails buying a competitor, a supplier, a distributor, or a business in a highly related industry.**
Reasons for Acquisitions

To increase market power firms use

- **Horizontal Acquisitions**
  - Acquirer and acquired companies compete in the same industry

- **Vertical Acquisitions**
  - Firm acquires a supplier or distributor of one or more of its goods or services; leads to additional controls over parts of the value chain

- **Related Acquisitions**
  - Firm acquires another company in a highly related industry
Reasons for Acquisitions

- **Overcoming entry barriers** into:
  - New product markets – product diversification
  - New international markets – geographic diversification
    - Cross-border acquisitions – those made between companies with headquarters in different country

- **Cost of new product development and increased speed to market**
  - Can be used to gain access to new products and to current products that are new to the firm
  - Quick approach for entering markets (product and geographic)
Reasons for Acquisitions

- **Lower risk compared to developing new products**
  - Easier to estimate acquisition outcomes versus internal development
  - Internal development has a very high failure rate

- **Increased diversification**
  - Most common mode of diversification when entering new markets with new products
  - Hard to internally develop products that differ from current lines for markets in which a firm lacks experience
  - The more related the acquisition the higher the chances for success
Reasons for Acquisitions

- **Reshaping firm’s competitive scope**
  - Can lessen a firm’s dependence on one or more products or markets

- **Learning and developing new capabilities**
  - When you acquire a firm you also acquire any skills and capabilities that it has
  - Firms should seek to acquire companies with different but related and complementary capabilities in order to build their own knowledge base
Problems in Achieving Acquisition Success

- Research suggests
  - 20% of all mergers and acquisitions are successful
  - 60% produce disappointing results
  - 20% are clear failures

- Successful acquisitions generally involve
  - Having a well conceived strategy for selecting the right target firms
  - Not paying too high of a price premium
  - Employing an effective integration process
  - Retaining target firms human capital
Problems in Achieving Acquisition Success

- **Integration difficulties**
  - Most important determinant of shareholder value creation
  - Culture, financial and control systems, working relationships
  - Status of newly acquired firm’s executives

- **Inadequate evaluation of target**
  - Due diligence – process through which a potential acquirer evaluates a target firm for acquisition
  - Can result in paying excessive premium for target company
Problems in Achieving Acquisition Success

- **Large or extraordinary debt**
  - Junk bonds: financing option whereby risky acquisitions are financed with money (debt) that provides a large potential return to lenders (bondholders)
  - High debt can negatively effect the firm
    - Increases the likelihood of bankruptcy
    - Can lead to a downgrade in a firm’s credit rating
    - May preclude needed investment in other activities that contribute to a firm’s long-term success
      - R&D, human resource training, marketing
Problems in Achieving Acquisition Success

- **Inability to achieve synergy**
  - Synergy: Value created by units exceeds value of units working independently
    - Achieved when the two firms' assets are complementary in unique ways
    - Yields a difficult-to-understand or imitate competitive advantage
    - Generates gains in shareholder wealth that they could not duplicate or exceed through their own portfolio diversification decisions
  - Private synergy: Occurs when the combination and integration of acquiring and acquired firms' assets yields capabilities and core competencies that could not be developed by combining and integrating the assets with any other company
    - Very difficult to create private synergy
  - Firms tend to underestimate costs and overestimate synergy
Problems in Achieving Acquisition Success

Too much diversification

- Firms can become overdiversified which can lead to a decline in performance
- Diversified firms must process more information of greater diversity
- Scope created by diversification may cause managers to rely too much on financial rather than strategic controls to evaluate performance of business units
- Acquisitions may become substitutes for innovation
Problems in Achieving Acquisition Success

Managers overly focused on acquisitions

- Necessary activities with an acquisition strategy include
  - Search for viable acquisition candidates
  - Complete effective due-diligence processes
  - Prepare for negotiations
  - Managing the integration process after the acquisition
- Diverts attention from matters necessary for long-term competitive success (i.e., identifying other activities, interacting with important external stakeholders, or fixing fundamental internal problems)
- A short-term perspective and greater risk aversion can result for target firm's managers
Problems in Achieving Acquisition Success

Too large

- Larger size may lead to more bureaucratic controls
  - Bureaucratic controls
    - Formalized supervisory and behavioral rules and policies designed to ensure consistency of decisions and actions across different units of a firm – formalized controls decrease flexibility
  - Formalized controls often lead to relatively rigid and standardized managerial behavior
  - Additional costs may exceed the benefits of the economies of scale and additional market power
  - Firm may produce less innovation
Effective Acquisitions (Table 7.1)

- Have complementary assets or resources
- Friendly acquisitions facilitate integration of firms
- Effective due-diligence process (assessment of target firm by acquirer, such as books, culture, etc.)
- Financial slack (cash or a favorable debt position)
- Merged firm maintains low to moderate debt position
  - High debt can...
    - Increase the likelihood of bankruptcy
    - Lead to a downgrade in the firm’s credit rating
- Emphasis on innovation and R&D activities
- Acquiring firm manages change well and is flexible and adaptable
Restructuring

A strategy through which a firm changes its set of businesses or financial structure

Can be the result of

- A failed acquisition strategy
  - The majority of acquisitions do not enhance strategic competitiveness
  - 1/3 to 1/2 of all acquisitions are divested or spun-off
- Changes in a firm's internal and external environments
- Poor organizational performance
Restructuring

3 restructuring strategies

- Downsizing
  - Reduction in number of firms’ employees (and possibly number of operating units) that may or may not change the composition of businesses in the company's portfolio
  - An intentional proactive management strategy

- Downscooping
  - Refers to divestiture, spin-off, or some other means of eliminating businesses that are unrelated to firms’ core businesses
  - Strategic refocusing on core businesses
  - Often includes downsizing
Restructuring

3 restructuring strategies

- Leveraged buyouts (LBOs)
  - One party buys all of a firm's assets in order to take the firm private (or no longer trade the firm's shares publicly)
  - Private equity firm: Firm that facilitates or engages in taking a public firm private
  - Three types of LBOs
    - Management buyouts
    - Employee buyouts
    - Whole-firm buyouts