Cass Business School
CITY UNIVERSITY LONDON

Successful Dealmaking

M&A Research Centre – MARC

MARC Working Paper Series - 2014

MARC – Mergers & Acquisitions Research Centre

MARC is the Mergers and Acquisitions Research Centre at Cass Business School, City University London – the first research centre at a major business school to pursue focussed leading-edge research into the global mergers and acquisitions industry.

MARC blends the expertise of M&A accountants, bankers, lawyers, consultants and other key market participants with the academic excellence of Cass to provide fresh insights into the world of deal-making.

Corporations, regulators, professional services firms, exchanges and universities use MARC for swift access to research and practical ideas. From deal origination to closing, from financing to integration, from the hottest emerging markets to the board rooms of the biggest corporations, MARC researches the wide spectrum of mergers, acquisitions and corporate restructurings.

Overview

How can companies execute successful M&A transactions? How can they gain maximum value from their M&A strategies? And how can they ensure the deal process and post-merger integration plans run as smoothly as possible? These are questions that many companies will be asking as the M&A market starts slowly to pick up and businesses seek growth opportunities in increasingly globalised markets for their products and services.

This report, produced by the M&A Research Centre (MARC) at Cass Business School provides insights on what distinguish successful deals, covering all stages in the M&A process. More specifically, the report is based on the results from two recent studies conducted by MBA students at Cass, including both primary and secondary data. One study focuses on a sample of 70 large transactions completed by US and UK acquirers between 2007 and 2011, comparing those which have been successful in terms of creating shareholder value with a matched sample of those where shareholder value has been destroyed since the completion of the transaction. The second study is a collection of primary data, using a survey of 31 professionals focusing on their views of the role of HR in M&A transaction success, complemented with seven in-depth interviews.

The prevailing rhetoric around M&A transactions is that most deals fail to deliver on their strategic promise and on lifting shareholder value. There has been some improvement in this regard: in the past, the failure rate has been as high as 70%, according to many studies; more recent studies have suggested a success rate of between 40% and 50%.[1] However, this still leaves many deals failing and suggests companies need to hone their M&A processes to improve their performance when acquiring.

[1] 'The Economic Impact of M&A: Implications for UK firms' (2011), *M&A Research Centre*; and 'Who says M&A doesn't create value?' (2012) *Accenture*.

The report highlights three main areas for focus during an M&A transaction:

- *Having a clear strategic intent and communicating it openly.* The report shows that acquisitions with the stated intention of acquiring to enhance or add capabilities to its existing systems ('enhancing deals') were significantly more frequent in the success group (34%) than in the failure cohort (just 23%). Within the enhancing deals group, the number of successes where access to R&D or new technology were the stated intentions was much higher at 29% than for the failure group, with 9%. In addition, two-thirds of the acquirers in the success group shared detailed information in public announcements about their plans after the deal closing, whereas only one-third of the failed acquirers shared such information.
- *Understanding the importance of retention of key operational personnel and involving HR early on in the deal process.* Successful acquirers were found to be quicker to remove and replace the senior executive team, but are also much more focussed on the retention of the operational staff. Retention rates for operational personnel was over 60% for the successful deals compared to just above 40% for the failed deals; however, these differences were the reverse for target CEOs and CFOs. The survey highlighted that a majority (60%) of the respondents said that post-deal issues could be better resolved if HR was involved at an earlier stage of the deal and with most suggesting the involvement of HR already at the targeting stage.
- *Having good investigating and negotiation skills to avoid overpaying for assets.* The group of unsuccessful acquirers paid a premium of 45% on average (median) for their target companies compared to 31% for the successful acquirer group.

The Findings

One of the studies, *An Analysis of Reasons for Failure in Mergers and Acquisitions*, measured shareholder value created or destroyed from six months before the deal announcement through to two years after the deal closed. It found that 54% of the initial sample of 474 UK and US acquirers suffered from negative returns in this period – and were therefore considered to have failed on their initial promise to shareholders. This demonstrates that improvement in dealmaking skills still needs to be high on corporate agendas.

The study then goes on to analyse a sub-sample of the worst performing acquirers, 35 in total taken from the bottom third of the initial sample, comparing them to a matched sample of successful acquirers, i.e. those where the creation of shareholder value is in the top third of the initial sample.

Strategic intent matters

There will be a number of reasons for a business to acquire or merge with another company. These might include access to particular capabilities, expanding into adjacent products, categories or geographies, consolidation to build scale or a need to diversify. The study looked at whether there was a difference between successful and unsuccessful deals in terms of whether the company acquired was in the same or adjacent businesses, but found no meaningful disparity between the two groups.

However, when it examined the results for businesses with a stated intention of acquiring to enhance or add capabilities to its existing systems ('enhancing deals'), it found there was a significantly higher percentage of these types of deals in the success group (34%) than in the failure cohort (just 23%). Within the enhancing deals group, the number of successes where access to R&D or new technology were the stated intentions was much higher at 29% than for the failure group, with 9%. Therefore, a focus on strategic enhancement leads to higher performance than, for example, a consolidation strategy on its own.

Drawing on previous academic literature, the study suggests that the most successful deals are those in which acquired companies are given greater autonomy with separate organisational structures and that, to be successful, acquirers need to be delicate in absorption methods, i.e., managing employee perceptions and creating willingness for organisational changes (see 'M&A is all about people section' below for further information).

Clear communication is key

While there will always be an element of uncertainty in any M&A transaction, clear communication should result in less disruption of day-to-day activities. The results of the study show that two-thirds of acquirers in the success group shared more detailed information in public announcements about their plans, compared with just a third in the failure group. In addition, deal-killer CEO declarations, such as "We will communicate more about the merger when we have more information to share" or "It is too early in the deal to begin planning", were more common in the public announcements made by the acquirers in the failure group, confirming findings from previous literature.[2] This links in with the point above about strategic intent – where the rationale for a transaction is less clear, communication is naturally much harder.

M&A is all about people

Management of people through an M&A process is generally one of the most difficult areas to get right. However, the study demonstrates that HR issues are possibly the most important factor determining the success or otherwise of a deal. Companies with a greater focus on HR – measured by the

[2] For further information on 'deal-killer declarations', see Galphin and Herndon, 2007.

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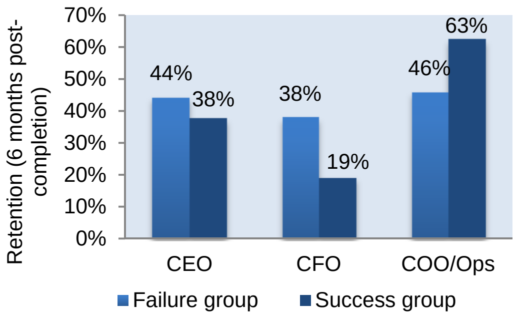
existence and use of an HR committee at board level – are more successful acquirers, the study found. There were more than twice the number of HR-specific committees in the success group than in the failure group. Around a quarter of successful deals had higher HR focus; only one in ten had this in the failed deals.

Figure 1: Retention rates of key target personnel in the six months after the completion of the deal



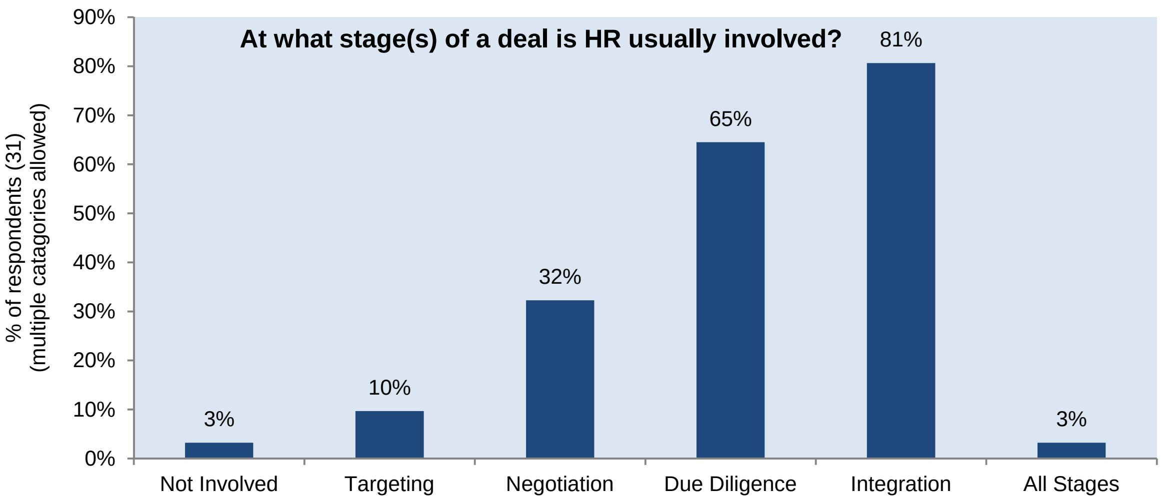
In addition, a company's ability to retain key operational executives varied significantly between the success and failure groups. Retention rates for operational and business personnel were 63% for the successful deals, while in the failed deals it was 46% in the initial six month-period after closing (Figure 1). It is likely that a failure to retain such staff would result in operational disruption, revenue loss and further loss of operational staff. Interestingly, the target top management team, CEOs and CFOs experience higher turnover post-completion, and here the higher retention rates are instead found in the sample of failed acquirers. The results varied similarly between the two groups over six-month, 12-month and 24-month time horizons.

Well-managed companies generally score better on employee satisfaction ratings post-completion. The study found that the success group had higher scores for employee satisfaction than those in the failure group. One possible reason for this might be that better and swifter – and by implication better planned – redundancy programmes reduce uncertainty for employees. The study found that most redundancies were completed by the end of the first year after the deal in the success group. The failure group, by contrast, saw greater reductions in employee numbers by the end of the second year. This finding again reinforces the point that there is value in being clear on the deal objectives and executing quickly.

Bring in HR early

Yet despite the importance of people management throughout the deal process, there is evidence to suggest that many companies do not involve their HR teams early enough. The second study, *Reasons for M&A Transaction Success*, is based on a survey of 31 HR and non-HR executives. It finds that less than 10% of companies involve HR at the targeting stage, but that over 80% involve the team at the integration stage (Figure 2).

Figure 2: HR involvement at various stages of the deal



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However, most executives interviewed suggested that having HR involved at the earliest stage possible was important and beneficial to a deal's success.

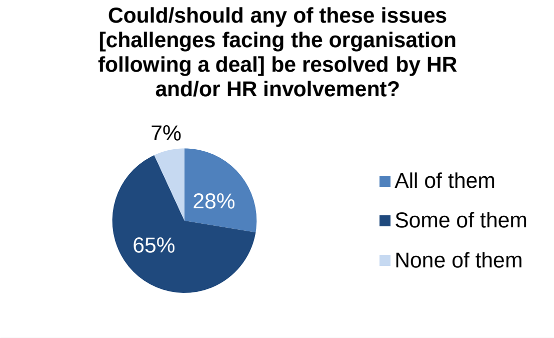
"HR involvement is critical at all stages. If you subscribe to the theory that actually it's the people that will make it work (which I do) and to the importance of the relationships and culture, HR has to be involved." (HR executive, Construction)

"Simply, you want to bring them in at the beginning when you're making the assessment of: 'Does this company make sense?' So I would say in the targeting process, but certainly in the negotiation or due diligence process, you want to make sure they are involved." (Non-HR executive, Industrials)

Indeed, when asked whether issues faced by organisations post-deal could or should be resolved by HR, 93% of respondents said that at least some of them could be if HR issues were better managed or HR teams were more involved in deals (Figure 3).

By the same token, the message from the interviewees was this: without effective HR management at an early stage, problems arise and expected returns on investment either fail to materialise or are significantly delayed.

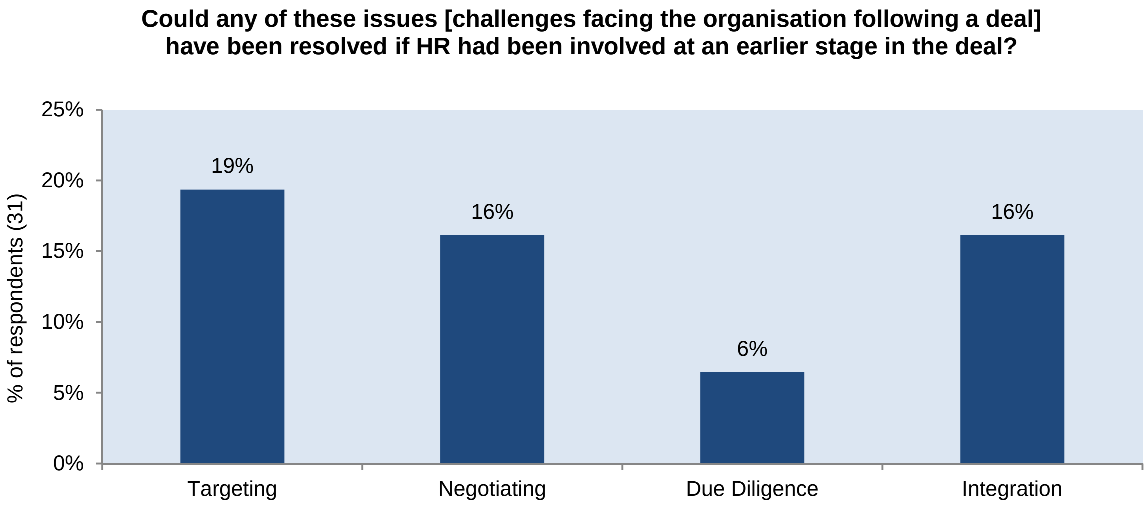
Figure 3: HR and post-deal issues



"….when you buy the business, there are a host of issues that weren't on your list to deal with such as people leaving, customer-facing issues, cultural issues, that you don't necessarily plan for. And those are the things that end up consuming your life instead of the things you thought you were going to do." (Non-HR executive, Manufacturing)

Most of the respondents also said that post-deal issues could be better resolved if HR was involved at different stage of the deal and there was significant support for including an HR component in the deal team as early as the targeting stage (Figure 4).

Figure 4: At what stage of the deal should HR be involved to reduce or solve the challenges?



Based on the survey respondents who had answered yes to the question if post-deal issues could be better resolved if HR was involved at different stage of the deal.

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Culture counts

Interestingly, the number one issue cited as a contributor to the failure of a deal by the executives interviewed was culture – an area that HR would be ideally-placed to judge at the early stage of a deal (Figure 5). The survey pointed to the other key reasons for failure as being leadership and retention issues and it found that these received a lot of attention during a deal, while culture was the single most overlooked issue. We took the tendency for issues to be focused on as a proxy for how important these issues are considered to be and ranked them accordingly, based on the number of respondents citing each issue; and then overlaid this ranking on the issues which tend to be overlooked, also ranked in order of respondents citing each issue. As a result, we are able to suggest an order of priority and/or areas of improvement in terms of HR areas to be focused on in order to improve M&A transaction success and, in particular, the contribution of HR to that success. Figure 6 (below) is the result of this juxtaposition.

Figure 5: HR issues in the course of an M&A deal

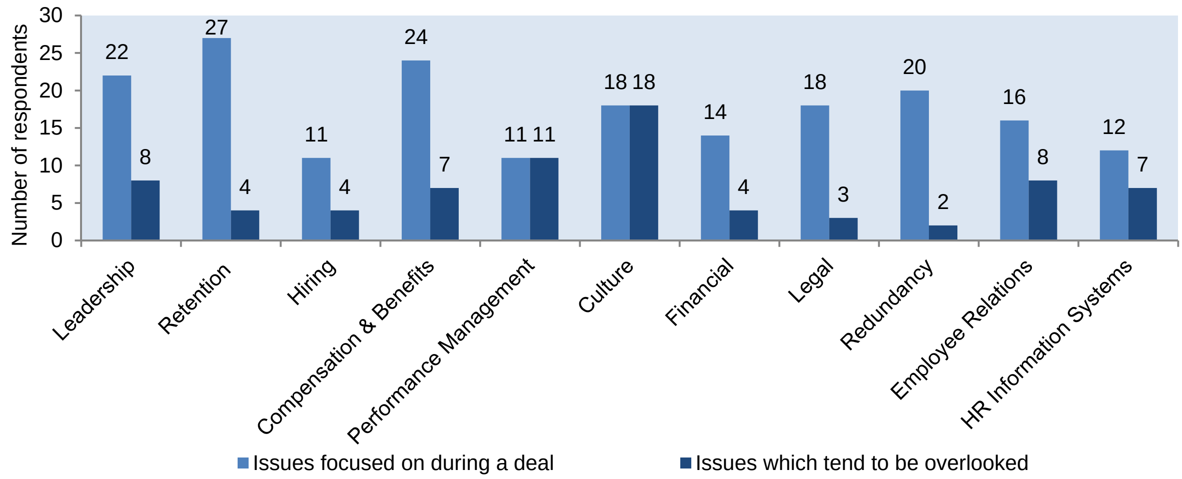
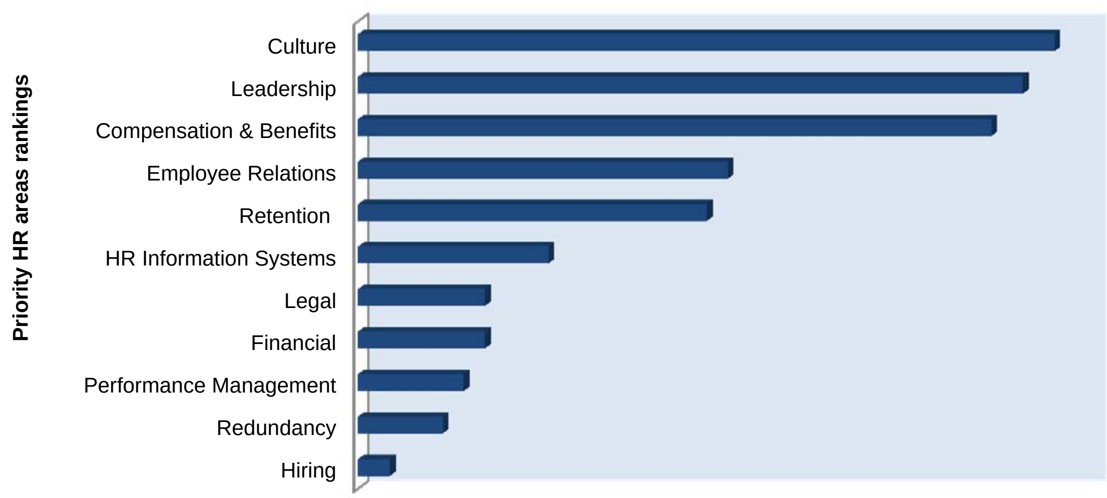


Figure 6: Relative priority HR areas to be focused on to improve M&A deal success



Note that the Priority HR rankings are based on the rank for 'Issues focused on during a deal' multipled by the rank for 'Issues which tend to be overlooked', see Figure 5.

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The financial argument

However, it is not just in avoiding problems related to the softer side of M&A that early involvement of HR can bring rewards. The survey found evidence of hard financial benefits where HR teams were used in the decision-making process.

"There are big advantages from a financial side, on analysis of strands of costs, from doing the transaction, what we are acquiring that we don't need, what we are selling that will impact other businesses, other functions that you're going to end up with cost that you can't use any more." (HR executive, Energy)

This statement is clearly backed up by the secondary data analysis from the study "*An Analysis of Reasons for Failure in Mergers and Acquisitions*, where the group of unsuccessful acquirers paid a premium of 45% on average (median) for their target companies compared to 31% for the successful acquirer group, indicating that successful acquirers are also better able to value the businesses they buy and avoided overpaying.

Notes on Authors

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Data and Methodology:

An Analysis of Reasons for Failure in Mergers and Acquisitions: In order to determine which deals were successful and those which failed, we measured the shareholder value created or destroyed over a time horizon from six months prior to the announcement of a deal to two years following its closure. Specifically, the definitions of successful and unsuccessful deals were based on the value-weighted total shareholder return (TSR) adjusted to the MCSI industry index, creating a monetary value (USD) of value created or destroyed over the period. 35 deals in the bottom one-third of failed deals were matched with 35 deals in the top one-third of successful deals, i.e. where significant value was created, according to the acquirer industry, relative size (Transaction Value over Market Value of the acquirer) and time of deal announcement.

Reasons for M&A Transaction Success: This paper is based on a survey of 31 respondents (conducted in 2013), HR and non-HR executives across ten different industries, with experience in and exposure to M&A deals. It makes a qualitative contribution to academic discourse on this subject by supplementing those results with interviews with seven executives, who provided in-depth experiential evidence and insights based on current or recent deals.

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Cass Business School
In 2002, City University's Business School was renamed Sir John Cass Business School following a generous donation towards the development of its new building in Bunhill Row. The School's name is usually abbreviated to Cass Business School.

Sir John Cass's Foundation
Sir John Cass's Foundation has supported education in London since the 18th century and takes its name from its founder, Sir John Cass, who established a school in Aldgate in 1710. Born in the City of London in 1661, Sir John served as an MP for the City and was knighted in 1713.