February 25th, 2016

THE WATERMARK WIRE

WHY DO ACQUIRERS FAIL IN CAPTURING ROI WITH M&A?

As discussed in previous issues of the *Wire*, failure in mergers and acquisitions (M&A) is pervasive. There are many contributing factors, but according to a survey conducted by Watermark Advisors, the three most common reasons for this are: (1) cultural issues leading to the loss of key people from the target, (2) overpaying for the target, and (3) integration issues. In this month's *Wire*, we take a closer look at cultural and social issues that result in failure to capture return on investment (ROI).

The Dean of UVA's Darden School of Business (2005-2015), Dr. Robert Bruner, wrote, "Failure pervades business, and most firms fail eventually" (*Deals from Hell*, 2005). That is, most firms fail. "In the world of M&A," he added, "most transactions fail to close. That deal you may be discussing has perhaps a one-in-ten chance of consummation." The stark reality is that "there is no clear value creation in the sense of earning returns significantly in excess of the opportunity cost of capital – only 20-30% of all transactions seem to do so."

While failure in M&A often means that a transaction does not close, an even graver outcome is that an acquisition that a buyer does close fails to create significant ROI. Why pursue an acquisition anyway? Fundamentally in business, it is because you believe you will earn a significant ROI by adding the target's business. If only one in four acquisitions do create a significant return over their cost of capital to the acquirer, then business decision makers should be preoccupied with failure if acquisitive.

Then what about cultural issues? In the second half of 2015, Watermark conducted a survey with acquirers who were headquartered in the Carolinas and Georgia. We first asked how many acquisitions their company had completed in the last ten years. 35% of the 22 responders had completed 5 or more, 10% had completed 4, 25% had completed 3, 20% had completed 2 and 10% had completed 1 acquisition.

When asked if they had experienced failure, and if so, what they believed contributed to it, respondents shared primarily the above three factors. While Watermark's survey is a small representation of U.S. acquirers, we do believe these three issues are likely the three most significant hurdles to acquirers capturing significant ROI.

What is a business's culture? "Culture" is a multifaceted concept. We define it as how business decisions get made inside an organization or company. Edgar Schein, foremost scholar of organizational behavior, believes, "Culture may be loosely thought about, but it is only after the merger that it is taken seriously, suggesting that most leaders make the assumption that they can fix cultural problems after the fact. I would argue that leaders must make cultural analysis as central to the initial merger/acquisition decision as is the financial, product or market analysis."

Why are cultural problems so pervasive between the acquirer and the target? (1) The problems get rooted early in the deal making process. Often, acquirers deemphasize the importance of social issues while in the middle of a transaction. Instead, they prioritize other subjects, such as valuation, financing the transaction, and deal structure. The advisors providing services to the buyer focus on their area of expertise, and very few have expertise on social and cultural issues between buyer and target.

As a result, social issues get inadequate attention and receive unsophisticated solutions that set the stage for problems if and when a deal is closed. Topics such as the target management team's autonomy and influence post-closing, organizational design, and contributions to integration are typically not well thought through.

Often, the buyer underestimates the cultural challenges that will arise after closing the deal. Therefore, it fails to allocate solid due diligence of the target's culture. Due diligence entails studying the similarities and differences between the culture of the buyer and the target. It also means analyzing the target's culture versus the target's strategic goals detailed in its projections.

The buyer's culture may be one of customer service and loyalty, whereas the target's may be focused on innovation and product distinctiveness or being the low cost provider. If and when two different cultures come together, how the buyer merges these cultures together is a delicate process. Done poorly, the likelihood of ROI capture evaporates.

Cultural and social issues affect both the transaction and integration phases. Many buyers are consumed by all of the challenges that demand attention in the transaction phase. (2) Because the uncertainty is high that a deal will actually close, buyers hold off integration planning until days or weeks before the deal closes. Waiting until the close of the deal does not give the buyer enough time to plan out integration processes that need to launch immediately after the transaction closes.

A well planned and executed integration process will answer the question that every employee at the target is asking, "What about me?" Until that question is answered, employees won't perform at their best. Target employees should be included in the integration process.

If target employees are left out of integration task force teams, and even further, often if not given a continuation of responsibilities, they will reach a conclusion that they are not as valued as they had been. This lack of re-recruitment will result in the target underperforming, and employees jumping ship.

(3) Often there is a large size difference between the acquirer and the target. The acquirer, because of its greater revenues and success, has a degree of hubris, sometimes small and sometimes large. As a result, it is overconfident in its understanding of the target's business operation.

This overconfidence leads to a series of poor decisions, often people related, which alienates the target's leadership. Soon, there are defections in the target's leadership. As that talent leaves, it takes specific knowledge with it of processes and relationships that is hard to replace.

The disciplined acquirer puts cultural and social issues in equal or even greater light to other areas in the transaction and integration phases. Most likely, such an acquirer has learned from previous failures in capturing significant ROI that the target's success is a result not only of its unique products or services, but also of its people and culture. This sophisticated acquirer has mastered a process of due diligence on culture. It places social issues as a top priority throughout the transaction process, initiating integration planning in the middle of the transaction, avoiding hubris tendencies, integrating cultures thoughtfully, and addressing individuals' concerns swiftly. Such an acquirer is much more likely to complete a successful acquisition.