10 Classic Merger & Acquisition Mistakes

ASIA PACIFIC
STRATEGY & CORPORATE FINANCE

Don’t swallow a Red Herring ……

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There are a lot of Red Herrings out there…….

- M & A is a technically challenging growth option for generating **Shareholder Value**
- It is a complex strategy, with many dimensions. Without a disciplined process for considering and executing deals, the potential of acquiring the wrong **Target** is real
- M & A is a **living process** – deals can take years to complete, and as such there needs to be a ongoing process of continually checking and balancing thinking on a particular Target to ensure that the risk of acquiring a **Red Herring** is minimised
- **Bidders vary in experience**. LCC's observation is that those that Bidders who are continually considering and investigating M & A initiatives tend to be far more disciplined in choosing the right deal than those with low levels of experience
- One needs to understand the concept of '**Winner's Curse**'. This is a situation where a Bidder wins a deal (effects Closing) – but is then cursed to make it generate acceptable shareholder returns. There is no return policy in M & A unfortunately…………
- When done in a disciplined way can be an exceptional way to generate shareholder value

A word on M & A Control Premiums………

- A **Control Premium** is the uplift in the value of a company that a Bidder must pay Target shareholders to convince them to sell their shares to the Bidder
  - An accepted typical range of Control Premium is between **15% and 30%** of the pre deal announcement share price of the Target. So if the base price was $1.00 Target shareholders would need to be offered typically $1.15 to $1.30 to sell their shares (but there are instances of much much (much…) higher Control Premiums being offered…….)
- In order to justify a Control Premium, a Bidder needs to understand the **Key Drivers** of a Target, and how it will be able to improve those Drivers to generate the extra financial performance that justifying paying the Control Premium requires
- If you can't generate more cash – how exactly can you justify a higher value than the day to day trading value of the Target ?
- Two obvious value drivers are the rate of sales and the profit margin on those sales. Ask basic questions such as: *How will we increase revenue and margin post deal closing ?*

If the Bidder can't clearly improve the Drivers how exactly can it then justify paying a Control Premium ?

1 "Ready, Fire, Aim"

Your strategy for this acquisition is again ?

- At the beginning is a basic thesis of why M & A is being considered for growth
  - Specifically what type of target should be considered in terms of geographic location, type of business and size profile ?
  - How does the Bidder consider the merits of one Target over another, given that all companies by their nature are individuals ?
  - Why should the Bidder pull the trigger on one deal and not another ? How does Bidder know what a good deal looks like ?
  - Is Bidder actually going to be any good at M & A deal execution and operational integration ? Who in the Management has cradle to grave experience on multiple deals ?
- Although there are a number of traditional M & A growth strategies it is a highly bespoke and customised undertaking – no 2 deals are the same
- No benchmarking of Return of Investment expectations

Action Item – Invest The Time In Figuring Out Why M & A Will Be Effective

The CEO needs to understand exactly how an M & A strategy will deliver shareholder value, and just as importantly establish strict criteria as to what Target should be closed – and what is a Red Herring

2 "The Excel Sheet Never Lies"

One can make a financial model justify anything ……..

- Deal teams love to build complex financial models for **MergerCo** filled with lots of positive **Assumptions**
  - Excel is an amazing tool – but it can be a financial weapon of mass destruction in the wrong hands………
  - We have seen instances where the longer a Client stares at the Spread sheet – the more they believe it……….
- If **Deal Fever** is present, there is often little time spent building up objective, hardened business cases
- Examples of poor assumption approach include :
  - A year on year growth rate (sales) of 10 % per annum *in perpetuity*
  - A sustainable profit margin (%) that is beyond what the best companies in the Sector are predicting
  - Highly favourable Foreign Exchange rates being used in cross border deals
  - A high ongoing COMEX gold price being assumed in the acquisition of a gold producer
  - Unrealistic recovery rates on contractual disputes being used in an Engineering or Contracting deal
  - Low interest rates being used over extended periods of time to model the debt coupon
  - Reductions in CAPEX spend in CAPEX heavy industries

Action Item – Avoiding Assumption Mistakes, Don't Just Believe Outputs

Make sure the deal team benchmarks critical data assumptions against long term averages (Macro data) and against industry leaders (Sector data). If the deal team is using data that is at odds with Macro Economics or Sector Averages you are likely to be about to hook a Red Herring……..

3 “Bidder Pays For Projected Benefits”

Don’t pay for possible future Synergies and Cost Savings

- In M & A **Cost Savings** are duplicated expenses that can be eliminated over time, and **Synergies** are growth opportunities that the combined business might capture
- One of the attractions of M & A is to build a larger company over a smaller operations footprint – chasing scale and leverage to drive profit (*& hopefully higher margins*)
- In a current M & A Deal I had an investment banker actually say – *we are looking for an acquirer who is willing to pay for synergies.* Best of luck with that !
- It takes time and expertise to develop and deliver financial benefits from an M & A deal. These things do not happen overnight – and it can be a bumpy road to achieving
- When under pressure to pay a high valuation to close a deal, however, Bidders often consider how the performance of MergerCo will likely
  - Conservative approach : How can our expertise improve the performance of Target ?
  - Aggressive approach : Conservative approach PLUS including assumptions on Benefits

Action Item – Never Pay Hard Dollars For Assumption Based Benefits

The Bidder needs to work hard to extract Cost Benefits & Synergies. Don’t be so generous as to pay Target's shareholders for the work that Bidder’s management is going to have to effect.

4 "Failing To Adjust For Increasing Deal Risks"

Don't fall in love with a Target and ignore obvious shifts ……

- As a deal progresses there can be a trend of accepting incremental risks that at the outset of the M & A process would have been rejected. Deals often get riskier in a process of "death by a thousand cuts".
- Always be vigilant for the development of a pattern where positive developments are included in analysis whilst negative developments are not – a "**bias**" can be created
- The CEO should consider progressing decision making on deals under what I refer to as a **Deal Envelope**. This is a series of specific elements that in combination balance the potential risks and returns in each deal **in real time** to formulate a position as to whether that Target is one the Bidder should continue to explore – or reject and move on

Action Item – Have An Acquisition Plan & Stick To It – Don't Assume More Risk

I believe that failing to adjust valuation and thinking for additional risk is a principal cause of deal failure. Often resulting from the nature of the M & A process itself – a desire to WIN. Bidders need to ensure there are strict analysis disciplines in place that objectively adjust the value and attractiveness of the Target as new information is learned. Risk is not a Set & Forget data input

5 "We will worry about Integration later"

Be prepared to "hit the ground running - **hard**…"

- Detailed integration planning needs to be thought about as a part of the Target identification process. Targets with difficult integration potential might need to be forgotten……….
- Shareholder value can be destroyed in the period immediately post deal closing – detailed first 10, 30 & 100 90 to 120 day plans need to be in place. KPIs need to be different for different time horizons – and a combination of qualitative and quantitative measures
- Investors & analysts expect to see progress on the integration of the acquisition in the quarterly or half yearly reports – there is no time to waste
- An experienced **core integration team** needs to be put in place early, with KPIs that are designed to cover off on both qualitative and quantitative elements
- "**Constraints**" need to be identified early. For example, are there different accounting systems between the Target and the Bidder – and if so how will timely financial information flow from Target to Bidder post closing ?

Action Item – Get The Thinking On Integration Going Early And Develop A Detailed Plan

There is no soft handover of operations in M & A deals – one must be up to speed and running on day one. Any process should be led by an experienced Operations Executive

6 "Messing Up The Deal Structure"

Poorly structured deals are like open wounds…..

- In public transactions there is often seen as little flexibility in deal structuring
- Keep front of mind that deal structuring and deal value are symbiotic………
  - If you can't align risk with the payment of consideration, you need to be able to defend exactly how the increased risk will result in a Valuation adjustment (downwards)
  - Particular care should be taken in multi faceted deals – (e.g.) declaring a dividend to shareholders as a part of an acquisition. This potentially increases the prospect of an undercapitalised Target
  - **Deal structuring should also consider how key staff will be retained post deal closing. Bidder does not want to lose great people**
- In private transactions deal structures can be more innovative and flexible. Examples include :
  - Milestone payments based on future performance align risk and consideration
  - Milestone payments based on key management retention
  - Specific contingent risks in the Target can be quarantined, & deal consideration released gradually

Action Item – Consider every aspect of the deal, and how risk and consideration can be aligned

Critical that the deal structure reflects both the risk envelope and the valuation thesis. Consider the 'human elements' in the deal; keep in place those valuable skills and resources that will be essential to assisting Bidder's team to drive increased performance

7 "Keep The Home Fires Burning"

Don't drop the ball on core performance……..

- A big trap for young players (CEOs) is the focussing on the acquisition Target, assuming that core operations will continue seamlessly
  - This is particularly the case where either the size of the Target is large compared to the Bidder, or the Bidder is a smaller company where the CEO is the chief dealmaker
- It is essential that there is a dedicated deal team driving any initiative, and that this team can progress under direction – allowing the CEO / CFO to continue to run Bidder per normal
- Picture a scenario where the deal being progressed does not close. In such an instance the deal team can be exhausted / disappointed (particularly if pursued for a long period of time). This is a specific example of why it is critical for the CEO / CFO to be used tactically in the progress of the deal – they must keep the Home Fires Burning and not dedicate all time to a Target that might end up being a Red Herring

Action Item – The Deal Team Must Allow The CEO To Focus On Bidder's Operations

As a part of the conceptualising of the M & A process understanding who will be deal champions and deal team members is exceptionally important. Use the CEO / CFO tactically………

8 "Poor Strategic Due Diligence"

Be across the Macro picture, and the effect of "Change"

- Strategic Due Diligence is the process of understanding critical commercial issues, and how they will effect MergerCo moving forward
- Whilst considerable effort is spent on looking at historic numbers, not enough is spent on understanding how the competitive landscape will shift and effect the Key Drivers of the Target
  - The sensitivity of Key Drivers need to be understood, as this will effect Control Premium, etc.
  - Accept that small changes in the Macro picture can dramatically effect Deal Value / Risk
  - Identify the top risks of Target, and if they arise post closing how Bidder will deal with those
- Macro factors should be considered in an objective and a disciplined fashion. Source data should be made available to all deal team members to ensure that there is no 'bias' creeping in to get the deal done
  - There will also be positives that are uncovered. The focus should on how the relevant stream of data that arises across the deal timeline is factored into analysis and strategy

Action Item – Enforce A Deal Discipline Of Debating "What Ifs"

SDD should have a **single focus** on understanding how the business and competitive landscape might shift, and where there is high potential of negative shift whether the Target should be prioritised as a deal for closing. The Deal Team should meet regularly and discuss / debate implications of information learned as a part of the Strategic Due Diligence process

9 "Incorrect Capital Structure"

Bad Capital Structures Destroy Value - Quickly

→ In order to drive shareholder value a balanced capital structure needs to be implemented and maintained. Bidder needs to have a stand alone **Capital Management Plan**

→ Bidders often want to gear MergerCo with high levels of debt – leading to very brittle capital structures that are prone to becoming stressed if the anticipated boosts to cashflow and profit do not flow through.

  → Debt is attractive as ordinary shares don't need to be issued – avoiding dilution for pre acquisition shareholders

→ Big debt, poor performance, banks get nervous (what a shock), analysts start to question and then potential capital raisings to de-lever the balance sheet

  → Consistent themes where there is a problem acquisition that has been fuelled by debt

  → Also can be a symptom of a Private Equity deal gone wrong – low margin for error in performance where so much debt being used in an attempt to amplify the shareholder value returns (when done well PE deals of course can deliver spectacular IRR)

Action Item : Bidder Capital Structure Is Based On A Capital Management Plan

Consider what things such as debt gearing levels should look like against a long term Capital Management Plan.

10 "Poor Stakeholder Communication"

Have A Plan Of Knowing What To Say, To Whom, When…

- Bidder CEOs should assume that everything said internally to be staff will be relayed externally – including confidential discussions. It can be quite frustrating at times as to just how leaky information shared with staff is (how is your social media policy by the way ?)
- Employees understandably want to know why a deal is being done, what it means for the company and most importantly what it means for them. Of course any such communication needs to also be rolled out against a backdrop of confidential negotiations continuing with the Target – and most importantly the fact that completion of the deal had not taken place (i.e. ownership has not shifted)
- Resignations often rise in the face of an M & A deal – and the loss of really good talent obviously can be damaging to performance (and therefore shareholder value) in both the short and long runs. Simple things like pay packets across seniority lines need to be considered. In any communications plan you may have a series of different styles of engagement : from 'town hall meetings' with all employees through to one on one with key management and leadership team members
- Target Clients are identified by competitors who try to steal them in the face of the 'unknown' of a change of ownership

Action Item : Prepare a Detailed Communication Plan That "Changes Gears"

A Communication Plan needs to be drafted that addresses various interest groups (shareholders, analysts, clients, employees, trade unions, government, etc.) and the anticipated communication protocol that will need to be identified with each group at specific periods of time.

Appendix & Glossary

A. Selected SDD Heads of Research

Each M & A assignment will require a bespoke approach

Size of market	What has the size of market been over the past 5 years, and what will it look like over the coming 5 years ? What are the drivers to changes in the size of the market ? How is Bidder / Target positioned to benefit / be challenged from a shift in market size ? What level of confidence is there that there will be a shift in market ? And if confident – when (timing of shift) ?
Market Shape	What is the shape of the market in terms of client & expenditure distribution and how will this likely shift over the short and medium terms ? How is the Target placed to leverage any market shift ? How is the Bidder ? Will in combination any market shift be better met ?
Competitor Analysis	Who are the incumbent and rising competitors in the industry ? What is the basis of competition : Differentiation, Price, Brand,
Cost Analysis	What is the Target's cost of doing business ? The Bidder's ? Are these data points at the high end or the low end of competitors ?
Customer profiles	Who are Bidder's current key customers ? Target's ? Who are the largest customers in the Sector and which competitors service those (if not Bidder / Target) ? How would we capture revenues from these customers ?
Political Shift	How does the political landscape effect the industry, competitors and most importantly the potential deal ? Should we wait for a political shift, or alternatively accelerate an opportunity expecting one ?
Macro Risks	What are the macro risks that cannot be controlled, but may be relevant. Weather is an interesting one – and has effected a number of Australian sectors in the last 2 to 3 years (Resources, Mining Services, Construction)

Where to Look

Finding information is never straightforward and needs to be a combination of reference and old fashion digging.

- Government statistical websites can be rich with Macro and Sector content
- Government sponsored industry sector research portals
- Review of Annual Reports of competitors
- Stockbroker Analyst Reports
- Peak Body Organisations which regularly publish specific research in support of their constituent interests
- Independent Data Vendors

Glossary

Assumptions	Key business and economic data inputs into a financial model
Bidder	The company that is seeking to make an acquisition
CAPEX	A reinvestment requirement to maintain quality of operations and competitive position
Control Premium	The additional money that is paid to Target shareholders by the Bidder over the day to day share trading price as an incentive for them to sell their shares
Deal Envelope	A specific LCC deal tool which outlines various risk and return factors that make a Target attractive or not attractive
Deal Fever	Rational economic thinking flies out the window in favour of (typically) a blind belief that (also typically) ridiculous Valuations will still generate positive shareholder returns !
Key Drivers	The business and value drivers that are the core to overall corporate performance
MergerCo	Name typically given for the post deal combined company of Bidder and Target
Shareholder Value Red Herring	The wrong Target to acquire. One that will likely deliver a Winners Curse
Target	The company that the Bidder is considering acquiring
Winners Curse	Concept of being cursed with an asset once acquired. Often the “Çurse” is a manifestation of acquisition under an auction situation

LCC Asia Pacific

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