Do most mergers really fail?

Challenging the conventional wisdom that the majority of M&A transactions do not add value

by Bill Pursche, FirstCall Advisors

The recent wave of M&A activity has once again raised the important question of whether acquisitions and mergers 'succeed.' The conventional wisdom -- citing numerous studies -- is that the majority of deals fail to add shareholder value to the acquiring company. According to the research, only 30-50% of deals are considered to be successful.

This begs the question: If most deals fail, why do companies keep doing them? Is it because they think the odds won't apply to them, or are executives more concerned with growth and being known as dealmakers than they are with increasing their shareholder value? Many writers contend that these are the reasons which drive M&A activity, with the implication that CEO's are basically greedy (because executive compensation is often tied to the size of the company) -- or incompetent.

It is time to question the basis for these assessments and the conclusion that most deals fail. Only then can the focus be put on where it really belongs, which is how to use M&A to create value.

How methodologies affect the studies

Virtually all of the major studies that examine merger and acquisition success use an 'outside-in' approach. In other words, they take publicly available data on stock price, ROE, or some other relatively available data and use it as a metric for establishing success. There are logical reasons for this approach: it allows for a larger sample of companies and deals, and it can be duplicated by anyone using the same methodology.

By its very nature, however, this approach has one glaring shortcoming -- it can only look at deals where there is public information available for the acquirer. If the acquirer is not public, or if there are no financials available, then the company and its transactions cannot be included in the universe of deals. Why is this an issue? For one thing, it leaves out all of the deals done by private equity firms. These firms do not have publicly traded stock, so any transactions they make are excluded from the analyses. In 2006, private equity firms accounted for 20% of worldwide transaction activity, and 27% in the U.S. (according to Thomson Financial). This omission might not matter if one assumed that the success rate of private equity deals mirrored that of the market, but in fact private equity firms have a solid history of deal success, as indicated by their returns. Given the

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way private equity funds are structured, not only would they not be able to achieve their historically high returns if half their deals failed, they would probably not be able to stay in business. So leaving private equity transactions out of the deal universe biases the analyses of deal success toward one of more failures. If the analysis is weighted by deal size, the effect is even more pronounced, since private equity firms tend to avoid very small deals.

The second methodological component which affects the results is that small deals are generally omitted from the analyses. Most of the studies use a minimum deal size that is equal to 5-15% of the acquiring company (usually determined by the relative size of market values). Yet there is both intuitive and analytical support to the argument that smaller deals have a higher chance of success. They are easier to manage post close, they can be integrated more quickly, and because the larger company is clearly the acquirer, these deals avoid the fighting for the upper hand that often takes place in deals where the target and acquirer are closer in size. While these smaller deals account for less transactional size in terms of dollar value, the account for the vast majority of deals -- thousands of them each year. Once again, the omission of these deals biases the results toward failure.

The implicit assumptions no one talks about

Underlying most of the studies that look at merger success are two implicit assumptions. One of them is based on long accepted financial theory, the other is more insidious.

Most of the approaches look at how the acquirer's stock price changes over some period of time after the announcement of the deal. For example, how much did the acquirer's stock price change from some point in time before the deal to some point in time after the deal? The assumption is that if the stock price went down, the deal was a failure.

The logic behind this is based on the financial concept that the stock price of a company reflects its underlying cash flows. Specifically, it reflects the present value of the future cash flows -- or more accurately, the market's assumption of those cash flows. Thus the stock price of an acquirer after a merger should include the effects not only of the deal cost, but of the present value of the synergies that will occur.

One issue is what time period to use to measure this change in stock price. Analysts have included different time frames into the studies, ranging from a few days and months before, to a few days and years after.

So what's the problem? It is simply this: *the conclusions are based on an assumption that the only thing affecting the stock price of the acquirer is the deal.* No matter what else is going on with the company, positive or negative (the successful introduction of a new product, winning a key patent infringement lawsuit, disastrous results in their

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existing business, a loss of key management) *all* of the stock price change is assumed to have occurred because of the announced deal.

The better studies try to adjust for some of this by comparing the stock price changes of the acquirer against some norm, such as the S&P. (The best ones go one step further and adjust versus the industry that the acquirer is in). But even these adjustments can go only so far in showing how much the stock price is really being affected *only* by the deal.

The simple fact is that so many other things go on after the merger, how can one assume that all the changes in the acquiring companies' stock price is due to the acquisition? Let's look at an example. Big Company A buys Small Company B (about 10% of Company A's size). Over the next 4 years, Big Company A's stock price declines 1% (or rises 1% less than the S&P). Therefore the acquisition of Company B is considered to be a failure. Anyone looking at this example would likely say that nothing of the sort can be concluded by such a stock price movement, yet this is exactly what is inherent in the studies that are so often cited.

An additional problem is: what happens if the company makes another acquisition? How does one separate the effects on stock price of the second deal from the first? The simple fact is they cannot. Thus the long term stock price changes of any company doing multiple deals -- which is the majority of companies in the S&P for example -- cannot reliably be used as an indicator of success of any one deal.

One way to adjust for this is to look at only short term stock effects. This can be accomplished by limiting the comparison of the stock price changes to those that occur just a few days after the deal is announced. This eliminates the effect from other deals and reduces the impact of other effects that are not deal related. But for this approach to work, the implicit assumption is that the market can perfectly predict three things: the possibility of synergies, the size of the synergies, and the synergies that will actually be captured. In other words, the market has to be able to look ahead to the future cash flows, know which ones will occur and when, and appropriately and immediately bake them into the stock price.

This is a dangerous assumption. Even with incredibly detailed data, management input from annual reports and conference calls, and extensive proforma information and calculations, analysts have a difficult time determining whether a stock price reflects the *standalone* business of a company, let alone the resulting cash flows after a deal. (Think of the range of analyst predictions for the stock price of a company. If such assessments of future cash flows were so easy for the market to do, these analysts should always agree, or at least have very little variation in their estimates.) Assessing the value of synergies is a far more complex task than standalone valuation. While many deal announcements include information on expected savings in headcount and limited other information such as changes in certain fixed costs, and may even have an estimated timetable, no one can accurately predict exactly which savings will come to bear and when, and what other effects the deal may have on the cash flows of the acquirer. Such

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effects include dis-synergies (i.e. declines in the standalone cash flows of the target or the acquirer brought upon by doing the deal), and even upsides from unexpected synergies.

So unless you believe that the market can perfectly -- and immediately -- predict every possible cash flow change resulting from the deal, it is hard to accept any short term drop in the acquirer's stock price as an indication of failure.

Where does that leave us?

All of this does not mean that we cannot determine merger success -- far from it. What it means is that we cannot *predict* it by examining immediate changes in stock price, nor can we assess deal success by looking at stock price changes over a longer term.

The only way to determine deal success is by examining the true incremental changes in cash flow that occur because of a deal, and comparing that to the premium paid.[1] A deal is analogous to an investment, for which the present value of the risk adjusted return can be accurately determined. By looking at how the cash flows of the companies change after the deal, one can determine if there has been enough increase in cash flows to recover the deal investment at the appropriate cost of capital.

Note that this requires information from *within* the acquiring company. Specifically, it requires knowing:

- the standalone cash flows of the target company that were included in the standalone valuation;
- the standalone cash flows of the acquirer that was expected to occur without the acquisition;
- the incremental cash flows that occurred as a result of the deal, including all deal costs and dis-synergies.

This analysis can only be conducted from within the acquirer and after a period of time has passed (to account for the time needed to capture the synergies). It also requires vigorous tracking of synergy capture and cost. Difficult? Certainly, but well within the skill of most companies -- in fact, most firms conduct similar analyses when assessing the return on a new business, market entry, or product.

This is the *only* way to truly determine deal success. And while some studies have attempted to approximate this by asking executives whether they thought their deals were successful, in most of these cases the accepted definition of success was not a financial one.

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Companies that do measure their deal success using this approach will have a much better handle on whether their deals are adding value, and perhaps even help them identify why they don't. While 'overpaying' is the general term for explaining deal failure, the term masks the many possible underlying reasons for not recovering the deal premium -- overestimating target standalone value, overestimating synergy value or the timing of synergy capture, etc. Many of these errors can be overcome with better execution of elements of the overall M&A effort -- valuation, bidding strategy, and merger integration.

Bill Pursche has been advising companies and senior executives for over 25 years. He has been involved in over 300 M&A and PMI efforts in a variety of industries and geographies, including numerous cross border deals. He is regarded as one of most knowledgeable experts in the world on synergies and Post Merger Integration.

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[1]Specifically, for a deal to be financially successful, the total price paid for the target cannot exceed the present value of the sum of the cash flow generated by the target plus the value of the actual *net* synergies captured. This strict definition of success is necessary because the pre-deal *market* value of the target can be greater than the present value of its underlying cash flows due to what might be called an "inherent potential deal premium" already built into the market value. Such potential premiums often occur when

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there has been an acquisition of another company in the same industry -- the market expects that other deals will follow suit, and some of this potential acquisition premium gets built into the target stock price, even before any deal is announced. Thus for an acquisition to be successful, acquirers will have to create synergistic value that is actually *in excess* of the premium paid, because they must not only maintain and capture the target standalone cash flows, but the inherent potential deal premium as well. For this reason, from a valuation point of view, the total potential *value* of a target should be calculated as the present value of its *standalone cashflows* plus the net synergies expected, and not as the sum of its market value and expected synergies. What is critical is that achieving the total value of the target is the bare minimum goal for the buyer, otherwise all the value created will accrue to the seller. No buyer should undertake a deal if the price they have to pay is equal to the target standalone valuation plus all the net synergies. In such a case, the best case for the value they can realize is equal to what they paid, and has an NPV=0.

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