Ten Ways to Beat the Odds in M&A
by James E. Schrager

EXECUTIVE SUMMARY

- Most mergers fail.
- Yet you can increase the odds of success.
- Ten keys to better mergers
- How eBay won one and lost one.
- How Newell Rubbermaid won many and lost one.
- Two tricks from a very successful serial acquirer.

INTRODUCTION: MERGER MANIA

Very few things get the animal juices flowing quicker than buying another company. The goal is all about growth, and everyone knows that the right acquisitions can supercharge your game plan. You’ve read about it, you’ve seen it, you’ve heard about the boost that great mergers and acquisitions (M&A) can bring. Yet, in the distant reaches of your memory, you also see the shadows of the HP–Compaq merger, the GM purchase of Hummer (or Saab), the near-complete destruction wrought by Daimler merging with Chrysler, or the wholesale disaster known as AOL–Time Warner. These are troubling reminders of a few of the more manic decisions that have been made by top managers when reaching for the next rung on the ladder. But how to combat the “fog of war” when in the kill zone?

One of the best things to emerge from the cognitive revolution of the past decades is a deceptively simple rule of thumb prescribed by Daniel Kahneman, the second scholar to win a Nobel prize in decision science (the first was Herbert Simon, of whom more later). Kahneman admonishes all decision-makers to start with the “base rate” for success and failure in their task, just to have a sense of what one is up against. This is a tremendously facile approach, yet the numbers almost always astonish those making important decisions. This alone is a strong indicator of how we get carried away by our own enthusiasm even earlier than we imagine.

THE BASE RATE

In the context of the acquisition game, the base rate is the percentage of acquisitions that fail to enhance shareholder value. This failure rate is variously reported by different groups over different time frames as 70% (Harding and Rovit, 2004 (Bain & Company)), 90% (Dion et al., 2007 (Hay Group/La Sorbonne)), 83% (KPMG, 1999), with A. T. Kearney reporting total returns to M&A were negative.

Allow me to ask a silly question: would you enroll in a university course where the vast majority of students were guaranteed to flunk? Would you step on an airplane that had a 10% chance of reaching its destination safely? Would you allow your daughter to drive a car with a known catastrophic failure rate of the braking system of 70%? Yet many management teams engage in this same behavior, probably without thinking that any of these statistics apply to them. Some teams beat the odds. The question is, can you?

TEN RULES TO APPLY WHEN SCREENING A POTENTIAL ACQUISITION

In Robert Bruner’s (2005) compendium of merger tragedies, which has a title reflective of the fact that acquisitions may at times seem to be the Devil’s handiwork (“Deals from Hell”), he presents a list of 17 “do’s and don’ts” for the potential acquirer. While his list is highly recommended, we start from a different proposition, which is that all mergers are not alike. A careful reading of the facts reveals patterns which emerge to help the savvy management team estimate for themselves, and their board, the “base rate” of success. Noted below are 10 rules to apply when estimating your chances of being the next Mobil–Montgomery Ward merger fiasco.

1. Strategy fit matters. Does the strategy of the acquirer fit well with the strategy of the target? eBay, upon becoming very successful, took a giant step backward by buying a conventional auction house. The key is to understand your strategy and see how it matches with the target company. If it does not fit, think hard before you commit.

2. Management structure matters. It cannot be a merger of equals, but must have one team leading the combined resources of the acquirer and the target company post-merger. I am not sure if there has ever been a successful “merger of equals”—in the world of business the term is essentially an oxymoron. Business is all about leadership, it isn’t about coequal heads setting the direction of the business. Simple question: if you are an executive, which of the two coheads do you heed? And if in fact they say the same things, then why do we need two?

3. Size matters. Big buying small is best. So many mergers of two giant firms end up on the scrap heap, while big firms buying smaller companies can be quite successful. The classic case of Newell Rubbermaid shows how this can work, as it was a big company buying small ones and fitting them into its system. And that brings us to process.

4. Process matters. Do we know how to do an acquisition? Not just how to write the check, but to actually know how to follow through to increase shareholder value? Well, how do you learn how to do that? Sadly, merger wisdom is often the byproduct of failure. Newell Rubbermaid learned, by doing many small mergers, what type of target to seek, what the acquirer could and could not add to the target, how to structure the right deal, and, most importantly, how to improve the business processes of the target to increase shareholder value. For
5. **Due diligence matters.** Herbert Simon, winner of the first Nobel Prize awarded in decision sciences (1978), famously noted that “experts see more than novices.” This is never more important than in due diligence, which is a game of cat and mouse. Note that Simon didn’t say “experts know more,” as that is a tautology. He saw it instead as seeing things, often in plain sight, that matter. How to develop this skill? With experience. If your team doesn’t have it, you need to find people who do.

6. **Industry matters.** Some industries are simply more amenable to growth through acquisition than others. For example, the automobile manufacturing business doesn’t seem to work well via M&A. But the automobile dealership business is another story—here we see large companies buying small dealerships and doing quite well. This may have something to do with size, as manufacturers tend to be large acquisitions, while individual dealers are small firms selling to large chains.

7. **Timing matters.** This is a tough, but obvious, concept: the best time to buy is when others are not buying. The price of your target can be wildly influenced by the M&A market, and like any other market it has periods of high prices and periods of low prices. To buy in a frothy market means you pay a high price, and if the target is a really good fit, you can live beyond that handicap. But if the target isn’t as good as you think, then a higher price can mean the difference between winning and losing.

8. **Ownership matters.** Private deals, with privately owned targets are, as a rule, better than public auctions. Private deals afford the chance to avoid the emotionally laden, high-publicity traps that public auctions can unleash for both winners and losers. The public auction can more easily distort a commitment to value by the acquirer and replace it, often at great cost, with a “we’ll win this” approach of the type that begat the phrase “the winner’s curse.” Avoid these pitfalls by doing private deals, which, although you may have competitors, are less likely to be played on a national stage complete with 24/7 media coverage.

9. **Goals matter.** Do we have a goal—and any goal—other than just increased size? More than just does the target fit, which is critical, but why are we doing this? Beyond size, will we be stronger as a result? Will we be able to do things that supplement our core strategy? Will we be uniquely positioned to do new things we couldn’t do before as a result of this acquisition? Does the target serve to help us in an area where we were vulnerable? Will our customers be more likely to buy from us as a result of this acquisition? Will our internal processes be improved?

10. **Objectivity matters.** Understand that you will lose your objectivity at some point in the M&A process. The prize will simply become too glittering and its allure will overpower you. The key is to know this in advance, and then to monitor yourself and get objective outsiders to help you. This can be someone who has been in battle before—and make no mistake, this will be a fight. You need people who will be thoughtful and comfortable being a devil’s advocate. Once you know you have lost your objectivity, hire others to do the talking for you. A skilled opponent will test and watch for small signs that you are too anxious. He or she will then exploit that weakness as you attempt to negotiate for your prize. A detached and skilled advisor can stop you from following your own worst instincts.

**SUCCESS VS. FAILURE: THREE EXAMPLES**

**One Company’s Success Story**

eBay’s purchase of PayPal is a classic example of an acquirer buying a company that was central to its mission and then, strategically, strengthening that company and integrating it into the parent. From the early days of the Internet, eBay was a fantastic company, as it allowed garage sale items to be sold every day to a nationwide, rather than neighborhood, audience. It fit the Internet perfectly because it wasn’t a store, so eBay had no inventory, no shipping operation, no damaged merchandise, and so on. All eBay sold was information, which is ideal for a medium—the Internet—that exists to inform. But eBay’s challenge was symbolized by the bags of mail it used to receive daily containing checks for 25 cents: the problem was how users could pay in an easy, safe way for the auction listings and products they sold to one another.

**PayPal had the solution and, importantly, eBay devised ways to make PayPal much bigger than it was when it bought it. eBay paid plenty for its purchase, but it has been a fantastic success.**

**One Successful Acquirer’s Failure Story**

Beginning in the 1960s, the Newell Company had done a fantastic job of growing by making a series of small acquisitions, paying the right price, strengthening the companies, and then adding those products to the existing Newell distribution chain. The 1990s were a very happy decade, and in 1998 the Milwaukee Journal Sentinel wrote: “Newell’s management team has a great track record of delivering extraordinary profit margins from so-called mundane businesses...” But then along came Rubbermaid.

This big company was in trouble, so it was available at a discount price. The products were different than Newell’s but sold through the same channels. Now here we have a well-tested, proven, serial acquirer with the chance to buy, at a good price, a large and glittering target. Do you buy it?

Newell did, and it turned out to be disaster. Why? Because doing a series of small acquisitions successfully turned out to be significantly different than acquiring one big company, even in the same industry. Rubbermaid was not easily converted to the Newell way of doing things, and its products did not fit easily into the Newell line. It was a case of the tail wagging the dog, and the acquisition caused many years of poor earnings.

**One Serially Successful Acquirer’s Secrets**

The Marmon Group was the industrial arm of Chicago’s very private Pritzker family. Sales grew from US$5 million to US$6 billion over 45 years while routinely doubling the return on equity on the S&P 500. The vast majority of this growth came from acquisitions, and Marmon Group consistently turned the base rate—the M&A failure rate over a decade it was a superlative merger machine, consistently acquiring targets and adding to shareholder value.

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rate discussed earlier—on its head, with success running at above 90%.

To do this it followed most of the 10 rules above, but it had a few extra tricks. One was that those managing the acquisitions trained themselves to “decide not to decide.” Now that doesn’t mean exactly what it says because, obviously, they always did decide one way or the other on targets. But they resisted the normal reaction to “decide” that a deal was good or bad before getting all the facts.

We are hard-wired to be instant decision-makers—it’s part of our “fight or flight” baggage. So, from the day Marmon Group was pitched a deal, through the final bit of due diligence, it remained enthusiastic, interested, and involved, but absolutely ready to walk away if the facts showed the deal wouldn’t work. By refusing to decide prematurely, it took rule number 10 out of the picture.

Marmon had another secret, and that was that it understood the base rate; that is, it knew that most potential deals were bad deals. As a result, it was always keen to look at new deals because, if only a few deals are good, the simple law of averages directs you to look at many deals. But when a deal started to unravel, Marmon was also quick to walk away and not push deals that wouldn’t work just because it had high hopes. It knew there would be many more deals yet to consider, and that by applying the base rate in every case it had the best chance of picking off the few that were really good if it kept looking.

MORE INFO

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Articles:
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