MERGERS & ACQUISITIONS

How Companies Can Ensure Success

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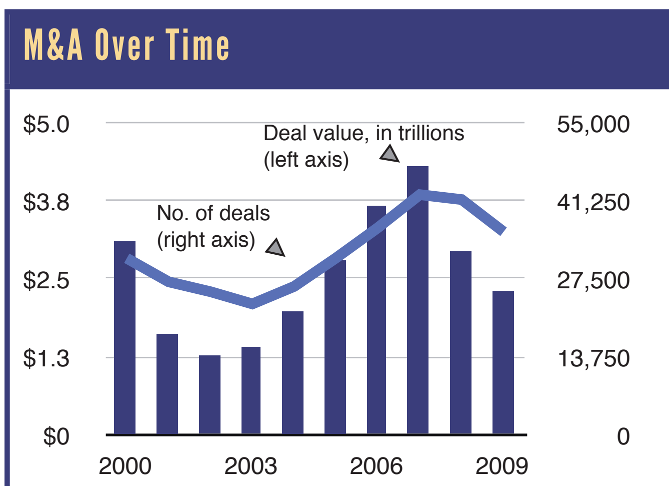
THE QUINTESSENTIAL MERGERS AND ACQUISITION (M&A) transactions of this decade have created long-term shareholder value and realized the future strategic needs of their respective firms. Chevron acquiring Texaco, J.P. Morgan Chase merging with Bank One, and AT&T buying Bellsouth. There are similarities between all of these groundbreaking deals; each had obvious revenue and cost synergies, while also increasing the combined entity's competitive advantage.

The economic recession curbed the volume of acquisition activity significantly, but the companies that did participate were able to take advantage of lower valuations.

M&A Over Time



Exxon, Pepsi, and Oracle all engaged in core acquisitions. However, have their pursuits been driven by a long-term strategic need, or are they simply capitalizing on the economic climate?

Strategic Acquisition Best Practices

The success of mergers and acquisitions hinges upon choosing a target that is crucial to the long-term strategy of a firm. All firm strategies centre on creating shareholder value through top-line growth, improved margins, and mitigation of risk. It is important to note that although the price of a target greatly affects the success of a deal, it should not be the sole driver.

Revenue growth is often cited as a major reason for companies to engage in strategic acquisitions. If this is the primary reason for an acquisition, success can only be achieved if the deal allows the combined company to achieve more absolute growth rather than the growth from the two stand-alone companies. The costs and risks associated with an acquisition must be outweighed by the newly-created revenue synergies. Deal activity is motivated by the opportunity to cross-sell products, acquire new product technologies or achieve greater distribution capabilities.

Margin improvement can be realized through successful recognition of cost synergies between two companies. Most cost synergies relate to economies of scale, and include reducing headcount and/or shutting down a corporate headquarters. These actions will reduce the expenses of the

combined entity, thus increasing shareholder value. These synergies are relatively quick to realize and more easily measurable than revenue synergies. As such, this is a fundamental part of almost every acquisition.

The final method of creating shareholder value through an acquisition is through reducing business risk as a combined entity. This decrease can be achieved through increasing control over supply, augmenting market share, reducing the number of competitors, improving response to customers' evolving needs, etc. Despite being the most evident reason for a transaction, the reduction of business risk tends to be difficult to quantify and measure.

This decade's best deals follow the framework for successful strategic acquisitions very closely. Do recent M&A transactions fare well when compared to the developed structure?

Analysis of Some Recent M&A Activity

Exxon purchased XTO Energy for growth. The deal signals Exxon's expectations of an increase in natural gas prices. It is important to note that Exxon has indicated that this deal is in the long-term interests of shareholder value creation, and could be initially dilutive. The revenue synergies are apparent as Exxon and XTO can share their respective natural gas expertise to extract more resources. Regardless of whether the price of natural gas does rise, the deal shows that the strongest companies are willing to commit to decisions for long-term value creation.

Pepsi buying Pepsi Bottling Group and PepsiAmericas is a shift of strategy for the company. By reacquiring the bottlers they had previously divested, Pepsi can achieve cost synergies through efficiency, and is able to gain more control over bottle manufacturing and their distribution system. It pulls them closer towards the end-consumer, and allows them to be more nimble to respond to shifting consumer demands. Pepsi is responding to the ever-evolving soft drinks industry, and has made an acquisition that they see as an integral component to their long-term strategy.

Oracle's acquisition of Sun Microsystems, and subsequent consolidation in the technology industry, is another example of companies responding to shifts in industry. Oracle recognized that customers required truly global and integrated software, hardware, and services. This forced Oracle to respond to these trends, mitigating their own business risk, while simultaneously attaining revenue and cost synergies with Sun. Oracle's CEO, Larry Ellison, noted that "We weren't in the hardware business, now we're diving in with both feet."

These recent transactions signal a true appreciation of successful M&A best practices by the various companies. They have each followed the framework outlined above, and ensured that their acquisitions are driven by a long-term strategic need, as well as a response to shifting industry landscapes. Furthermore, they share very distinct similarities with some of the most successful deals of the last decade. The economic recession has lowered valuations for the different acquisitions, thus reducing the downside potential of each deal.

The most striking similarity is that each deal was a response to an evolution in their particular industry. Oracle responded to consumers' desire for a complete platform. Exxon acted in response to the development of unconventional natural gas, and Pepsi to consumers' breadth of soft drink preferences. Moreover, each company is not concentrating solely on economies of scale, but focusing on acquiring different products. Exxon expanded its reach in natural gas, Pepsi moved towards vertical integration, and Oracle extended into the hardware sector. This bodes well for the transactions, as they have become stronger competitors in each of their respective industries.

It is important to note that the recession has indeed improved the risk vs. reward prospects of each deal. Exxon's foray into natural gas will hurt shareholders if the price of natural gas does not rise to the levels indicated in their valuation, but these levels are lower than those that prevailed if Exxon had purchased XTO in the preceding boom period. Pepsi may not reap the expected synergies with its bottlers, and the deal could take the company away from its core competencies. Customers may not be drawn to an integrated technology provider such as the combined Oracle-Sun. In both of these cases, the downside potential has been greatly reduced due to the lower price tags. As a result, the potential payoff of these deals is far more than the relatively low levels of risk the companies are taking. In the words of Larry Ellison, these deals are "opportunistic".

Disasters Waiting to Happen?

In desperate times, companies can often forget the golden rules of successful strategic acquisitions. A company cannot overpay for an acquisition, and the deal must make strategic sense for the company, as per the developed framework.

Kraft's acquisition of Cadbury follows the M&A framework very closely, but is the price justified? The deal has potential revenue synergies from the dramatically increased geographic distribution capabilities for Kraft. Furthermore, cost synergies through administration and operational savings are estimated at $625 million. However,

Expected Synergies	Risk: Low	Risk: High
High	Exxon-XTO Pepsi-Bottlers Oracle-Sun	Kraft-Cadbury
Low	Apple - P.A. Semi	GM-Delphi

Acquirer	Target	Reason	Fit with framework
Exxon	XTO Energy	Value creation for many years, expected higher price for natural gas	Revenue synergies present + increased exposure to future energy sources
Pepsi	PBG and Pepsi-Americas	Change in business conditions, accelerate revenue growth, speed up decision making as consumer demands shift	Cost synergies present + increased competitive advantage responding to shifts in soft drink industry
Oracle	Sun Micro-Systems	Consumer demands shifting to integrated hardware and software	Revenue and cost synergies present + increased competitive advantage
Kraft	Cadbury	Desire to expand confectionary business globally	Revenue and cost synergies present + increased competitive advantage, but overpaying, deal was worth more to Hershey
GM	Delphi	Assure uninterrupted supply of parts, access to increased government funding	Low revenue and cost synergies + no increased competitive advantage compared to peers

because Kraft experienced competition from Hershey, the higher valuations are unable to justify the increased competitive advantage. The fact that Hershey was able to muster the resources to compete in this deal may signal that the upswing in valuations has already begun. Kraft increased their bid price, against Mr. Buffet's advice, and will be overpaying. This has deviated the company from realizing its primary goal: creating long-term shareholder value.

GM spun off Delphi, its largest parts supplier in 1999, but has now acquired a minority stake in the company. Is there an evolution in the industry that places GM at a strategic advantage to its competitors through this deal? The simple answer is no, excess cash should have been directed to solve some of GM's fundamental problems. GM did not face significant problems ensuring parts supply throughout Delphi's extended bankruptcy, and there was no reason to reacquire them now. The deal draws comparisons to Pepsi acquiring its bottlers again, but in Pepsi's case, the deal helped Pepsi better meet customer's changing preferences.

Due to lower valuations in recessionary periods, there are some acquisitions that do not necessarily need to achieve high revenue and cost synergies. Apple made a relatively small purchase of a boutique microprocessor design company called P.A. Semi. The microprocessors produced by the company are not currently featured in any of Apple's products. Apple was interested in the firm's intellectual property and development expertise. The deal does not directly address an immediate long-term need for Apple and may be solely driven by Apple's desire to keep the technology away from competitors.

Conclusion

Those most apt to benefit from acquisition activity coming out of the downturn, at depressed prices, are the most well-capitalized companies, since they are able to take advantage of financially weaker targets, and generate long-term shareholder value. Furthermore, the most successful companies are those that have not let the financial downturn make them overly cautious. They struck early and ahead of competitors thus reducing their deal price, integrating earlier, and increasing their competitive edge