TAKEOVERS, AND MANAGING

RELEVANT TO ACCA QUALIFICATION PAPER P3

TAKEOVERS AND MERGERS CAN GIVE RAPID ACCESS TO NEW MARKETS AND TO NEW PRODUCT LINES. HOWEVER, THERE IS SOME GREATER RISK PRESENT BECAUSE NEW AREAS ARE BEING EXPLORED.

Synergy is defined by Goold and Campbell as 'links between business units that result in additional value creation'. Takeovers and mergers are often promoted as methods of increasing shareholder wealth, but in what circumstances is that likely to occur? How will the necessary synergy arise?

We can start by looking at growth possibilities as set out in Ansoff's matrix.

	Current markets	New markets
Current products	¤ Market growth ¤ Efficiency gains ¤ Consolidation	¤ Market development
New products	¤ Product development	¤ Diversification – related – unrelated

1 Market growth, for example, by taking over a competitor. This could produce synergy through economies of scale and efficiency gains, and can decrease the threat from competitors. Both of these should help to increase shareholder wealth. There is, in theory, relatively little risk as the company is staying on its home territory which it knows well, but see the information about the Morrison's – Safeway merger on page 6.
2 Market development and product development. Takeovers and mergers can give rapid access to new markets and to new product lines. There is some greater risk present because new areas are being explored and there is asymmetry of information insofar as the sellers of companies in these new areas usually know more than the buyers. However, it can be appreciated that these categories of takeover can allow a company to expand globally and to present more comprehensive product ranges, thereby allowing the possibility of increases in shareholder wealth. One of the main drivers behind the recent bid for Cadbury by Kraft was the access Cadbury has to many overseas markets, such as the rapidly developing economies of countries like India, Brazil and Mexico where Kraft had poor penetration.
3 Diversification. Both products and markets change and inevitably there is a greater risk that things will go wrong. Diversification has to be divided into two categories:
   - Related diversification, including vertical integration (backward and forward), and horizontal diversification. Here, there is some connection between the activities of the businesses.
   - Unrelated (conglomerate) diversification, where there is no commonality between the different businesses.

Looking first at related diversification. Backward integration is where a business takes over a supplier; forward integration is where it takes over a customer or distributor. Both are forms of vertical integration and both can have advantages:

- assurance of supply of vital components or of distribution channels

Studying Paper P3?
Performance objectives 7, 8 and 9 are relevant to this exam

MERGERS BUSINESS UNITS

- saving costs through better coordination
- increased differentiation of the product or service because components and delivery can be closely controlled
- confidentiality of manufacturing processes (fewer outside orders)
- simple increased profit – we know our suppliers make a profit selling to us so if we take them over we should get their profit too.

However, there can be very significant disadvantages arising from vertical integration:
- Avoiding the discipline of the market, meaning that both parties become too comfortable with their in-house, dedicated relationship. Quality, innovation and cost control can all suffer if you know that whatever you make will be bought by another group company without the tiresome business of competing with other suppliers.
- Taking on additional fixed costs (raising operating gearing). Third party suppliers only contribute variable costs.
- Being tied-in to what turns out to be an inferior partner. What if another supplier has a technical breakthrough and you are saddled with your in-house supplier of old-fashioned components.
- Damaging the other business. Even though vertical integration is a form of related diversification, the other business is different. A component manufacturer and distributor have expertise and know-how that an assembly company does not have, and value can be easily destroyed.

ONE OF THE MAIN DRIVERS BEHIND THE RECENT BID FOR CADBURY BY KRAFT WAS THE ACCESS CADBURY HAS TO MANY OVERSEAS MARKETS, SUCH AS THE RAPIDLY DEVELOPING ECONOMIES OF INDIA, BRAZIL AND MEXICO.

Despite these potential dangers, it should be seen that both backward and forward integration can offer the possibility of wealth increases for shareholders. However, if should be said that vertical integration is not currently fashionable. In fast-moving technological, economic and competitive environments, flexibility, speed of reaction (ideally pro-activity rather than reactivity) are vital and these qualities are often better met by sub-contracting not just the supply of components and the sale of goods, but of many other business processes such as IT, accounting and human resources management. It might be better to strip down your business to the core activities where you can add value, and to outsource everything else to experts in those activities.

Similarly with horizontal integration. For example, a merger of an airline and a hotel business to form an operation such as SAS Radisson. There are considerable connections between two such companies. For example, both are in the travel industry, both international, and both can segment their markets into similar business and leisure sectors. A merger can offer the possibility of cross-marketing, such as offering passengers accommodation in airport hotels, sharing loyalty point schemes, and integration to provide holiday packages. All of these offer the possibility of value creation.

In unrelated diversification there is no commonality between the various entities. Such mergers are often justified by management claiming that they:
- offer cost-savings
- offer shareholders less risk because they own a more diversified business.

However, if the businesses are truly unrelated, from where are the cost-savings going to come? Processes, suppliers, systems, distribution chains and skills will all be different with no opportunity of sharing, skill transfer or economies of scale. If the combined earnings of the group are simply the sum of the individual earnings there can be no increase in value or gain for the shareholders. Taking over a well-run unrelated business at a fair price provides no mechanism for increasing earnings or share price.

Similarly, the diversification argument is bogus because each shareholder is free to diversify personally and to construct a portfolio which suits their specific needs. Indeed, many shareholders might resent the diversification because it disturbs the content of their carefully constructed investment portfolio.

All too often, unrelated diversification destroys value because the new owners do not run their new business properly. Sometimes changes are needed, but there often seems to be an irresistible desire to tinker with the new acquisition because you can, and to be seen to exercise management power. But do the new owners have the skills to effect successful change in this new business that has a different culture, its own body of expertise and know-how, its own constraints and opportunities? As was once said, the most important rule of takeovers, as with medicine, is 'first do no harm'.

The only justification for taking over an unrelated business is if the business is presently poorly run and the new owners believe they can turn it around by applying suitable management expertise. Normal management approaches should allow profits to be increased or cash flows to be maximised by the sale of under-utilised assets: take over a poorly-run, and, therefore cheap business, turn it round, and sell it at a profit. Indeed, this argument is one of Porter's tests for assessing the wisdom of a takeover: the better-off test – how will the acquisition provide advantage to either the acquirer or the acquired? (His other two criteria are the attractiveness test and the cost of entry test.)

We have examined the possible justifications for takeovers and mergers, but how would those takeovers be planned and how should they then be managed? There are two approaches to be aware of, though you will see that there are considerable parallels between the types of management and the corporate roles presented.

1 **Goold and Campbell** described three styles of managing strategic business units (SBUs):
   - Financial control. This adopts a portfolio approach and relies on head office applying strict financial targets. This is suitable, indeed the only approach possible, for the common management of very diversified businesses. Insist on certain profits, margins, returns and market share, but otherwise be hands-off.
   - Strategic control. Attempts to create linkages between the strategic business units to improve competitive advantage. Head office coordinates the activities of the SBUs, though they are largely develop their own strategies. For example, a gas boiler manufacturer taking over double-glazing company. Both can operate independently but the manufacturer can begin to offer a coordinated home heating and insulation service, perhaps offering comprehensive packages to householders. The airline and hotel (SAS Radisson) example mentioned earlier is another instance of strategic control.
   - Strategic planning. Head office drives the group strategy with strong coordination of the SBUs which are expected implement the head office strategy. For example, a supermarket taking over a bank so that additional services, such as credit cards and loans can be offered by the group.

THE ONLY JUSTIFICATION FOR TAKING OVER AN UNRELATED BUSINESS IS IF THE BUSINESS IS PRESENTLY POORLY RUN AND THE NEW OWNERS BELIEVE THEY CAN TURN IT AROUND BY APPLYING SUITABLE MANAGEMENT EXPERTISE. NORMAL MANAGEMENT APPROACHES SHOULD ALLOW PROFITS TO BE INCREASED OR CASH FLOWS TO BE MAXIMISED BY THE SALE OF UNDER-UTILISED ASSETS: TAKE OVER A POORLY-RUN, AND, THEREFORE CHEAP BUSINESS, TURN IT ROUND, AND SELL IT AT A PROFIT.

2 **Johnson, Scholes and Whittington** described the roles that a corporate parent might play in adding value to its business units.

- Portfolio managers. Here the head office acts as an 'agent' between the SBU and the investors. Value is added by acquiring and exploiting undervalued assets, enforcing rigorous performance targets and divesting businesses when they no longer promise increasing value. This approach to adding value very much relies on financial control to make the subsidiaries perform adequately, after which they can be sold on at a profit.
- Synergy managers. Here, additional value is added by exploiting synergies between the various sub-units: sharing resources, increasing buying power, cross-marketing. An example could be a holiday company buying a car-hire company so that complete packages can be offered to travellers. Synergy managers will often exploit the strategic control approach to managing.
- Parental developers. As a parent with a child, holding company skills and expertise are used to improve performance of the SBUs.

Looking further specifically at the opportunities for parental development, the Ashridge portfolio display sets out two criteria that should be considered:

1 The fit between the SBU's critical success factors (what it needs to be good at) and what skills, resources and understanding head office could supply to help the SBU achieve those critical success factors. This is known as 'Feel'.

ASHRIDGE PORTFOLIO MATRIX

High

Feel. The fit between the SBU's critical success factors (what it needs to be good at) and what skills, resources and understanding head office could supply to help the SBU achieve those critical success factors.

Ballast businesses	Heartland businesses
Alien businesses	Value trap businesses

Low **Benefit**. The opportunities for helping the SBU achieve its critical success factors. High

2 The opportunities for helping the SBU achieve its critical success factors. This is known as 'Benefit'.

These two variables are set out as a matrix, seen above.

For example, consider a pharmaceutical firm such as GlaxoSmithKline (GSK). In addition to carrying out research, this large pharmaceutical company has very valuable skills in following and carrying out the very onerous protocols in place for testing the safety and efficacy of new drugs. It also has great marketing skills.

It has opportunities to takeover or merge with a number of different companies as follows.

1 A merger with another large pharmaceutical company, such as Pfizer. This would be high on the 'Feel' axis because the companies do almost exactly the same things, but would be low on the 'Benefit' axis because Pfizer is already very successful and probably does not need much help from GSK. Pfizer would therefore be a ballast business and there would be no great parenting benefit arising from a merger. The companies would do as well separately as they would if combined.
2 A small biotech company. Good at research but without adequate resources for clinical trials and marketing. This target would be high on the 'Feel' axis as both companies are in pharmaceuticals and molecular biology, and would also be high on the benefit axis, because GSK could really help the small company to test and market its discoveries. That target would be a heartland business. Beneficial parenting could be used to increase value.
3 A video-games manufacturer such as Nintendo. Very much an alien business: different business entirely and Nintendo does not need help that GSK could provide. So low 'Feel' and low 'Benefit'
4 A small video-games company with good products but poor marketing. Obviously, again, low 'Feel' because the activities are very different, but GSK might be lured into thinking it could add value to this company by helping it with its marketing. But therein lies the trap: you think you can help, but are likely not to be able to supply the right type of help. GSK knows about marketing, but not marketing video games.

Unfortunately, as you will see after reading about the Morrison's–Safeway merger below, disappointing post-merger results are not uncommon. Goold and Campbell[1] suggest that this arises because corporate executives too often presume synergy when more objective analysis might cast doubt on this. Synergy, they say, is over-predicted because of four biases:

- The synergy bias. Executives tend to assume that part of their function is to find and utilise synergy. Therefore, to show that they are doing a worthwhile job, they seek to find synergy at all costs.
- The parenting bias. A belief that synergy will result only by forcing business units to cooperate. However, often business units will already be cooperating if it is in their interest to do so. If cooperation has to be imposed (and executives often do so to prove they are doing their job), it might be evidence that the solution is flawed.
- The skills bias. The belief that the skills needed to achieve synergy are present in the organisation. However, often those skills will not be within the organisation and tasking someone with inadequate skills to implement, say, a company-wide approach to logistics is probably doomed to fail.
- The upside bias. Managers concentrate so hard on the potential benefits of synergy that they overlook the possible downside risks. This bias goes hand in hand with the parenting bias: a presumption that globalisation, uniformity and centralisation can only yield benefits.

DISAPPOINTING POST-MERGER RESULTS ARE NOT UNCOMMON. GOOLD AND CAMPBELL SUGGEST THAT THIS ARISES BECAUSE CORPORATE EXECUTIVES TOO OFTEN PRESUME SYNERGY WHEN MORE OBJECTIVE ANALYSIS MIGHT CAST DOUBT ON THIS. SYNERGY, THEY SAY, IS OVER-PREDICTED BECAUSE OF FOUR BIASES.

WHEN IT COMES TO SYNERGY, EXECUTIVES WOULD BE WISE TO SUBJECT ALL SYNERGY OPPORTUNITIES TO A CLEAR-EYED, SUITABLY SCEPTICAL ANALYSIS.

To avoid such failures, executives first need to be aware of the four biases and to guard against them. When synergy is well managed, it can create additional value with existing resources. But if it is poorly targeted and managed it can cause immense damage to many stakeholders. When it comes to synergy, executives would be wise to subject all synergy opportunities to a clear-eyed, suitably sceptical analysis that clarifies the benefits to be gained and which takes into account the possible downsides.

CASE STUDY

The Morrison's and Safeway merger

In 2003, Wm Morrison, a relatively small but profitably supermarket based in the North of England, launched a £3bn bid for Safeway, a supermarket four times its size with particular strength in Scotland the South of England. The announcement of the bid drove up Morrison's share price to an all time high as investors believed that the merger was bound to be successful:

- Both businesses were supermarkets, so the merged company could apply greater pressure to suppliers.
- Back-office, distribution and marketing costs could be cut because of economies of scale.
- Morrison's had a reputation for being very tightly run with good cost controls and these skills could be applied to the much larger Safeway.

The merger went through in early 2004 and within the next 15 months, or so, Morrisons had to issue five profit warnings. In the year to the end of January 2006, the group made a pre-tax loss of around £300m compared to combined profit of about £650m before the merger.

Profits have now greatly improved (£655m to end of January 2009) and the company's performance is now very strong, but there were severe problems for a couple of years.

What caused those problems to occur in the merger which seemed to be such a good idea initially? Here are some of the reasons frequently given:

- Morrison's was run by Ken Morrison, the 72-year-old son of the founder and who had been with the business for around 50 years. As is perhaps often the case where the CEO shares his name with that of the firm, the CEO had a reputation for being autocratic and doing things very much his way. Morrison's was the only company on the FTSE to have no non-executive directors until investors forced the issue in May 2004. As was reported at the time[2], at an initial meeting with 300 Safeway staff at their head office, Mr Morrison derided the Safeway's performance and profit record, severely damaging morale.
- Safeway's operations director and trading director resigned and Morrison's failed to persuade many Safeway staff to move north to the group's headquarters. Other key Safeway staff were removed soon after the takeover, particularly those with expertise in the Safeway IT system.
- Morrison's was very much a cost leader, delivering very good value products to a market, based in the north of England, which it knew well. Safeway's was a more up-market chain with many branches in the wealthier south of England. Almost overnight, Safeway stores began stocking Morrison-branded products and pursuing a national pricing policy. Consumers were confused and margins were damaged. The stores no longer accurately addressed what their customers wanted and many customers moved elsewhere.
- It was very difficult to integrate the two company's IT systems and this meant that duplicate systems had to be run for much longer than expected. As the company said: 'The performance of the group overall remains heavily impacted by the temporary dual running costs of distribution, administration and IT functions necessary to the conversion process.'

REFERENCES

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