

# Making M&A Pay: Avoiding the "Winner's Curse"

by Milyae Park



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Deal fever is raging again. Cingular and AT&T. Procter & Gamble and Gillette. Harrah's and Caesars. ChevronTexaco and Unocal. Sanofi-Synthélabo and Aventis. Clearly, more and more companies are acting on the belief that joining forces can help them achieve high performance.

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Strategic collaborations are a cornerstone of high performance. However, deal fever frequently comes with a curse . . . "the winner's curse." This is the chance that, in the throes of acquisition delirium, companies overestimate potential synergies and/or get caught up in the deal momentum—and consequently overpay for their purchases. The curse is common and potentially ruinous. Sufferers may be punished by capital markets, hamstrung competitively and constrained by burdensome capital structures. At a minimum, they'll spend years searching for new ways to meet financial goals and trying to justify their buy.

Daunting as it may seem, there are ways for companies to inoculate themselves—to more fully realise M&A's great potential by avoiding its pitfalls. Whether it's a mega-deal, a

bolt-on acquisition or a multi-step transaction over time, mergers and acquisitions can be a viable way to create significant corporate value. The initial (and possibly the most daunting) challenge is matching the purchase price to the target's value-creation potential. Following are some observations and suggestions for avoiding the winner's curse and, consequently, smoothing the path to high performance.

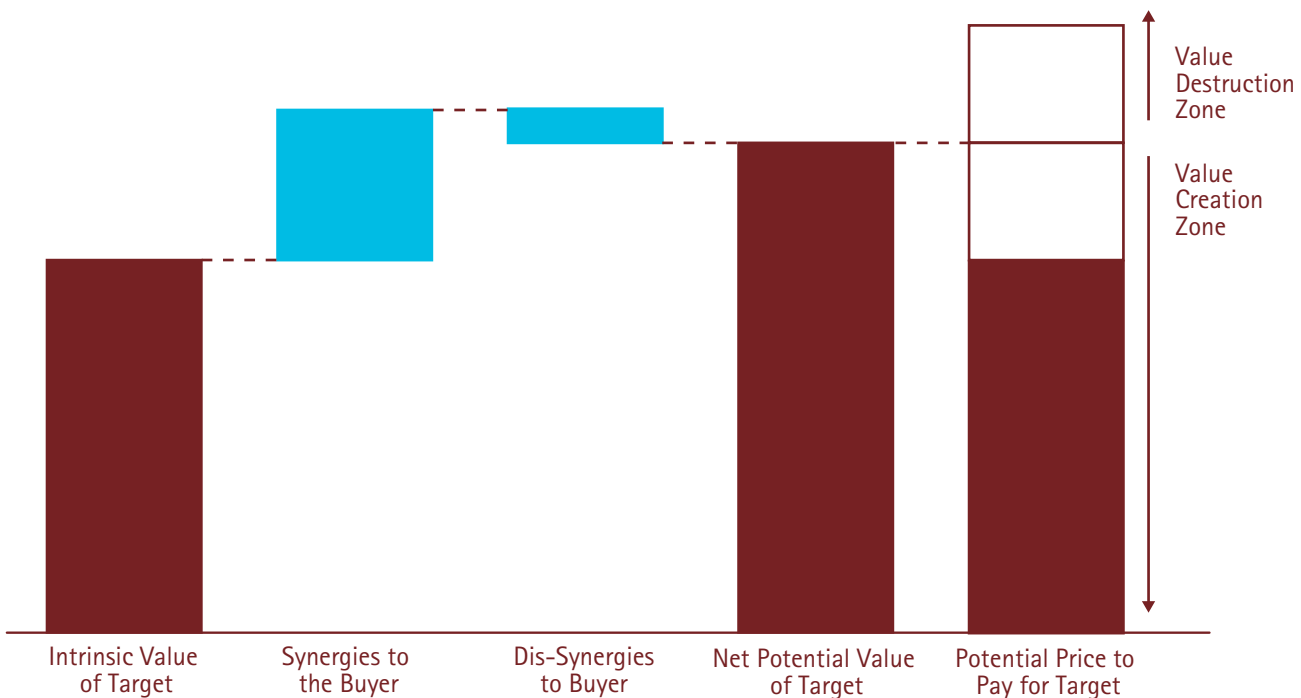
### The "Pre-cursors"

What causes the winner's curse? After all, acquirers don't want to overpay. And they fully understand that paying too much causes myriad long-term problems. Nevertheless, companies frequently fail to:

**Separate price from value.** The intrinsic value of a target company is

a function of its future free cash flows, predicated on how it transforms market position, organisation, capital and other assets into performance. Generally, intrinsic value is measured by discounted cash flows. This is supplementary to, but different from, multiples analyses. The net value of a target company reflects the combined net synergies—the acquisition's pluses as well as its minuses (for example, transaction costs and costs associated with disruption to business-as-usual). Price is the final amount paid for a target, after negotiations (Figure 1). An acquirer overpays when it shells out more than the sum of the target's standalone cash flows plus the net value of the captured synergies. When this occurs, the acquirer has little choice but to frantically (and often futilely) seek more synergies.

Figure 1: Value and price composition of a target.



### **Estimate synergies accurately.**

Oftentimes, the acquirer's assessments of potential synergies are too informal-too "back of the envelope." Lacking the bandwidth or the skills to calculate benefits effectively, some organisations default to a percentage of valuation-without relying on extensive hard data or detailed market analyses. This approach is particularly common when estimating the potential revenue synergies of the two organisations. However, it is also prevalent in estimating cost synergies.

**"Check their work."** Many acquirers feel that their initial assumptions about a deal's fit, rationale, structure and valuation do not need to be revisited. This is seldom the case. As business conditions change, a company's understanding of the acquisition's benefits evolves, and first-pass assessments do not always carry the necessary rigour.

**Retain perspective.** Adrenaline, personal agendas and the tendency to be swept up by the wave of competitive bids can obfuscate rational thinking and even push the deal price to unrealistic levels. Such heat-of-the-moment budget busters are particularly common in auction situations. But surprisingly, they also crop up in one-on-one situations.

### **The Complications**

Falling share price and loss of investor support notwithstanding, overpaying for an acquisition destroys value-value that may be impossible to recoup. First and foremost, an overpriced deal diverts funds and energy from the rest of the business. This discourages growth and innovation; curtails the newly merged

organisation's ability to make other business moves; and leaves it more vulnerable to competitors eager to aggressively capitalise on the situation. Most ironically, overpaying compromises the company's ability to pursue a better-placed acquisition that might have helped the company achieve its strategic goals in the first place.

Excessive purchase prices also overload the acquirer's capital structure-producing too much debt or diluting equity. In extreme cases, irresponsible purchases can even expose the company to regulatory or compliance problems.

America Online's 2001 purchase of Time Warner is a good case-in-point. At the time, many believed that the new organisation's scale would initiate a new growth phase. However, within a year, it was clear that the deal had destroyed value: The new company's attentions were diverted from its core strategic direction and its balance sheet was saddled with debt. A \$54 billion goodwill write-off ensued.

### **Inoculating Against Winner's Curse**

Once an acquiring company has been infected, there is no cure for the winner's curse. But although there is no panacea, there are ways for companies to stave off the curse. Four ingredients comprise the inoculation: people, processes, perspective and preparation.

**People.** It's critical that the right skills and bandwidth be deployed to each area of the deal. For example, a team member who understands the science in a mid-cap pharmaceuticals acquisition may not be the right

person to determine the range of intrinsic values for the target company. That person might help determine strategic fit, but to avoid overpaying, someone with deal experience and financial know-how is needed to perform value assessments.

Interconnected teams also are vital. Deal teams generally include a few deal-experienced personnel or perhaps the organisation's business development group. Ensuring cross-functional pre-deal expertise and involving the people who will staff the post-merger integration team(s) are essential. After all, these professionals are among the best qualified to identify areas where significant value creation can be garnered. Including the integration (and other appropriate) teams also helps the acquirer discover additional issues that could influence the purchase price. For example, they might identify a potential inability to integrate the two businesses' manufacturing lines.

**Processes.** Numerous process-related issues affect the deal price and consummation of an acquisition. For example, M&A strategy should basically be a process-developing standardised, repeatable, measurable mechanisms for creating and pursuing deals; managing multiple deals in the pipeline and across business units; and identifying alternate ways to grow inorganically. Another is target screening-processes for identifying, assessing, prioritising and valuating the right targets, and recognising/quantifying transaction alternatives. Target courtship might also be considered a process-knowing how and when to approach a target, and understanding the balance involved in wooing versus negotiating.

Oftentimes, a different, more relationship-oriented team leads the courtship process. Lastly, there's due diligence-strategic, operational and financial processes, which can help ensure that:

- The right strategic fit exists.
- The business plan reflects the reality of the target. This is particularly vital because management optimism, differences in accounting methodologies, and even liberties with financial statement "geography" can create distorted pictures of a target company's prospects.
- Assumptions about the target company's operations mesh with the acquirer's understanding of the target's potential (for example, correct product portfolio combinations, marketing capabilities and IT infrastructure support).
- Capital investment levels, R&D capabilities, and SG&A (selling, general and administrative) and other support costs are in line with the acquirer's vision of what it will take to grow the business.
- Cost allocations have been accurately reflected across divisions. This is highly germane if the acquirer is buying some portion of a seller's operations, or if certain divisions at the target company generate significantly greater or fewer synergies than others.

A good example of getting the diligence process right is the Kellogg Company which, by the late 1990s, had lost its leading market position and 20 percent of its share price (despite a booming economy). Kellogg executives set out to re-establish the company's competitive edge by bolstering its presence in the snack

category. But because Kellogg lacked access to a direct snack-distribution channel, it opted instead to acquire one. Kellogg targeted Keebler, a leading US food producer, which seemed to have a direct-store-delivery model that would meet Kellogg's distribution needs.

During the deal execution, Kellogg refined its due diligence to focus on the most important drivers of the target's value: Kellogg's fit with Keebler's direct-store-distribution system and how the savings would help offset the cost of the deal. In the end, Kellogg exceeded its synergy estimates, created significant value through the transaction and avoided the winner's curse. Within a year, Kellogg's stock rose more than 25 percent and the company again began to outperform its competitors.

**Perspective.** In the heat of the deal-particularly in competitive situations-discipline is critical. The primary deal negotiator should know the company's walk-away price and be prepared to stick to it. Basically, this price should be set at a point well below the upper limit of the acquirer's value-creation zone, since value is only created when there is an excess of intrinsic value plus net synergies over the purchase price (per Figure 1). A good practice is to start negotiating at a rate below that walk-away price, thus ensuring wiggle room later. Failing to adhere to the walk-away price could be devastating: Budgeting a few percentage points on a large deal often translates into hundreds of millions of dollars/euros/pounds/yen/rand left on the table, or the need for additional synergies to reach the company's goals.

Rules-of-thumb (for example, paying 30 percent above the market value) should not be used to determine purchase price. Instead, the pricing parameters of every deal should be formulated individually. Particularly in the deal environment (where it is easy to get carried away), it is always better to negotiate using thorough, pragmatic estimates.

That said; don't pay for it unless you can value it. Many companies correctly review the cash flow projections of a target to calculate the intrinsic value. However, some mistakenly separate their valuations of the target from the strategic value of the transaction. They might assume that although "the value of the target is \$5 billion, we can pay a lot more because there is strategic value in acquiring the asset." This may be true up to a point, but the "softer" elements, such as strategic value, should still be embedded in the value of the deal. For example, an acquirer's potential ability to fend off competition with, say, a new technological advance provided by the target company, should be factored into the market share and related revenue forecasts of the target.

**Preparation.** Knowing the target company, its potential deal sensitivities and deal breakers, and the key components of value provide much of the information the buyer needs to negotiate a good deal. Nevertheless, it still must expect the unexpected. So when the unexpected happens, the best-prepared acquirers will be able to respond quickly and appropriately-perhaps even capitalising on the unexpected.

Another key aspect of preparation is planning upfront for post-merger

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integration (PMI). Some companies are convinced that the PMI process can be left until after the deal closes. But savvy companies know that value creation is accelerated when PMI is planned during the deal-execution phase. Such planning includes (but is not limited to):

- Executing the initial communications plan.
- Setting financial goals and folding them into synergy estimates during due diligence.
- Identifying tactical "turn on the lights" issues.
- Managing customer and employee experiences.
- Setting cultural objectives.
- Assessing readiness for "Day 1."

After Cingular Wireless and AT&T Wireless Services announced their

\$41 billion merger in October 2004, they wasted no time. Training programs were launched. Call centres were staffed with thousands of temporary customer service representatives to handle anticipated spikes in inquiries. Numerous other elements of the integration process were thoroughly planned. Simply put, everything that could be legally accomplished before Day 1 was accomplished before Day 1. The de novo entity design started shortly after the merger announcement and continued for the eight months leading up to deal close. Not surprisingly, Cingular's management announced "increased operating synergies" and faster savings than originally projected.

## Eradicating the Curse

With widespread discipline and adherence to M&A best practices, the winner's curse could be stamped out. In fact, there seems to be a trend in this direction—with more than a few companies executing deals with strong potential to maximise synergies and inspire high performance. For example, Procter & Gamble, with its Gillette acquisition, and Johnson & Johnson, with its bid for Guidant, offered premiums at a fraction of the norm, thus promoting standards for avoiding overpayment. Potential acquirers that are serious about instilling rigour and discipline into their M&A people, processes, perspectives, and preparation will be better positioned to achieve high performance by joining forces. For the less serious and less disciplined . . . caveat emptor.

**About the author**

Milyae Park is a lead for Accenture's Corporate Strategy/M&A Practice in London, where she has helped numerous clients with pre-deal M&A, deal execution, post-merger integration, alliances/ joint ventures, growth strategies and business restructuring. Before joining Accenture, Milyae worked for Goldman, Sachs & Co., and received her MBA from The Wharton School.

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