Mergers and acquisitions (M&A) are among the most dramatic and visible manifestations of strategy at the corporate level. With a single deal, the strategic course of the organizations involved can be altered permanently. Capital market reactions may create enormous changes in shareholder value and the careers of individual managers at all levels may be profoundly affected.

The importance of M&A in corporate strategy can be ascribed to a single important fact: they allow the company’s portfolio of resources to be transformed very quickly. Acquirers can gain immediate access to technology, products, distribution channels, personnel, and desirable cost and market positions.

The M&A phenomenon shows no signs of slowing and has even embraced the high-technology sectors where it was formerly rare. However, a harsh reality underlies this surge in activity, whether it be in high- or low-technology industries: about half of these transactions fail. The results are the same, whether measured in terms of capital market reactions, financial results, or employee retention.

Yet, these results do not imply that companies should abandon M&A. Indeed, the success rates are not substantially different from those for internal (organic) development and other forms of external development such as partnering.

Further, there is considerable variation in success rates: some acquirers seem to show a systematic capability for generating value from transactions, while others seem to destroy value just as systematically.

What can we learn from this mixed record? This article raises a set of fundamental issues that need to be addressed by managers undertaking M&A activities. The discussion covers strategic and implementation issues. It concludes by suggesting how M&A can be made a successful business process for a company, delivering deal after valuable deal.
The 1990s saw a shift by corporate strategists toward resource-based thinking. In this view, companies are seen as bundles of productive resources and capabilities. These bundles generate competitive advantage for companies when they are difficult to replicate and also difficult to separate and trade in markets. An implication of such resource-based thinking is that for an acquisition to make economic sense for the acquirer, there have to be unique sources of value creation in the deal that are specific to the combination of acquirer and potential target.

To illustrate, no competitive advantage will accrue through buying a company that is worth the same to all potential acquirers. The situation is similar to an auction and ensures that the winning bidder will pay at least as much as the target is worth to it, or to any other bidder, hence the transaction is like exchanging cash for an equivalent amount of cash. If, however, Acquirer A values the target (correctly) at a higher amount than other potential acquirers, A will pay less than it values the target for, as the price only rises to the valuation of the second-highest bidder.

Acquisitions are made for a variety of reasons: to realize economies of scale and scope; to access resources such as technology, products, and distribution channels; to build critical mass in growth industries; to remove excess capacity and consolidate a mature industry; or to change the rules of competition as deregulation and technological change trigger convergence across industries.

However, unless each transaction is assessed for the unique value-creation potential of the combination, it is unlikely to generate competitive advantage for the acquiring company. Operationally, this amounts to managers asking what the key resources of the target company are in each transaction and how they will generate value when combined with the resources of the acquirer.

The answers from this kind of analysis are sometimes startling. Take the example of Cisco Systems, which stunned analysts in 1999 when it paid $7bn for Cerent, a start-up with $50m in sales and no profits. Yet, when Cisco announced $1bn sales revenues from Cerent’s products a scant nine months later, it became clear that the price reflected Cisco’s ability to extract value from the unique combination of its manufacturing and distribution resources and Cerent’s technology. When screening targets that display this degree of fit, acquisitive companies such as Cisco and Symantec may examine as many as a hundred potential targets for every one they finally acquire.

After target selection, there are important strategic issues to be faced during the next stages of bidding and negotiation. Typically, managers face two kinds of problem. First, good strategic information on the quality of the target company’s resources is seldom available. Second, there is a tendency among decision makers to persist with an acquisition, in spite of information that it may not be the best course of action. The former problem typically manifests itself as a difficulty in valuing the target; while the latter problem comes up when managers get caught in bidding wars, or ignore warnings that emerge during due diligence.

There are no panaceas for these problems, but some measures may alleviate them. For example, it is useful to think of a “negotiation range.” This is the range of valuations for the target that has its lower limit equal to the book value of the target and the upper limit (reservation price) set a little below the best projection for post-acquisition value creation (Figure 1).

Important intermediate valuation points are listed here approximately by increasing value:

- the current market value of the target;
- valuations of comparable transactions;
- discounted cash flow (DCF) valuations with post-acquisition synergies;
- valuations including option value of the target.

An acquirer who is disciplined will not revise the
negotiation range upward after negotiations have begun—after all, it is much more likely that information uncovered during negotiations will prove to be negative rather than positive.

Working out the negotiation range does two things. First, it drives home the fact that without accurate information on the quality of the target's resources, the valuation should be stated as a range, rather than an exact figure. Further, for each significant point in the negotiation range, there is a clear strategic rationale with some explicit assumptions. As negotiations on acquisition price proceed, it is easy to evaluate what assumptions are being challenged and in which direction. Second, the negotiation range tends to prevent managers persisting with the deal in the face of negative evidence. The upper bound represents a reservation price, at which a disciplined acquirer should walk away from the deal.

**Implementation issues**

Combining two distinct organizations with their respective structures, systems, and histories is a complex task, but it must be done if the strategy motivating the acquisition is to be implemented.

As stated earlier, resource-based thinking suggests that companies are bundles of productive resources. However, acquirers may not want to keep the whole bundle. The first task of acquisition implementation, therefore, is to decide which resources to retain and which to divest after the acquisition. Resource-based thinking suggests this can be difficult, because the resources that make up a company are closely tied to each other.

This can lead to unanticipated consequences. For instance, even if a target company is acquired primarily for its technical development team, separating it from the sales group can destroy a source of inputs that made the technical team valuable. Thus, knowing how to "deconstruct" the target company into organizational subunits and knowing what linkages to preserve are very important.

The second task is to "connect" resources in the target company with those in the acquiring company in a manner that generates the unique value that (should have) motivated the transaction. This includes decisions on the extent to which the target companies, or more precisely its organizational subunits, will retain their administrative identity after acquisition and the speed at which integration must take place.

What do these steps mean from the perspective of the company which is the target? Selective retention of resources amounts to corporate restructuring. Further, connecting resources in the two companies implies making changes in reporting relationships, monitoring, reward systems, and location.

In short, post-acquisition implementation by the acquirer invariably results in the target experiencing a great deal of change.

Organizational change can be stressful for employees and a source of demotivation. Indeed, "post-merger stress" is a recognized problem that may undermine the strategic logic behind the transaction. More importantly, change can damage the valuable resources that made the target company attractive in the first place.

Some resources, such as a good product design team, a skilled research team, a competent salesforce, or an efficient manufacturing unit, are
valuable because they embody a group of people who have learned to work well together. These teams have "organizational routines" that work smoothly, time after time, to create productive outcomes. When personnel are lost, or the patterns of communication, reporting, and incentives are changed, these routines may be disrupted. Of course, not all valuable resources are based on organizational routines, but managers must discriminate between resources that are and those that are not.

Returning to the acquirer's perspective, the managerial task is to choose the resources to retain and connect them appropriately to the resources of the acquiring company. This has to be done in a way that minimizes the harmful consequences of change.

Solutions vary by context, but two examples illuminate approaches by acquirers in different sectors of the economy. NationsBank, before it merged with the Bank of America in 1998, had grown through a series of acquisitions. NationsBank created value in its acquisitions by replicating its own efficient systems and processes within the acquired organization. The resources it sought were location and customer relationships. Its acquisition "formula" was based on an established, routinized, and constantly honed post-acquisition integration process. The process was clearly and honestly described to the top management of the target company during negotiations and to the entire acquired organization on the day of the announcement.

Given its value creation strategy, NationsBank would invest considerable effort in planning the details of converting systems and processes, changes in reporting structures and incentive systems, and limiting redundancies. These changes would be implemented within weeks of announcement, so that each newly acquired unit became seamlessly integrated into a homogenous organizational framework.

Cisco Systems, another company that has grown through acquisitions, designs, makes, and sells telecommunications equipment such as the switches and routers that control the internet. Cisco creates value by combining the technological expertise of target companies with its own marketing, distribution, and manufacturing expertise.

Like NationsBank, Cisco moves fast soon after the announcement and one of the first things it does is to ensure that the management information and communication infrastructure of the target company (including sales order processing, intranet, and telephones) is matched with its own. Like NationsBank, Cisco believes in early, honest, and clear communication to employees in the target company about their roles in the merged organization. But Cisco is buying resources that are based on highly tacit and rare technical knowledge, embedded in organizational routines.

To minimize disruption, the technical teams of acquired companies are often left unchanged in terms of composition, people they report to, and projects they work on. Usually, the technical and sales organizations of the target become a business unit within one of Cisco's lines of business. Thus, while Cisco aims to transform target company employees into "100 percent Cisco employees," it is careful not to change things that may disrupt the productive functioning of research and development teams.

These examples serve to illustrate the fact that careful thought is required in planning the implementation of the merger.

**M&A as a process**

Given the increased incidence of M&A, it is unlikely that a company will only ever make one acquisition. This is particularly true of companies whose strategy is built on growth through acquisition. What can such companies do to build and improve their acquisition management skills? Many successful acquirers treat M&A as a business process. This implies recognizing the sequence of activities that must take place in any given transaction and creating the organizational arrangements to ensure continuity and coordination across these tasks. The acquisition
value chain is a useful device to prompt thinking about how M&A can be organized as a business process (Figure 2).

A trait of many acquisitive companies is to create a separate unit that specializes in managing acquisitions. The unit need not be large, but does require the presence of a core of dedicated personnel who develop acquisition management skills on many transactions. Such a group may also be involved in managing alliances and partnerships, which share some characteristics of the acquisition process, particularly in the selection and negotiation stages. Versions of this core M&A team exist in several active acquiring companies such as Cisco, Symantec, Intel, Hewlett, Packard, Sun Microsystems, and (formerly) at NationsBank.

In any given transaction, the transaction team comprises members of this core group and members from the part of the acquiring company that will house the acquired unit. In addition, experts from functions such as human resources, legal affairs, corporate finance, and information systems serve on this team for the phases of the acquisition that require their expertise.

Cisco and Symantec, for instance, have created “virtual” transaction teams of experts from various business functions. Such an innovation clearly makes sense in industries that suffer from chronic shortages of skilled personnel.

Key members of the transaction team, who come from the acquiring business unit and the M&A group, will typically be a party to every stage of the acquisition, beginning with target selection and ending with post-implementation evaluation. This ensures continuity and consistency at each stage, so pre-acquisition strategy is effectively implemented.

Having a core group that specializes in managing acquisitions allows tacit experience to accumulate within this team. However, research shows that a company can make the most of this experience if it invests in a process of “knowledge codification” — articulating the lessons learned from experience and setting them down in manuals to guide future transactions.

These “cookbook” manuals are valuable to future managers. However, the real value lies in the brainstorming and detailed analysis that take place after every transaction and precede codification. This generates a deeper understanding of the complex processes involved.

Conclusion
When a merger or acquisition fails, shareholder value is destroyed and society at large suffers if the productive resources in the target are destroyed or underused.

Managers can improve their prospects of success in the following ways:
1 Establishing a value range for the target that accounts for incomplete knowledge and guards against bias in making decisions.

2 Undertaking a transaction as a business process with defined stages.

3 Developing and retaining M&A expertise.

4 Being aware of the dangers in ignoring warning signs that emerge during negotiations.

5 Understanding when to walk away from a deal.

As understanding of the complexities of these processes increases, the success rates of mergers and acquisitions should rise.

Further reading

