Mergers and Acquisitions: Drivers, Issues and Countermeasures

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Since the beginning of the 21st century, Chinese enterprises have been storming the world capital market with a series of mergers and acquisitions (“M&A’s”). This is a direct result of a combination of economic globalisation, the rapid growth of China’s economy and the economic strategies initiated by Chinese government of “going out and bringing in”and “taking full advantage of internal and overseas markets”.

From the takeover of IBM’s personal computer division in 2004, to the announcement of acquiring IBM’s low-end server division and Motorola Mobility in 2014, Lenovo Ggroup Ltd. is witness to this rapidly rising and far-from-completed era. On 6th October 2014 Anbang Insurance Group Plc., which is a previously obscure Chinese insurance company, announced its acquisition of the famous New York Waldorf Astoria Hotel for US$1.95 billion,. This was held by The Hilton Group. Seven days later, Anbang Insurance Group announced its acquisition of 100% in FIDEA, a Belgium insurance company with over one hundred year history. European and American capital markets were shocked by these mergers & acquisitions.

In this storm ofera of mergers & acquisitions launched by Chinese investors, there are winners, however there are also losers. Amongst those who failed in theirSome failed attempts at cross-border merger and acquisition attemptsare are CIC's investment in Blackstone, SAIC Motor Corp’s acquisition of Ssangyong and Chinalco's unsuccessful attempt in investing in Rio Tinto. In fact, many western scholars’ research proves that the risk of mergers and acquisitions is relatively high. In studying the long-term profitability of corporate takeovers in Europe, Marina Marty Nova, Sjoerd Oosting and Luc Renneboog at Tilburg University’s Law and Economics Centre found that the profitability of both acquiring and targeting companies had significantly outperformed the industry average prior to the takeover; however the profitability of the combined firm decreased significantly subsequent to the takeover. Based on studies by Professor Raymond Noe’s studies at Ohio State University’s Fisher College of Business, 60-80% of mergers and acquisitions are considered financial failures in terms of their ability to improve profitability and their ability to outperform the expectation by the stock market.

If M&A’s are so risky, why are there so many smart and experienced people still rushing in to engage in this high risk corporate activity? In this article we will be discussing the key drivers and potential issues with M&A’s. We will then follow up with some recommendations and counter-measures to address those issues.

Synergies

It is said that in most M&As, synergies are not only the key drivers to, but also the core objective. Synergies have always been a predominant motive in the acquirers' public documents to convince their existing and potential investors. Achieving synergies is not only the a reason for a M&A, however it is the ultimate benefit of the investment activity. Synergies mean that the overall benefits of the new combined company are more than the simple sum of both parties which operate operating separately. This is because synergies increase efficiency and effectiveness through the sharing of resources which both the acquirer and acquiree did not have before the M&A. In other words, the purpose is to achieve economies of scale and economies of scopeEconomies of Scale and Economies of Scope by sharing their various resources after the M&A. Economies of scope arise from the business scope of the company, instead of the business scale of the company. This happens when the total cost of making two kinds of products is lowered simultaneously when comparing to the sum of the costs of making each kind of product separately.
There are four different types of synergies: operation synergies, management synergies, financial synergies and intangible asset synergies.

Strategic Tools to Achieve a Company's Fast Growth

Newly rising enterprises in developing countries take M&A's as a tool to achieve their fast growing strategy of conglomeration, diversification and economies of scale. Enterprises can develop naturally through organic growth, but M&A as a strategic tool of achieving fast growth has its own features and advantages. These advantages include:

1) Marketing advantages: buying in a new product range, buying a market presence (especially true if acquiring a company in overseas), integrating sales departments or rationalising distribution and advertising, and eliminating competition or protecting an existing market;

2) Production advantages: achieving higher utilisation of production facilities, buying in technology and skills, obtaining greater production capacity, securing future supplies of raw materials, and improving purchasing by buying in bulk;

3) Finance and management advantages: buying a high quality management team which exists in the acquired company, obtaining tax advantages, etc.

As demonstrated in cases such as Geely's acquisition of Volvo and DSI, Chinalco's beteiligung investment in Rio Tinto and Lenovo's acquisition of IBM's personal computer division and Motorola Mobility, for the newly rising enterprises in emerging markets, obtaining new technology and processes, securing supplies of raw materials and buying the an overseas market presence lie at the core of motivation to adopt a M&A strategy.

Access to Capital Markets

In the Chinese share market's examination and verification system, a listed company is a scarce resource in China. A company's development needs plenty of capital; it is far from enough, if a company depends solely on its capital accumulation. According to many relevant literatures, listed companies are target companies in M&A's. The existence of a share market has caused the cost of M&As to fall substantially. In a share market, the financing cost is relatively low, and financing is a key point of an M&A. It is very difficult to become a listed company in China, especially so for private enterprises. This is due to the imperfection and relatively small scale of the Chinese share market, and the strictness of the Securities Regulation. As a result, the method of "purchase shell corporations" is increasing. After buying a shell company, integration will follow, which will include injection of quality assets into the shell company and the taking away of the non-performing assets. Consequently, the operating performance of the listed company will improve significantly, as will the financial condition. The evaluation of the shares by the share market will change significantly; the acquirer's price-earnings ratio will rise, and will finally meet the allotment standards stipulated by Securities Regulation and then achieve the objective of raising further financing within the share market.

- **Maintain Competitive Advantages, Overcome Barriers to Entry**

During the economic global financial crisis, enterprises had to face tough competition for survival and development. To prevent being acquired by larger enterprises, some companies had to buy other companies or they had to unite with other companies in the form of a group companies. Furthermore, M&A's can make it comparatively easier to enter new business areas for enterprises. In this way, corporations can bypass trade barriers, launch new businesses, exploit and dominate the market, and reap long-term large profits.

- **Other Factors**

There are some other motivating factors for M&A's, such as speculative activity, discovering and buying target companies in which market value is underestimated, improving reputation of the corporation and management and increasing market value.

- **Motivation of Government**

In Mainland China, state-owned enterprises still hold the dominant position. M&A activities are not always as a result of economic behavior. The government plays a very important role in a corporation's strategic decision making. Division, M&A and reorganisation of state-owned enterprises are taken by government in reformation o f the state-owned economic system reforming, with the purpose of upgrading China's industrial structure, and optimisation of optimising the resource allocation and promotion of Chinese enterprise groups' competitiveness in international arena.

2. Issues with M&A

The M&A is a high-risk economic venture as there are many uncertainties throughout the process. The following are the main reasons that contribute to failure of M&A's:

- **Paying too Higher Purchasing Price**

The main reason contributing to failure of an enterprise's merger and acquisition is simply by paying too much, which leads to disastrous results for the M&A. Over-payment could bring about unrealistic expectations for profitability post-M&A, and the newly incorporated company is likely to accrue a significant amount of goodwill impairment which will reduce the profitability, or at times contribute huge losses to the newly incorporated company. There are many reasons why over-payment occurs, such as (1) information asymmetry. This is often because the information received by the acquiring party is only the information other side hopes to display, which leads to the acquiring party making an ill informed decision; (2) the personal motivation of the M & AM&A. Kellor R Dixon found that managers often enter into the negotiation for an M&A to satisfy their own personal motives like empire building, which is essentially improving their own reputation or to receive higher managerial compensation. As a result, they often lose focus on the fact that they need to look at the strategic benefits of the M&A and instead they enter into a an M&A arrangement that is not of strategic importance to the company; (3) unsound corporate governance structure and governance system. This will cause the board of directors and other governance body members to be driven by individual(s) with strong characters and influence, which could lead to an unsound M&A decision that is not based on decisions around the expectations of the economy.

- **The Issues and Problems concerning Integration after M & A**

The core motive of an acquisition of mergeracquisitions and mergers is to achieve synergies and its achievement relies on whether the effective integration of resources after the M&A can be achieved in a way to be expectedthe expected manner. The integration process can be very complicated and difficult when there are differences between the acquirer and the target, especially concerning overseas markets, such as in corporate cultures, work ethics, and management styles, stage of development, distribution channels and so forth. What is more, the diversified factor could make the integration of cross-border M&A's even more difficult. Diversified factors could be ethnic, cultural, moral, and religious or differences in local laws and regulations. If the differences cannot be resolved effectively, all levels of the combined company could be affected, including all aspects of the integration, for example, communication, decision making, production and transfer of employees.

- **The Loss of Talented Employees and Valuable Clients**

In the industrial age, the primary assets responsible for creating wealth within the an organisation were tangible assets. In this new intellectual era, intangible assets are the primary drivers of wealth (such as knowledge, individuals, goodwill, brand, etc.). These intangible assets have not only materialised in new production equipment, or a patent certificate, but also internalised within the company's staff members, who have mastered the necessary knowledge, built the brand and created goodwill for the company. Unfortunately, intangibles are not what most M&A managers are looking at as they consider these deals. While they create extremely detailed analysis of the 'hard facts', they miss the 'soft facts' that really drive the deal. This kind of mindset by management could lead to outflow of a great number of key personnel after the M&A. Professor Raymond Noe found that one out of four top performers will leave a company within 3 months of the announcement of an event involving a major change within an organisation. 47% of senior managers in the acquired company leave within the first year. Wayne R. Pinnell concluded that all companies need to remember is that the people, who produce profits, represent the company and establish rapport with the customers and are ultimately the ones who will make the combined company succeed.

- **Power Politics**

Randall S. Schuler and Susan E. Jackson of the Rutgers University School of Management and Labour Relations, observed that there is a tendency to assume that power disputes are more common in the case of acquisitions than mergers, and that the fact is that there is hardly such a thing as "a merger of equals". Further, it was observed that the distribution of power was not equally spread out or shared post M&A.

3. The Thinking and Countermeasures

Despite many M&A failures, there are also countless stories of successes. This demonstrates that there might be a way to succeed in M&A's. Throughout the process of M&A's (including before, during and after the actual M&A), management of the acquirer should take the following steps to reduce the risk of failure:

- **Establish a Competent Corporate Governance Structure and System and Prevent a Person or a Small Group of Individuals from Dominating the Governance Body.**

The M&A deal entered into by a person or a small group of individuals who dominate the governance body of the acquiring company will always benefit the deal-makers more than the acquirer given the personal motivation mentioned in item 2. This kind of M&A deal may be stopped and, therefore the risk of failure eliminated from the very beginning. If a competent corporate governance structure and system is established. This corporate governance structure should be capable of preventing a person or a small group of individuals dominating the governance body (normally board of directors) and the process of decision-making. An informed decision could then be made with full participation of a strategy committee and a risk committee which is attached to the bBoard of dDirectors. Both the executive directors and the independent directors could express their views during the decision-making making process.

Clarify the M & A Targets, Formulate the M & A Strategy and iIts Plan

The goals of the M&A need to be clarified before the M&A with a view of ensuring the achievement of them. The development of strategies after the M&M&A should be formulated based on the targets set. Next, M&\AM&A managers need to find an accurate market positioning, core scope of the business and key competitiveness of the combined company after the M&A. Never proceed with a an M&A that is simply aimed at expanding the scale of operations.

Carry Out Detailed Investigation for the Target Enterprise and Selecting the Right M&A Target

The key factor for a successful M&A is to select the target enterprise correctly. Because of "asymmetric information", the management of the acquirer often rushes into making decisions based on insufficient or incomplete information, which could lead to the M&A's transactions to fail in achieving their objectives. This could make the new company end up in an even worse position after the M&A. Therefore, firstly, the acquirer should select the target enterprise from a strategic perspective. Target enterprises should meet the strategic layout of the acquirer, should be conducive to the long-term development of the acquirer and be helpful to the realisation of synergies. The competitive advantages, weaknesses and growth potential of the target company should be evaluated objectively by the acquirer before, during and after the M&A process. Secondly, a detailed financial analysis of the target company would provide a reasonable and effective basis for the purchase price, and also assist in making financial forecasts and predicting risks related to the combined company.

These investigations involve looking at the target company's political environment, cultural and social environment, macroeconomic condition, technology environment, legal environment and environmental protection, therefore acquirers tend to engage the management and consulting companies to conduct these investigations. As for the financial analysis and investigation before the M&A, an independent public accountant would normally be engaged to perform financial due diligence. They engage in an external party not only due to the external party's expertise, but also their independence from the company. This avoids the prejudice of the M&A managers, who may be anxious to see the deal done, and therefore ensure the objectivity of their conclusions in those investigation reports.

Integration of management systems and processes

The two parties normally have their own management systems and processes before the M&A. Those should be reviewed thoroughly after the M&A to determine what is useful or healthy and what is not. They should then modify these accordingly and restructure by means such as business process re-engineering and change management, in an attempt to improve the competitiveness of the company and assist the company to achieve long-term development.

Integration of assets and liabilities

During the integration of various assets, the acquirer should identify, absorb, or remove assets according to its own development strategy and core competencies. They should pay special attention to the integration of intangible assets. Debt integration involves adjusting the debt structure with the purpose of adjusting the gearing ratio to a more reasonable level.

Integration of human resources

Human resources are the most robust and most active amongst the productivity factors, which plays a decisive role to the production efficiency after the merger and acquisition. Therefore, the primary problem of the integration of human resources is to retain talent, stabilise talent and reduce the turnover of personnel due to the M&A.

Integration of corporate culture

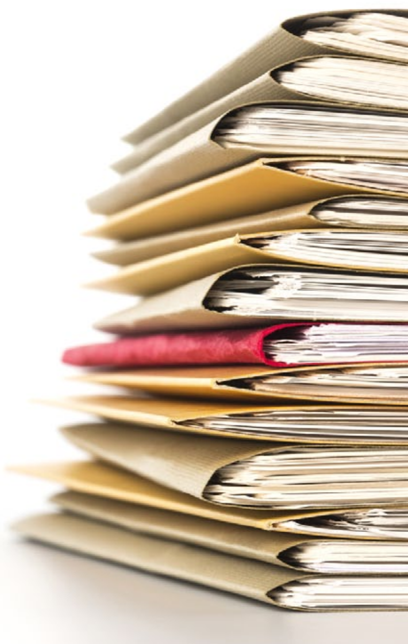
It is inevitable for conflict to arise due to collision of cultures after the M&A. It is therefore necessary to integrate a corporate culture, shape the common enterprise value, and consciously create an ideal pattern of enterprise culture. Irene Rodgers, author of 'Successful Mergers, Acquisitions and Strategic Alliances – Strategies for Culture Bridging' thinks that poor communication and ineffective management of the different corporate cultures are two main reasons for the failure of M&A.

Financial integration

The combined company should carry out an effective integration for the financial systems and financial processes of both parties to the M&A in order to generate financial data to meet the internal control requirements, for the internal use by management to build the basis for decision-making and to be used by public or government agencies.

During the process of integration, the acquirer or the combined company also tend to seek external help from professionals, such as engaging a professional consulting company to re-engineer the business and management processes, or hire an independent accountant to help complete the financial integration process.

In November 2012, HP made an impairment of 8.8 billion US dollars for the Autonomy's assets, when HP had just been acquired in 2011. It reminded the market again that M&A's can be a double-edged sword for the acquirer. Acquirers must have a clear vision of the purpose of and the problems and risks associated with the M&A. They must then make pre-arranged plans and countermeasures in advance, before and during the process of the M&A, to cope with them, and in order to lower the risks to an acceptable level.



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