The Open University

Mergers and Acquisitions - Audio

Mergers and Acquisitions; a discussion.

Narrator:

Why carry out merger and acquisition activity when most of the evidence indicates that it doesn’t create value for shareholders?

Well there are a number of reasons why mergers and acquisitions or M&A take place. One is that a company wishes to acquire more power, more market share. Or it wishes to expand into new areas and acquire knowledge. So for example buying biotech firms or buying social networking sites.

But all the evidence, or most of the evidence, suggests that M&A activity doesn’t create any value for shareholders after the acquisitions or the merger. And that really comes down to one word which is over-optimism, or what the textbooks call hubris. And that might be for a whole range of reasons. So the managers of the acquirer might be over-optimistic and not really look ahead and see problems about integration, cultural difficulties. They might have a lack of the knowledge or industry in which they're moving into and it might just be poor management practises.

Or it could be IT systems. For example Santander has had a lot of trouble integrating its IT systems in the companies it’s bought.

Some do work don’t they though?

A classic example was when British Airways bought British Caledonian many years ago and within six months people had stopped mentioning the word British Caledonian because they'd so successfully integrated the two companies that people just thought it was one.

Yeah that’s true but those examples are few and far between. Most don’t work and for the most obvious reasons in hindsight. Take for example the Morrison take-over of Safeway in 2003 –

What – the retail supermarket?

Yes, that’s right. The Safeway board recommend it to their shareholders. So a Morrison group was formed and in actual fact there were then five profit warnings and it was a bit of a

disaster for a time though Morrison have now turned it round. And the problems were really that they were supermarkets, which served different markets. So Morrison was at the lower end and Safeway was at the top end of the supermarket in offering higher quality products. And applying the same model, the Morrison model, to Safeway supermarkets really discouraged or turned off Safeway customers. The other difficulty was that Morrison had a very small network of stores in the north of the UK and Safeway were dispersed throughout the UK so had much higher distribution costs and a much more difficult system of distribution to manage. Morrison had real difficulties in grappling with that distribution system.

So it looks as if most mergers and acquisitions are actually negative NPV projects that the cash flows that they expect are not what they get.

Yeah that's right. And the reason that they fail, that they don't generate value is because managers are over optimistic about what they can achieve.

Narrator:
Why pay a bid premium?

Well you have to pay a big premium to persuade people to sell. They're not going to sell you the shares and fill in lots of forms if you offer them the current share price or less. You have to offer them more than the current share price. And how much more you have to offer them depends on a number of things. It depends on the state of the stock market. So there's this ratio you've come across called Tobin's Q, which is the ratio of market value to book value. And when that's high that means the stock market is highly valued. And you often find that mergers take place at that time because people think somehow that everything's worth more and you can afford to pay a bigger bid premium when the market's bullish. Another factor that's quite important is competition. And in the Anglo Saxon world the US and the UK, you often get competing companies trying to get hold of a third company. The famous one was when RBS and Barclays were fighting to get ABN AMRO. In the end it all went horribly wrong and Barclays did well to get out of it. But at the time they were bidding up the price they were going to pay and ended up paying too much.

Yeah that's a good example. And Time Warner and the AOL acquisition is another one. That happened in 2000 but in 2009 Time Warner having had a pretty disastrous impact on profits, having taken over AOL, decided to dis-invest and sell off AOL again.

Yes it's worth remembering that actually don't always buy another company for life as it were. Sometimes they buy them with a fairly short-term time horizon like private equity.

They do. I think there's a tendency to get carried away when you're bidding for a company and just keep going with the share price and keep offering more that really puts the bid premium up. Private equity tends to have a bit of a tighter view on it. That's because they maybe as you say not investing for the long term but investing for the short to medium term. And so they'll be looking at what they can sell the company on for in perhaps five to ten years and that will provide a cap as to how much they bid. In 2006 Sainsburys wanted eight pounds a share from a private equity consortium who were bidding for them and private equity just wouldn't pay that amount and they walked away.

And so in the end common sense should be a factor when you're looking at M&A. Maybe a good idea is to think about what the company would be worth to somebody else a few years down the road, to keep your common sense in perspective.

Narrator:
Who benefits?

Well, it's the seller if they go to receive cash because they can walk away. They've received a bid premium above the market price. They walk away happy and they can invest elsewhere.

But what happens if they get given shares Jane?

Well then they may well be suffering. Just think back to the Morrison group and those five profit warnings. Very low dividends paid. They don't receive very much. They have to share the pain of the consolidation.

I know some people who do make a lot of money out of M&S and that's the financial advisors because what happens is that both the buyers and the sellers recruit investment banks to help them and the investment banks get paid a percentage of the amount of the proceeds of the deal. So if you're buying a company, bizarrely you're advisor gets more the more you pay for the company which is a bit of a paradox. I've always thought they should pay less the higher the price that the buyer pays. I can understand that the seller is happy when he gets .. the proceeds but not the buyer.

Yes so it's the investment bankers who are really gaining from these transactions.

And the other thing that's quite interesting I suppose is that financial advisors don't give the kind of advice that we think you maybe need in terms of how to adapt after the event. Financial advisors limit their advice to the actual deal itself and then in a sense wash their hands and walk away.

Yeah it’s the management responsibility to make sure it all works which is why it means you really have to investigate thoroughly before you go ahead and make sure you’ve got the expertise to make it work afterwards.