

# Week 8 Chapter 7: Acquisition & Restructuring Strategies.

- M&A strategies can be used because of uncertainty in the competitive landscape. These strategies can be to:
  - **increase market power** because of competitive threat
  - **spread risk** due to an uncertain environment
  - **shift the core business** into **different markets**
  - **manage industry and regulatory** changes.

# VARIED INVESTOR SUCCESS OF MERGER & ACQUISITION STRATEGIES

M&A value creation is challenging:

- Shareholders of acquired firms often earn above-average returns from acquisitions.
- However shareholders of some acquiring firms may earn returns that are close to zero depending on the situational environmental factors

# MERGERS, ACQUISITIONS AND TAKEOVERS: WHAT ARE THE DIFFERENCES?

- **Merger:** Two firms agree to integrate their operations on a **relatively co-equal basis**.
  - There are few true mergers because one firm usually dominates in terms of market share, size or asset value.
- **Acquisition:** One firm buys a **controlling interest in another firm** with the intent of making the acquired firm a subsidiary business within its portfolio.

# MERGERS, ACQUISITIONS AND TAKEOVERS: WHAT ARE THE DIFFERENCES?

- **Takeover** is a special type of acquisition strategy where the target firm does not solicit the acquiring firm's bid.
- A **hostile takeover** is an unfriendly takeover that is undesired by the target firm.
  - **Rationale for strategy:** Pre-announcement returns of hostile takeovers are largely anticipated and associated with a significant increase in the bidder's and target's share price.

# REASONS FOR ACQUISITIONS: INCREASED MARKET POWER

- Market leadership results from market power.
- Factors that increase market power include:
  - ability to sell goods or services above competitive levels
  - cheaper primary or support activities than competitors
  - size of the firm, resources and capabilities to compete in the market and share of the market
  - purchase of a competitor, supplier, distributor or business in a highly related industry.

# REASONS FOR ACQUISITIONS: INCREASED MARKET POWER

Market power is increased by:

- **horizontal acquisitions** – acquisitions of other firms in the same industry
- **vertical acquisitions** – acquisitions of suppliers or distributors of the acquiring firm
- **related acquisitions** – acquisitions of firms in related industries, e.g. Amazon's acquisition of Lovefilm.

# INTERNAL INCENTIVES TO DIVERSIFY

## Horizontal acquisitions

Firms have similar characteristics, such as:

- strategy
- managerial styles
- resource allocation patterns
- previous alliance management experience.

- Acquiring and acquired companies compete in the same industry.
- The firm's market power is increased by exploiting:
  - cost-based synergies
  - revenue-based synergies.
- Acquisitions with similar characteristics result in higher performance than those with dissimilar characteristics.

# REASONS FOR ACQUISITIONS: INCREASED MARKET POWER

Horizontal  
acquisitions

Vertical  
acquisitions

- Vertical acquisition involves acquiring a supplier or distributor of one or more of the firm's goods or services.
- Increases a firm's market power by **controlling** additional parts of the value chain.

# REASONS FOR ACQUISITIONS: INCREASED MARKET POWER

Horizontal  
acquisitions

Vertical  
acquisitions

Related  
acquisitions

- Related acquisition involves acquiring a company in a highly related industry.
- Value creation takes place through synergy generated by integrating resources and capabilities.
  - Because of the difficulty in implementing synergy, related acquisitions are often difficult to implement.

# REASONS FOR ACQUISITIONS: OVERCOMING ENTRY BARRIERS

- **Barriers to Entry** are factors associated with the market or with the firms operating in it that increase the expense and difficulty faced by new ventures trying to enter that market. Barriers include:
  - economies of scale
  - differentiated products
- **Cross-border acquisitions**
  - are made between companies with headquarters in different countries
  - are often made to overcome entry barriers
  - can be difficult to negotiate and operate because of the differences in foreign cultures

# REASONS FOR ACQUISITIONS:

## LOWER RISK THAN DEVELOPING NEW PRODUCTS

- Outcomes for an acquisition can be more easily and accurately estimated than the outcomes of an internal product development process.
- Acquisition strategies are a common means of avoiding risky internal ventures and risky R&D investments.
- Acquisitions may become a substitute for innovation and, thus, should always be strategic rather than defensive in nature.

# REASONS FOR ACQUISITIONS: INCREASED DIVERSIFICATION

- Using acquisitions to diversify a firm
- - is the quickest and easiest way to change the portfolio of businesses.
- Both related diversification and unrelated diversification strategies can be implemented through acquisitions.
- The **more related** the acquired firm is to the acquiring firm, the **greater** is the probability that the acquisition will be successful.

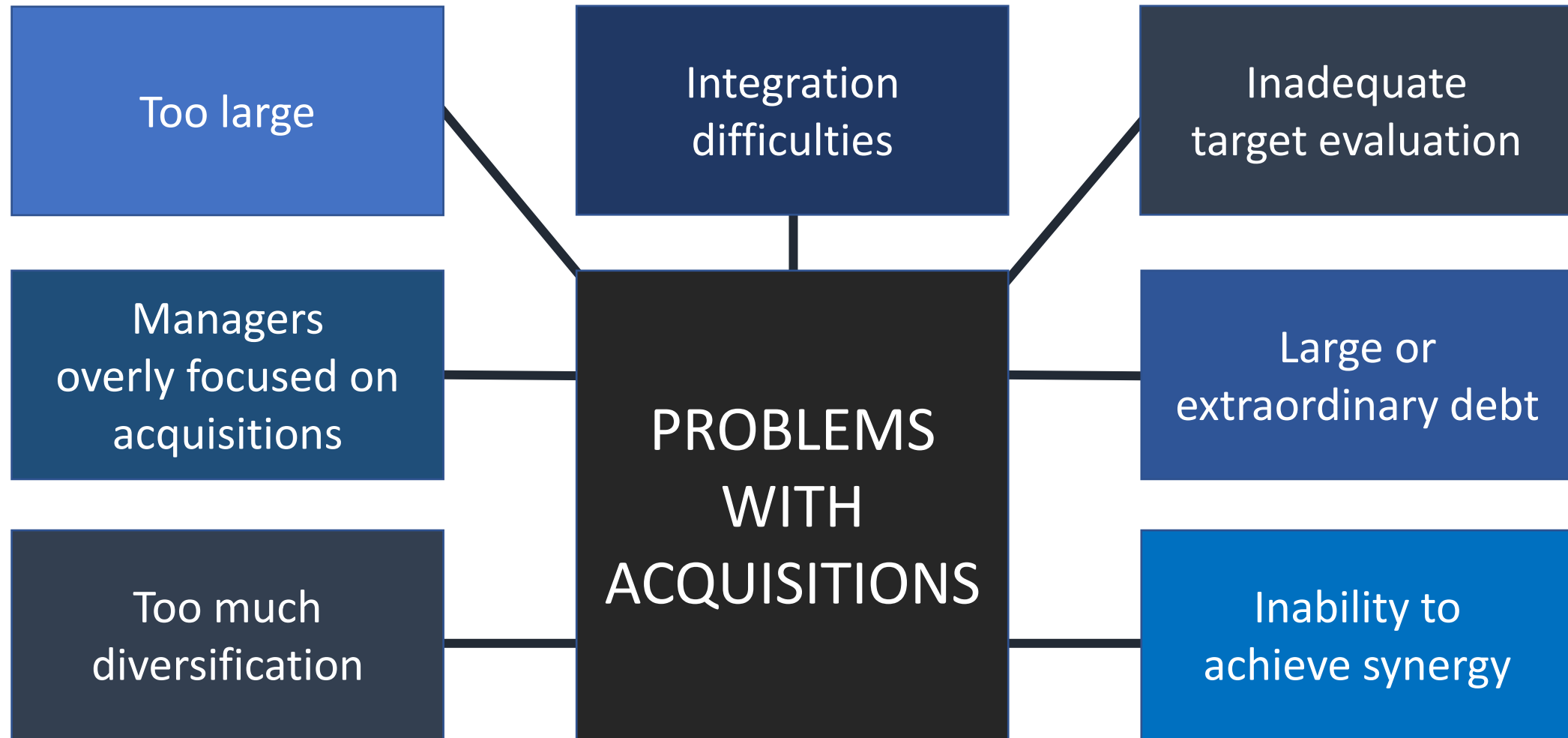
# REASONS FOR ACQUISITIONS: RESHAPING A FIRM'S COMPETITIVE SCOPE

- An acquisition can reduce:
  - negative effect of an intense rivalry on a firm's financial performance
  - firm's dependence on one or more products or markets.
- Reducing a company's dependence on specific markets alters the firm's competitive scope.

# REASONS FOR ACQUISITIONS: LEARNING AND DEVELOPING NEW CAPABILITIES

- An acquiring firm can reduce inertia and gain capabilities that it does not currently possess, such as:
  - special technological capability
  - a broader knowledge base
- Firms may acquire other firms with different but related and complementary capabilities in order to build their own knowledge base

# PROBLEMS IN ACHIEVING ACQUISITION SUCCESS



# PROBLEMS IN ACHIEVING ACQUISITION SUCCESS: INTEGRATION DIFFICULTIES

Integration challenges (as in the UPS case) include:

- melding two disparate corporate cultures
- linking different financial and control systems
- building effective working relationships, particularly when management styles differ
- resolving problems regarding the status of the newly acquired firm's executives
- loss of key personnel weakening the acquired firm's capabilities and reducing its value.

# PROBLEMS IN ACHIEVING ACQUISITION SUCCESS: INADEQUATE EVALUATION OF TARGET

Due diligence is the process of evaluating a target firm for acquisition.

- Ineffective due diligence may result in paying an excessive premium for the target company.

# PROBLEMS IN ACHIEVING ACQUISITION SUCCESS: INADEQUATE EVALUATION OF TARGET

## **Evaluation** requires examining:

- financing of the intended transaction
- differences in culture between the firms
- tax consequences of the transaction
- actions necessary to meld the two workforces
- accuracy of the financial position and accounting standards used
- quality of the strategic fit and the ability of the acquiring firm to effectively integrate the target

# PROBLEMS IN ACHIEVING ACQUISITION SUCCESS: LARGE OR EXTRAORDINARY DEBT

**Junk bonds** are a financing option whereby risky acquisitions are financed with money (debt) that provides a large potential return to lenders (bondholders).

High debt (e.g. junk bonds) can:

- increase the likelihood of bankruptcy
- lead to a downgrade of the firm's credit rating
- preclude investment in activities that contribute to the firm's long-term success such as:
  - research and development
  - human resource training
  - marketing

# PROBLEMS IN ACHIEVING ACQUISITION SUCCESS: INABILITY TO ACHIEVE SYNERGY

## **Synergy**

- occurs when assets are worth more when used in conjunction with each other than when they are used separately
- is created by the efficiencies derived from economies of scale and economies of scope and by sharing resources (e.g. human capital and knowledge) across the businesses in the merged firm.
  - Firms experience transaction costs when they use acquisition strategies to create synergy.

# PROBLEMS IN ACHIEVING ACQUISITION SUCCESS: INABILITY TO ACHIEVE SYNERGY

**Private synergy** occurs when the combination and integration of the acquiring and acquired firms' assets yield capabilities and core competencies that could not be developed by combining and integrating either firm's assets with another company.

- Advantage: It is difficult for competitors to understand and imitate.
- Disadvantage: It is difficult to create.

# PROBLEMS IN ACHIEVING ACQUISITION SUCCESS: TOO MUCH DIVERSIFICATION

## **Overdiversification**

- Related diversification requires more information processing than unrelated diversification.
- Due to the additional information processing, related diversified firms become overdiversified with fewer business units than do unrelated diversifiers.
- Overdiversification leads to a decline in performance, after which business units are often divested.
- Even when a firm is not overdiversified, a high level of diversification can have a negative effect on its long-term performance.

# PROBLEMS IN ACHIEVING ACQUISITION SUCCESS: MANAGERS OVERLY FOCUSED ON ACQUISITIONS

Managers invest substantial time and energy in acquisition strategies in order to:

- search for viable acquisition candidates
- complete effective due-diligence processes
- prepare for negotiations
- manage the integration process after the acquisition has been completed.

# PROBLEMS IN ACHIEVING ACQUISITION SUCCESS: MANAGERS OVERLY FOCUSED ON ACQUISITIONS

- Managers in target firms operate in a state of virtual suspended animation during an acquisition.
- Executives may become hesitant to make decisions with long-term consequences until negotiations have been completed.
- The acquisition process can create a short-term perspective and a greater aversion to risk among executives in the target firm.

# PROBLEMS IN ACHIEVING ACQUISITION SUCCESS: TOO LARGE

- Additional costs and complexity of management may exceed the benefits of the economies of scale and additional market power, creating diseconomies of scope.
- More **bureaucratic** controls result from size.
  - Formal rules and policies ensure consistency of decisions and actions.
  - Formalised controls often lead to relatively rigid and standardised managerial behaviour.
- The firm may produce less innovation.

# EFFECTIVE ACQUISITION STRATEGIES

**Complementary assets/resources**

**Buying firms with assets that meet current needs to build competitiveness**

**Friendly acquisitions**

**Entering friendly deals to make integration go more smoothly**

**Due diligence/careful selection process**

**Deliberately evaluating and negotiating to lead to easy integration and building synergies**

**Maintain financial slack**

**Providing enough additional financial resources so that profitable projects may be capitalised upon rather than forgone**

# EFFECTIVE ACQUISITION STRATEGIES

## ATTRIBUTES

**Low-to-moderate debt**

**Sustained emphasis  
on innovation**

**Flexibility**

## RESULTS

**Maintains financial flexibility as new firm**

**Continues to invest in R&D as part of the firm's  
overall strategy**

**Has experience managing change and is flexible  
and adaptable**

# RESTRUCTURING

- **Restructuring** is a strategy through which a firm changes its set of businesses or financial structure.
  - Failure of an acquisition strategy often precedes a restructuring strategy.
  - Restructuring may occur because of changes in the external or internal environments.
- Restructuring strategies include:
  - downsizing
  - down-scoping
  - leveraged buyouts.

# RESTRUCTURING

## Downsizing:

Reduction in the number of a firm's employees and in the number of its operating units, but does not change the essence of the business

## Down-scoping:

Refers to divestiture, spin-off or some other means of eliminating businesses that are unrelated to a firm's core businesses

## Leveraged buyout:

When a party buys all of the assets of a business, financed largely with debt, and takes the firm private

# RESTRUCTURING

## Downsizing

- Tactical
- Short-term
- Cuts labour costs
- If acquisition fails to create anticipated value
- Paid too much for target

## Down-scoping

- Strategic
- Long-term
- Focus on core businesses
- More positive effect on firm performance than downsizing

# RESTRUCTURING

## **Leveraged buyout (LBO)**

- In an LBO, one party buys all of a firm's assets in order to take the firm private (or no longer trade the firm's shares publicly).
- **Private equity firms** facilitate or engage in taking a public firm private.
  - Significant amounts of debt may be incurred to finance the buyout.
  - A firm may immediately sell off non-core assets to pare down debt.
- An LBO is a strategy that can correct for managerial mistakes or overcome managers making decisions that serve their own interests rather than those of shareholders.

# RESTRUCTURING

## Leveraged buyout (LBO)

- There are three types of LBOs:
  - management buyouts (MBOs)
  - employee buyouts (EBOs)
  - whole-firm buyouts.
- **MBOs**, more so than **EBOs** and whole-firm buyouts, lead to downscoping, increased strategic focus and improved performance.
- **LBOs**:
  - offer protection against a capricious financial market
  - allow owners to focus on developing innovations and bringing them to market
  - enable firm rebirth to facilitate entrepreneurial efforts

# RESTRUCTURING

## **Leveraged buyout (LBO)**

- LBOs are considered a significant innovation in the financial restructuring of firms, but they can involve negative trade-offs:
  - Resulting large debt increases the firm's financial risk, as is evidenced by the number of companies that filed for bankruptcy in the 1990s after executing a whole-firm LBO.
  - Short-term and risk-averse managerial focus results in these firms failing to adequately invest in R&D and other core competency drivers.
- Most LBOs have been completed in mature industries where stable cash flows are possible.

# RESTRUCTURING OUTCOMES

- Short-term outcomes
  - Reduced labour and debt costs
  - Emphasis on strategic controls
- Long-term outcomes
  - Loss of human capital
  - Higher or lower performance
  - Higher risk