Doing deals — a case for building a business empire, really?

BY ALBERT LEE

The world of deal making is always perceived as exciting, what with the thrill of the chase and the media headlines that come with it. When asked, many CEOs say that merger and acquisition (M&A) sits high on their agenda and at times, keeps them awake.

With the Dow Jones and Bursa Malaysia trading at historical highs since the 2008 global financial crisis, one cannot help but wonder if the good times could be just around the corner. Global deal indicators in 1Q2013 surged 11% from 1Q2012 and grew 15% in the last 12 months (Intralinks Deal Flow Indicator, Mergermarket, 1Q2013).

In good times, deal making can seem to do no wrong. The market always loves a good story and a big deal, fuelled sometimes by a hodge-podge of reasons endorsing "the whole is greater than the sum of its parts" view. M&A is often seen as a strategic and quick way to build a business empire, but is it really so?

The AOL-Time Warner merger at the turn of this millennium was the largest merger (US$360 billion valuation) in corporate history. The strategic rationale to merge a successful "brick and mortar" content provider, Time Warner, and a leading edge Internet communication company, AOL (remember, this was during the dotcom boom), was to create a media behemoth that would dominate the new economy for years to come.

One year after, the merged entity recorded US$99 billion in losses and a 97% decrease in shareholder value, along with countless job losses and the decimation of its employees' retirement funds.

At the outset, the parties involved knew that combining two large companies wasn't going to be easy. Steve Case, founder of AOL, admitted, "It was a good idea, but the execution of it wasn't what it needed to be". Dick Parson, former Time Warner president, added, "Life was going to be different going forward given the very different cultures, but I underestimated how different".

The strategic rationale behind this deal appeared sound but failure to execute trumped the intentions behind the deal.

Interestingly, the merged entity also wrote off US$100 billion of goodwill from its balance sheet. Which raises the question, did the largest deal in corporate history suffer from an overly optimistic view of the expected synergies, which led to an unrealistic valuation at the very outset?

Fast forward to 2002, post dotcom bubble: Hewlett-Packard (HP) announced the acquisition of Compaq. The idea was to merge two ailing computer makers and create a larger and financially stronger personal computer (PC) business.

From day one of the merger, HP was able to swiftly integrate the two PC operations and businesses, and eliminate redundant capacity. Two years on, the combined PC business did turn profitable, and generated US$210 million operating profits against its revenue of US$24 billion globally (a margin of 0.9% of sales).

So it seems that the strategic rationale was sound and the execution was a reasonable success.

But how much did HP shareholders have to pay for acquiring Compaq? The acquisition cost HP shareholders a whopping US$24 billion, in exchange for a Compaq PC business with anaemic profits in a fiercely competitive product segment. A decade later, HP had to write off US$1.2 billion from its balance sheet related to the Compaq brand, practically rendering the brand worthless.

Both cases share the tragedy of overpaying. KKR co-founder Henry Kravis famously said, "Don't congratulate us when we buy a company, congratulate us when we sell it. Because any fool can overpay and buy a company, as long as money will last to buy it."

The Cisco story

Since 1993, Cisco, a Fortune 500 company, has been embarking on an aggressive M&A strategy. From 2008 to 2013 alone, Cisco acquired 38 companies with a total deal value of US$15.3 billion. Cisco's earnings per share grew 14% from 2008 to 2012 and revenue grew 16% over the same period.

Cisco is known for its disciplined M&A approach. Mike Volpi, Cisco's then chief strategy officer, said the company's strength was its global distribution network. Its M&A strategy then was to acquire companies with product portfolios complementary to Cisco's, enabling it to quickly integrate into the market and push new products to customers.

To quote Mike, "The first and perhaps most important principle of a scalable and repeatable M&A is that an acquisition is not an event but a process. Companies are like human beings. When trained in a given discipline, they perform incredibly well."

Many M&As fail to realise their intended synergies. Cisco seems to have achieved a sustained period of revenue and earnings growth even while pursuing an aggressive M&A strategy with a disciplined approach.

Enduring debates will continue on why some M&As failed and others succeed. The fact remains that doing deals can be complex, and failure is expensive. We believe any successful deals needs three key elements:

1. Sound strategic rationale;
2. Don't overpay; and
3. Post-deal execution.

Sound strategic rationale: The danger of strategic rationale is that it can become a bias, and blind senior management when the due diligence throws up conflicting evidence. Due diligence must never be a self-serving exercise to "rationalise" or rubber-stamp a deal. It should be an objective and cold hard look at the historical results and prospective potentials of the business to be acquired instead.

Don't overpay: Emotion and intuition are powerful forces, but one must have the discipline to walk away if the price is not right or if there is a lack of justification on value. Business building from the ground up takes time and effort. One should not think that doing deals would be any easier and then risk destroying a business that took years to build with an expensive M&A blunder.

Post-deal execution: Fundamentally, companies are not created to be bought or integrated. Buyers must be committed to execution post-deal to realise any intended synergies rapidly. As the euphoria fades after the closing, it all boils down to execution to generate the returns. And we have seen that integration can be a challenge when two organisations have conflicting cultures, structures and processes. A sound integrating process must be put in place. But equally important, buyers must have the tenacity to see it through.

So, are doing deals the case for building a business empire?

One should then take it a step further and ask, "Is empire building the ultimate goal of a business?" There are other equally important objectives to ponder — building sustainable competitive advantage, preserving shareholders' value and upholding corporate social responsibilities, to name a few.

At the end of the day, doing deals is one way of achieving an organisation's goal but it should never be the case of the tail wagging the dog. E

Albert Lee is executive director in PwC's Transaction Services team. This is the first of six fortnightly articles by PwC Malaysia's Advisory practice. This series looks at how businesses can manage change amid uncertainties by strengthening fundamentals and planning ahead. The next article will look at intangibles as key differentiating factors in the value of a company.