How acquisitions lead to success

By Chuck Green

Given the increase of mergers and acquisitions over the last several years in various industries, Chris Nelson, president of Mixtec Group, a Pasadena, CA-based consultant, believes Wal-Mart really started something. "I think there are several reasons for the recent trend of mergers and acquisitions, but for every action there is a reaction, and Wal-Mart is the driving force. They caused consolidation over the last ten years in the retail market, and now you are seeing huge consolidations in foodservice; everyone is buying everyone," Nelson says. "All of the sudden, these large customers want to deal with people who are of equal size and scope and can give them national

distribution, food safety, and a year-round supply of inventory."

One example is in the fresh-cut salad business, where in 2004, Ready Pac Produce, Inc., a receiver and repacker of fresh-cut produce, merged with Tanimura & Antle, Inc. (T&A), a grower and shipper of fresh-cuts. "Ready Pac was in distribution in 50 percent of the U.S. and up against the Doles and Fresh Expresses that had national distribution and facilities around the country," explains Nelson. "So Ready Pac merged with T & A to form a more competitive entity."

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MOTIVATING FACTORS

Among the current motivators prompting a merger or acquisition is the pressure on businesses to rethink their ability to get the capital required to add equipment or introduce new products or technologies, according to Allen Vangelos, a consultant for Novelle Consulting, LLC, Laguna Beach, CA, which specializes in serving the produce industry. "That is triggering many mergers and acquisitions to bring equity partners into their businesses to help address some of those issues," he says.

Vangelos thinks the industry overall is looking to narrow margins. "Obviously, in looking at narrower margins, the inclination is to look at 'How do we drive margins upward? What is our overhead and how do we reduce it?' Well, it is a question of commodity versus successful value-added business and a decreasing number of key customers to sell to," he says. "With an increased asset base through merger or acquisition, you might achieve better margins." Vangelos also points to the elimination of duplicate services, plants, and facilities.

Only a small percentage of businesses in general pass to the third generation successfully. "Agriculture has always been a family-based business. You are seeing more and more of them [merging] because third generations do not have quite the entrepreneurial spirit of the first and second generations," explains Nelson. "Also, I think some of what we are seeing in mergers and acquisitions is that companies have run up against [the limits of] their skill sets and their inherent weaknesses versus the competition. Therefore, they are forced to sell out."

MEASURING SUCCESS

One way to execute the merger and acquisition process successfully is to ascertain the compatibility of business partners and evaluate whether they share a common business philosophy. "If they do not, the process will struggle. You have to start with a commonality and a vision for this new venture to have a fighting chance," explains Vangelos. "It takes two strong-willed people trying to come together to solve these issues."

One of the most challenging aspects of a merger/acquisition is integration management, or matching up company cultures. According to Nelson, it is essential to ensure that the cultures are compatible. "Integration is all about people in support of the key drivers of your business,"

he says. "It is a talent-based business; otherwise we are selling commodities."

It is important to define success prior to executing a merger. "You have to understand the elements of how you are going to measure success before you establish the new entity," says Vangelos. "Otherwise, without a good roadmap, you are doomed to stumble along and let egos get in the way."

When success is defined in advance, it is important to lay down a timeframe. "You need a strong vision of what you are trying to accomplish and a timeline to get that done. Due diligence and planning is going to eliminate a lot of speed bumps in that first year," says Nelson.

THE IMPORTANCE OF DUE DILIGENCE

Accurate due diligence is key to measuring success. "Above all the financial resources and other assets brought to it, it comes down to how well the group who conducted the due diligence thought out the people component," says Vangelos. "Because as automated and sophisticated as we are, the process is still going to be driven by people."

According to Anju Seth, professor of business administration at the University of Illinois at Urbana-Champaign, if you are the bidder, using detailed data to substantiate your determination of the value of the target firm or the ability of the acquiring firm to finance the acquisition is the catalyst for conducting due diligence effectively during a merger or acquisition.

"In the due diligence stage, both sides look deeply into the validity of the assumptions that went into the preliminary or first stage evaluation. In other words, you are examining the logic of those assumptions," says Seth. "Would you make the same assumptions given the new data you have after digging deeper into the company's background? I think of it as a stage of trying to assess the validity of the assumptions in an evaluation of the merits of the deal."

The top steps in the basic due diligence process can vary depending on the type of business involved and the strategic objective that drives the acquisition. "For instance, if you are acquiring a branded products company, you primarily would be concerned about the factors driving market share and how those might change," explains Seth.

KEEPING A TIMELINE

Vangelos thinks a timeframe has a great internal use, because it forces people to work against a goal. "You need to have

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Opposing Views

The Hewlett-Packard and Compaq companies conducted a thorough investigation of potential synergies prior to their merger. However, according to Anju Seth, professor of strategic management at the University of Illinois at Urbana-Champaign, "The chief executive officers (CEOs) of the two companies just did not listen to what their own business division heads were telling them: that realizing these synergies would be an extremely difficult exercise."

Citing the considerable integration risks and arguing that Hewlett-Packard could create more value as a stand-alone company than in combination with Compaq, the merger was "bitterly opposed" by the families of the founders of Hewlett-Packard, who jointly held 18 percent of the company's shares.

Hewlett-Packard's top management projected that the merger would enable the combined company to compete more effectively with IBM and yield $2.5 billion in cost synergies by mid-2004. "The CEOs created integration teams, who made detailed plans in advance of the actual merger but then appeared to downplay the significance of the implementation difficulties that were raised by the teams," explains Seth.

In the end, although shareholders of both Hewlett-Packard and Compaq were skeptical (the firms' stock prices fell around 20 percent and 10 percent respectively on the initial merger announcement), the merger was approved by a narrow 51.4 percent margin. On May 5, 2003, after a bitter eight-month proxy fight and a disruptive boardroom squabble, Hewlett-Packard completed its purchase of Compaq for $25 billion.

Less than two years later, however, CEO Carly Fiorina was forced out by the board after the merger did not yield the profits or shareholder returns that she promised. "It is still an open question: Is the company worth more combined than separately?" asks Seth. "For many years, the profitable printer business has been subsidizing money-losing divisions so that shedding divisions may well be warranted."

performance timelines clearly established, describing the steps required to realize success," he says. "You need a timeline so you can see what the scorecard looks like in six months, a year, and beyond."

skill sets to run a $1 billion company than it does a $100 million company. You cannot just work harder; you have to work smarter," says Nelson. "Some of the things that got you to where you were successful

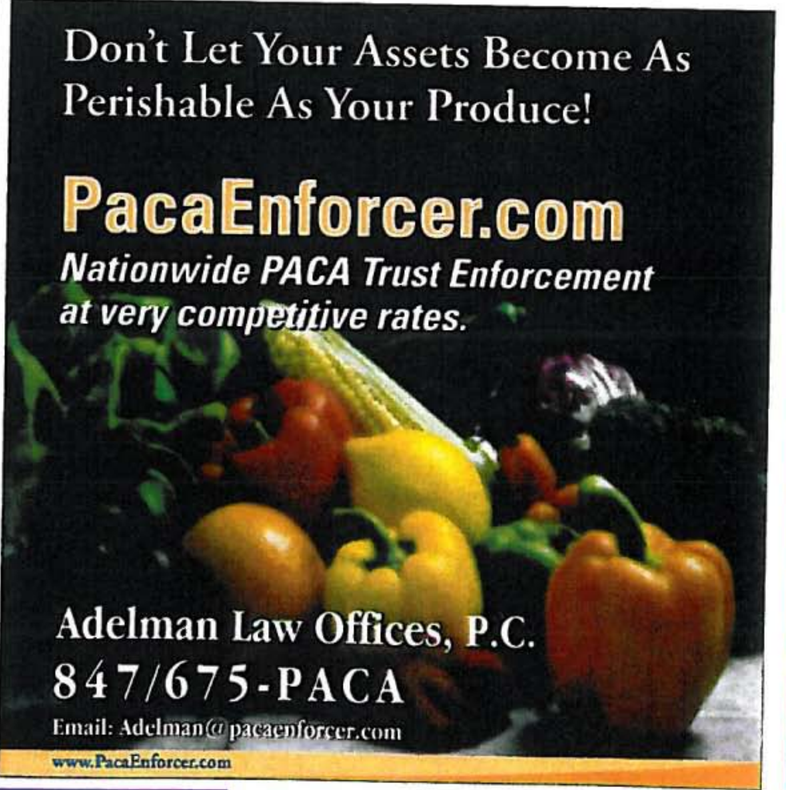
It is important to have an exit strategy in the event that a merger/acquisition is not successful by a certain date.

Vangelos does not subscribe to the idea that measuring the success of an acquisition is essentially the same as measuring the success of two businesses prior to an acquisition. "You had to have a reason for wanting to merge," Vangelos says.

Nelson agrees that the measurements vary among companies. "It takes different

as a small company need to go by the wayside in a larger one."

Vangelos says the financial aspect, as well as the recognition of what you want to accomplish, brand sales, new products, and cost efficiencies, are top quantitative measures for evaluating the success of a merger. "You also have to look at the personality of companies coming together. A lot depends on the



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Due Diligence is Critical

Faulty strategic planning and inadequate due diligence in its acquisition of Snapple cost Quaker somewhere between $1 billion to $1.5 billion, according to Anju Seth, professor of business administration at the University of Illinois at Urbana-Champaign. Quaker acquired Snapple in December 1994 for $1.7 billion, representing a premium of 28.6 times earnings. "Quaker's initial plan was to exploit the seemingly straightforward synergies between Snapple and Gatorade, its sporting drink success," explains Seth.

However, serious difficulties emerged in the first few months, as Quaker belatedly discovered that Snapple's manufacturing processes were extremely inefficient, and problems surfaced with outdated raw-material inventories. "Most critical, however, was the inability to realize synergies from integrating the distribution systems in the face of strong opposition from Snapple distributors, who realized considerably higher margins from Snapple than they would with Gatorade," Seth says.

All these issues could have been foreseen with better due diligence before the acquisition. Snapple was ultimately sold to Triarc Company for $300 million in 1997, and PepsiCo eventually acquired Quaker in December 2000 for $13.4 billion in stock. Seth says, "As has been often noted, bad bidders in acquisitions frequently make good targets."

dynamics of companies to know which of those points might be more prominent than others," he says.

To Nelson, quantifying the success of a merger or acquisition has much to do with whether a company survives through the first year and continues to grow. "Grow your top line, grow your bottom line, and retain good people while absorbing a new culture, and I think you have been a success," he says. "That takes lot of planning and hard work."

It is also important to examine the financial statements, but do not just look at profit/loss statements and balance sheets. "You also want to construct accurate prior years' cash flows," notes Seth. "The objective is to understand the business model of the target firm, consider how the business model is likely to change under the management of the acquiring firm, and make realistic projections of profit potential down the road."

Business Case in Point

Evaluate the Need

The TimeWarner/America Online (AOL) merger was expected to generate synergies by distributing Time Warner's films and music over AOL's global Internet network. According to Anju Seth, professor of strategic management at the University of Illinois at Urbana-Champaign, this very logic was flawed. "Why undertake a costly and risky merger to undertake a venture that could be achieved with a strategic alliance?" Seth asks.

Further, realization of any potential synergies was hampered by a culture clash between AOL's "new media" executives and their more traditional counterparts at Time Warner. Exacerbating the situation was the collapse of the dot.com boom and the steep decline in cable valuations. "Even when the Internet revived, Time Warner managers—who ultimately ran the company—seemed unable to manage the 'new media assets' to exploit their potential for generating cash flows," explains Seth.

PLANNING AHEAD

It is important to have an exit strategy in the event that a merger/acquisition is not successful by a certain date. "If the thing is not working after a certain time, there is an exit plan so you can cut your losses," explains Vangelos. "If you decide to liquidate part of the company without such a plan, you keep spending money and trying to figure out a cure for it and keep hoping next year will be better."

Nelson notes that the issue is not unusual in the produce business, where people buy a produce company and find out produce is not scaleable. However, a successful merger/acquisition is no reason to believe it will go just as well the second time. "I look back at some companies who practiced that and found out two years down road, they were diluting their management and resources so much that they were not paying any more attention to their core business," explains Vangelos. "Twenty years ago, everyone thought acquisitions were the way to go. The way you grow a company was just buy, buy, buy. They found out (as others have) that it takes time, people, and effort to run all those things."

Chuck Green is a freelance writer based in Atlanta, GA. His work has appeared in the *Chicago Tribune, Los Angeles Times, Wall Street Journal, Real Estate Journal, Washington Post,* and other business publications.

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