

Pottinger
PERSPECTIVES



**THE SEVEN DEADLY
SINS OF M&A**



Many of the world's largest and most successful businesses have been built by mergers and acquisitions. From Sinopec to Facebook, Pfizer to Mizuho, Time Warner to Unilever, M&A has been a crucial contributor to the success of each business. But of course the reverse is also true – some of the world's largest and most disastrous corporate failures have been brought about by ill-conceived, ill-timed, or poorly executed transactions.

Chroniclers are fond of reminding us that history repeats itself. This seems as true in the corporate world as anywhere else, no doubt because many of the lessons of recent events are so often ignored. With the world economy already a decade into the low growth era, boards and executive teams are under more pressure than ever to buy their way out of the financial doldrums. Meanwhile the cost of debt is at 5000 year lows, and equity markets are not far from all-time highs, making both transformational and catastrophic acquisitions easier than ever to finance.

With these exceptionally difficult choices in mind, we've looked back over the last thirty years of M&A to identify the root causes of the more epic disasters. These are the Seven Deadly Sins of M&A: the warning signs that boards, CEOs and advisors can and must look out for in the year ahead. And, as a cautionary note, we observe that the companies and the CEOs that led them

into the wrong battles are much better remembered than the advisors who cheered them on from the sidelines.

"The evil that men do lives after them; The good is oft interred with their bones." So spoke Anthony of Julius Caesar. The sins of mortals are well understood – they have been reflected in histories and mythologies for thousands of years. No matter how much social mores or the cultural fabric into which they are woven may have changed, the frailties of the human condition are as relevant today as they were in the age of Shakespeare.

And so it is with M&A. Though the lessons painful, they are important. Consolidation and the pursuit of the right type of scale remain essential for most business who seek to increase efficiency, reduce costs and unlock stronger long term growth. Of course there is much more to the examples below than we have time to address – none the less, they serve as powerful examples of

what can go wrong when the trigger is pulled on the wrong deal.

Envy: The grass is always greener

Beware over-reaching!

Make sure that you do what is right for you, rather than simply mimicking what others have done. Major leaps into adjacent or alluring industries have destroyed huge amounts of value time and again, as risks were not understood. With many leading businesses having already achieved very strong market positions in their home markets and traditional business segments, the temptations of other activities that lie up or down the value chain, or are temptingly close to the core business, can only increase. This may be all the more true where growth or margins in your traditional business are coming under pressure.

Meanwhile the forces of disruption – the *mot du jour* in 2016 – are ever greater, needling large and successful companies



to attempt to outthink or outspend younger, nimbler and crazier competitors. These businesses arguably have much less to lose, making experimentation and innovation (largely financed by other people's money) much easier to justify.

One of the critical lessons of the last twenty years is that imagination – or re-imagination – has differentiated some of the most successful businesses from their competitors. But the line between art and folly is a fine one. It's essential to be mindful of the benefits to your core and non-core

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businesses. Focus too much on spreading your wings and you could deprive the engine room of the fuel it needs to run efficiently. Focus too much on the immediate future, and your cash cows never give birth to the milkers of the future.

The AOL/Time Warner transaction is a case in point, setting both companies back a decade. At the time, AOL was one of the leading companies in the dot-com boom. It was thus a compelling merger partner for Time Warner, which had failed to establish a significant presence online. However, a combination of a poor integration between the companies and poor timing caused

US\$99bn of goodwill to be written off within two years. Time Warner's envy of the success of a much younger business clouded its judgement and led to one of the biggest corporate disasters of all time.

Pride: The final step before you fall

Don't believe too much in your own infallibility!

Many, many serial acquirors have eventually come unstuck through remaining loyal to strategic thinking that didn't evolve, or simply believing that they had the magic

touch when it came to choosing targets and closing transactions. And it seems almost inevitable that the more acquisitive businesses will eventually make mistakes, though hopefully these will be on smaller transactions.

HSBC's 2002 acquisition of Household International marks a rare blemish on an otherwise long and successful track record of timely acquisitions. Over the previous 20 years, HSBC had closed a series of strategically critical transactions on excellent terms. This had included acquiring the UK's Midland Bank – one of the UK's leading banks – for a song in the early 1990s at the

back end of a recession in the UK. This positioned HSBC overnight as one of the world's most significant and internationally diversified banks, and allowed a neat pivot of its global head office from Hong Kong to London.

A decade later, it snatched leading French bank CCF from under ING's nose in 2000. This followed what can best be described as an accidentally hostile bid by the Dutch company, who had been a minority shareholder in CCF for some years. Both were strategically critical transactions, justifying the willingness to pay up (where this was needed) in order to make a major leap in markets where HSBC had previously had only a modest presence.

Then, in 2002, HSBC flew off-piste and acquired Household International, a large US sub-prime lender for US\$16bn – HSBC's largest ever acquisition. By 2009, it had written off the entire investment. As Michael Geoghegan, HSBC CEO said, with glorious British understatement, "This is an acquisition we wish we had not undertaken".

Much, much worse, however, was that HSBC's hands were strategically tied during the financial crisis, and it missed the best opportunity in 100 years to acquire a leading US financial institution on highly attractive terms.

Greed: The long term starts tomorrow

Don't pursue a transaction solely for short term ends!



Nearly every major company is surrounded by investment bankers who spend most of their waking hours trying to figure out how to persuade one company to buy another, motivated by the short term lure of year-end bonuses, or pressure to perform simply to keep their jobs.

All too often opportunistic acquisitions of this nature prove to be anything but. Once the shine wears off the newly minted

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subsidiary, the underlying business often erodes rapidly, leaving you with little to show for the investment of time and money, and validating once again the old adage *caveat emptor* – buyer beware!

It’s much more effective to identify very clearly where you want to end up strategically, and what acquisitions may get you there. This allows you to focus energy and firepower on the deals that unlock significant opportunities and which will stand the test of time – and to avoid all the others.

Quaker Oats paid US\$1.7bn for Snapple in 1994, despite numerous warnings that this substantially overvalued the company. At the time, Snapple products were flying off the shelf following an extremely successful advertising campaign. Quaker saw an opportunity to leverage public perception

about the product, as well as its relationships with larger retailers, to create significant additional value. However, a poor advertising campaign, along with an influx of competing products from Coca-Cola and Pepsi, eroded market share and led to a loss of US\$1.4bn within 27 months.

Snapple was a hot brand, and the deal was superficially attractive. Indeed, perhaps in other circumstances, the transaction might

have worked out much better for the acquirer. Either way, Quaker Oats was not prepared for what surely were predictable downside scenarios (new products and increased competition from obvious competitors), and suffered accordingly.

Lust: If it walks like a duck...

Pay attention to the due diligence!

No matter how enamoured you are with a particular target, don’t allow enthusiasm for the deal to blind you to risks identified in due diligence. If you find bad news, dig deeper to find out if there is more. No matter how alluring the corporate bauble in question, pay someone you trust to answer the question: “*What could go wrong?*” – and then heed their advice.

Indeed Warren Buffet has urged acquirers

to hire a second advisor and incentivise them to argue the case for not doing the deal. And as he said in an essay in Time Magazine in 2014: “*Focus on the future productivity of the asset you are considering. If you don’t feel comfortable making a rough estimate of the asset’s future earnings, just forget it and move on*”. Investment outperformance really can be that simple.

It’s time for HP to take a bow in the M&A hall of shame. Its acquisition of Autonomy for US\$11.7bn in 2011 has all the hallmarks of a transaction born out of pure, unadulterated determination to own one of the sexiest businesses of the year. With big data and analytics all the rage, and surrounded by a phalanx of advisors, HP allegedly raced through its due diligence and cemented a deal at a massive valuation.

As Wikipedia puts it: “*The deal valued Autonomy at US\$11.7 billion (£7.4 billion) with a premium of around 79% over market price that was widely criticised as ‘absurdly high’, a ‘botched strategy shift’ and a ‘chaotic’ attempt to rapidly reposition HP and enhance earnings by expanding the high-margin software services sector.*”

This is one side of the story. The other is that HP sued Autonomy founder Michael Lynch and others for \$5bn, the largest ever claim against an individual in UK legal history. Lynch’s response: “*After three years of Meg Whitman’s stonewalling, is this it? HP’s claim is finally laid bare for what it is: a desperate search for a scapegoat for its own errors and incompetence*”.

The case, as they say, continues, with a trial in London scheduled for 2018.



Gluttony: Just another wafer thin mint?

Beware the deal to end all deals!

With this much corporate excess in the frame, it's hard to ignore Monty Python's Mr Creosote, who finally explodes from consumption of a single, "wafer thin" mint at the end of a stupendous dinner.

The pursuit of scale for scale's sake has led to some of the most dramatically successful transactions of all time (for the bankers, at least), but the worst imaginable outcomes for shareholders. No matter what the size, these transactions are the final step too far – leaving the buyer with much worse than indigestion after the inevitably lavish closing dinner.

Here, of course, the ultimate prize must go to RBS for its part in the cataclysmic acquisition of ABN Amro. After a series of successful acquisitions in the UK, not least the hostile reverse takeover of leading UK bank NatWest for £21bn in 2000, RBS completed its ill-fated acquisition in October 2007. The company was itself the result of some 250 years of M&A, dating back to 1765, so it was no stranger to large transactions, and its CEO "Fred the Shred" (Fred Goodwin) had a reputation as one of the toughest and most rapacious deal doers of that time.

The story is an intricate one. During 2006, both Barclays and RBS had courted ABN Amro in what would be the largest financial services M&A deal in history, and one of the most complex given the many jurisdictions involved. News of Barclays' interest finally leaked into the public domain in March 2007, and Barclays confirmed that it had proposed a €6bn transaction, with consideration to be paid primarily in shares.

This catalysed RBS to act – and to act quickly. Following hastily convened discussions in Geneva, the terms of the

consortium bid were agreed between RBS, Fortis and Banco Santander. ABN Amro was advised, with a public announcement of the €2bn+ deal a few days later, modestly higher than the all share bid by Barclays. Approximately 80% of the consideration was to be paid in cash, meaning that the bidder was hugely exposed to any potential downturn in bank valuations as the year progressed. Remember that this was right at the peak of the asset price bubble, just months before the TED spread canary began to sing (highlighting rapid increases in the perceived risk of lending to banks).

Before the transaction had closed, UK bank Northern Rock suffered a run on deposits and was forced to seek emergency funding from the Bank of England. By the time RBS held the keys to ABN Amro, the enormous challenges it faced – and its lack of preparedness to address them – was becoming clear. Within 12 months, RBS was facing ruin. As The Economist commented (with somewhat glib hindsight) *"Having built a reputation for skilfully taking over flabby rivals and surgically cutting costs, RBS's management team dived into the ABN AMRO transaction with its eyes shut tight"*.

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Unusually, the bidder was a three way consortium led by RBS and including Fortis and Banco Santander. Fortis was to acquire the Benelux businesses (for €4bn), Santander would acquire the Brazilian and Italian activities (€0bn), and RBS would acquire the US banking operations (including LaSalle, the jewel in the crown) and ABN Amro's global wholesale banking activities, as well as various retail businesses in the Middle East and Asia, and a struggling London-based investment banking business for a total of €7bn (or €6bn net of the proceeds from the LaSalle sale).

In parallel with all this, ABN Amro announced that it had agreed to sell LaSalle to Bank of America for €1 billion, stripping RBS of one of the key elements of the business that it was hoping to acquire.

Of course all these numbers don't quite make sense. How could a \$16bn acquisition bring down a bank as big as RBS, particularly after it had raised £12bn in a rights issue completed in June 2008 to attempt to prop the company up as the financial crisis unfolded. In its enthusiasm to close the deal, and beat Barclays to the prize, RBS had proceeded with the transaction despite having had minimal access to undertake due diligence. Indeed the UK's Financial Services Authority subsequently described the entire due diligence disclosure material as amounting to just *"two lever-arch files and a CD-ROM"*.

Worse, the subsequent investigation by the UK's Financial Services Authority revealed that RBS had already been chronically undercapitalised, and that this was further



Lehman Brothers Times Square by David Shankbone

exacerbated by the acquisition.

“Only £2.3bn of core tier 1 capital was held to cover potential trading losses which might result from assets carried at around £470bn on the firm’s balance sheet. In fact, in 2008, losses of £12.2bn arose in the credit trading area alone (a subset of total trading book assets). A regime which inadequately evaluated trading book risks was, therefore, fundamental to RBS’s failure. This inadequacy was particularly significant for RBS, given that the purchase of ABN AMRO significantly increased RBS’s trading book assets”.

A little more than a decade after the Barings fiasco, another British financial icon

Creosote, and a rather gleeful waiter quietly collecting the bill. And so it was with the ABN Amro deal. With advisory fees from the initial acquisition, underwriting fees on the subsequent rescue rights issue, and a series of bond issues, this was quite possibly the most remunerative deal of all time.

Wrath: “Anger is never without a reason, but seldom with a good one”

We could write here of the anger of shareholders in the aftermath of a disastrous transaction. But this would be unrepresentative, as most investors spend more time looking forward rather than dwelling on the pain of past mistakes.

happening, enraged by the very idea that the organisation’s impending demise might have anything to do with them. The largest of all time was the US\$600bn failure of Lehman during the financial crisis, but there have been many others, large and small, over the years.

On 15th September 2008, Lehman Brothers filed for bankruptcy protection. One notable aspect of the collapse was the anger and arrogant disregard of Lehman’s CEO Dick Fuld. Just a couple of months previously, Lehman had announced its first negative quarter in fourteen years, losing US\$2.8bn. Fuld’s response to the possibility of his resignation and a reshuffle of the board and management was: *“I’ve given you fourteen years of earnings. I have one bad quarter. This is how you respond?”.*

Given the spectacular fall from grace which followed so rapidly, it is no surprise that this story has spawned many books, not to mention the odd movie or two. With this type of defensive, self-centred anger clouding Fuld’s judgement, it is little wonder that attempts to rescue the bank proved challenging and, in the end, unsuccessful.

Sloth: Make the hard decisions now

Don’t get too excited about closing the deal!

The day that a transaction completes is always an exciting one (well, perhaps not for RBS). But for the buyer more importantly it marks the beginning of the long, arduous progress of integration and delivering all the cost savings and revenue gains that will unlock value for shareholders. These plans should be established and thoroughly tested before ever a deal is inked, but as we have seen with the RBS example above, this is not always the case.

Time and again, I hear about companies

“I’ve given you fourteen years of earnings. I have one bad quarter. This is how you respond?”.

lay in ruins, and RBS eventually had to be bailed out by the UK Government, which ended up owning a majority stake, effectively nationalising the business.

Similarly, both ABN Amro and Fortis were nationalised by the Dutch Government in September 2008. Meanwhile, Santander emerged more or less unscathed. It on-sold the Italian business relatively quickly, retaining the Brazilian bank, and was able to acquire Britain’s Alliance & Leicester shortly thereafter, consolidating its position in the UK.

Did Barclays dodge a bullet? Whether this was achieved by luck or judgment is a moot point. Either way, it is possibly one of the greatest corporate escapes of all time.

Finally, pause for a moment and consider the investment bankers. The Monty Python sketch ends with a dismembered Mr

Much more important is the need to remain absolutely objective when the environment around you shifts, no matter how difficult this may be to do.

“If you can keep your head when all about you are losing theirs and blaming it on you...”

Great businesses have been destroyed by getting caught up in the moment – by letting anger take a hold when the cards were stacked against them. It’s the equivalent of sporting teams failing to harness the positive power of fight on the field of play. When time, the scoreboard and the referee’s decisions have you backed into a corner, and the blood is boiling, it’s all too easy to let anger get the better of you.

There are numerous examples of companies heading towards failure, whose leaders could not (or simply would not) accept responsibility for what was



Monthly Pythons The Meaning of Life Mr Creosote Sketch

that want to save time and money by not looking thoroughly at the whole landscape of opportunities in front of them. These companies typically do not have a clear strategic destination. As Lewis Carroll once said, *“If you don’t know where you are going, any road will get you there”*.

Potential deals are born of ad hoc, opportunistic conversations, rather than a focus on the best and safest paths for growth. No-one stops to ask whether this is the best possible acquisition that could be made. Due diligence commences without so much as a single workshop to think about where the risks might lie, let alone how those risks might be uncovered.

All this doesn’t just lead to failed acquisitions (although the failures have been spectacular). It also leads to failures to make acquisitions that would be transformative for the companies in question. If the strategic importance is not clear, or the nature of likely risks is not well thought through, it is all too easy for boards and management to get spooked when uncomfortable information emerges in due diligence.

And no matter how carefully prepared the integration plans may be, unforeseen circumstances will often arise that appear to stand in your way. When they do, it’s critical to remember that it’s usually easier to make the hard decisions sooner rather than later.

In 2001, Suncorp, a substantial Australian bancassurance business, agreed to buy GIO, one of its major rivals in general insurance. Both organisations had core general insurance platforms, but following the deal, management couldn’t agree which one to

keep. Meanwhile as a knock-on aspect of the original transaction, Suncorp also acquired insurance joint ventures with three of Australia’s motor clubs. These two each had their own insurance systems.

Time rolled by, and all the platforms were retained. This added incremental cost and complexity in all sorts of ways. Eventually, as the third ranked business in a country where duopolies have flourished, Suncorp needed to participate further in consolidation, and proposed the acquisition of Promina, another leading insurance business which also operated different platforms within its various insurance brands.

This time around, happily, a very clear and deep line was drawn in the Queensland sand, ensuring that there would be extensive consolidation of the many underlying platforms, no matter what challenges emerged following completion of the A\$7.9bn transaction. Unsurprisingly, the cost, complexity and risk of this integration process was enormously greater than if Suncorp had simply chosen one of the two platform options following its acquisition of GIO.

The moral for consolidators? Invest in establishing a strong, flexible and scalable technology platform at an early stage. The near term pain and cost will be outweighed many times by your ability to integrate acquired businesses cheaply and quickly.

So where does this lead us?

The costs of failed M&A transactions are huge. Billions of dollars of shareholder value are destroyed (much of it often representing the retirement assets of ordinary people),

tens of thousands of jobs are lost, and whole communities can be wiped out.

So how can you tell whether the deal in front of you is all that its proponents claim it to be? The failings of the past seem blindingly obvious when viewed with the clarity of retrospective vision. But are these weaknesses really so hard for the board, management or financial advisors to identify at the time? Is it really so difficult to learn from the litany of failed M&A transactions, not to mention the much more successful deals?

My own experience is that, in most cases, it really is not so difficult to tell the better deals from the bad ones. Our firm has had an excellent track record in helping our clients avoid the latter, and we have been involved in far too many situations over the last fifteen years for this to be simple luck. Of course the credit for this must lie with the clients concerned, who have had the courage to hire advisors who may tell them things that they don’t necessarily want to hear, and more importantly have listened to and acted on that advice.

And if you are contemplating M&A, or struggling to figure out where to place your bets in the face of slowing growth and increasing environmental uncertainty, we’d be delighted to help you make the right choices. **P**

Nigel Lake is CEO of Pottinger and author of *The Long Term Starts Tomorrow*. He has previously lived and worked in most of the world’s top thirty economies.

Twitter: @Nigel_Lake

Latest issue from Pottinger Perspectives:



'It's smaller than I thought' -- a common phrase overheard in the presence of Da Vinci's Mona Lisa hanging in the Louvre museum in Paris. A wildly undeserving observation, however, when thinking about the impact of the painting and its meticulous execution. Likewise with successful joint ventures.

Joint ventures can be an efficient way to add scale, avoid the risk of an outright acquisition, enter new markets and create new business relationships. But they also bring huge risks and uncertainties when undertaken in the dark. If would-be partners don't think through strategy and execution carefully in advance, they are more likely to destroy value rather than create it. Small partnerships can create disproportionately large and painful problems, whilst large ones frequently fail to create much value at all.

<http://www.pottinger.com/mona-lisarsquos-smile-the-art-of-creating-a-happy-joint-venture.html>

About Pottinger

Pottinger is a multiple award-winning strategic and financial advisory firm.

We de-risk M&A transactions and strategic transformations by integrating strategic insight, transaction expertise and data analytics, enabling leaders to make decisions that stand the test of time.

We work with clients who are ready to think differently and act differently. Our assignments typically relate to one or more of:

- Strategy and public policy
- Mergers and acquisitions
- Partnerships and joint ventures
- Restructuring and capital advice
- Risk, sustainability and related decision-making

Together our team has advised on over 200 M&A and financing transactions, as well as many significant strategic advisory assignments. Our experience covers most of the world's larger economies, and we enjoy the complexity of assignments that extend across borders and cultures.

We are regarded as an industry leader in productivity and as a role model for investment in our people. We have been recognised by the Australian Government's Workforce and Productivity Agency as a benchmark for effective skills development and for seven consecutive years we have been awarded "Recommended Employer" by the Australian Business Awards.



Cassandra Kelly
Chair



Nigel Lake
CEO

For further information, please contact us:

e cassandra.kelly@pottinger.com

e nigel.lake@pottinger.com

p +61 2 9225 8000

w pottinger.com