Thomas Straub

Reasons for Frequent Failure in Mergers and Acquisitions
GABLER EDITION WISSENSCHAFT
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A Comprehensive Analysis

With a foreword by Prof. Dr. Dr. José-Carlos Jarillo

Deutscher Universitäts-Verlag
Foreword

This is an important book. The topic is important, and Dr. Straub approaches it with a new approach. In fact, one could say that the book’s importance stems from its lack of disciplinary focus, relying instead on a holistic understanding of the phenomenon. Too often, academic research is pursued within a narrowly defined academic “field”, necessarily blinding researchers to realities whose essence is inter-disciplinary. This is typically the case with research on Mergers & Acquisitions, making most of the “findings” relatively unimportant for practice.

Yet M&A are a crucial part of business development. It is evident that companies’ long-term success is at least partially dependent on their strategic actions. And these are often shaped in practice by merger and acquisition activity. Thus phenomena as varied as globalization, value-chain optimization, or product diversification are often implemented as M&A operations. In no few cases, M&A activity constitutes the company’s strategy. If, as noted above, strategic moves do have an impact on long-term success, it follows that M&A activities are at the core of many business successes… and failures. As such, they play an important role in the development of the whole society: wealth is created (or destroyed) mostly by companies.

Perhaps the most remarkable aspect of the phenomenon is its very high failure rate. Study upon study (well summarized in this book) show value destruction in about two thirds of the operations. And those are not the smallest ones: from America Online/Time Warner to Daimler/Chrysler, literally dozens of billions of euros are routinely destroyed. Why is such an apparently dangerous exercise pursued with ever greater intensity and why, being so crucially important for their companies, do managers fail almost systematically? Evidently, given the sums in play, one feels like asking everybody to stop until these questions are answered.

Straub’s book tries to do just that. He takes a very broad approach, which allows him to look for very different but interrelated conditions necessary for M&A success. Reading his book, it becomes obvious why it is so difficult to succeed: for an
operation to add value, it has to meet many different requirements, in many different areas. It’s enough to have one shortcoming for the whole enterprise to fail.

But Straub’s book also shows, indirectly, why the issue has not been well-covered in the past: since the requirements are in many different areas, they have been studied by scholars from very different traditions, who tend to be ignorant of the other specialties. Since the key for success is the simultaneous satisfaction of all requirements, they necessarily miss the important points.

Thus this study draws from the fields of finance, industrial organization and sociology to try to understand what the conditions for success are. In the end, it is remarkable how important personal considerations are (the desires of top management) in what should be a relatively analytical exercise.

The book is not, of course, a “how to” manual. In the end, the reader will clearly understand why such a book could not exist, given the myriad different situations in which M&A happen, and the importance of specifics. But if the main requirements for success are well understood, the reader will have a deeper understanding of the phenomenon in general, and how to engage in a specific one, should the need arise.

Prof. Dr. Dr. José-Carlos Jarillo
Acknowledgements

This doctoral thesis is the work of several years at the HEC of the University of Geneva. It results from many contributions from a number of individuals to whom my thanks and gratitude are due. I would like to acknowledge especially the assistance of the following people and institutions:

First of all I would like to express my gratitude and big thank to my PhD supervisor Professor José-Carlos Jarillo from the HEC of the University of Geneva for his friendship, his helpful comments, the liberty he gave me and his confidence which enabled me to organize and to make this thesis a coherent and especially an original contribution to the body of literature on the subject of performance determinants of Mergers and Acquisitions. I have particularly benefited from his vast experience knowledge on this subject matter.

I also would like to express my thankfulness and show grateful appreciation to the president of my thesis Professor Gilbert J. B. Probst from the HEC of the University of Geneva for his notable help, his guidance, his incisive comments as well as his faithfulness. Even though I was officially part of the chair of strategic management he integrated me in his team of assistants. His friendship and his moral and encouraging support has been a powerful engine in the progress of my work.

Furthermore, I would like to thank the other members of my dissertation committee, Prof. Bernard Morard from the HEC of the University of Geneva, for his support regarding the statistical part of my work, Prof. Yves Flückiger from the Department Political Economy of the University of Geneva and Prof. Peter Gomez from the University of St Gall, for their valuable critical comments, their advise, their reflexions, as well as for serving on my committee.

I would like to thank Professor Susan Schneider from the University of Geneva, Dr. Jean-Yves Mercier from the ProMan Consulting company in Geneva, Dr. Hans-Jürgen Ott and Christian Ott from Heidelberg for their support and help regarding my questionnaire, Dominique Couturier and Alex Stancu, both from the University of
Geneva for their statistical support, Benoit Lecat and finally Ilse Everts, for her precious advise.

In addition, as my survey was anonymous I do obviously not know the informants around the globe who helped me in filling out my questionnaire. A special thanks also goes to them.

I wish everybody had colleagues like mine. I want to thank Stefano Borzillo, Heidi Armbruster, Achim Schmitt, Eva Simeth, Katty Marmenout, Gaëtan Devins and Patricia Klarner for a great time at the HEC of the University of Geneva as well as to Dr. Sebastian Raisch for his support and very useful advice during the writing of my work. Their huge kindness and the good atmosphere in the group have been a source of strength and joy.

Finally, I convey my sincere thanks to my parents, my family and my friends from Geneva and the rest of the world for their patience and understanding during the course of my thesis.

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1 Introduction

Discussions on the increase in the volume and value of Mergers and Acquisitions (M&As) during the last decade have become commonplace in the economic and business press (Jarillo 2003; Gaughan 2002; Jansen 2001, and Picot 2000). According to an article in the Neue Zürcher Zeitung, the merger-and-acquisition carrousel turned faster in 2005 than at any other time during the last five years (Neue Zürcher Zeitung 2005).

According to the Dealogic research institute in New York, deals worth a total value of US$ 2.04 billion were announced worldwide in the first nine months of 2005. This is 43% more than during the same period in 2004. It seems that more and more companies are merging and thus growing progressively larger. The following figure 1.1 supports this impression.

Figure 1.1: Mergers & Acquisitions 1985-2005

![Figure 1.1: Mergers & Acquisitions 1985-2005](image)

Source: Thomson International Securities and Dealogic

M&As are not regarded as a strategy in themselves, as stated by Hitt et al. (1991), but as an instrument with which to realize management goals and objectives (Jarillo 2003). The terms merger and acquisition are “used interchangeably to mean any transition that transforms one economic unit from two or more previous ones” (Lubatkin & Shriever 1986).
These goals and objectives have, for decades, been of central interest to research on M&A (Trautwein 1990; Brouthers et al. 1998; Reid 1968; Steiner 1975; Jensen and Ruback 1983, and Simon 1964).

A variety of motives have been proposed for M&A activity, including: increasing shareholder wealth (Salter and Weinhold 1979), creating more opportunities for managers (Meeks 1977; Mueller 1969, and Reid 1968), fostering organizational legitimacy, and responding to pressure from the acquisitions service industry (Jemison and Sitkin 1986 and 1986(a)). Among others, Edith Penrose contributed significantly to our understanding of firm-level growth, and corporate diversification strategy (Penrose 1995). According to Grant (2002), she provided a fundamental model of the firm as a collection of firm-specific resources, with diversification being driven by excess capacity in these resources. If resources and capabilities are drivers of corporate strategy, their essential characteristics are that they can be applied across product markets and that they are subject to some form of indivisibility so that the marginal cost of deploying them in an additional application is less than their initial use’s marginal cost. In other words, they are subject to ‘economies of scope’, which is formally defined in terms of ‘sub-additivity’ (Baumol et al. 1982).

In *Competitive Strategy*, Michael Porter’s (1980) work on the tradition of industrial organization, he provided a summary of strategic management objectives (see Bain 1959; Caves 1982, and Spence 1977). The overall objective of strategic management is to understand the conditions under which a firm could obtain superior economic performance (Barney 2002)\(^2\). Eckbo (1983) and Halpern (1973) consequently analyzed efficiency-oriented motives for M&As. Accordingly, the dominant rationale used to explain acquisition activity is that acquiring firms seek higher overall performance (Bergh and Holbein 1997; Hoskisson and Hitt 1990; Sirower 2000, and King et al. 2003).

Despite the inherent goal of performance improvement, results from acquisitions are often disappointing. A strategy of external growth through acquisitions can produce results ranging from outstanding success to dismal failure, as indicated by a number

\(^2\) In the present work the variable M&A performance will represent the company’s owner perspective and exclude other perspectives like social or managerial interests of a deal.
of studies ranging from Dewing’s (1921) pioneering research to the present (Agrawal and Jaffe 2000; Haspeslagh and Jemison 1991; Sirower 2000 and King et al. 2004).

It is thus evident that M&As do not reliably yield the desired financial returns (Jensen and Ruback 1983; Lubatkin 1983; Ravenscraft and Scherer 1987(b); Agrawal et al. 1992 and Loughran, and Vija 1997). Studies by Porter (1987) and Young (1981) also suggested that M&As have a high failure rate. According to these studies, managers of the acquiring firms rated half of all acquisitions as unsatisfactory. Kitching (1974) stated that 47 per cent of acquisitions failed or were not worth undertaking; a survey by Lybrand (1992) indicated that 54 per cent of acquisitions fail; Hunt et al. (1988) suggested a failure rate of 45 per cent. More recently, Sirower (2000) concluded that about 65 per cent of acquisitions fail to benefit the acquiring companies whose shares subsequently underperform in their sector. Child et al. (2001) stated that as many as 50 per cent of acquisitions fail.

Figure 1.2 underlines this tendency.

Figure 1.2: Overview of M&A Failure Rates by Consulting Firms and Scientific Studies

![Figure 1.2: Overview of M&A Failure Rates by Consulting Firms and Scientific Studies](Image)

Source: (Jansen 2002)
Haspeslagh and Jemison (1987, 55) even argued that “nothing can be said or learned about acquisitions in general.” In fact, Barney (1988) concluded that successful bidding firms might simply be “lucky”. Agrawal and Jaffe (2000) also stated that the mixed results are still an unsolved puzzle (King et al. 2003). While this may be partly true, it would be unfortunate if this were the only wisdom we could offer executive teams gambling with shareholder resources, or other stakeholders having to deal with this subject.

1.1 Research Interest

Consequently, there is a recognized need for research to identify a theoretical framework that could help explain acquisition performance (Hitt et al. 1998; King et al. 2003; Hoskisson and Hitt 1994, and Sirower 2000).

Although there is a large body of research on M&A performance, very little research has concentrated on helping us better understand how M&As could be undertaken (Hitt et al. 1998).

What distinguishes the successful cases from the failures? What lessons can be learned? Prior research on acquisitions has only partially addressed the question of why so many well intended and well advised acquisition efforts end in disappointment. It could therefore be useful to focus on M&A performance (Jemison and Sitkin 1986).

Most previous research on M&As³ focused on individual aspects of the acquisition process, such as the motives for or objectives of the acquisition, post-acquisition performance (either stock returns or operating performance), sources of shareholder wealth in the corporate acquisitions process, influences on post-acquisition integration, and others. Sirower (2000, 13) stated that “despite a decade of research, empirically based academic literature can offer managers no clear understanding of

how to maximize the probability of success in acquisition programs”. Previous studies have investigated corporate acquisition issues within uni-dimensional frameworks, i.e. one issue at a time. In order to pursue more rigorous and practical studies in future, it is necessary to take a comprehensive viewpoint that includes the most critical corporate acquisition issues in a multi-dimensional, comprehensive framework.

Generally, the reasons for the failure of prior strategic management research on M&A activity can be clustered into three fields: the acquiring firm may select the wrong target\(^4\) (*strategic logic*), the target firm may be poorly integrated\(^5\) (*integration*) and the acquiring firm may pay too much (*price*) (Hayward 2002; see also Gilson and Black 1995; Haspeslagh and Jemison 1991, and Eccles et al. 1999).

In fact, one can find as many published studies that have a positive conclusion regarding the impact of a good ‘strategic fit’ on M&A performance (Lubatkin and Srinivasan 1987; Chatterjee 1986, and Elgers and Clark 1980) as those that do not (Singh and Montgomery 1988 and Shelton 1988). However, Jemison and Sitkin (1986 and 1986(a)) stated that empirical research concerning the impact of M&A Integration on M&A performance is notably lacking. Furthermore, Ravenscraft and Scherer (1987(b)) revealed that an important reason for the bad post-takeover returns was the write-up of asset values stemming from the payment of high acquisition premiums. Following the same stream of argument, Salter and Weinhold (1979) argued that acquirers frequently overestimate the target’s value, while underestimating the costs of realizing synergies, and therefore pay too much.

Consequently, it could be useful to regard strategic logic (i.e. strategic management) as a necessary (but not sufficient) condition for M&A success, and consider integration (i.e. organizational behavior) and an appropriate price (i.e. finance school) as important complementary issues.

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Thus, one cannot merely address an acquisition’s strategic logic without understanding that the price and the target’s integration into the parent firm are also important prerequisites for M&As’ success.

By means of a comprehensive method that includes all the three dimensions, the purpose of this study will therefore be to identify and understand those conditions and attributes that contribute to M&A success and failure. The study is based on the hypothesis that wealth creation in mergers and acquisitions is influenced by the simultaneous impact of a number of factors. The findings of this study should consequently provide guidance that has not hitherto been available.

What can a comprehensive perspective contribute to the understanding of corporate M&As? The approach taken in this thesis emphasizes the above-mentioned three fundamental dimension clusters’ combined influence. To date, these three dimensions have only been examined separately. These prior approaches therefore failed to provide the full picture. Consequently, the collective impact of all three dimensions as a whole on M&As’ outcome has never been tested. A comprehensive emphasis of all three main dimensions - strategic logic, integration, as well as price – as dependent key determinants of M&As’ outcomes does not, however, imply a rejection of the research made in each of these areas to date. On the contrary, strategic logic, integration and price are themselves the fundamental elements through which this author’s comprehensive approach will be built.

1.2 Research Objectives

As mentioned above, several studies have been done on specific areas, which have indicated that post-M&A performance⁶ is possibly influenced by factors derived from various management schools of thought: the strategic management school, organizational behavior and the financial school (Haspeslagh and Jemison 1991; Larsson and Finkelstein 1999; Datta et al. 1992, and King et al. 2004).

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⁶ M&A performance will be seen in the perspective of the owner of a firm.
The overall research objective of this work, which is to understand the reasons for frequent failures in M&A, can be summarized as follows:

\[ \text{M&A performance} = f (\text{strategic logic; organizational behavior; financial aspects}) \]

The main hypothesis of the study is therefore:

Strategic logic, organizational behavior and financial aspects are positively related to post-M&A performance.

In order to divide the overall hypothesis into manageable tasks, the author continues by specifying three subordinate research objectives.

Multiple studies show that M&A performance is influenced by M&As’ strategic logic (Rumelt 1986; Williamson 1975; Salter and Weinhold 1979; Lubatkin 1983 and 1987; Larsson and Finkelstein 1999, and Barney 1988).

The first research objective is to integrate the most relevant determinants of M&A performance that have been derived from strategic management into a single model.

Other studies have shown that the integration aspect of M&As is a very important field of research in respect of post-M&A performance (Fowler and Schmidt 1989; Chatterjee et al. 1992(a); Weber and Piskin 1996; Hitt et al. 1993; Cartwright and Cooper 1995; Buono and Lewis 1985, and Schein 1985).

The second research objective is to integrate the most relevant determinants of M&A performance that have been derived from organizational behavior (integration) into a single model.

Other studies have shown that financial aspects, especially the price paid for the M&A, are a very important field of research in respect of post-M&A performance (Ravenscraft and Scherer 1987(a); Sikora 2002; Dogra 2005, Kusewitt 1985; Eccles et al. 1999; Jarrel et al. 1988; Jensen and Ruback 1983, and Datta et al. 1992).

The third research objective is to integrate the most relevant determinants of M&A performance in the financial field (especially regarding price) into a single model.
1.3 Foundation of a Comprehensive Model

A number of theories have been developed to explain M&As and their success or the lack thereof, most of which are, however, relatively limited, and while a few are complementary, others are autonomous or even conflicting. Due to their inadequateness, none of these theories capture the essence of M&As as a complex phenomenon (Hitt et al. 1998).

It is therefore obvious that the research on the determinants of M&A performance is highly fragmented. Furthermore, the various research streams are based on limited assumptions. In order to integrate valuable ideas from different perspectives, we first need to establish a common foundation of fundamental assumptions, or a frame of reference for our model. This frame of reference has to integrate the distinctive research streams that focus on the determinants of M&A performance.

It is obvious that distinctive perspectives are based on distinctive epistemological assumptions (Raisch 2004). Although conventional approaches are thoroughly grounded in realism as well as positivism, other modern approaches are located in constructivism (Malik and Probst 1982; Nelson 1995). To improve the pragmatism as well as to further develop theories, it is therefore crucial for our research to build frameworks and lean on in-depth empirical studies (Porter 1991). Simultaneously, we are conscious that no theory can at any time try to characterize or describe the full complexity of various phenomena (McKelvey 1999).

In order to establish a comprehensive model, the present study thus suggests combining different theoretical research perspectives on the determinants of M&A performance. This is the only practical approach with which to achieve our research objective: the establishment of a more integrated approach to the analysis of the determinants of post-M&A performance. A single research perspective could never by itself capture the essence of the complex phenomenon of M&A to the same extent, and thus wouldn’t allow the same degree of generalization and validation.
1.4 Comprehensive Model and Hypothesis

Following these research objectives, the comprehensive model can be visualized as shown in figure 1.3:

**Figure 1.3: Comprehensive Model: 3 Integrative Perspectives**

This framework responds to the first research objective by addressing the problem of fragmentation through the integration of the most important competing research perspectives on determinants of M&A performance. The model's main hypothesis suggests that the integrated model is an improvement on any single perspective approach.

Based on a thorough literature review, the most important determinants of post-M&A performance are derived from the different perspectives (see Haspeslagh and Jemison 1991, Jarillo 2003). More exactly, we analyze the influence of strategic logic, organizational behavior and financial aspects on M&A performance within a single model. Based on the literature, strategic logic is represented by six variables based on Larsson and Finkelstein (1999): (1) market similarities and (2) market complementarities (e.g., Chandler 1977; Teece 1982; Williamson 1975, and Rumelt 1986); (3) production operations’ similarities and (4) complementarities (e.g., Bain
1959, and Lloyd 1976) and, finally, (5) market and (6) purchasing power (e.g., Caves and Porter 1977; Chatterjee 1986, and Scherer 1990). Organizational behavior is reflected by three variables: (1) acquisition experience (e.g., Fowler and Schmidt 1989; Kusewitt 1985, and Bruton et al. 1994), (2) relative size (e.g., Kusewitt 1985; Seth 1990; Larsson and Finkelstein 1999, and Bruton et al. 1994), and (3) cultural compatibility (e.g., Schein 1985 and Chatterjee et al. 1992(a)). In conclusion, financial aspects are reflected by the following three variables: (1) acquisition premium (Sirower 1994 and Hayward and Humbrick 1997), (2) bidding process (Datta et al. 1992), and (3) due diligence (Rappaport and Sirower 1999). All twelve variables are presumed to be positively or respectively negatively linked to M&A performance, as illustrated by figure 1.4.

**Figure 1.4: Comprehensive model with variables**

Based upon the present literature as well as criticism thereof, we generated a framework that integrated the most important competing research perspectives on determinants of M&A performance. The model comes close to what managers have always had to do in practice: Define the strategic reasons for an M&A, deal with the