Warning Against Binge Buying. When is M&A the Right Answer to Your Growth Challenges?

By Laurence Capron & Will Mitchell

One of the truisms of business life is that mergers and acquisitions often create more headlines than value. Some studies indicate that 70% of deals fail to achieve their objectives. In our research on 150 ICT firms ("Build, Borrow or Buy: Solving the Growth Dilemma", Harvard Business Review Press, 2012), only 27% of the responding firms reported they were able to extract the value that they wanted to achieve from their target firms' capabilities following their acquisitions.

M&As can also damage employees' careers. We vividly recall a situation one of our students encountered while working for a first-tier supplier in the auto industry. His company's newly appointed CEO had attended a seminar and learned that he needed to have audacious goals for transforming the company, and that M&A was an effective tool for rapid transformation. The company had deep pockets at the time, so the CEO went on a buying spree. Our student was put in charge of integrating the hodge-podge that his boss had purchased. He wanted our advice on how to avoid integration mistakes. We were able to help—up to a point. But, in truth, the major mistake had already been made. Most of the acquisitions made little sense and fit together poorly. A year later, the parent firm was in a mess and on the market, the CEO was gone, and our student was looking for another job.

Does our student's experience sound familiar to you? For us, similar stories are far too common. Our students come to see us because they need to integrate firms that their CEO just bought, while knowing little about the strategic rationale for the acquisition, and wondering whether a more flexible approach such as an alliance would have been a more effective way to obtain the resources they needed.

Yet, very few corporate events make the CEOs' heart race like a big acquisition deal. And, undoubtedly, M&A is a critically important part of the tool kit for responding to changes in your strategic environment. But why do executives jump to M&As as their first choice—when, in fact, acquisition should often be the mode of last resort? In our research, we find that many CEOs suffer from blind spots about alternatives ways of undertaking important changes. They also often underestimate the difficulties they will face in integrating a target. And they often overlook the necessity to sequence and balance acquisitions with other modes of growth.

Blind Spots: Why do executives jump to M&As?
Many firms expect acquisitions to accelerate their growth, but executives often turn to them for the wrong reasons, including their own self-interest, an over-commitment to the buy mode and to the allure of a particular target, the value of M&A as a blocking strategy, and its use as a strategic shortcut.

Managerial self-interest. M&A activity is often seen as driven by greed, personal aggrandizement, and other self-serving managerial motives. Indeed, many studies document that acquisitions feed managers' egos, reputations, and empire-building aspirations; increase their compensation and perks; mask the poor performance of their current portfolios; maintain their attractiveness for future CEO posts, or simply protect their present jobs. At the basic level of raw ambition, problems arise when executives use acquisitions unthinkingly as a shortcut to meet growth targets and generate publicity for themselves. At a deeper level, managers abuse M&As because of incentive systems that encourage them to ask the wrong questions: emphasizing size over real synergy, speed over careful due diligence, and short-term focus on earning per share over long-term value creation.

Over-commitment. Even leaders who do not suffer from excessive self-interest can mismanage an acquisition by becoming overcommitted—both to acquisition as a mode of growth and to the particular target that first inspired their interest. It is easy to get carried away by the dynamics underlying the acquisition process. For instance, it is hard to ignore the many stakeholders who push hard toward the completion of a deal. Internally, the M&A and business-development teams have been working on the deal for weeks or months, and are deeply invested in it. Externally, powerful forces at investment-advisory and banking partners have financial incentives, and a strong reputational interest, to push the deal forward. Thus the process itself often leads to an escalation of commitment.

It is important to have the discipline not to escalate your commitment simply because you have spent a lot of time analyzing a deal (the so-called Law of Sunk Costs). One company we know devised the strategy of appointing a "green team" and a "red team" to assess each potential deal. The teams undertake independent due-diligence analysis of potential deals. The green team is responsible for making the positive case; the red team makes the equally important negative case. Staff members take turns serving on red teams, so that no one becomes "type-cast" as a corporate naysayer. Senior management assesses the green and red cases and makes a final decision. While this approach requires extra analysis, as well as time and money, the company has found it invaluable. They not only avoid bad deals, but also gain a better understanding of the deals that they undertake.

Blocking strategy. Firms sometimes use acquisitions to stop competitors from purchasing a target (some of this motive was at play in Boston Scientific's pursuit of Guidant). While such efforts sometimes yield short-term payoffs, they rarely create lasting value. The buyer has to incur the costs of integrating and/or breaking up the target. Moreover, competitors can almost always find alternative—and sometimes superior—ways of obtaining the "blocked" resources. Nonetheless, 50% of executives in our telecom survey involved in M&As reported having bought a resource provider to prevent a competitor from acquiring it.

Strategic shortcuts. Even executives driven by a thoughtful strategic vision sometimes use acquisitions when other modes would work better. Executives tend to view acquisitions as a shortcut to implementing their strategies. Acquisitions rarely provide a quick fix. 65% of the telecom executives who chose acquisitions reported encountering frictions during the integration process. Integration almost always brings unanticipated roadblocks and expenses.

Once you have clarified the strategic reasons for making an acquisition and come to the conclusion that you need full control over an external resource partner (either because you lack internal skills to build or you cannot craft an effective contractual relationship with a resource partner), you then have to assess carefully whether you can integrate the target firm

Can you intergrate the target firm?
To assess your ability to integrate a target firm, you must consider whether you can *clearly map* the integration pathway and keep the people on both sides of a deal *motivated*. If you cannot identify a clear integration pathway that will create enough value to justify an acquisition, you may be strongly tempted to pull the word "synergy" from your back pocket to use as justification for the deal—one that can dangerously cloud a healthy instinct to walk away from a bad deal.

Knowledge Question: Can You Map Integration Clearly?
Whether the steps along an integration path are clear from the start or unfold over time, you need sufficient clarity to identify the major milestones. You have achieved integration clarity when you can define the scope of resource combination, the scope of the resource divestiture, and the timeline of your integration process.

Scope of resource combination. This first aspect of integration clarity is crucial. You must identify which resources will fill your resource gap. In some cases, M&A due diligence can accurately inventory the target's resources. In other cases, you will only be able to gather in-depth information after the deal closes—when you will need to set up cross-company teams to evaluate the resources. For example, the Chinese bank Minsheng bought a substantial stake in the West Coast U.S. banking company UCBH in 2007 without realizing that the American bank's allowances for bad debts were grossly understated; Minsheng ended up writing off the investment.

Resource-seeking acquisitions come in three flavors. While any one acquisition may encompass several of these goals, typically one objective dominates:

- Exploitation acquisitions provide resources that strengthen your core domain by adding something new to the resource base, which will enhance your existing activities in established markets.
- Extension acquisitions provide resources that extend your existing activities into new geographic markets, or enable you to develop new products for existing markets.
- Exploration acquisitions provide resources that make it possible for your firm to explore new market spaces, potentially consisting of disruptive technologies, product categories, or business models.

Clarifying which of these three goals you want to emphasize will help define the scope of your resource combination—meaning which resources to integrate and which to leave as autonomous assets—either to retain or to divest. Defining the scope of the resource combination for an exploratory acquisition is typically far more difficult. Exploratory acquisitions may involve targets whose skills you do not yet clearly understand, and might conceivably destroy if you were to integrate them into your current organization too quickly.

Scope of resource divestiture. In addition to the desirable resources that inspired the acquisition, target firms almost always have resources that you do not need. Thus, while designing your plan for integration, you also need a parallel process for divesting unnecessary resources—including those of both the target and your own firm. As you integrate the businesses, you will need to sell product and service lines, manufacturing facilities, intellectual property, and other resources that do not contribute to achieving your strategic goals. Unless you divest unnecessary and obsolete resources, you risk collecting a jumble of resources that lead to corporate bloat.

Integration timeline. The third aspect of integration clarity requires that you understand the optimal time horizon for integration and divestiture.

Expect time horizons to vary depending on whether the acquisition is motivated by an exploitation or an exploration opportunity. An exploitative acquisition can be integrated relatively quickly, mainly by aggregating relevant resources and selling off the unnecessary or obsolete parts. With exploratory acquisitions, however, dealing too hastily with resources you do not yet understand well is potentially destructive. That said, you should not allow such acquisitions to function fully independently if you hope to gain the value of their potentially promising resources.

Although you may be unable to identify even the major milestones of a clear integration process, you may still be tempted to go ahead with the deal while hoping that a clear pathway will emerge later. However, the paths that emerge in such cases often lead directly over cliffs. The only way to avoid disaster is to identify the major goals for the acquisition before concluding the deal, and then create a detailed integration plan as soon as possible once the deal is closed. Google, for instance, purchased YouTube for $1.65 billion in 2006, with the goal of connecting on-line search and video streaming. Google allowed YouTube to operate largely independently for about two years, while it learned more about YouTube's people and worked with them to develop specific opportunities for the integration. After this initial period of independence, Google then actively connected Google's core search business to YouTube's video streaming platform.

Governance Question: Can You Sustain Key Employees' Motivation At Both Firms?

Much of the value of acquisitions is in their people. If you lose too many of the wrong people, you will struggle to gain full value from an acquisition. The retention challenge—which applies to acquirer and target alike—has two elements: first, you must identify the talent you want to retain; second, you need to create incentives to make retention more likely.

Identifying key people. It is easy to make mistakes about which people at a target are most important. It is especially easy to confuse high visibility with high value. No preeminent scientist or star equity analyst works alone. There is almost always a less-visible supporting team that is critically important to overall performance. Therefore, it's important to look at the work of star players in a team context. In the financial industry, for instance, commercial banks that buy investment banks sometimes make the mistake of focusing their efforts on retaining visible "product stars" from the investment banks while ignoring the "client executives" who are critically important for maintaining client accounts. Deprived of critical team components, stars sometimes falter post-integration. There will be times when you should try to keep valuable teams more or less intact.

When evaluating key resources, it is important to track them back to their DNA. If a target grew organically, then most of its value was created through R&D, marketing, and other functional resources. If its growth was externally driven, then you should focus on the key deal-makers and the teams who scan and evaluate external sourcing opportunities.

A senior executive from a life-sciences firm that was purchased by a multinational pharmaceutical company told us that the firm's scientists were given the most attention and the best retention packages. However, the acquirer failed to realize that most of the innovation had resulted from the target's previous partnerships and acquisition deals—with in-house scientists in a mainly supporting role. In the senior executive's view, the key people were actually the corporate-development people and business unit managers who brought external innovation into the firm.

Retaining key people. Targets need to become part of the acquirer as quickly as possible. In part this means aligning incentives of *all* members of the corporation—whether they have just joined or have spent their entire careers there. Clearly, neither side's managers will work to implement an integration without sufficient incentives.

The personnel of target companies are often deeply resentful of the acquisition. Many will continue to refer to themselves as working for the target company long after the deal is done. This is a clear red flag suggesting that an acquisition will fall far below its integration potential. Indeed, many such employees will immediately begin searching for new opportunities—with the brightest stars enjoying the greatest number of attractive options. You will need to do everything possible to create a welcoming atmosphere that will encourage a sense of affiliation with the newly combined enterprise.

If you do not require target employees' immediate affiliation or, indeed, an explicitly combined entity, you may avoid many short-term difficulties and the cost of some incentives. Leaving the target to operate autonomously within its new parent can help retain key personnel. The start-up life-sciences venture Sirtris retained its independent identity within acquirer GlaxoSmithKline (GSK) for several years after the 2008 acquisition. GSK wanted to preserve Sirtris's entrepreneurial culture and retain valuable scientists whose knowledge differed substantially from GSK's existing resource base.

Acquisitions also threaten people at the acquiring firm. Unless the acquirer foolishly puts its thumb on the scale (always a destructive idea), the goals of integration—to produce a rational combination of old and new resources—will necessarily disrupt the careers of some of your current staff. That disruption can be positive. After all, the value of an acquisition lies partly in the opportunity to change the way your business operates. The status quo can become stultifying, and your people may, in general, relish the chance to leave behind obsolete practices and careers. Just as you need to identify key target firm employees whose loss you seek to prevent, you must also do likewise in your existing organization.

Sustaining motivation. Motivation is of course an issue in both target and acquiring firms. From interviews we conducted at telecom companies that had purchased businesses in order to obtain new market and technical knowledge, we learned that many acquirers knew they needed the targets' cultures and mindsets, but they were also concerned about disrupting their own staff.

In our interviews across many industries, executives have wondered how best to keep incumbent staff motivated while they import new skills from the target. There is no simple answer here. Your business runs the risk of failing if it cannot balance internal with external growth. Acquisitions are exciting because they bring new opportunities. At the same time, they threaten the status quo. You must provide incentives to keep your staff fully engaged with legacy activities even as you are exploring new paths. Helping them understand the coherent vision that inspired the acquisition is a first step. Showing them how their legacy work will be combined with the target's new resources will calm many misgivings.

If you have serious concerns about your ability to integrate the target into your current organization, then you should step back and reconsider other modes of growth like internal development or alliances. In the event they remain infeasible, you should revisit your strategy.

Sequencing and Balancing M&As

The process of any program trying to grow through acquisition becomes even more arduous because of the disproportionately rigorous demands of integration. Aggressive use of acquisitions will stretch your company both organizationally and financially—potentially leading to lower performance and higher risk. You will need to exert substantial effort to prevent internal fragmentation and financial fragility.

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Binge buying—too many acquisitions undertaken too quickly—may leave little time to digest what's been consumed. Cooper Labs, for instance, grew rapidly in the medical sector through a series of acquisitions during the early 1980s. The expansion succeeded as long as Cooper was able to integrate its growing set of business activities. But the pace of unchecked acquisitions surpassed its integration limits, and Cooper foundered. Lockheed Martin and Raytheon both struggled to integrate several closely sequenced major acquisitions in the past few years.

Lastly, it is important to revisit past acquisition decisions and assess whether acquired businesses should be divested. Divestiture is a way to correct prior acquisition decision mistakes or to adjust the business portfolio to new market conditions. Firms that engage actively in acquisitions but avoid divestitures are like hoarders, eventually finding themselves overwhelmed by clutter. They become uncompetitive across most or all of their unconnected businesses, which become attractive targets for more efficient competitors. By contrast, firms that have particularly successful acquisition strategies are almost as active in divestiture as in acquisition.

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