
How Value Is Destroyed in Acquisitions and Disposals



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Corporate incentives are often skewed towards short-term gains at the expense of long-term value.

In the cost reduction plans of most major banks, headcount reduction looms large, while comments about value creation through cost reductions are rarely, if ever, found. Why is this the case? As we explored in our [last article](#), the way costs are allocated in large firms makes it difficult to cut costs when necessary because managers challenge internal cost allocations rather than make value-enhancing changes to their business units.

Because of the misaligned incentives inherent in large banks in particular, this makes cost cutting akin to squeezing a sausage, pushing the meat to one end or the other but not reducing its size. These misaligned incentives also cause value destruction in acquisitions and disposals.

In M&As, buyers of a majority stake almost always pay a “control premium” to reflect the value of the increasing control they can exercise as a majority shareholder. Conversely, those selling down from a majority stake to a

minority stake expect to be financially compensated for the loss of control. Academics have confirmed this by analysing endless public transactions and generally point to the logic of this through four theoretical value enhancements, which the controlling party can now exercise:

- the cash flows from the existing assets to the firm can be increased
- the expected growth rate in these cash flows can be increased
- the length of the high growth period can be extended
- the cost of capital can be reduced

In essence, the acquiring party is theoretically, willing to pay the acquisition premium to gain control because they believe that they can create more value than the existing owners.

How decisions are made

But incentives can hinder value creation. To see how, we have to look at how corporate decisions are made in the offices and subsidiaries of large global organisations around the world. They are generally mapped to a specific global product line. So if a bank has a global division called Asset Management, then subsidiaries or departments within subsidiaries or branches of the bank around the world are mapped to this global product line. The Head of Asset Management is responsible for operations and benefits from their financial performance. In line with this, he or she becomes responsible for proposing any acquisitions, restructuring, disposals, etc. of these entities. Frequently responsibilities are delegated to a regional or local Head of Asset Management reporting to the global head.

For example, one of us (Boris) was the CEO of a mid-sized Asian asset manager, reporting to the global Head of Asset Management. All operations in Asia within the Division of Asset Management reported to him. If he wanted to purchase, dispose of, or close any of the operations, Boris needed first and foremost to obtain global approval within his product line and then coordinate with the local offices. The same, of course, applied to other departments too. The regional head's financial rewards (and career progression) or continued employment depended mainly on the success within the division and less on the success of the entire firm. Put another way, the bonus of a regional head of a product was mainly set at the global product level.

How they appear on the balance sheet

In typical accounting treatment of a majority stake, you consolidate the entire subsidiary's assets and liabilities on the parent company's balance sheet and all of the subsidiary company's revenues, expenses, gains and losses appear on the parent company's income statement. However, in the parent company's equity portion of the balance sheet, the company maintains a separate account that tracks the value of the non-controlling interest in the subsidiary. There you subtract the gains or loss from the subsidiary, which belong to the minority shareholder. However, in respect to the important cost allocation driver of headcount, this means that the division responsible for the majority-owned subsidiary will also consolidate the full headcount of this firm. There is no headcount portion tracking the subsidiaries in the parent company's equity portion. The division is essentially paying for 100 percent of the cost allocations driven by the consolidated subsidiary's headcount even though it only obtains a majority – 100 percent minus minority stake – of the profitability of the subsidiary.

The alternative to the consolidation of the subsidiary is equity method accounting. Here the parent company recognises its share of the profit and loss of the subsidiary purely through its income statement by beginning a baseline with costs of the original investment and then subsequently recognising its share of the earnings or losses both as an adjustment to the original investment on the balance sheet and also in the income statement. Headcount is not consolidated and hence does not appear in the firm's internal cost allocation key.

Generally accepted accounting principles and International Financial Reporting Standards require the parent company to use consolidated accounting when it owns a controlling stake – usually over 50 percent. When a company owns a stake that is less than controlling but still allows for significant influence over the business, it must use the equity method. Accounting rules generally define a controlling stake as between 20 to 50 percent of the other company's equity.

Low-hanging fruit

If you are the head of a region and have a number of majority stakes in joint ventures and you are looking to enhance your division's earnings by reducing costs, there is no easier target than to sell down from your majority stakes to minority positions. The result will be that the allocated costs driven by headcounts of the subsidiaries which you had funded 100 percent will

disappear completely. Instead of paying 100 percent of their respective allocated costs but only obtaining your equity stake in earnings, you have now turned it on its head. The division will have the minority stake earnings without funding any allocated costs. The result is a win for your division and for your career prospects. Interestingly, the same argument can be made for all the other consolidated financial data and their cost allocations. Revenues or direct costs that appear in the consolidated statement and drive cost allocation keys will likewise disappear.

At the corporate level, value has been destroyed for two reasons. First, the price at which the shares are sold is at book value (or even lower), all in the interest of realising higher earnings for your division through the reduction of allocated costs. If the buyer of your stake (usually an existing minority partner or management of the subsidiary and hence familiar with your operations) realises this, he will not pay an acquisition premium and might even negotiate a discount. Second, the costs allocated through headcount do not, of course, go away but are simply reallocated to other divisions in your firm. From a value creation point of view, there is no reason to go ahead with this transaction. In short, there is every incentive to dispose of shares to under 50 percent ownership to ensure equity accounting instead of consolidation. Again, we see how the short-term incentives of banks destroy value.

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