The Fine Art of Friendly Acquisition

by Robert J. Aiello and Michael D. Watkins

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SPECIAL REPORT

Making M&A Magic

For all the sound and fury surrounding mergers and acquisitions these days, most of it still signifies…well, nothing. An astounding number of mergers and acquisitions fail – more than half, by some estimates – which makes them a costly proposition strategically and financially for the companies on both sides of the deal. In this special report, HBR publishes two articles intended to counteract this troubling M&A trend. "The Fine Art of Friendly Acquisition" explores the best thinking – and best practices – for clinching a solid deal between two companies. And "Integration Managers: Special Leaders for Special Times" introduces a powerful new approach to what comes next – making two companies one.

The Fine Art of Friendly Acquisition

by Robert J. Aiello and Michael D. Watkins

Integration Managers: Special Leaders for Special Times

by Ronald N. Ashkenas and Suzanne C. Francis

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The Fine Art of Friendly Acquisition

Surprisingly, LBO shops regularly create more value through M&A than most corporate executives do. The reason: a set of nuts-and-bolts principles – relentlessly applied.

by Robert J. Aiello and Michael D. Watkins

A recent study on M&A turned up a surprising statistic. Between 1984 and 1994, some 80% of LBO firms reported that their fund investors had received a return that matched or exceeded their cost of capital, even though in many cases the prices paid for the companies those funds acquired were pushed up by competing bidders. That figure stands in stark contrast to the overall record of M&A investments, which from the corporate acquirer's perspective has been dismal, at times disastrous.

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The fact that financial acquirers are so much more successful than most corporate acquirers may come as a shock to some managers. After all, financial investors don't bring synergies to their acquisitions, and they often have relatively little operational experience in the industries involved. Indeed, it's highly likely that the target's management team will initially view potential acquirers with substantial skepticism.[1]

Why, then, are financial acquirers so successful? Based on our experience advising companies on both acquisitions and negotiation strategy, we believe the answer lies in their approach to the acquisition process. Most corporate managers treat acquisitions as a direct-march-up-the-hill kind of exercise: "I want to buy this company. Let's find out what it's worth, offer less, and see if we get it." The actual deal-management process is often delegated to outside experts – to investment bankers and lawyers.

Savvy acquirers use early negotiations to foster a sense that both sides are working together in good faith to arrive at a mutually advantageous transaction.

But senior managers at financial investors – and the more successful corporate acquirers – treat deal management as a core part of their business. They approach potential acquisitions with sensitivity and a well-established process. They adjust their negotiating postures and objectives as the deal evolves. And they take the trouble to carefully coordinate the different actors – senior managers, lawyers, investment bankers, and so on – throughout the process. It is this care and effort that enables successful acquirers to create the value they do.

In this article, we'll describe how successful acquirers manage their deals. Our focus is primarily on friendly deals, but much of what we found is applicable in a hostile context as well because even a hostile bid has to end in an agreement to work together. All friendly M&A deals pass through five distinct stages: screening potential deals, reaching an initial agreement, conducting due diligence, setting the final agreement, and ultimately closing. We'll walk you through that process, comparing good practice with bad, and then we'll suggest ways companies can turn their deal-making experiences into organizational learning.

Screening Potential Deals

Acquisition possibilities can pop up without warning and usually need to be evaluated quickly. A core challenge in sizing up potential acquisitions, therefore, is to balance the need to think strategically with the need to react opportunistically. Experienced acquirers follow two simple rules in screening deals.

Robert J. Aiello *is a managing director and cohead of the Technology Mergers and Acquisitions Group at Prudential Securities in New York City.* ***Michael D. Watkins*** *is an associate professor at Harvard Business School in Boston.*

Look at everything. Successful acquirers are always on the lookout for deals. An LBO shop such as the New York City-based Cypress Group might complete only two or three deals a year, but it will have explored as many as 500 possibilities and have closely examined perhaps 25 of them. Successful corporate acquirers do much the same, albeit on a smaller scale. Cisco Systems, for example, typically evaluates three potential markets for each one it decides to enter and then takes a hard look at five to ten candidates for each deal it does. Assessing a large volume of opportunities confers two main benefits. It gives Cisco an overall sense of what kinds of strategic acquisition opportunities exist and at what price, making the company better able to assess the value of each prospect relative to the others. On a more basic level, it forces managers to bring discipline and speed to the screening process.

Keep a strategic focus. A common mistake for novice acquirers is to cast strategy aside in the face of an exciting opportunity. "The failure starts right at the beginning," one senior financial professional explained to us. "Someone at the top falls in love, and the word comes down, 'We are going to do that deal.' Once the decision gets made, the guys doing the deal just want to get it done. They start stretching the operating assumptions to make it work." Senior executives at LBO firms, however, are strict about sticking to guidelines. Joe Nolan, a partner at GTCR Golder Rauner, is very clear about his firm's focus: "We look for businesses where acquisition will be a core part of the growth strategy. We back people who know how to both operate and acquire companies, which is a rare combination. We invest in service companies and not manufacturing."

From Talking to Planning

Initial negotiations can take place in a variety of ways. Some cases occur through a structured process, such as an auction; others happen less formally through conversations between senior executives. Either way, the challenge at this second stage is for the senior management of both companies to agree that the potential for a deal is sufficient to justify investing resources in further exploration. Successful friendly acquirers follow much the same rules of thumb in nursing potential transactions through this phase.

Don't get bogged down over price. It is usually unwise to try to establish a firm agreement on price this

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early. The parties simply don't have enough information. As Bob End, one of the founding partners at Stonington Partners, puts it: "You have to do some preliminary feeling out, but if you focus on price at the beginning, you are setting yourself up for failure. People start staking out positions and end up souring on the deal. I'd rather get some momentum around the business possibilities, to get people nodding their heads."

Identify must-haves. Although acquirers cannot afford to get tied up with too much detail at this stage, it is essential to pin down certain issues. Many of these are driven by the acquisition's strategic rationale. GTCR Golder Rauner, for example, focuses on the management team's experience and its incentive structure. Cisco insists that the management of target companies believes in employee ownership. It's also important to clarify the roles that the target's top executives will play in the combined organization: who will be retained, and what will they do? American Home Products' merger with Monsanto foundered, for example, because the two CEOs could not agree on which of them would be number one. Finally, it is essential that the acquirer be comfortable at this stage with any potential liabilities–such as environmental exposures, retiree health-care liabilities, or class action suits–that could materially affect the price of the transaction.

Get friendly. It's only natural that the management team of a target company going into preliminary negotiations should feel nervous, even suspicious, of potential new owners. Savvy acquirers use early negotiations to foster a sense that both sides are working together in good faith to arrive at a mutually advantageous transaction. They are flexible and respectful in their negotiations, and they try to help target managers see the career opportunities that could result in the new organization. Says Jeff Hughes, vice chairman of the Cypress Group: "We build relationships with partners. It's how we approach deals from the very beginning, from the first meeting. You can't get a deal done unless you understand what the seller wants. You always have to solve people's problems." It's important to build "relationship capital" early on because it will be needed in the later stages of the deal. As the acquisition moves through due diligence, final agreement, and closure, the acquirer's deal team will inevitably become much more assertive and demanding.

Gearing Up for Negotiations

The next stage, due diligence, is the most time consuming and least creative part of the process: the deal goes from the high romance of partnership to the mundane world of fact checking. Unsurprisingly, the eyes of many senior managers tend to glaze over at the prospect, and they leave the job to business development staff, line managers, accountants, lawyers, and bankers. But that boredom is dangerous: acquirers have wiped more value off their market capitalization through failures in due diligence than through lapses in any other part of the deal process. Smart acquirers approach a $1 billion acquisition with the same attention to detail they would apply to investing $1 billion in building a new plant.

Managing the Deal Team

No team can make a bad deal good, but a bad team can make a good deal bad. The challenges of managing a deal team are, in essence, much the same as those of any large project: how can you bring a large team with a variety of skills and agendas together to quickly achieve an objective that not everyone may agree with? It's a task familiar to any film production company, and experienced acquirers go about it in much the same way.

Use the same principal actors. While each deal involves a large total cast, deal teams at successful organizations such as Cypress and Cisco always have at their core a small group of people who have worked together in the past. They are then supplemented by inside and outside experts. Having an inner circle of people who are familiar with one another facilitates coordination and communication. It also grants the team a certain amount of emotional resilience in what can be an unsettling experience. "We are nine senior professionals, and all of us have worked together for at least a decade," explains Cypress vice chairman Jeff Hughes. "That's long enough that everyone knows it's not personal if a deal gets killed. We all succeed or fail together." All transactions must have a clear leader and, although deal managers often start as a deal's advocate, they must be prepared to kill the deal if necessary.

Explain the plot. Team members have to talk to one another, of course, particularly during due diligence. As obvious as this advice might be, it can often be overlooked even though communication can be encouraged by fairly simple formal means, such as placing the working groups in a bullpen environment. Some of the most experienced acquirers require their teams to conduct daily round-table discussions, so that everyone can hear the progress, the issues, and the concerns of the rest of the team. The deal managers encourage team members to contribute to these meetings and take care to discourage any hoarding of information.

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Turn over all the rocks. In the excitement of the moment, the novice acquirer may be distracted from looking too closely at the details. That's a mistake because a deal that dies at the due diligence stage almost always dies for the right reasons. Recently, a prospective buyer was conducting diligence on a rapidly growing development-stage consumer service company with a robust product that dominated its niche. Initial assessments were highly favorable, but a deeper look revealed that the visionary founder had not put in place an adequate financial control system. The target's profitability was illusory, and the buyer abandoned the transaction. Hidden problems of this type are about more than money – they also raise important concerns about the competence, even honesty, of the target's management team.

A deal that dies at the due diligence stage almost always dies for the right reasons.

Size up the other side. Experienced acquirers use due diligence to deepen their knowledge about – and links with – the target's management. Every such interaction offers acquirers a priceless opportunity to assess people's abilities and personal agendas. Do the target's managers have command of their company's operational details? Do they work well as a team? Are they easily flustered or hostile when challenged? Are they enthused by the transaction, or are they more concerned about their personal futures? In due diligence for a recent media deal, for instance, it became clear to the acquirer that the target's founder and owner had certain priorities and motives for the deal, including a desire for a major role in the combined entity. Using that knowledge, the acquirer was able to structure a deal that satisfied the founder's aspirations to such an extent that he was willing to make significant concessions on price.

Feed due diligence into business planning. For novice acquirers, the due diligence process is just an information-gathering exercise, a break between initial and final negotiations. They usually do not begin to formulate strategy or build a valuation model until the process is complete. In some cases, different people conduct due diligence and final negotiations. Experienced acquirers, however, link their due diligence closely to business planning. Stonington Partners, for example, puts together a book on each acquisition, covering the investment thesis, the business model, capital structure, a base case valuation, a sensitivity analysis, and third-party due diligence. Stonington also keeps the original deal team involved throughout the process.

Getting to Final Terms

The fourth phase of the deal, in which the management teams of both sides and their advisers conduct negotiations on price and strategy, is the most sensitive. A typical mistake for novice teams at this stage is to come to the table with a large list of outstanding issues, which they then try to resolve in no particular order. The danger of this approach is that talks will get stalled on relatively trivial items, exhausting the hard-won goodwill gained in earlier stages and affording openings for rival bidders. Experienced acquirers are conscious of the need to maintain the momentum of the talks, and they are always aware of external threats.

Use multiple negotiation channels. Senior managers, who may have steered the process to this point, often take the view that their company needs to speak with one clear voice at the negotiating table, and therefore they limit the negotiating team to a few key people. We strongly disagree with this approach. Successful acquirers usually divide their deal team into two or three separate negotiating groups: managers, lawyers, and perhaps investment bankers.

This division of labor has a number of important benefits. For one, it allows for parallel processing. The legal

Managing the Deal Cycle

The negotiation of every deal goes through five distinct phases, and for each phase, experienced serial acquirers strictly adhere to several negotiating principles:

1 Screening Potential Deals

- Look at all potential deals in your market, not just at the deal at hand.
- Don't cast strategy aside in the face of an exciting opportunity.

2 Reaching Initial Agreement

- Don't focus on price yet.
- Identify the details critical to the deal's success.
- Use early negotiations to foster a sense of trust with the target's top executives.

3 Conducting Due Diligence

- Look for the devil in the details.
- Deepen your understanding of the target's operating managers.
- Link due diligence with business planning.

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teams can, for example, make significant progress on the acquisition agreement while the bankers address the terms and structure of the financing. The managers, meanwhile, can focus on strategic and personnel issues, stepping into the other negotiations only to overcome impasses. Negotiating through multiple channels also makes it easier to send informal messages. An acquirer's management team may, for example, insist that the major selling shareholder sign a noncompetition agreement. At the same time, however, without conceding this point, the acquirer's investment banker or lawyer could hold hypothetical conversations about different ways to address the same concern. Finally, negotiation at different levels isolates acrimony. The principals can use the bankers and lawyers to deliver hard messages or to take inflexible positions without poisoning relationships with their counterparts.

Cultivate alternatives. When an opportunity goes live, some deal managers focus on it to the exclusion of other opportunities. That's a natural instinct given constraints on managers' time. Nevertheless, we believe acquirers should carry on as vigorous a dialogue as possible with alternative targets. The value of understanding your best alternative to negotiated agreement (or BATNA) has been well explored in popular books on negotiation, such as Roger Fisher, William Ury, and Bruce Patton's *Getting to Yes* (Houghton-Mifflin, 1992). Knowing what the alternatives are makes it easier to judge the relative value of the deal at hand and can shift the balance of power between acquirer and target. In a recent acquisition of a telecommunications company, for example, the acquirer was able to announce in the middle of negotiations that it had agreed to buy another, related company, significantly reducing its need for the first target. An acquirer's deal team behaves more confidently when it knows it has a choice – and that confidence gets projected across the table.

Are You the Strongest Acquirer?

In competitive bidding situations, an acquirer should compare its position with its rivals' along the following dimensions:

- **ability to realize synergies with the target**
- **financing capacity**
- **ability to make quick decisions**
- **attractiveness of currency, in the case of stock-for-stock acquisitions**
- **reputation for getting deals done**
- **reputation for treating target's management with respect and for successfully integrating target's management**
- **postacquisition performance record**

Anticipate the competition. In most acquisitions, the target has a choice, and negotiations may even be taking place in the context of a structured auction. Before deciding on tactics, therefore, acquirers should assess their advantages and disadvantages relative to other potential bidders. (For a list of the key points to consider when comparing your company with potential competitors, see the exhibit "Are You the Strongest Acquirer?") That assessment should include a calculation of the long-term cost of losing the opportunity to a competitor. In some cases, an acquirer may want to avoid that situation by making a preemptive initial bid. IBM's unsolicited bid for Lotus Development, for example, was made at twice the target's prebid stock price.

In general, however, experienced acquirers avoid such tactics. Indeed, some financial acquirers have a strict policy of not participating in competitive auctions because they're convinced that the winner is often the party that overpaid. For the same reason, many corporate acquirers, like Cisco, also insist that substantive conversations be carried out on an exclusive basis.

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Setting Final Terms

- Negotiate on several fronts simultaneously.
- Make sure you have alternatives to this deal.
- Anticipate the competition.

Achieving Closure

- Oversell to stakeholders.
- Close quickly after setting final terms.

Making It Happen

Once the ink on the final agreement has dried, it's easy for managers to think that the deal is done, but a surprising number of deals fall apart between final agreement and closure, the last stage of the process. There are sometimes very good reasons for that to happen – an environmental disaster may happen, some undisclosed

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liability may become apparent, or some adverse change in the target's competitive position may occur. (For instance, in 1998, Tellab's acquisition of telecom equipment maker Ciena fell apart when Ciena lost two key contracts after the final agreement was reached.) But a lot of deals fail at this point because acquirers do not take the trouble to sell the deal to key stakeholders or because they allow too much time to elapse between agreement and closure.

Sell, sell, sell. It's understandably hard for management, at the end of an exhausting negotiation, to shift quickly to the task of enthusiastically selling a deal to stakeholders. But in many cases, the final agreement is the first time investors get to voice their opinion on the deal, and their reactions can torpedo it. Earlier this year IMS Health, a major health care information provider, agreed to merge with TriZetto Group, an Internet health care company. The market reaction was immediate and negative – investors wiped some $2 billion off the companies' combined market capitalization. The press noted at the time that a "lack of details surrounding the deal caused the shake-up in the stocks." A major shareholder subsequently released a letter to the company noting management's "inept" performance on an analyst conference call. The transaction was subsequently restructured as merely a sale of an IMS division to TriZetto.

Smart acquirers, therefore, are swift to follow their final deal agreements with aggressive and carefully planned public relations and investor relations campaigns, often involving professional PR advisers. Full and clear disclosure of the terms and the rationale for the deal is key. As Ammar Hanafi, vice president of business development at Cisco Systems, puts it: "I tend to overcommunicate. The Street has to understand the strategy and how the acquisition fits in."

Nor can any corporation afford to neglect its key internal constituencies, as Deutsche Bank's CEO Rolf Breuer learned to his cost earlier this year from Deutsche's failed merger with rival Dresdner Bank. His mixed signals about the future of the combined organization's investment-banking operations outraged investment bankers in both camps, ultimately scuppering a deal that would have created a global force in banking.

Move fast. However aggressively the CEOs and managers have sold the deal, not everyone will be happy with it. The target's line employees in particular will be worried about adapting to a different operating culture. In some cases, they will have legitimate concerns for their job security. At the same time, the target's customers will be wondering whether the acquirer will damage long-established relationships. Savvy acquirers keep the time between signing and closing as short as possible – ideally, to less than three months. They realize that quick closure gives them a better chance of showing the target's employees and customers that the deal will work. As Steve Holtzman, chief business officer at Millennium Pharmaceuticals, expresses it: "Time is your enemy. Once you have the idea, and you are agreed, then get it done. You can't go in and slam the deal together necessarily very quickly; you may need an up-front courting process. But once the courting is done, nail it." What's more, a prompt closure provides a signal to key constituents – including investors – that the acquirer's managers know what they're doing.

Learning from Experience

All too often, the expensive lessons that acquirers learn are forgotten once the deal is over. But LBO shops constantly refine their approach; they treat every deal – even the missed opportunities – as a learning experience. Says GTCR Golder Rauner's Nolan: "If we passed on a deal and it succeeded, we'll revisit why we let it go. If we do something and it doesn't work out the way we expected, we sit down and figure out the lessons learned. We also try to pass those lessons on to the executives we've been working with."

In our experience, it's wise to postpone a detailed analysis of a deal for at least a month – especially if there have been problems. In the aftermath of a failed deal, team members will be disappointed and may well channel their energies

Postmortem Questions

Whether a deal succeeds or fails determines which questions to ask when trying to glean lessons learned. In both cases, the questions are straightforward, but the answers are invaluable.

What to Ask After a Failed Deal	What to Ask After a Successful Deal
• Was missing this acquisition a win or a loss for the company?	• What did we do well in the process?
• If it was a loss, what could we have done differently?	• What problems did we miss and when?
• If it was a win, what did we do well that kept us out of this transaction?	• How can we improve our process to uncover those problems earlier?
• How could we have spotted the flaws earlier and spent less time on this opportunity?	• How does what we bought compare with what we thought we were buying?

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Ispat: A Great Corporate Acquirer

Although the majority of corporate acquirers have a poor track record, a few have successfully pursued long-term acquisition strategies. One such company is steelmaker Ispat International.

Ispat (which is Sanskrit for "steel") is one of the world's largest steel companies. This growth has come almost entirely through a decade-long series of acquisitions, starting with the purchase in 1988 of Trinidad and Tobago's state steel companies, and culminating with the purchase of Unimétal, Tréfileurope, and Société Métallurgique de Révigny from the French steel giant Usinor.

What's interesting about Ispat is that its M&A activities are organized very much like those of an LBO shop. To start with, Ispat's acquisitions are strictly focused. As president and COO Johannes Sittard explains: "While our expertise could be used in other industries, we never go outside our core business. So we understand the candidates and have a clear vision for where they could fit."

Once an opportunity has been selected, Ispat sends a small team to visit the seller. Here Ispat tries to gauge the seller's expectations and see if purchasing the assets makes sense. One of the key must-haves for a transaction to proceed to the next stage is that the target demonstrate that its labor supply and access to electricity are solid.

Ispat's due diligence process, which has been honed over time, focuses not just on gathering facts but, as Sittard observes, "We use due diligence to learn about the people who are running the company and to convince them that joining Ispat is an opportunity for them to grow. These conversations provide information you will never find in a data room."

The company works with the potential acquisition's management to develop a five-year business plan that will not only provide an acceptable return on investment but will also chime with Ispat's overall strategy. Ispat's managers know that they may end up responsible for managing the target, and that helps discourage them from making unrealistic assumptions about its prospects.

Ispat relies on a core team of just 12 to 14 professionals to manage its acquisitions. Based in London, the team's members all have solid operational backgrounds and have worked together since 1991. To support the team, Ispat draws in additional experts from its operating units as needed. The company learns from its experiences. "We are a small team, and acquisitions are much of what we do," Sittard explains, "so postacquisition assessments are a permanent part of our conversations."

into a hunt for blame. With the benefit of further information, though (including the subsequent performance of the target), the lessons should become clearer and may often turn out to be quite different from initial impressions. The first postmortem session should therefore be brief, focusing primarily on setting an agenda and a time for holding the later meeting. And fixing that agenda should not be very difficult to do because, as you can see from the exhibit "Postmortem Questions," the key issues are fairly obvious, although which questions need to be posed depends on whether or not the deal was a success.

As successful acquirers have found, effective deal management is a source of sustainable competitive advantage, especially in rapidly growing or consolidating industries. Companies that can't close deals and are known to be dysfunctional negotiators will have fewer opportunities and will soon be outgrown by their more acquisitive competitors. Conversely, companies that effectively execute an acquisition strategy can vault to leadership positions in their industries. A case in point is Ispat International, a corporate acquirer that conducts its M&A activities very much as an LBO shop does. Twelve years ago, Ispat was a little-known Indian steel company with a single mill in Indonesia. Today, thanks to a series of well-managed and well-timed acquisitions, it is one of the world's leading steel companies. (For the story behind Ispat's success, see the sidebar "Ispat: A Great Corporate Acquirer.")

Following the operating principles we've described will certainly help companies become better acquirers. And they will become even better if they learn how to learn. But there will always be some element of art to deal making. Mastery of the art of acquisition can be achieved only through experience.

1. The study that turned up the surprising statistic was published in a 1996 article in *The McKinsey Quarterly* entitled "Growth Through Acquisitions: A Fresh Look," by P. L. Anslinger and T. E. Copeland.

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