

Protecting Shareholder Value During M&A¹

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Introduction

"What can a Board of a potential acquiring company do from a governance perspective to maximise the chance of acquisitions creating value for shareholders?" This is the question addressed in this paper.

The question is important because there is evidence that while acquisition activity creates value overall, listed bidders, on average, erode shareholder value when they undertake an acquisition. It appears, again on average, that the target firm is paid the expected wealth created from the acquisition as well as some of the value of the bidder firm.

What aspects of governance might minimise the change of shareholder value erosion when acquisitions are contemplated or undertaken?

The activity of Private Equity ["PE"] firms provides some insight into 'good practice' from a governance perspective. This activity is of interest because:

- there is evidence that, on average, PE acquisitions do not transfer wealth to target shareholders and that the top quartile PE firms do well from acquisitions; and most importantly;
- PE acquisitions, by their nature, generally do not involve synergies. Consequently recovery of any premium paid plus generating value over and above this premium must come from governance changes as well as operational improvements.²

The term 'governance' is used here in the broadest sense³. It is used in the context of a board having the right to:

- Establish and monitor governance structures and management processes in the firm. These processes include strategic planning, resource allocation, performance management (KPIs, targets and reporting/monitoring) and risk management;
- Hire, fire and set the level and structure of top management compensation;
- Veto or ratify major strategic initiatives.

Value created / value eroded from acquisitions

There are some consistent themes arising from empirical research examining the market reaction to bid announcements and surrounding events.

1. The 'market' sees overall wealth increasing from acquisitions. Australian evidence from Bishop, Dodd & Officer⁴ estimate \$7.2 billion value created by takeover bids between

¹ This paper is the essence of a presentation given to the ASCI Annual Conference, "Reflections and Predictions: Governance in an Uncertain World". Thursday 26th May 2011. My thanks to Dan Dempsey and John Russell.

² The market for PE funds is becoming increasingly competitive making it difficult to simply buy at 'bargain' prices or below 'fair value'.

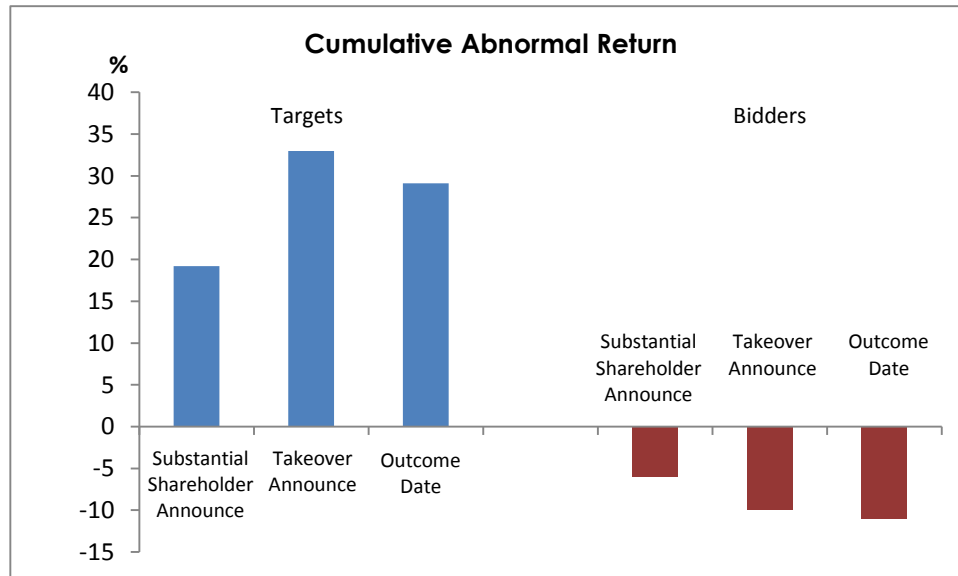
³ Fama E & M Jensen, "Separation of Ownership and Control", Journal of Law and Economics, 22 1983 provided a useful distinction between decision management, decision control and residual risk bearing. Decision management (initiate and implement) is the role of management, decision control (ratify and monitor) is the role of the Board and shareholders focus on diversifying to minimise risk. See also Brickley, Smith and Zimmerman "Designing Organisations to Create Value" McGraw Hill 2003, Ch 12.

⁴ Bishop S, P Dodd & R Officer, "Australian Takeovers: The Empirical Evidence", CIS 1987.

1974 and 1984. Using slightly different controls, Brown and da Silva Rosa⁵ identified total shareholder wealth increases of \$20 billion from takeovers between 1974 and 1985. US evidence reports an average of \$117m per tender offer bid⁶;

2. Target firm shareholders experience a value increase, on average. This is not surprising given most bids involve a premium over the prevailing market price. Figure 1 below shows the cumulative abnormal return to target shareholders from announcement of a substantial shareholder notice through announcement of the offer to announcement of finalisation taken from the Casey Dodd and Dolan study⁷;

Figure 1: Cumulative abnormal return to targets and bidders in Australia



3. Bidding firm shareholders lose value, on average. This finding is common across time and geographies. For example, studies by Walter⁸ and by Casey, Dodd and Dolan report an average negative outcome for Australian Bidders. The cumulative abnormal return for Bidders of circa -10% from the Casey, Dodd and Dolan study also appears in Figure 1 below. Bruner summarises US and wider studies;
4. Shareholders of PE funds earn around market returns net of fees but outperform gross of fees i.e. they cover 'management fees' which are on average, 3%⁹. The top quartile of PE firms in the US earn an IRR of 36% compared with 26% for the market¹⁰. The now Australian Centre for Financial Studies found from its review of research that there '... is a general consensus across different methodologies, measures and time periods regarding a key stylised fact: LBOs and especially MBOs enhance performance and have a salient effect of work practices.'¹¹

⁵ Brown P & R da Silva Rosa, "Takeovers: who wins", JASSA, Summer 1997.

⁶ See R Bruner, "Applied Mergers & Acquisitions", Wiley, 2004, Ch 3 for a detailed summary of the empirical research.

⁷ Casey R, P Dolan & P Dodd, "Takeovers and Corporate Raiders: Empirical Evidence from Extended Event Studies", The Australian Journal of Management, December 1987.

⁸ T Walter, Australian Takeovers: capital market efficiency and shareholder risk and return", The Australian Journal of Management, 1987, 9.

⁹ Kaplan S & A Schoar, "Private Equity Performance: returns, Persistence and Capital Flows", Journal of Finance, August 2005.

¹⁰ Gadiesch O & H MacArthur, "Memo to the CEO: Lessons from Private Equity any Company Can Use", Harvard Business Press, 2008.

¹¹ Melbourne Centre for Financial Studies, "Public Companies being taken private:" A research report into private equity", Study commissioned for the Australian Council of Super Investors, August 2009.

Of interest for the current purpose is the consistent evidence that bidders, on average, transfer wealth to target shareholders. Why?

Explanation of the poor performance of the 'average' bidder

Obviously the price paid by bidders in wealth eroding takeovers is 'too high' relative to the benefits they expect to extract. There are numerous explanations with multiple reasons probably being applicable in individual circumstances. Being aware of these explanations enables the Board to be on guard when management is contemplating or conducting a bid.

- Poor due diligence: missing some vital potential impacts on the attractiveness of the industry / segment and or the relative competitiveness of the target or not being adequately 'fact-based' i.e. an emphasis on financial and legal due diligence rather than commercial;
- Rose coloured glasses on synergies and operational improvements and relatedly;
- Synergies not based on the current business's core competence therefore making them hard to estimate and hard to deliver;
- Hubris: bidder management not wishing to lose out on something they have started, not knowing when to stop pushing the offer price up;
- Management compensation based on size not value creation thereby providing the wrong motivation;
- Poor implementation of the changes required to deliver performance improvement and relatedly;
- Under-estimation of the challenges in combining different cultures: this and underestimation of the challenges with meshing systems and processes may well be the single largest reason for challenges in success; and/or
- Not on the front foot with corporate strategy. Ideally it is a well 'designed' corporate strategy that drives value growth. Often corporate strategy is reactive and overly influenced by 'brokers' selling transactions rather than value creation.

Which, if any, of these explanations dominate is challenging to discern ex post and each bid is likely to be circumstantial.

Interestingly there is evidence that institutional investors can have an influence on increasing the likelihood of value creation rather than value destruction. A recent US research paper found that concentrated holdings of a successful bidder by independent long-term institutional investors was positively related to positive post-merger performance and that the presence of these institutions makes the withdrawal of bad bids more likely.¹² The following quote from the Australian Financial Review is also interesting from the perspective of how institutional investors can affect decisions:

"Rare earth company Lynas Corporation has abandoned a contentious deal to sell two mineral deposits to a related party, Forge Resources, after heeding shareholder advice to concentrate on its core business.

... Lynas Chairman Nick Curtis, who is chairman of Forge, told the AFR it was ultimately feedback from the company's institutional investors that brought the deal undone. 'We reflected on the conversations we had with the major

¹² Chen X, J Harford & L Kai, "Monitoring: Which institutions matter?", Journal of Financial Economics, 86, 2007.

shareholders and good governance is about hearing and acting on shareholder conversations' he said." AFR 12 May 2011.

What do PE firms do around Acquisitions?

PE firms' acquisitions are interesting from at least the perspective that they generally will not generate synergies. Consequently value creation will have to arise through improved operating performance and better governance. They make interesting case studies for this reason.

Outlined below is a set of the activities PE firms engage in around acquisitions. This provides some insights into what governance activities a Board can focus on.¹³ All have a common theme of reducing agency costs through improved governance. There is growing evidence that 'good' governance generally (not just around acquisitions) leads to improved performance and value.¹⁴

1. Careful Due Diligence

PE firms either undertake or commission substantive research into the attractiveness of segments, the relative competitive position of the target in these segments and how these are likely to change over time. This fact base, in addition to usual financial and legal due diligence, often provides the most up-to-date view of the competitive environment and the relative status of the target available.

From this the PE firm can make an informed view of the strategic issues the business faces and therefore potential changes to strategy and operating performance that could create value. As noted below, this also forms a solid basis for strategic discussions with management.

In this regard Gadiesch and MacArthur note:

"The first thing that the best PE firms do is to develop a clear understanding of where and how a business makes money and why they'd want to own it. They conduct a rigorous and dispassionate due diligence, building an objective fact base of the business and its industry." P 28

This philosophy sits behind my approach to strategy development.

2. Engage in Strategic Discussion with Management post acquisition

The fact base established in the due diligence phase provides a platform for subsequent updating and, more importantly, for engaging in detailed strategy discussions based on fact rather than opinion. The latter can be incredibly time wasting. The Board discussions post-acquisition are often more focussed on strategy than prior thus making the meetings more effective.

In this regard I am reminded of a favourite quote:

"Strategy discussions often happen in corridors and at the time of unexpected events, like a takeover offer or opportunity. The strategic planning process is therefore really about establishing an agreed "fact base" so that on-going strategy discussions are constructive and on shared facts rather than based on intuition and opinions about the underlying competitive landscape that may well differ. Without a

¹³ The list has been derived from various sources including discussions with PE firms, and articles including Gadiesch O & H MacArthur, op cit; K Wruck, "Private Equity, Corporate Governance, and the Reinvention of the Market for Corporate Control", Journal of Applied Corporate Finance, Summer 2008, "The Future of Private Equity" An interview with Steve Kaplan, Journal of Applied Corporate Finance, Summer 2009, ACFS op. cit. and Bruner op. cit.

¹⁴ See Bruner op. cit. Ch 26 for a discussion of some of this evidence.

shared view of the fact base around the competitive environment then it is unlikely that there can be a shared view on the best strategy and path forward.”¹⁵

3. Smaller and changed Board

There is evidence that PE firms both reduce the size of the Board and reconstruct the members to ensure the 'best' mix of skills. Wruck¹⁶ notes that the typical board of a PE controlled company has relatively few members (5 – 8) with only one executive director. These include individuals with strong management experience or industry expertise and financiers. Perhaps most importantly she notes that the Board has considerable equity based incentives.

Reducing the size often means less compromise, faster and 'harder' decisions.

Typically a non-executive and independent Chairman is appointed to maximise the 'ratify and monitor' responsibility of the Board. This tends to be less of a necessity in Australia than the US as it is more common to have the CEO as Chairman in the US thereby giving rise to a conflict of interest.

4. Clarification of decision rights / organisational responsibilities and improved governance processes

Often decision rights are 'decentralised' to the area where relative knowledge is greatest. When accompanied by a streamlined hierarchy, this can lead to more informed and 'faster' decision making.

Interestingly the management team is often not changed however a tension develops between managements' strategy development / implementation and the 'oversight' / input by the Board. Where one stops and the other starts can get blurred and often requires frank discussion to get the mix 'right'. Clearly the objective is not to have two management teams – the Board and Management.

Introducing a 'competitive' market for capital is another outcome whereby business units prepare high quality requests for capital carefully linked to supporting the approved strategy. This assists in creating a culture whereby capital is viewed as 'expensive' but readily available if the case is strong.

Similarly a culture of judicious cost management often results from scrutiny of plans and budgets.

One CFO of a firm that had been through a PE 'experience' commented on how the culture changed post PE acquisition to one whereby every dollar (albeit capital or operating cost) mattered and was scrutinised. He noted that this had stayed with him post re-listing.

Allied to this is another cultural change to a 'results' matter culture thereby increasing the focus of management to what does really matter in the end.

I encourage adoption of a set of management process that are not only linked together but also linked to a valuation of the business. Ideally strategy development is not only based on the fact base mentioned earlier but also pushed into forecasts of the likely financial outcomes enabling a valuation of alternative strategies and selection of the best among alternatives i.e. that which has the greatest expected value creation. This latter activity enables a closer linkage between decisions and the likely impact on a goal of creating value.

¹⁵ Unfortunately I've lost the exact source but I recall the sentiments being attributed to Henry Mintzberg. See Kaplan S & Beinhocker, "The Real Value of Strategic Planning", MIT Sloan Management Review, Winter 2003.

¹⁶ Wruck op cit p 11.

The linkage of processes follows from strategy development to resource allocation to performance management to incentive compensation and to investor communications. The strategy development process should define the capital & resources required to implement it over time thereby guiding the resource allocation process. A value creating strategy should attract the capital required to implement it. The first year of the strategic plan provides the basis of the budget which, in turn, feeds the targets for KPIs and performance monitoring. This process, in turn, feeds the KPIs and targets for rewarding executives for delivering or exceeding the Board approved strategic plan. A detailed understanding of the plan, and how it creates value, helps the business create and deliver an effective investor communication strategy (for listed firms).

5. Changed incentive compensation

"It's not how much you pay, but how" is the catchy but revealing title of an article by Michael Jensen and Kevin Murphy.¹⁷

Typically PE firms will restructure senior executive remuneration in a number of ways to reflect the sentiments of this title:

- Increase the (long term) incentive component relative to base;
- Ensure the performance hurdles are related to shareholder value drivers, including cash flow;
- Increase the equity holdings to a level that can have a significant impact on executive wealth, thereby providing strong motivation for value enhancement (and retention).

Incentive schemes based on the drivers of value that management control provide powerful motivation to improve performance.

6. Short time horizon for implementation of change

PE firms usually have a 2 – 5 year horizon for investments. This means a creating a sense of urgency to improve performance is an essential part of the changes made. Typically there is a 100 day and 3 year plan to bring about the change. This fits with the anecdotal statement that any synergies or performance improvement initiatives not implemented within the first two years after an acquisition will not be achieved.

7. Delisting

Several PE firms explicitly stated that one of the real benefits of a PE acquisition and delisting is that change can be implemented without worrying about quarterly earnings reports – that the longer term beneficial changes can occur 'below the horizon'.

Often changes will dilute EPS in the short term but with longer term increases. To the extent that the changes can be made without management worrying about the time and energy required to deal with analysts is a bonus. Certainly analyst 'road-shows' are expensive in terms of CEO and CFO time, let alone the distraction from achieving improved outcomes.

Delisting not only saves management time and assists with its focus but it also saves listing fees (usually a minimum of \$1m) and the quite significant compliance costs. If capital requirements and liquidity of shareholdings are not issues then it is appropriate to ask why a firm is listed.

¹⁷ Jensen M & K Murphy, Harvard Business Review, May-June 1990.

8. High leverage?

Many PE acquisitions are associated with high leverage. While this adds to equity risk it has additional motivational / governance benefits.

- The leverage often enable management to own a 'significant' share of the firm thereby providing enhanced motivation for value improvement;
- The high interest payments enhance a focus on careful cash flow management to ensure they can be met. This, in turn, assists to create a cash flow culture in the Business.

Wruck goes as far as to argue that leverage, per se, is a secondary driver of PE returns relative to the motivational / governance effects outlined.¹⁸

Implications for a Board of an Acquiring Firm

The setting for this paper was around what a Board member of an acquiring company can do to maximise the chance of an acquisition being value creating, especially given the poor record of the average acquiring company.

Examining the reasons for poor performance and looking to the actions of PE firms to improve governance provides a number of guidelines. One set of guidelines arising from such consideration is listed below.

1. Be on the front foot with corporate strategy – be pro-active in developing a value growth strategy that may or may not include acquisitions and don't be re-active to 'opportunistic' deals;
2. 'Demand' careful due diligence around a fact base for both the bidder and the target – ideally the bidder fact base is part of corporate strategy development process that precedes any acquisition activity;
3. Value the bidder and target on a stand-alone basis, assess the likely value enhancement from stand-alone improvements of the target as well as from synergies;
4. Ensure a maximum price is set from valuations and that the bidding process does not breach it. Walk away if necessary;
5. Ensure establishment of 100 day and longer term implementation and integration plan – and monitor progress;
6. Establish sense of urgency around improvements (100 day plan) – if most not there in 12 – 18 months then won't eventuate;
7. Ensure incentive based compensation linked to the drivers of value (and successful implementation);
8. Seek external valuation assistance to verify and challenge assumptions.

¹⁸ Wruck, op. cit.