Zachary Scott
INVESTMENT BANKERS

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Success in Mergers and Acquisitions

To be successful, mergers and acquisitions need to be made with the company's strategic vision clearly in focus.

by Michael T. Newsome

STRATEGY	RATIONALE	EXAMPLE
Product Line Extension	A wider range of products/services through an existing distribution channel or customer base.	Acquisition of Mikron Industries by Quanex Corporation to broaden product offering to a common customer base.
Market Extension	Broadening the geographic base of customers for existing products.	Acquisition of Portland-based Arcentia by Ivey Imaging to put capabilities in close proximity with key customers and prospects.
Adding Capabilities	Buy or build. It may be less expensive or more certain to acquire technology or new capabilities.	Acquisition of Viking Industries by Pella Corporation to provide to this wood product company knowledge of vinyl window manufacturing.
Cost Reduction	Consolidation to achieve critical mass or eliminate redundant overheads.	Acquisition of Wards Cove plants by Ocean Beauty Seafoods to create sales efficiencies in the canned salmon market.

Proclamations that businesses exist to grow bigger, become more diversified, make the most or best products, have the happiest customers, provide fruitful employment, pioneer new products, or serve the community, only confuse the measurement of business success. In our view, businesses exist to guide scarce capital resources towards the most productive users and the most economically beneficial uses, in order to increase the wealth of the shareholders.

Many business owners and managers view mergers or acquisitions as an effective path to building a successful business. Given the priority of shareholder wealth, what is really the point of a business combination if it fails to increase the value of the enterprise for the owners? As we have explored in past *INSIGHT* editions, acquisitions all too frequently fall short of the value aspirations of their architects, the primary reason being lack of discipline.

Fundamentally, value is created when the combined enterprise ends up being worth more than the sum of each of the businesses before the combination. This means that the price paid for an acquired business must be less than it's contribution to the combined enterprise, as measured by the cash that it will generate over its life.

For the most part, poor results are not solely the consequence of flawed financial analysis. There are abundant reasons why acquisitions fail to create value. At the time of the transaction, the decision makers always have a rationale for the value ascribed to the acquired business and the benefits (synergies) expected from the combination. Based on the exact science of hindsight, business combinations more often go astray due to inadequate strategic vision, lack of discipline in due diligence, and/or inappropriate transaction structure. In this article, we examine the importance of strategic vision to acquisition success. Follow-up articles will look at due diligence and transaction structure.

STRATEGIC VISION

Great companies are invariably led by people with a well-developed vision of what the business needs to look like in the future in order to realize the benefits of a competitive advantage in its chosen markets. The objective is to assemble a set of characteristics and/or capabilities that sustainably differentiate the business from its competitors and enable it to earn an extra increment of return for the value delivered to its customers. In other words, a strategic vision is predicated on a deep understanding of the needs of the target customers and how to satisfy them (and, therefore, make lots of money). This is easier said than done; but the result is a roadmap for the interrelated judgments that must be made with regard to the products, service points, supply chains (purchased or manufactured), processes, and employee talents necessary to transform the existing business and achieve the vision. An acquisition fits with the strategic vision if it serves as a shortcut (in time or cost) to progress along the roadmap. Provided that the benefits (future cash flow) exceed the acquisition cost, it may contribute new shareholder value.

Unproductive acquisitions are often detours from the roadmap in an effort to get a "good deal," or just to get a deal. Once off the trail, resources are diverted from the primary mission in an effort to realize the benefits of the "deal," which, in effect, redefines the roadmap. Such deals are often made for reasons that are inconsistent with the strategic vision —diversification (tinker here and there), pursuit of quality (only the best), bargain deal (too cheap to pass up), sales growth (bigger is better), buy management (rather than hire), denying a competitor (can't let them have it), or scarcity value (won't be left out). These are rarely compelling reasons to buy another business, regardless of how attractive the price seems to be.

INVESTMENT THESIS

The preeminent investment consideration should be, "How does this business combination strengthen our competitive position?" And it should be closely followed by the query, "How does this opportunity measure up against other options for furthering the business along the strategic roadmap?" If these questions can be answered satisfactorily, then there may be a genuine strategic rationale for the investment. In the absence of a clear strategic vision, it is not uncommon for businesses to approach all opportunities as though they are equally likely to create wealth. Therefore, the most promising opportunities may be underexploited.

To improve the odds of creating value, the business combination must, in some meaningful way, result in either the acceleration of revenues and/or the elimination of duplicative costs. As illustrated in the above table, opportunities to accomplish these goals are

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likely to be found in four areas.

A business combination has to surmount two hurdles to create value—it must fit into a well-developed business strategy, and the price paid for an acquired business must be less than it's contribution to the combined enterprise. Acquisition analysis and planning is an imprecise science, at best. No one is omniscient with regard to changes in the competitive environment. It is easy to invest heavily in a deal where the sought-after competitive advantages never materialize. Because the future is unknowable, it pays to be disciplined about pursuing only those opportunities that fit with the strategic vision and build real competitive advantages. The prospects for creating value improve significantly if the acquirer is dispassionate about both the ability to mesh the two businesses at an operational level and the timing of realizing the expected benefits of the combination.

Once an acquisition investment thesis is formed, the next step in the process is to conduct due diligence. This is where risks are identified, the investment thesis is confirmed, and the basis for apportioning risks in deal structure are determined. We'll explore these two phases of the acquisition process in the Fall issue of *INSIGHT*. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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