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REVIEW OF RISK MANAGEMENT TECHNIQUES IN MERGERS & ACQUISITION

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ABSTRACT

The aim of this paper is to identify, assess and prioritize the risks associated with mergers and acquisitions with the aim of deploying focused and coordinated strategies to mitigate these risks. These strategies should target to minimize the impact of the perceived risk and to also maximize the realization of the opportunities that come with mergers and acquisitions (Hubbard, 2009). The paper identifies some of the reasons why companies opt to go into mergers or acquisitions. It also attempts to identify some of the critical factors responsible for the failure of mergers and acquisitions. It further suggests some solutions on how companies can minimize the risks associated with mergers and acquisitions.

Keywords*: Mergers, Acquisitions, risk assessment, synergy, due diligence, management, business integration, corporate culture*

INTRODUCTION

Mergers and acquisitions have become part and parcel of the global business environment. Different companies have different motives for going into mergers and acquisitions ranging from optimizing management welfare to ultimately improving shareholder wealth (Rose, 1997:67). Some companies go as far as combining with other companies that are far away from their geographic location, sometimes with companies that are in different industries and even with companies with totally different cultures as theirs. Combining with such companies comes with reasonable levels of risks. Managing these risks is a major challenge that companies involved in mergers and acquisition have to deal with. In fact the survey conducted by KPMG in 1999 on mergers and acquisitions revealed that only 17 percent of the deals added value to the combined company, 30 percent produced no visible difference, and as many as 53 percent actually created negative value. In summary as much as 83 percent of mergers and acquisitions were unsuccessful in producing any tangible business benefit with respect to shareholders value.

In as much as firms going into mergers and acquisitions hope to strike synergy and improve the profitability of the merged entity over and above the profitability of the two firm if they acted separately, research such as the KPMG study shows that this is not often the case (Hughes, 1989). The rest of the paper is organized as follows: The second section will consider the reasons why companies go into mergers and acquisitions. The third section looks at the risks and pitfalls encountered by companies that go into mergers and acquisition and the reasons why some mergers and acquisitions fail. Section four looks at risk management techniques that can be employed to avoid these pitfalls. The paper reaches a conclusion in section five.

REASONS WHY COMPANIES MERGE

Organizations go into merger and acquisition for various reasons. It could be to expand into new markets in a different geographical location within the same industry. It could be a means of integrating forward or backwards. It could be a strategy of diversifying into an entirely new industry; this could be by remaining in the same geographic location or going into new locations. It could be a strategy to respond to changes in consumer taste and demand. It could be to satisfy industry regulatory changes including getting around tax laws (Ross, Westerfield and Jaffe, 2002). Some companies in order to avoid been acquired by an undesirable buyer or for fear of been run out of business may decide to go into a merger or allow itself to be acquired. Furthermore companies can opt for merger or acquisition with the aim of reducing cost, becoming more competitive, improving revenue, improving profitability and ultimately creating greater economic value for shareholders.

BP and Mobil’s merger in Europe was consummated on the grounds that with a bigger size and combined market power resulting from the merger the new entity will be better positioned to compete against the other major oil companies. And secondly it was anticipated that the merger will bring about significant cost savings as the combined companies will be able to reduce overhead by eliminating duplicating facilities, and cut down on staff cost (Finkelstein, 1999). Companies can hope to take advantage of the potentials of been able to cross sell for example in the merger of Citi-Bank and Travelers, and AOL and Time Warner (Vedpuriswar, 2003). Companies like PSINET and International Paper adopted growth by acquisition strategy, using acquisition as an approach to grow and expand their operations. International Paper for instance acquired Union Corporation for $7.1 billion in 1999 and later Champion Paper Corporation for $9.6 billion in 2000. PSINET made about 76 acquisitions between January 1998 and December 2000 (Ratner, 2001) with the largest acquisition been the purchase of Metamore Worldwide in

March, 2000 for $11.9 billion (Miller, 2001). Access Bank went into a merger with Intercontinental Bank (note that this is actually an acquisition as Access bank spent 50 billion to acquire 75 percent of Intercontinental Bank shares) with the hope to use it to enhance it's retail banking offering and increase the number of branches it has nationwide (Manuaka, 2011). On the other hand the merger will enable Intercontinental Bank meet the required regulatory 10 percent minimum capital adequacy level. And in an event that Intercontinental Bank does not meet the recapitalization requirement they will be nationalized. To avoid this, its shareholders had to vote in support of the merger and against nationalization. So while Access Bank went into the merger to become more competitive, increase its growth and profitability Intercontinental Bank went in to the merger to firstly meet the current banking regulatory requirements, remain relevant thereby satisfying it's shareholder's desire.

In addition to the reasons given above some companies go into mergers to basically achieve economy of scale and economy of scope. This is particularly so as the parties involved usually hope to cut down cost by eliminating duplicate functions and also lessen average total cost of production as they increase the number of products they produce thereby increasing aggregate profit margins (Ravenscraft & Scherer 1987). Increase in market share helps the new venture to be more competitive; in some situations cross selling is achieved when company A can sell its services to the customers of company B and vice versa. Some companies go into merger for tax purposes. A profit making company can buy a loss maker with the intention of using the loss maker as a platform to reduce its tax liability; geographic diversification and hedging. Some companies use it as a diversification avenue by getting into other markets such that unfavorable market earnings in one market may be evened out by favorable market earnings in another market. This sort of diversification or hedging can also be achieved by a firm acquiring another firm in a different industry within or outside its geographic location. Some mergers also hope to improve profitability by integrating vertically (Maddigan & Zaima, 1985). Some firms go into merger to provide avenue for effective resource transfer and utilization and sometimes also achieve better information flow within its system (King, Slotegraat & Kesner, 2008). So companies go into mergers and acquisitions for various reasons but ultimately to improve shareholders' wealth. However, improvement in shareholders' wealth can only be achieved when there is true synergy between the merging parties. That is when the value and performance of the merged entity is greater than that sum of the separate individual companies.

Whatever the reason may be, mergers and acquisitions entail complex procedures and require close attention right from the initial negotiations, deal closure and post deal integration (KPMG, 1999). The organizations involved must take into consideration time constraints, as the merger or acquisition process is not open ended. It should indeed be completed within a reasonable time frame as undue extension of the process may have adverse effect as will be explained later in this paper. The parties involved must also carefully allocate resources and properly decide on adequate prioritization of the various activities and processes involved in the entire merger process. In as much as mergers and acquisitions are intended to bring good fortunes to businesses many of them end up failing.

WHY MERGERS AND ACQUISITIONS FAIL

Why does some mergers fail and others succeed? Could it be that the key players in the merger process do not know of the pitfalls or could it be that they knew and did nothing about it or simply did not do enough? The merger process is quite a complex one and requires a lot of skill and careful and thorough planning and execution. The planning stage should include the initial negotiation stage before the actual process begins. And it is worth noting that the merger process does not end with the signing of the agreement between the merging parties, in fact that is far from it. The post agreement state or what is often referred to, as the integration stage is very critical to the survival of any merger. This section will consider the risks and pitfalls involved in a merger and acquisition process. It will further attempt to understand and highlight the reasons behind the failure of mergers and acquisitions.

Obviously mergers and acquisition come with some level of risk to the parties involved just like any other business venture. The level of risk involved depends on the nature of the merger/acquisition. Factors capable of increasing the level of risk in a merger or acquisition between two companies include geographic locations of the companies, the disparity between their cultures, the level of divergence of their internal technological systems, the degree of disparity between their values and believe systems. Some acquisitions fail from the very beginning when one of the parties involved pays too much for the acquisition. Studies have shown that demoralization among employees can cause productivity of the firm to drop by between 25 and 50 percent during a merger process (Tetenbaum, 1999). And finally lack of adequate and effective post merger and integration strategy are very harmful to mergers and acquisition. More often than not organizations ignore simple but yet important issues such as effective communication during merger process. Balmer & Dinnie (1999) are of the view that top management often pay less attention to effective communication and issues bothering around corporate identity during mergers and focus mainly on legal and financial matters.

The over payment made by a company during an acquisition may be such that wipes out any future profitability potential the new entity possess (Henry 2002). There is a possibility that during a bidding process some of the bidders participating in the process may be doing so for various reasons. These bidders may make bids that are irrational thereby influencing other bidders to bid and eventually pay too high. Tata Tea for example in its quest to quickly gain access to the US, Canada, Europe and Australia market acquired UK based Tetley for £271 million. It was reported that Tata Tea overpaid; paying an excess of £100 million more than the second highest bidder (BBC News, 2000; and Vedpuriswar, 2003). However, even when an acquisition is financially sound it may yet face other hurdles such as people issues and non-alignment of cultures. The entire process may end up making employees feel insecure due to fear of losing their jobs, and the resulting restructuring within the organisation may create anxiety and agitation among the employees (Appelbaum et al 2000). Research has it that 65 percent of mergers and acquisitions that fail are as a result of people issue (Fontaine, 2007).

Morosini (1998) argues that misunderstood national cultural differences are the major factor responsible for the high failure of many mergers and acquisitions. He further suggests that the issues of intercultural differences should be discussed before a merger is consummated. It should be brought up during the evaluation and negotiation stages of the merger. He sees a direct relationship between the way intercultural differences is handled before the merger and the success of the merger. Organisations going into merger need to understand the importance of cultural synergy to the success of the merger. They need to learn the culture of the other party. It is only when you understand the values and believe system of a particular organisation that you can efficiently and effectively communicate with the people from that

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organisation. Cultural differences in a merger could be as a result of any of the following: two companies originally situated in two different national cultures, for example the merger of UK-based Beecham and the US-based Smithkline (Ullah, Farooq, Ullah, & Ahma, 2010); two companies with different structures and different management styles for example the merger of Daimler Benz and Chrysler (Tuck School of Business at Dartmouth, 2002), two companies with different approach to public relations, decision making process and level of risk tolerance for example the merger of Exxon and Mobil (Vedpuriswar, 2003). The 1998 merger of Daimler Benz and Chrysler is a clear example of a merger that failed due to cultural issues. While Daimler Benz favoured hierarchical and centralized decision-making, Chrysler preferred a more decentralized decision making structure and equal empowerments. Daimler Benz attempted without success to run the Chrysler US operation the same way it ran its office in Germany, which is methodological decision-making process. The employees in Chrysler on the other hand are used to a more open and creative approach where they are allowed to freely express their innovative talents (Business Management Article, 2008).

Gitelson, Bing & Laroche (2001) identified seven possible post-merger factors that cause mergers and acquisitions to fail. The first factor is when the employees within the organisation get pre-occupied with activities that will bring no positive result to the merger process. During this period of uncertainty misinformation or lack of it get people confused and their productivity drop drastically. The second factor identified is list making. Departments and units within the organization all start clamouring for resources as soon as the merger is announced. Most people focus on the allocation of resources than the real value drivers and activities that will positively impact the growth of the company. This particular factor played out in the merger between two small companies: the first is a location based Services Company and the other is a software solutions company (names of companies are withheld). After the merger of the two companies was announced to the employees, employees from both sides were more interested in how resources will be allocated within the organisation. Issues like who stays in what office, who takes what computer or gets what car were more important than actual issues that will affect the progress of the new company. It would have been better if they got everyone to focus on real value drivers than on trivial issues that will not have any positive impact on the bottom-line. Everyone should be encouraged to be result oriented and focus on activities that will create tangible value. The third factor is organizational proliferation. It should be understood that the way one organisation sees things and operates might be different from another organisation especially if they are in different industries or countries. The organisation should therefore, focus a lot of attention in ensuring that people are adequately carried along and not left in the dark or to guessing. Temporary organisational structure may be setup to help employees and managers properly navigate their way around the emerging structure. The fourth factor is infrequent and irrelevant communication. Top managers may shy away from passing information to employees, shareholders and customers for fear of not wanting to pass the wrong information. This lack of information may cause panic created out of the perceived vacuum. To curb this there must be clearly defined communication channels. The organisation involved should make deliberate effort to create good communication strategies. In case of an international merger the communication strategy adopted must take into consideration the communication preferences of the companies involved in the merger. The fifth factor is triangulation. It is identified that managers and employees don't know who to report to and how they fit in during a merger. Some organisations are more rigid than others when it comes to following a defined organisational hierarchical structure. This is even more pronounced when the two organisations are situated in two different countries with very different ideologies when it comes to decision making process and reporting lines. The organisation should aim to quickly help employees adapt to the new organisation. Reporting lines should be quickly defined and people from both sides of the merger can be made to work together in small teams and be made to provide solution to some problems. The sixth factor is the issue of time and space. Time is of the essence in every merger as all the stakeholders including shareholders; employees and customers expect quick improvement in performance within the period preceding the merger. The time frame within which the stakeholders expect performance to begin to improve may vary depending on the location and culture of the stakeholder. Different cultures assign different time frames to expected improvement in organizational performance after merger. Even though the world and indeed business environment is becoming continuously more virtual some individuals that may not be physically present within the headquarters where decision is made may feel left out. To solve this problem the integration team must ensure that the various expectations of the stakeholders in terms of time and space is met. The organisation must be quick in completing the merger integration process and communication should be clearly transmitted in a timely manner (Homburg & Bucerius, 2006). Employees located in different countries should be grouped together to handle common tasks. The last factor focuses on ensuring there is strong and competent leadership. Employees need a visionary leader with sound character to lead them especially during and after mergers. They need to be guided and encouraged to remain focused and committed to the objectives of the new entity. The new leadership should be able to highlight and communicate clearly the reasons behind the merger and the benefit every stakeholder within the organisation is to gain as a result of the merger. This leader must possess good interpersonal skills and understand the cultural diversities of the firms involved in the merger especially in a cross border merger. The next section will further expatiate on the strategies for minimizing the risks associated with mergers and acquisitions.

STRATEGIES FOR MINIMIZING THE RISKS ASSOCIATED WITH MERGERS AND ACQUISITION

Companies going into merger or acquisition should endeavor to identify and highlight synergies accurately during the early stages of the negotiation. They should not stop at carrying out quantitative valuation of the business they want to combine with, even though it is very important to pay a fair and sustainable amount for an acquisition; they should also evaluate culture, value system and human compatibility of both organisations. The issue of cultural compatibility cannot be found in the company's financial books although some valuable information may be found in the employee manual. The companies should make concerted effort to understand the culture of each other including believe and value systems before proceeding with the mergers and acquisitions process. The KPMG (1999) findings revealed that successful companies as far as merger and acquisition is concern are companies that adhered to three key activities in the pre-deal phase (also referred to as the hard keys), these include: synergy evaluation; integration project planning and due diligence.

Companies should be sure to structure the financing of the acquisition in ways that will minimize their risk exposure. The way a merger deal is financed is important as the options chosen affects how the risk involved is shared between the parties. There are two possible risk scenarios associated with the financing structure of the deal: the decline of the share price of the acquiring company upon announcement of the deal and the likelihood that the merger may end up not realizing the anticipated synergy. In a situation where the deal is fully paid for in cash by the acquiring firm it assumes both risk automatically (Rose, 1997). But if instead of paying fully in cash the acquiring firm adopts stock swap the risk will be shared between the two parties. Furthermore, Warren Buffet suggests that businesses should be bought at prices that will eventually produce reasonable returns for the acquirer (Buffet, 2005). When it comes to valuation the company should thread with caution. You should not over pay for the assets of the company you want to buy. Sirowe (1997) is of the opinion that "When you make a bid for the equity of another company, you are issuing cash or claims to the shareholders of that company. If you issue claims or cash in an amount greater than the economic value of the assets you purchase, you have merely transferred value from the shareholders of your firm to the shareholders of the target – right from the beginning."

Eccles, Lanes and Wilson (1999) suggest that firms should put organizational discipline and analytical rigor over emotion and ego when it comes to mergers. In case of an acquisition, the acquired company should be willing to let go of the running of the company and the acquiring company should be sure to have the ability and competence to manage the acquired company's business more efficiently and effectively (Porter, 1985). And when it comes to integrating the processes, values, services, products and cultures of both firm it should be done with utmost attention and speed in such a manner that does not leave any stone unturned.

Ashkenas et al, (1998) suggests companies should learn from the several successful acquisitions made by GE. GE Capital through its various acquisitions has consistently practiced four key principles (Gray, 2003). The first is that integration of the acquired companies should not be seen as a onetime project but as an ongoing process that should commence way before the merger is consummated. Right from when the two companies start discussing the possibility of a merger they should start assessing the possibility of a smooth integration. If a company starts assessing the possibility of smooth integration way before the deal is closed it will have enough time to identify potential problems and determine if the problems can be fixed or if the negotiation should be stopped. Secondly, the integration process should be taken as a separate and very important mission. A very experienced manager with good interpersonal skills and sound cultural sensitivity should be appointed to oversee the entire integration process. KPMG (1999) also identified selection of the right management team to oversee the integration process as very important. This person must understand the cultural diversity of both firms and also possess good understanding of their various management styles and organizational structure. Thirdly certain areas of the integration process should be implemented as soon as possible such as issues bothering layoffs and restructuring. This will help douse tension that could build up as a result of anxiety and uncertainty. And fourthly, the company should not focus on integrating only the obvious operational aspects of the organization but also the firms' cultures and employees (KPMG, 1999). To achieve smooth fusion of cultures and employee relations the company can start by creating small groups comprising employees from the two firms and getting them to work together to solve simple tasks. However, on the issue of integration of culture Appenbaum, et al (1999) are of the view that the integration of two contrasting culture may not always be the best solution. They agree that integration is very important and must be treated with utmost seriousness and that a robust strategy and implementation plan should be developed for the integration process. They however, suggest that there are four options: the firms could decide to go for total integration of the two cultures; allow a dominant culture swallow the less prominent culture; allow the two cultures to co-exist side by side; or do away with both cultures. They believe that the optimal strategy could be a function of the degree of variance between the two cultures and the extent to which each of the firms value their own culture and identity.

These views are corroborated in Tetenbaum's (1999) "seven key practises" necessary for a successful merger or acquisition. In summary Tatenbaum (1999) argues that it is important to have a senior human resource executive in the merger negotiation process from the onset. He is of the view that they should be involved early enough to carry out cultural audit and that if this is done it can save the process from potential pitfalls. He further suggests that the team responsible for integration should identify the cultural traits that are in line with the objectives of the new entity and ensure these traits are imbibed into the new entity. Managers from both entities should be engaged and involved in the process. Tatenbaum's research revealed that 47 percent of senior managers in an acquired firm leave within the first year of the acquisition. He therefore suggests that the integration team should do all that is possible to retain and motivate talented personnel. The team should ensure that the right people are deployed to the right roles. Also the team should carefully manage the downsizing exercise such that builds confidence and does not cause exodus of employees. Likewise the team should ensure that systems and procedures that are implemented are consistent with the strategic intent of the new entity such that takes into consideration the cultures of the merging entities.

Communication is very important in a merger as it plays a significant role during the integration of the firms; this is also further highlighted in the KPMG (1999) studies. Clear and sincere communication promotes confidence among the employees and builds trust. It helps to take away rumours and hence minimizes negative reactions from employees. It is safe to let the employees know what is going on than for them to guess and spread false information. They need to know about the other company, the intention of the company they are merging with, the likely changes that will take place and how these changes will affect them. They need to know what will possibly happen to their jobs, their colleagues and their company at large. Employees appreciate transparency and openness and usually respond negatively when they perceive signs of dishonesty like were the case when Intel acquired Chips & Technologies in 1997 and when IBM acquired Rolm in 1984. In both instances sizeable number of employees from the acquired companies left due to lack of openness and the fact that the acquiring companies were not properly carrying employees in the acquired companies along in its decisions and actions.

Sirower (1997) suggests that the acquiring company should figure out the market expectation of the company to be acquired before the acquisition, the impact the eventual merger will have on competitors and what their response is likely to be. The company should estimate the possible improvement in performance as a result of the merger and the resources including human resources that will be required to attain that performance. It should look beyond the merger period to the post merger period and estimate possible further investments that may be required to move things forward in the desired direction. The company should consider and compare alternative opportunities such as entering into a strategic alliance as against a merger or acquisition. And if going into a merger is the preferred option it should combine with the right company. Take the case of Union Bank of Switzerland, which concluded after deep consideration that merging with Swiss Bank Corporation (SBC) was a better option for it than merging with Credit Suisse especially for the following reasons: stronger potential synergy, closer cultural match and smaller overlap in the area of investment banking (Paterson, 1997). Coming together will help both companies realize a saving of CHF3.5 billion per year from operations, infrastructure, trading rooms, branch network in Switzerland and employees. Excess capital realized from the sales of redundant facilities and operation can be re-injected into the business.

CONCLUSION

It is indeed a fact that mergers and acquisitions are burdened with risks including overpayment and strategic incompatibility. However, companies can minimise the chances of failure by assessing the level of risk involved from the onset, keeping the integration process flexible and focused, and paying attention to factors that can drive value (Heinick, 2010). Mergers and acquisition should be treated with utmost caution. The companies involved should look before they leap. The implications of a wrong merger or acquisition go well beyond financial losses. The company's entire business process may be disrupted, employees may leave, customers may flee, and suppliers may lose confidence. It is therefore imperative that the companies going into the merger carry out in-depth assessment of the transaction. They should thoroughly analyze every area of potential failure; analyze areas that they consider synergistic. Failure to embark on in-depth risk analysis could as well mean the beginning of failure (Eccless, Lanes & Wilson, 1999). Before going into the merger the company should ensure that there is clearly defined and understood reason to go into the merger in the first place. It should consider other alternatives that may be available such as strategic alliance. And even when the company ascertains that going into a merger or acquisition as the case may be, is the right option it has to then decide on which company to merger with after a thorough analysis of all the available companies. The underlying objective of the merger or acquisition should be to grow shareholders' wealth. The deal should not be entered into for the wrong reasons such as the protect the interest of the chief executive and other members of top management. It is known that some chief executives push for mergers simply to retain their position and/or boost their personal ego (Wulf, 2000). It is therefore important that the board of directors ensure that the deal is not merely to satisfy the desires and interests of top management but rather to create real and sustainable value for the shareholders and indeed other stakeholders.

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