Mergers: game, set and mismatch

Corporate love and marriage often go together like a horse and railway carriage. Peter Webb asks why what sounds right in theory can look wrong in practice and what distinguishes merger success from failure

History shows mergers are often the greatest misuse of investors' money. Company 1 buys company 2 and successfully creates company 1.5! When a merger or takeover is announced it is important to understand the nature of the deal: why is the company being taken over or merging and what is the motive?

In maturing industries, mergers or takeovers are sometimes completed to bring cost savings to the business. This can be achieved by cutting out duplicated parts of the supply chain or routes to market. Often looking for economies of scale is not so straightforward. If the business is already uncompetitive it is probably the business that needs internal reform rather than trying to leverage its power over the industry. It may make commercial sense in theory, but economic reality will always dawn later rather than sooner.

The bargaining power of suppliers can also have a significant bearing on things. If Tesco merged with Wal-Mart in the UK then the suppliers would no doubt be under enormous pressure and such a merger would be unthinkable from a regulatory viewpoint.

Two clothes empires may be less objectionable. Non-perishable goods suppliers have a very large and wide market to aim for and as such, while their bargaining power may increase, its effect would not be as exponential as the former example.

Basing a takeover or merger on entering a new product area is risky. The question you have to ask here is why the company is pursuing this goal. If organic growth is poor in its existing business, is muddying the water by buying growth the right strategy? Once tangled up in the pursuer's net, the young enterprising company may take time to integrate and may lose key people who don't want to be small fishes in a big pond. Lotus was a big competitor to Microsoft until IBM acquired it and the rest, as they say, is history.

Going for vertical integration is also a weak reason to take over or merge. An example of vertical integration would be a distributor buying a retailer or vice versa. The two entities tend to exist for specific reasons and for specific roles. In my experience, merging the two into one corporate structure would mean margin pressures or operational issues from the weaker business, which tends to indirectly leak into the other. You can also find that business partners of either may mistrust or try to leverage the relationship against the company. This wouldn't happen if they were separate businesses.

If there is no clearly definable motive I would classify it as empire building. Most 'ego' mergers destroy the brand and structure of one company and merge it amorphously into the other. Doing this often means bad practices and inertia overtake the bought company and old systems and ways of doing business die when the merged party loses its identity. Customers are a fickle bunch and often they will not show the same purchase patterns as before. By keeping a merged operation separate on some levels, companies can at least ensure the dynamism and existing structures in the acquired business are retained.

Remember Midland Bank? This was acquired by HSBC on the basis of expanding market reach and also on producing economies of scale. It achieved both because it followed a simple, slow and well-managed integration path.

In contrast, when Hewlett Packard took over Compaq it immediately re-branded everything from its products to its buildings. It successfully stamped its style and authority all over the acquired company and also successfully stamped on its employees and customers, who promptly decided to get out of the way. When HP acquired Compaq the combined sales of their PC divisions put them in the number-one position in the market. But by Q3 2002, a little over a year later, Dell had the top spot.

On the flip side, sometimes these sorts of actions can throw up interesting opportunities as well. All takeovers are difficult, in my opinion, and there is never an easy integration between two businesses. There is generally always some level of disconnect between the theory and the reality of putting the takeover into practice. Inevitably, when this 'disconnect' occurs the business will suffer.

There are two takeovers in the market at the moment that I have my eye on. The first is the **Morrisons (MRW)** takeover of Safeway and the other is the **Clinton Cards (CC.)** takeover of Birthdays. Both are choking somewhat on their feast but I think negative sentiment is overdone on both in what are essentially pretty stable businesses. If either sees a return to reasonable levels of profitability, of which I see both as having excellent chances, then the current share prices on both these companies show significant undervaluation.

There needs to be a very clearly demonstrable reason for any takeover to take place. If there is none it will probably destroy rather than create value. Companies that integrate slowly and carefully are more likely to succeed than those that don't. Companies that maintain some element of identity in the acquired company also seem to retain more value. On the flip side, if an acquisition has taken place and is not working out, if the core business is stable, then it may be seen as an opportunity as much as a problem. ■