Covalence Solutions LLC

Strategic Directions

Organizational Structures and Controls to Support a Growth Acquisition Strategy

Acquisitions and Diversification to Support Growth

A Brief Overview of Mergers and Acquisitions

Those who cannot remember the past are condemned to repeat it. - George Santayana

Introduction

The 1960's through the 1990's have provided students of mergers and acquisitions ample opportunities to study the characteristics of companies that have been successful in post merger and acquisition environments. Noteworthy among these studies has been the work of Charles W. L. Hill, Alfred D. Chandler, Jr., Andrei Shleifer, and Robert Vishny to name but a few. This white paper outlines some of the key concepts and conclusions that have been drawn by the preceding authors, about organizations that operated in the context of a Mergers & Acquisitions (M&A) diversification strategy. This Section and those that follow are not intended as an endorsement of any particular strategic approach or of the conclusions of the Authors referenced herein. The intent of the document is to provide a backdrop for discussions about corporate structure as it applies to the integration of acquired or merged companies.

Lessons of the Past

The 1960's – Unrelated Diversification

Because of the anti-trust environment of the United States Government in the 1960's, much of the M&A activity was focused on unrelated diversification.[1] Shareholders rewarded this strategy over related diversification strategies in part because of the costs associated with gaining approval from the government for these types of mergers.[2] The 1960's wave of unrelated acquisitions has been associated with the development of conglomerates in the United States. By the 1970's, it had become clear that these acquisitions did not improve the financial performance of the acquirer.[3] Approximately half of all unrelated acquisitions from the 1960's were divested by 1989.[4]

The 1980 through 1990 – An Economic Correction of the 1960's

The 1980's, as a result of the relaxation of the government's anti-trust posture under the Reagan administration, was dominated by "bust up" takeovers. Many of these acquisitions were highly leveraged. The scale of the acquisitions is also noteworthy. Approximately 28% of the 1980 *Fortune 500* were acquired by the end of the 1980's. [5] The 1960's had produced large conglomerates, often with 30 to 50 unrelated divisions. These companies were ripe for restructuring and divestiture because the complexity of managing a portfolio of this magnitude was causing companies to perform below more focused competitors.

Within several years, divestitures of a significant percentage of an acquisition's assets followed a takeover. Seventy percent of the divestitures of assets acquired in hostile takeovers ended up managed by companies that already operated in related markets.[6] Many saw this period as an economic correction to the unrelated diversification of the 1960's. Once again, financial investors rewarded the divestiture trend, however this time they favored related diversification over unrelated.[7]

There are several conclusions that have emerged about characteristics of success from case studies of the takeover period of the 1980's. Morck, Shleifer, and Vishny (1988) and Servaes (1989) point out that many of the successful acquisitions of the 80's were of poorly performing divisions or companies by related acquirers. By placing better management into these companies or improving internal capital investments, they were able to improve operational performance. Evidence also suggests that divisions of dissimilar companies fair poorly against companies that are specialized. Thus, synergies and focus have paid dividends. Restructuring efforts to support the acquisitions of this period were successful when they were driven by an operational imperative to refocus on core competencies. Restructuring driven by investment banks, financiers, speculators, and managers to achieve short-term profits were less successful.[8]

Leverage Buy Out's – Criteria for Success

A McKinsey study demonstrated that some (21 out of 800) unrelated diversification LBO's of the 1980's were successful as measured by returns of 18% to 35%.[9] These companies shared several common characteristics. Perhaps the most important was their ability to achieve value creation through operational performance, not from financial leverage, market timing, or industry selection.[10] The second most important factor for these companies was their ability to retain managerial talent at the acquired entities. Since 85% of the successful companies retained pre-acquisition managers, management at these companies must have been talented already. Key to motivating the senior management at the acquired companies was the substantial ownership positions given to operational management. If the companies were successful, management became millionaires.[11] The final success factor was that most actions taken to create value were achieved within two years of acquisition. Thus, the pace of change was rapid, highly focused and an imperative.

Conclusions

What becomes clear from examining the successful M&A companies is this: operational synergies and improved operational performance was cornerstone of their success, independent of strategy. However, largely, related diversification has offered the best opportunity for success. Be it as it may, considering the vast sums of capital and tumult that has been associated with the M&A boom, it is difficult to comprehend how fundamental concepts such as these, could be lost in the fray.

Organizational Options

One of the many reasons for the bewildering and tragic character of human existence is the fact that social organization is at once necessary and fatal. Men are forever creating such organizations for their own convenience and forever finding themselves the victims of their homemade monsters.

Aldous Huxley

Related Diversification as a Strategy

Diversification in the 1990's – Focus on Core Competencies

Related diversification strategies focus on managing risk and increasing financial performance by increasing geographic market coverage and exploiting synergies between similar product or service offerings. The majority of the growth to support related diversification in the 1990's has come through mergers and acquisitions, consolidations, or roll-ups.

Benefits of Related Diversification

The economic rational for diversification is described by transaction cost theory. This theory argues that cost efficiencies are gained by managerial coordination of exchange via the *visible* hand of the price system versus the *invisible* hand.[12] Furthermore, the underlying assumption of this statement is that diversification can lead to more efficient utilization of resources through economies of scope.[13] Economies of scope imply that financial gains can be achieved through the sharing of resources or the transfer of skills between otherwise distinct businesses. This is the fundamental principle of related diversification. Synergies are typically associated with internal growth and development. An acquisition strategy is fundamentally at odds with this approach since it is often associated with short term returns on investment. Thus, to ensure that the whole is larger than the parts, management must facilitate the integration and collaboration of the companies acquired.

Chandler and the M-form Company

The M-form organization, first defined by Chandler, has been credited with enabling economies of scope for multi-business companies. As companies become more complex and diversified, functionally organized vertical hierarchies moved to the M-form structure to make complexity manageable. *"M-form firms can achieve a more efficient allocation of capital resources, and police efficiency of divisions more effectively, than the external capital market could were each division a freestanding firm in its own right.[14]"* Conceptually, an M-form firm is composed of self contained business units structured either along geographies or products/services. Operating day-to-day decisions are decentralized to the division level. Accountability for profits resides with the divisions. A distinct and separate corporate head office accomplishes coordination of the divisions.

What has emerged from case studies of related diversification strategies are variations of the M-form structure that have led to financial success. The next section attempts to summarize the characteristics of successful M-form organizations as a function of the market segments analyzed.

Corporate Structure and the M-Form Organization

M-form Variations to Address Varying Complexities

Table 1 was created based upon the independent works of Charles Hill and Alfred Chandler in 1994. The basis of the information in this table was the results of an in-depth study of 24 companies selected for their financial success. Much of the table builds upon a table that Chandler created in 1995. Chandler's work was an extension of a 1987 study by Goold and Campbell that defines three main strategic "styles" that have been successful for certain types of companies: Financial Control, Strategic Control, and Strategic Planning. The M-form structure defined in this table breaks the study participants into three components: Corporate or Head Office, Divisions – focused on customer segments or product lines, and a Business Units – organized based upon service or product segments within a Division.

Control and Planning Directions

The purpose of the table is to increase the understanding of what mechanism a merged corporate form envisions for planning and control. The level of operational integration, information system support, and corporate functions required, change dramatically based upon these decisions. Additionally, change management scope, timeframe, and direction is also defined based upon the answers to these high-level management decisions. Thus, as a precursor to planning the integration effort, concepts about where planning and control reside within the organization must be defined clearly to establish the scope of the change effort.

Table 1 - Planning and Control for M-form Companies

Coporate Form	Financial Control	Strategic Control	Strategic Planning
Size of Head Office	Small	Large	Large
Mechanism of Control:			
- Budgets	Strong	Moderate - tied to Strategy	Weak - tied to Strategy
- Strategic Plans	None	Moderate	Strong
Responsibility for Strategic Direction	Business Unit	Divisions	Head Office
Inter-business Dependencies	Low	Moderate	High
Suited for:	Service Industries	Stable Products	High Tech
	Mature Manufacturing	Complex Marketing	R&D High
	Products that are not technically complex	Focus is on Efficiencies	Short Product Lifecycles
	Competition is in distribution & marketing	R&D is important but not Critical	Creative Product Designs
	Stable Markets	Higher degree of Market Diversity	
Notes:	High Tech companies do not work well here	Strategy is developed by the Divisions. Divisions have strategic development staff.	Strategy is developed collaboratively from Business Unit, Division, & Head Office Management
	Most succesful rollups were in markets that did well with this type of control	Capital Projects and proposals are developed by the divisions.	Strategic Planning is focused on interbusiness synergies.
		Head Office sets goals and financial targets.	Financial targets and budgets are flexible and not tied to compensation.
		Budgets and financial goals are taken very seriously.	

[1] Shleifer and Vishny, 1994
[2] Matsusaka, 1990
[3] Ravenscraft and Scherer, 1987
[4] Porter, 1987
[5] Shleifer and Vishny, 1994
[6] Bhagat et al, 1990
[7] Morck, Shleifer, and Vishny, 1990
[8] Chandler, 1991.
[9] Anslinger & Copeland, 1996
[10] Kaplan, 1989
[11] Jensen, 1989
[12] Coase, 1937
[13] Penrose , 1959; Chandler 1962,1977
[14] Hill, 1994