

BUSINESS COMBINATION & RISK MANAGEMENT

PART I

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Executive Summary

In the beginning, corporations were given a very narrow legal mandate. However, as capitalism grew, the legal rights of artificial entities were expanded to mirror those of natural persons. Consequently, corporations acquired the rights to own and be owned, sue and be sued and even engage in activities outside of their charters.

No other legal right has corporations exercised more than the right to enter into unions – a recent study by Thomson Reuters indicates that the dollar value of global mergers & acquisitions activities in 2010 surpassed a whopping \$2.4 trillion and this number is projected to grow in the coming years as capital market activities resurge.

Business combination is a good strategy to grow inorganically, when properly executed; it can lead to economies of scale, give a company opportunity to make a foray into uncharted territories, acquire an important source of supply, cross-sell products and expand internationally.

However, bigger is not always better. When poorly executed, mergers and acquisitions can put a company on a perilous journey –

sometimes leading to the demise of even the biggest of corporations. Lack of proper planning, management hubris, failure to evaluate the quality of a target's assets, valuation modeling mistakes, inadvertent violation of laws and a lackadaisical attitude on the part of the Board have all lead to business combinations horror stories.

While there have been uproars about executive remuneration in recent times, vast more money are wasted on poor acquisitions every year - it is therefore essential to examine business combination from a risk management standpoint.

In part one of this paper, we introduce the concept of mergers and acquisition and succinctly discuss successes and failures in business combinations. We also discuss how to develop a sound pre-acquisition strategy. In part two of the paper, we will examine the approaches for designing effective post-merger plans in order to ensure that the combining entities are properly integrated. We will also examine the accounting, regulatory and valuation issues to consider in a merger and acquisition transaction.

Introduction

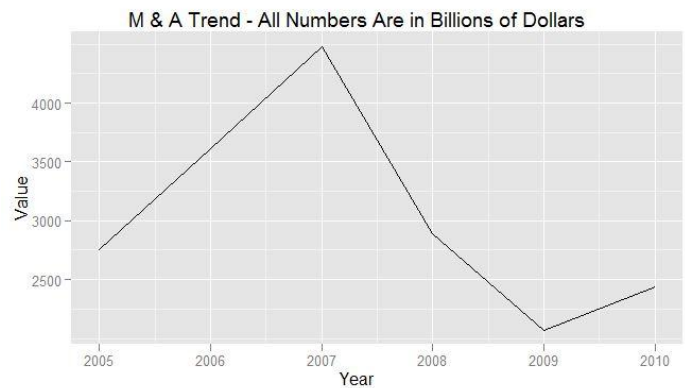
Business combination is a transaction in which a company (acquirer) obtains a controlling interest in another business (acquiree). In order for a business combination to qualify as an acquisition under relevant accounting rules, the acquiring

company must obtain ownership of more than fifty-percent (50%) of the outstanding shares of the acquiree.

Business combination is one of the most potent strategies available to companies to maximize shareholders' wealth - when properly implemented; it can lead to a greater market share, economies of scale, higher efficiency, positive synergy, knowledge acquisition, revenue growth and tax advantages. Business combination can also make a company bigger and the sheer size of an organization can be used for political leverage. The recent nationalization of Dexia – Belgium's largest bank - is a testimony to the fact that too-big-to-fail institutions are implicitly backed by the full faith and credit of the government.

Despite the allures of business combination, if poorly implemented, it can lead to diseconomies of scale, higher cost, concentration risk, conflict of objectives amongst disparate businesses, data integration issues, loss of key personnel, redundancy especially at management levels and outright failure.

Actually, studies have shown that more than 50% of all mergers and acquisitions failed to create the anticipated business values. Bad basis for decision making on the part of the company's management, empire building, failure to properly integrate the newly acquired company, inadequate measurement of a target's contingent liabilities, insufficient evaluation of the commercial and technical viability of the acquiree's business model, valuation modeling mistakes have all led to business combination gone awry.



Notwithstanding the dismal performance of some mergers and acquisitions however, the volume of acquisition activities continues to soar. According to Thomson Reuters, the value of worldwide Mergers and acquisitions activities rose by 22.9% to US\$2.4 trillion in year 2010 over the comparative figure in 2009 and this trend is expected to improve as the credit market opens up in the future.

Vast amount of resources are committed to mergers and acquisitions every year and if poorly implemented it can spell the death knell for any company. It is therefore expedient to examine business combination from a risk management perspective in order to aid organizations in avoiding the pitfalls inherent in mergers.

Failures & Successes in Mergers and Acquisition

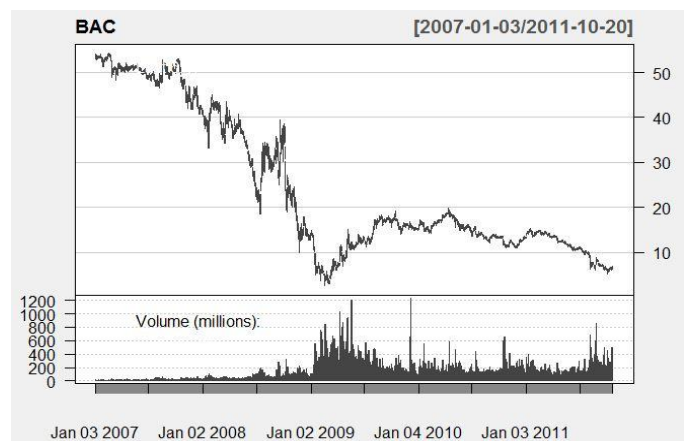
To underscore the importance of our discussion, it is vital to discuss some of the biggest failures and successes in business combination. These mini case studies will help decision makers develop knowledge of best practices to inculcate into their practices and also help them develop the sound judgment required to identify poor targets in order to avoid acquisition hazards.

Failures:

Washington Mutual (WaMu): WaMu was one of the biggest financial institutions in the United

States and had grown into a large bank via organic growth and mergers and acquisitions. In fact, WaMu acquired sixteen (16) banks in the west coast between 1990 and 1996. However, WaMu's greatest undoing was the acquisition of Long Beach Financial – a notorious company, with very poor underwriting standards. For instance, it was reported that Long Beach Financial made a \$720,000 mortgage loan to a strawberry picker with an annual income of \$14,000. WaMu also made a foray into the subprime credit card market through its acquisition of Provident for \$6.5 billion in 2005. However, as the financial bubble started to burst in 2007, WaMu and its acquired companies began to incur losses and charge-offs at an unsustainable rate and was eventually bought by JP Morgan at a break-up value. WaMu's greatest mistake was its late entry into the subprime market and the acquisition of companies with poor asset quality. The company failed to evaluate the quality of its targets' assets and also failed to understand the risk contributed by its acquirees to its risk appetite tolerance.

Bank of America (BofA) & Countrywide: BofA has always been driven to be big. The vision of the company's management has always been to build a southern brand that can compete side by side with Wall Street. And to be honest, the company was very successful in this endeavor. However, even in success, one must know when to stop. In a bid to feed his own ego, former BofA CEO and mergers and acquisition strategist, Ken Lewis, acquired the king of subprime mortgages, Countrywide for \$4 billion in 2008 at the pick of the financial meltdown.



The fundamental flaw in this acquisition was BofA's failure to adequately analyze Countrywide's contingent liabilities. It turned out that Countrywide had been reckless and dishonest in its loan acquisition, underwriting and securitization strategies consequently costing investors huge losses. In order to make good on their losses however, investors hit BofA with a litany of lawsuits claiming billions in damages. In addition, BofA has suffered huge credit losses running into the billions of dollars from the toxic mortgages it acquired from Countrywide.

It is worthy to note that in a similar strategy BofA acquired Merrill Lynch at the peak of the financial crisis and has also suffered billions of dollars in losses as a result of this acquisition.

This case study highlights the importance of properly evaluating the contingent liabilities (such as warranties, litigation etc.) of a target before consummating a merger.

The White House & Solyndra: The White House has been embroiled in a controversy over a loan guarantee of \$535M it made to Solyndra shortly before the "Green Technology" firm went belly up. While this is not a private sector arrangement, the decision making process is very similar.

The major misstep made by the government in this guarantee arrangement is the

failure to properly evaluate the risk of bankruptcy of the investee, that is, the financial due diligence upon which the decision to invest was made was done hastily. A strategy that could have been used to avoid this pitfall was to calculate the Altman Z-Score risk of bankruptcy.

Secondly, the government decision makers failed to properly evaluate the sustainability of Solyndra's business model vis-à-vis its competitors. No sooner the government invested in Solyndra than its Chinese counterparts developed cheaper and more efficient solar panels consequently rendering Solyndra economically unviable.

However, it should be noted that government often times invest in projects for other than profit making reasons, for example, to encourage the development of a fledgling industry as in this case.

AOL & Time Warner: Perhaps the great grandfather of business combination failures in history, the union between America Online and Time Warner in 2000 was doomed to fail from the outset because it was a combination of two culturally incompatible entities. First, AOL was a relatively new generation company whereas Time Warner was an old traditional media powerhouse. While the management of the former made decision at a relatively rapid pace and in quick succession, the management of the latter was more conservative in its decision making process. Consequently, the management philosophy of the two entities did not completely mesh.

Secondly, the merger was consummated so that the two companies can take advantage of each other's competitive advantage. On the one hand, AOL ISP platform was based on dial-up technology and if AOL was to remain competitive, it needed to upgrade its network to broadband cable network. As a result, AOL wanted to merge

with Time Warner in order to access Time Warner's high speed broadband network facilities.

On the other hand, Time Warner felt like the internet was going to become the broadcast medium of choice in the new millennium, consequently, it entered into a merger with AOL so that it can sell its proprietary contents to AOL's paid subscribers of about 32 million people.

In hindsight, the rationale for entering into this merger seems shortsighted. It was not well established that AOL's paid subscribers, who were mostly based in the rural areas of the United States, had any interest in paying for online proprietary contents. Also experts have asserted that AOL could have fared better entering into a strategic partnership with Time Warner to provide access to its broadband network rather than going into an outright merger.

Some of the largest M&A Transactions in History				
No.	Year	Acquiror	Acquiree	Value (in Bil. USD)
1	1999	Vodafone	Mannesmann AG	202.8
2	2000	AOL	Time Warner	164.7
3	2007	Shareholders	Philip Morris	107.6
4	2007	RFS Holdings BV	ABN AMRO	98.2
5	1999	Pfizer Inc	Warner Lambert	89.2
6	1998	Exxon Corp	Mobil Corp	78.9
7	2000	Glaxo Wellcome	Smitkline Beechan	76
8	2004	Royal Dutch	Shell Transport	74.6
9	2006	AT&T	BellSouth Corp	72.7
10	1998	Travelers	CitiCorp	72.6

However, the grand reason for the failure of the merger was the overvaluation of AOL due mainly to the internet bubble of the 1990s. During the 1990s, many of the dotcoms were tremendously overvalued and to some extent without ever making any profit. In the case of this merger, AOL, which was making about half the cash-flow of Time Warner, was valued higher ending up with 55% of the voting shares and Board representation in the combined company, AOL Time Warner Inc., valued at about \$360B.

Also, it has been reported that some of the assumptions and statistical data used to calculate the fair value of AOL were a little suspect, for example, AOL boasted that it had 32 million paid subscribers as at the time of the merger but it was not clearly established whether the list contained names of members who only subscribed for the 30 days free trial marketing promotion. Statistical numbers like these are important and should be verified because they drive the estimation of future revenue upon which the market value of a company is based.

Eventually, when the internet bubble started to burst in the early 2000s, it was obvious that AOL was highly overvalued and the consolidated entity had to take a massive goodwill impairment loss of \$54B on AOL in order to comply with relevant accounting rules. By 2003, the stock price of AOL Time Warner had fallen from its peak price of almost \$90 in 2001 to \$13. Since AOL turned out to be an unequal partner, AOL Time Warner changed its name back to Time Warner and almost all the Board members from AOL were replaced by Time Warner representatives.

All in all, the proposed synergy of the merger never materialized and both companies went their separate ways in December of 2009.

WorldCom: Between 1991 and 1997, WorldCom completed the acquisition of sixty-five (65) companies and grew from a relatively obscure long-distance telephone company in Mississippi to one of the largest telecommunication companies in the world. However, all these acquisitions were done without a clear strategic vision on how to integrate the disparate systems and business processes within the combining entities. Poor integration of the acquired companies resulted in disparate systems of accounting and eventually resulted in a huge

financial misstatement. When the results of the investigations of the accounting malpractices that led to the bankruptcy of WorldCom came out in 2006, it was reported that the total accounting fraud at the company amounted to a staggering \$79.5 billion making it one of the largest scandals in America's corporate history.

For instance, after the acquisition of MCI, WorldCom reduced the book value of some of MCI assets by several billion dollars and increased the value of goodwill by the same amount. This loose interpretation of acquisition accounting standards enabled WorldCom to book smaller charges against earnings by spreading large expenses over a longer period.

In addition, WorldCom management treated operating expenses as capital expenditures and tweaked its assumptions about the accounts receivables it inherited from the acquired companies ignoring the credit department's lists of bad debts. First, this strategy reduced the amount of money that the company would provide for bad debt resulting in higher earnings than actually generated by the company. Second, ignoring to properly record bad debts increased the amount of cash WorldCom received from third parties when it sold the receivables to manage working capital.

The lesson learned from this case study is that growing too big too fast can make a company too complex to manage and that having adequate plans to integrate the combining entities will save a corporation operational nightmares and even bankruptcy in the future.

Successes:

However, it is not all gory tales; some business combination transactions have turned out to be very successful and are worth emulating.

eBay & PayPal: This merger illustrates how a company can drive value by vertically integrating with a major supplier of services. The critical success factor in this business combination which was consummated in 2002 for \$1.5B was the complementary nature of the missions and visions of both the acquirer and acquiree. Prior to the merger, both companies operated in the same market space and in fact, PayPal was already serving seventy-percent (70%) of eBay's customers. Therefore, the acquisition gave the consolidated entity an opportunity to more tightly integrate PayPal's services with eBay online auctioning system in order to better serve their customers.

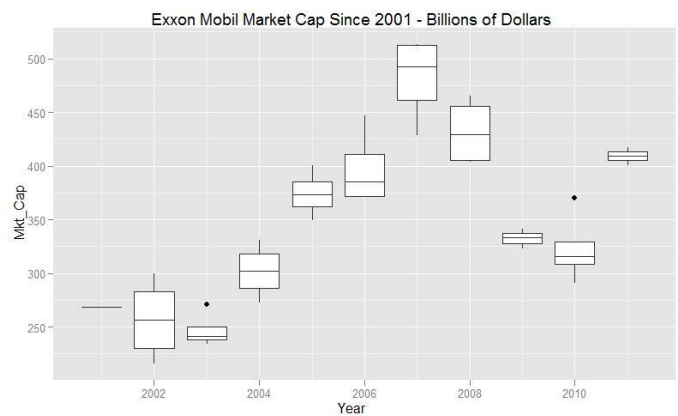
Another factor that made this merger a success is the similarity in the management philosophy and operating style of both eBay and PayPal - because both companies were founded during the dot-com era it was relatively easy to integrate them.

Lastly, eBay's acquisition of PayPal reduced competition in the person-to-person payments business. Prior to the merger, eBay had a subsidiary – BillPoint - which directly competed with PayPal; however, BillPoint could not catch on with PayPal because it came late into the business. Consequently, after the merger, eBay shutdown BillPoint and focused its attention on PayPal. This move reduced competition and turned PayPal into a virtual monopoly in the person-to-person payment business.

Disney & Pixar: When Disney took over its smaller rival Pixar for \$7B in 2006, critiques thought it was going to be a terrible failure like other large acquisitions in the media industry. However, Disney and Pixar avoided the treacherous journey of most business combinations by having a clear strategic vision for the new company.

The consolidated entities anticipated potential integration challenges and took steps to address them beforehand. Specifically, the company established steering committees to create a learning culture and to develop learning teams. The combining entities also had a history of working together and understood the cultural dynamics of each other before the merger so they meshed easily.

Since the merger, the two companies have released on a number of block buster hits such as WALL-E, Ratatouille and Toy Story 3. The merger can be considered successful because the consolidated entity achieved the proposed synergies for going into merger.



Exxon-Mobil Merger: The merger between Exxon and Mobil, which was consummated in 1999, highlights how companies can maximize shareholder's wealth by entering into a horizontal integration.

The merger succeeded because both companies focused on their core industry (oil industry). Consequently, the consolidated entity achieved operating synergies vis-à-vis a reduction in duplicate facilities, research & development expenditures and general and administrative costs.

Also, because both companies were in the same industry, it was relatively easy to integrate them. One of the ways of measuring the success of

a merger is the comparison of the pre and post-merger market capitalization. A review of the chart above indicates that the market cap of Exxon-Mobil has increased from about \$270B in 2001 to about \$401 as of the end of the third quarter of 2011, an indication that the merger was a success. Indeed a testimony to the saying that the whole is greater than the sum of its parts.

Pre & Post Acquisition Strategies

Pre-Acquisition Review:

Successful mergers begin with a thorough pre-acquisition review. A pre-acquisition review helps a company to evaluate the complexity and riskiness of the merger and acquisition strategy. It also gives the acquirer an opportunity to anticipate some of the challenges that will be encountered during the post-acquisition phase and how to mitigate or eliminate the impact of those challenges.

A practical way to implement a sound pre-acquisition strategy is to develop a checklist to gather information and important data about the target that will impact the ultimate decision making process. A checklist process will also help a company perform its own due diligence and determine the extent of involvement of outside consultants. To implement this process, the information to be collected about the target can be categorized into different sections such as (i) General Background (ii) Product Lines, Markets, Industry Condition and Competition (iii) Financial Consideration (iv) Operations (v) Human Resources (vi) Legal Matters (vii) Management Styles and (viii) Research & Development.

Once the sections for which the pre-acquisition data are required have been identified, a checklist can then be developed to gather the relevant information about the specific areas. An example is shown below:

GENERAL BACKGROUND INFORMATION	Y	N	Note
Have you obtained information or made a judgment about: <ol style="list-style-type: none"> a. The image of the company and its products and services compared to those of industry leaders? b. The reputation of present owners, directors, management and professional advisers? c. The trend of market share? d. Recent major developments among competitors? e. The extent of government regulation (including EPA and OSHA) under which the company operates? f. Other external factors affecting the company? g. New developments planned or in progress, including: <ul style="list-style-type: none"> • The relationship of programs to the company's position in the industry? • The state of definition and discipline in specific plans? • Capital equipment commitments? h. Special skills and advantages, such as: <ul style="list-style-type: none"> • Technical position? • Established market? i. Major litigation, pending or potential? j. Cyclical factors affecting the industry? k. Credit rating? 			
Source: Fiserv Preacquisition Review Checklist			

Please note that the list above is not exhaustive and was included to show an example of a pre-acquisition checklist. Also note that a separate checklist should be created for each of the categories noted above. In addition, all answers (Yes or No) to the questions in the checklists should be supported by verifiable evidence.

Conclusion (Part 1):

In part one of this paper, we introduced the concept of mergers and acquisition and succinctly discussed successes and failures in business combinations. We also discussed how to develop a sound pre-acquisition strategy. In part two of the paper, we will examine the approaches for designing effective post-merger plans in order to ensure that the combining entities are properly integrated. We will also examine the accounting,

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