Perfecting the Art of the Deal

Applying Strategic Stress Tests to Greatly Increase the Odds of M&A Success

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Numerous studies have shown that roughly two out of three corporate acquisitions fail, as measured by the performance of the stock of the acquiring company. What if those odds could be flipped? What if it were possible to succeed two times out of three and just fail a third of the time?

Our research suggests this is possible. A 20-person team that spent two years investigating 2,500 major corporate failures from the past 25 years found that almost half stemmed from ill-conceived strategies that should never have been pursued. Applying the lessons derived from that research can help executives dodge problems and reshape strategies in ways that greatly increase the chances of success.

The issue is timely because there's likely to be an awful lot of acquiring over the next few years. That's because the sort of lull in activity that currently exists has historically been followed by a burst of M&A activity. The severity of the recession may, in fact, mean deal activity will be far greater this time around. The crisis is creating scads of targets, many of which never would have been in play before. And many companies that are available for purchase are especially attractive because they haven't had time to really deteriorate; they just need a shot of liquidity, and they'll be good to go again.

But the possible downside is enormous, too. Just ask Bank of America about its $50 billion acquisition of Merrill Lynch. Or ask private-equity fund Bay Harbour Management about its decision to buy the Steve & Barry's retail clothing chain out of bankruptcy proceedings for $168 million last year, only to announce three months later that it would liquidate the chain. Based on our research, we identified both those deals as flawed at the time they were announced, but it was too late for BofA and for Bay Harbour. (For more on our thoughts on these and other deals, see our blog at blog.billiondollarlessons.com)

The time to get things right is now, not when the deal pipeline starts to fill. That's because our research found that, once a deal is in the works, it's hard to stop, even when it's a bad idea. Companies need to agree ahead of time on the sorts of quality checks and process safeguards that will let them strengthen weak ideas and stop bad ones. In other words, executives can take advantage of the current lull to make sure that, when the deals start flowing again, they can have those two in three odds, not the one in three that have historically prevailed.

In this paper, we'll lay out a quality assurance process that we call the Strategic Stress Test. Companies should be putting this process in place now, because good deals will make heroes of the acquiring companies and their senior executives while bad deals will sink others.

The Strategic Stress Test

Acquisitions are tempting for a CEO. While many issues such as organizational change get filtered through level after level of a business, the CEO can, almost alone, transform a company by making the right, strategic purchase. Besides, CEOs typically don't want to just occupy the chair for a few years. They're usually bold people and want to attempt something that will leave a mark on their companies and their industries. Acquisitions can accomplish that goal.

The environment in which CEOs operate practically demands acquisitions. Securities analysts often argue for them. Investment bankers and consultants offer a steady stream of targets, along with assurances that buying them would be guaranteed successes. If earnings ever falter, investors insist on having a story—ready by the next earnings report—about how the company will soon return to prosperity. Boards may share investors' impatience. Often, M&A offers the only quick fix.

Yet acquisitions usually fail, partly because decisions have to be made fast when an opportunity arises. Something is for sale. Do you want it? Well, do you? The clock is ticking. (BofA CEO Ken Lewis decided to buy Merrill after less than an hour of negotiating, for fear that he'd be outbid if he didn't act immediately.)

The other main problem is that the evaluation of deals can happen in an echo chamber. If the senior executive team perceives that the CEO wants something to happen, they often censor objections and gloss over potential problems. Even the best investment bankers and consultants become too optimistic about the chances for success. (Studies have shown that, try as they might, their judgment is influenced by the prospect of getting big deal fees or additional work following a merger.) Boards can spot problems, but directors are sometimes reluctant to speak up because they don't have as much information as the CEO and seldom have as much background in the industry. In addition, vetoing a deal or demanding major changes to a strategy is usually a bring-on-the-next-guy decision, so, when in doubt, boards tend to acquiesce in silence. Even Warren Buffett says in *Snowball,* the recent biography of him, that, while on the board of Coca-Cola, he failed to challenge the CEO about an issue even though he was quite sure the CEO was making a serious mistake and was right.

Given the tough environment, CEOs need a way to get a fast, objective read on the potential problems with deals, perhaps as a warning that a deal should be avoided at all costs but more often to shape negotiations and to warn ahead of time about where problems with post-merger integration will occur. Based on our research, we have devised a process that is so quick that it can occur in as little as a weekend. The process is

unbiased because it is led by individuals who have not been involved in the strategy discussions that led to a possible deal, and because those individuals have no stake in any work that might follow an acquisition. The process can spot almost any problem because it incorporates research that has investigated every issue imaginable.

The process would have prevented a great many of the failures we studied for our recent book, *Billion-Dollar Lessons: What You Can Learn From the Most Inexcusable Business Failures of the Last 25 Year.* We have seen the process work in many different companies in numerous situations, reshaping deal strategies and heading off potential problems.

Philosophically, the process is akin to the "devil's advocate" that the Catholic church used for centuries to safeguard canonization, by which the church declared someone to be a saint. In the Middle Ages, the church began appointing a person to gather all possible evidence that would challenge the idea that someone should be canonized. While the name "devil's advocate" is a bit challenging, two things should be noted. First, the formal name of the office was *promotor fidel,* or "promoter of the faith." In other words, the idea was to build the church, not to be punitive. Second, the office was effective. Since Pope John Paul II abolished the office in the early 1980s, the rate of canonization has increased by a factor of more than 20, amid reports that church officials have ignored compelling, unflattering evidence.

Our strategic stress test calls for an independent review, akin to the Catholic church's devil's advocate process, and consists of three parts, as shown in Figure 1.

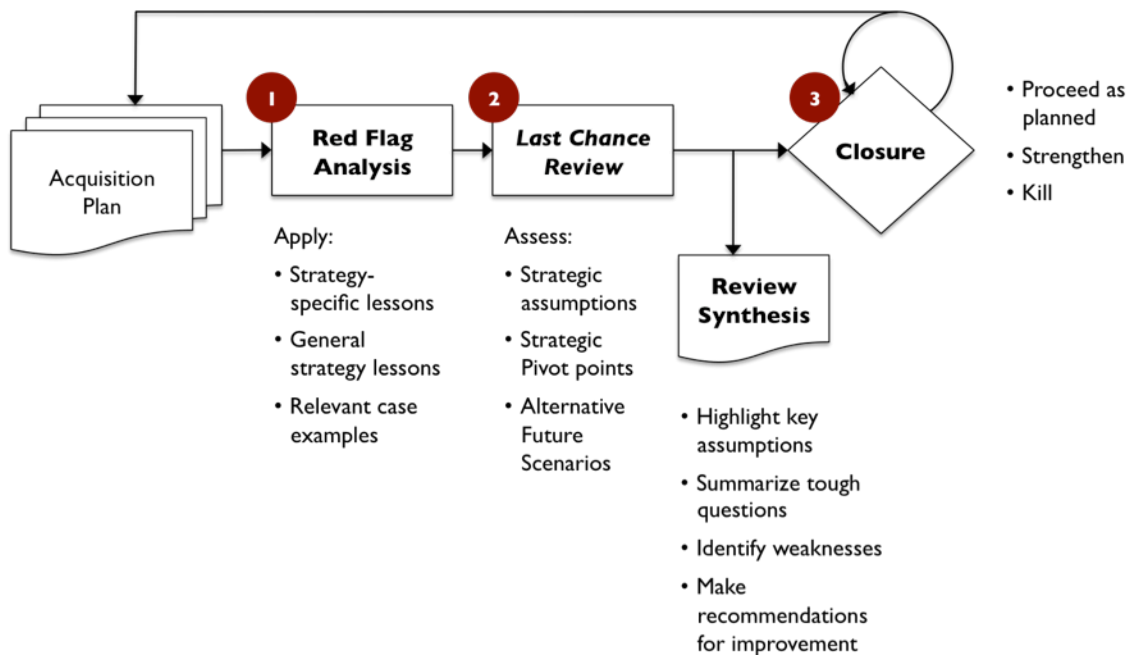

Figure 1 – The Strategic Stress Test for M&A Transactions

The first examines the potential deal against the lessons of past failures. We draw on our research to find companies that attempted something similar to what is being contemplated and failed. That way, we can be sure a proposed strategy doesn't raise any of the red flags that indicated the others were about to flop. This part of the process differs from the norm because the tendency in businesses, as in business books, is to look at success stories and say, "Here's how we can be like those guys." We instead look at failures to figure out, "Okay, here's how we can avoid being like those guys." After all, you don't go to a roulette table and interview just the winners if you want to get a sense of the odds inherent in the game. You would interview losers as well as winners.

The second part consists of a "last-chance" independent review that looks at any red flags, at any questionable assumptions, at all risks, etc. This review should be done toward the end of the process but before it's too late, before the momentum is so great that almost nothing can stop the deal. As one executive put it, "Once the lawyers are in the room, it's too late to turn back." The review should certainly be done before the CEO has made any sort of commitment and therefore risks embarrassment if he backs away from the deal.

The third part consists of working with management and, if appropriate, the board of directors to come to closure. We generally find that most of the value of the strategic stress test comes from the discussion that it sparks and the questions that it raises. Still, it is important to have the discipline to develop a final report that summarizes and synthesizes the team's discussions and findings, including a prioritized list of critical questions. This report drives management's final deliberations on the potential transaction, at which point a company might decide to either kill a deal or to scale ambitions back to more realistic levels.

Red Flags

The research for *Billion-Dollar Lessons* suggests that any deal should be passed through three initial screens to look for red flags. One is based on the strategy that is underlying the deal. This is necessary because our research found that seven strategies are most often associated with failure. The second screen checks to see if you might be making one of the seven most common mistakes that showed up in the research. The third screen draws on our database of failures to find examples that resemble the strategy being considered, to allow for comparisons that can highlight potential problems.

The First Screen

The seven strategies most associated with major failure are: 1) *attempts at synergy*; 2) *moves into adjacent markets*; 3) *financial engineering*; 4) *consolidation of an industry*; 5) *rollups*; 6) *the leveraging of what is expected to be a breakthrough in technology*; and 7) *"staying the course"*—essentially, continuing to try to build the traditional business even though the industry may be changing. These seven strategies aren't always going to fail. Far from it. These strategies can also produce notable successes. Still, if you are pursuing

one of these seven strategies you need to be sure you aren't making one of the mistakes that often doomed such strategies to failure.

While it would take too much space to go through all those failures here, we'll cite the four red flags that indicate potential problems with a consolidation strategy, as long as the pressure from the recession has so many industries in a consolidation phase.

First, purchasers often focus so much on the assets that they're buying that they gloss over the problems they're also taking on. Ames Department Stores actually made this mistake three times over 15 years, buying chains of discount stores to try to get national scale and compete head-on with Wal-Mart, only to find that many of the stores were deeply unprofitable and needed to be closed. Ames filed for bankruptcy protection twice and liquidated in 2002.

Second, companies focus so much on generating economies of scale that they don't realize they are often creating diseconomies of scale, too. US Air made this mistake when it acquired Piedmont in the mid-1980s, to achieve national scale. US Air's systems couldn't handle the additional size, and they broke down—on payday, armies of secretaries sometimes had to type everyone's paychecks manually. US Air and Piedmont had been two of only three airlines that were profitable every year since deregulation in the '70s (Southwest was the third), but, combined, generated more than $3 billion of losses in the five years following the merger.

Third, although companies typically assume they can hold on to customers after a merger, that's often not true. Alcatel and Lucent had customers virtually locked in, because their telecommunications equipment uses such sophisticated and specialized technology that the costs of switching to a new supplier are enormous. Yet, as often happens, competitors used the Alcatel-Lucent merger as an opportunity to attack viciously. Alcatel-Lucent wound up in a debilitating price war to keep customers, forcing the company to take billions of dollars of write-offs, costing the executive team their jobs and leaving the company with a dubious future.

Fourth, companies focus so much on being the consolidator that they miss the fact that it's often better to be the seller than the buyer. This is the mistake that Yahoo made in 2008 when it spurned Microsoft's takeover offer. As we said in our blog at the time, Jerry Yang should have taken the money and run to the bank.

The Second Screen

This test checks for the mistakes that were the most common in our research, regardless of strategy. The mistakes include these six:

1) *Underestimating the complexity that comes with scale.* This was the US Air error. A recent study found that if you double the capacity of an operation by having it manufacture twice as much of exactly the same thing then you decrease overhead by 15%. But if you double the size by adding a product line that differs even in relatively minor ways you increase overhead by 25% to 30%.

2) *Overestimating the increase in purchasing power or pricing power or other types of power that come with size.* Some 2 ½ years ago, we criticized Oshkosh Truck for buying a maker of unrelated construction equipment. Much of the rationale was that Oshkosh would double the amount of steel it bought and would increase purchasing power. But Oshkosh was going from a quarter of one percent of the world's steel production to one-half of one percent. Nobody cared. While Oshkosh spent $3 billion in cash on its acquisition, the combined companies had a stock market value of less than $1 billion even before the market crash that began last summer.

3) *Overestimating your hold on customers.* This was the Alcatel-Lucent mistake. Many retailers also made this mistake when they bought additional chains and thought they could change the pricing policies or product offerings. It turns out that customers like what they like and resist change. It also turns out that competitors are very aggressive about using a merger as an argument to get customers to switch their loyalties.

4) *Playing semantic games.* Sometimes, companies justify a move into a new market with a phrase that looks great on a PowerPoint slide but that doesn't hold up to scrutiny. In the mid-1980s, Avon decided that it wasn't really about selling cosmetics door-to-door; the company was about a "culture of caring." On that basis, Avon bought a chain of retirement homes and a maker of medical equipment—then soon sold them at a loss of hundreds of millions of dollars. While the Avon example may seem extreme, this kind of mistake is actually common.

5) *Overpaying.* This is covered so widely in the business literature that we won't go into detail here.

6) *Misunderstanding risk.* As the current crisis shows, even companies that put great effort into quantifying and managing risk—such as those on Wall Street—turned out not to be very good at it. The desire for short-term profits (and bonuses) can overpower good sense.

The Third Screen

This screen involves a detailed, side-by-side comparison of a potential deal with prior deals, both ones that succeeded and ones that failed.

To illustrate how we use that third screen, as well as the first two, we'll evaluate Pfizer's recent agreement to buy Wyeth for $68 billion. The driving force behind the deal is that Pfizer's blockbuster cholesterol drug Lipitor will soon have its patent expire, so Pfizer wants to buy products that will make up for the revenue it will lose. Pfizer says that adding Wyeth will give it a better portfolio of products. Pfizer also sees synergies that will let the combined companies cut costs. There are aspects of an adjacency strategy, too, because Pfizer mostly makes prescription drugs, while buying Wyeth will move the company into the market for over-the-counter drugs and veterinary medicines. Finally, there are elements of a consolidation strategy, given that the whole industry is under pressure and that big mergers are being undertaken to reduce capacity.

Based on the red flags associated with synergy strategies, Pfizer seems to be seeing opportunities that aren't there. While it talks of a "portfolio," it seems to be mostly playing a semantic game. Veterinary medicine has almost nothing to do with Pfizer's current business. The products use different technology. They are sold through different sales channels. They have different buyers. Even the products that Wyeth makes for human consumption have little in common with Pfizer's current product line. Wyeth's products are sold at retail outlets, rather than being prescribed by doctors. Pfizer, in fact, sold its over-the-counter business several years ago after finding that it wasn't a good fit with the prescription business, so it's hard to see why the two types of businesses would work well for Pfizer this time around. On the cost side, there will be room for some cuts. But companies only reach their cost goals about half the time, and the fact that Pfizer and Wyeth are such different businesses suggests that some hoped-for cuts will prove elusive.

Looking at the red flags for adjacency strategies identifies a potential issue that actually has nothing to do with the deal itself. The issue is that Pfizer is operating from a position of weakness, rather than strength. Apparently, a sense of desperation can lead people to overlook potential problems with the new market, so deals that stem from problems in the core business require special scrutiny.

The fact that Pfizer is pursuing a consolidation strategy suggests that there may actually be diseconomies of scale from the merger. In addition, there may be problems lurking within Wyeth that Pfizer has discounted, and competitors may attack the combined company more vigorously than Pfizer is assuming will happen.

The second screen, based on the most common red flags regardless of the strategy being pursued, suggests that Pfizer may be overpaying. It is paying a 30% premium over the price of Wyeth stock before the merger was announced, but it seems unlikely that Pfizer can somehow make Wyeth 30% more valuable than it was while operating under a respected management team. Pfizer also seems to be playing a semantic game when it describes a combination of veterinary and human drugs as a portfolio.

The third screen, looking for more detailed comparisons, provides further bad news. Big Pharma has a long record of bad deals. For instance, in the 1990s all the major companies decided they should move into an adjacent market by buying the so-called pharmacy benefit managers that make bulk drug purchases and distribute product to consumers. These acquisitions, based on a hope for synergies, all failed, and the PBMs were sold. Pfizer itself shows up in the list of failures. Looking for synergies, Pfizer bought Warner Lambert for $100 billion in stock in 2000 and Pharmacia for $60 billion in stock in 2002. Both deals fared poorly. Pfizer had a market value of $150 billion at the time of the Warner Lambert deal, putting the value of the three companies combined at some $310 billion. Yet Pfizer's market value was just $130 billion last summer, before the market collapse.

While Pfizer's investment bankers no doubt painted an impressive picture of synergies and economies of scale, and while Pfizer surely faced pressure from securities analysts to

do something to fill the hole that will be left when Lipitor goes off patent, our screens suggest that the Wyeth deal will be a mess.

When we started a blog in 2006 to test the predictive value of our research and to create a track record of our projections about which deals would fail and which would succeed, we expected to have more problems than we've had. After all, we're outsiders without access to the wealth of information that Pfizer has about Wyeth and any potential problems. It turns out, though, that spotting bad ideas isn't that hard, based on our research. The real issue turns out to be how to modify or kill a bad idea before it costs you and your shareholders $68 billion.

Which brings us to the second part of our process.

The Last-Chance Review

Our last-chance review uses the findings from the screening format to stimulate a discussion that draws out the assumptions and critical success factors underlying a proposed deal—many of them typically unstated—and all the potential problems. The review then tests potential strategies against various possible scenarios to see if a different competitive environment could shift the balance in favor of or against a deal.

While different methods can work, our preference is to gather a dozen or more senior executives for a day-long discussion. If the issue is consequential enough, we try to have the most senior people in the organization, but the work can also be delegated down a level. The crucial thing is to have in the room all the requisite knowledge about a possible deal.

During the discussion, we probe for potential problems based on the three-stage screening that has already been done. For a consolidation strategy, for instance, we'd explore whether any diseconomies of scale might arise to hinder successful integration. We'd examine key forecasts around customer retention, making sure possible challenges such as customer loyalties, competitor poaching, and the rationalization of sales and distribution are adequately addressed.

Once the discussion has identified all the important assumptions, and they have been evaluated, we guide staff through a process that checks the assumptions against numerous scenarios. Will the recession be longer than expected? Will the stimulus package create opportunities? What if competitors respond more aggressively than expected? What if a key supplier goes out of business? And so on.

Here is how a last-chance review might have looked for the Pfizer deal with Wyeth:

Pfizer would have gone through its normal strategy-setting process to try to identify ways to keep growing despite the impending loss of much of Lipitor's revenue. Pfizer might have identified some potential internal projects and, in conjunction with its investment

bankers, some possible acquisitions. As the Wyeth acquisition plan gained traction—but before the CEO had committed to it—Pfizer would have conducted a strategic stress test.

Given the magnitude of the potential deal, the review would likely have included the senior executive team. Prodded by the results of the three screens for red flags, the review panel would have worked with the CEO and key managers to identify strategic assumptions and key aspects of the acquisition plan. The review would have explored the specifics on where the cost-cutting would occur, on why Wyeth's over-the-counter drugs would be a good fit with Pfizer's prescription drugs even though Pfizer had recently decided there were no synergies, on the robustness and safety margins of the deal economics, and so on. The review would have bluntly laid out the history of failures involving strategies that focused on adjacent markets, synergies and consolidation, as well as the problems with acquisitions by Pfizer and others in the industry. At the end of the day, analysts might have been sent off to do some research into Pfizer's acquisitions of Warner Lambert and Pharmacia to see what went wrong and whether those problems were likely to recur.

If need be, the acquisition idea would have been tested against various scenarios. For instance, what if the Obama administration's health-reform effort is deployed quickly? What if it is delayed? What if the recession ends quickly? What if it drags on for years?

Coming to Closure

More than once we've seen leaders exercise the equivalent of a "pocket veto" of due-diligence processes by disassembling review teams without formally addressing unwanted results. At some point, of course, management needs to make the final call and choose from the finite alternatives in front of it. That said, our work does not end with the delivery of the final report. Instead, a formal response to the questions raised is built into the process. If structured properly, the license and charter of the strategic stress test are widely communicated to the appropriate levels of an organization. This sets up the broad expectation that issues that are raised will be addressed, and lessens the chances that uncomfortable findings will be buried.

The closure process needs to stay in the real world, which is one of alternatives. The objective is not compare potential deals to some model of perfection, because none could measure up. The review needs to focus on whether a deal is the best one possible without fatal flaws, not whether it is perfect. We need to remember that doing nothing can be a bad strategy, too.

The result of the Pfizer-Wyeth review could have taken various forms. Pfizer might have simply decided to walk away from the Wyeth deal. Pfizer might have gone to the negotiating table with a more realistic view of what it should pay for Wyeth. For instance, investment bankers typically argue that it's possible to cut 10% to 15% of I/T expenses when two big companies consolidate, but those savings seldom materialize; potential acquirers can go through a proposal and knock out phantom savings, based on solid historical arguments, as a way of talking down the asking price. Finally, Pfizer

might have decided on a variant of its acquisition strategy. Perhaps, rather than risk everything on a single throw of the dice, Pfizer might have adopted more of a Cisco strategy, buying lots of little companies that are really nothing more than a nascent product and plugging them into the Pfizer marketing machine. Pfizer still would have been filling a revenue gap through acquisition but would have been doing so in a way that hadn't already been shown to be a failure and that would have a better chance for success.

More generally, the closure process can have three outcomes. It can decide that the deal makes sense and should proceed. It can identify addressable weaknesses that can be shored up, making the proposed deal stronger. Or, less frequently, it can kill the deal, by uncovering structural problems that outweigh the potential benefits and can't be fixed. In any event, the review helps build consensus among the management team and board of directors around the eventual outcome—everyone has had their say and has seen the strategy survive a rigorous test, so the behind-the-scenes expressions of reservations that can doom a strategy simply lack credibility.

Conclusion

The pressures to do M&A deals are great, and opportunities will abound in coming years. But the history of M&A is so dodgy, and the risks so great in this environment, that it doesn't make sense to trust the traditional internal processes to make all the right choices. It's crucial to look at why failures occurred in the past and to find ways to make sure those lessons get past the corporate antibodies and become part of the evaluation process. The result will be better deals.

While the temptation might be to wait until a deal is on the table before deciding whether to conduct a strategic stress test, that would be a mistake. Those advocating the deal will want to dispense with any reviews, lest they kill the potential acquisition. The result will be emotional arguments that, "Well, we have to do something."

Our colleague Dan Ariely, author of the engaging best-seller *Predictably Irrational,* has conducted research that shows that people act very differently when they're in what he calls a hot state than when they're in a cold state. A potential deal creates a hot state in which thinking is clouded. So, it's important to take advantage of the current lack of deals to consider, coldly and rationally, what the best possible process is for heading off mistakes. That way, when deals become possible—as they surely will, in droves—the advocates for those deals can't argue for dispensing with a strategic stress test. They'll have already agreed that it's necessary.

Although many deals done since the start of the economic crisis have turned out to be bad ideas, many good M&A possibilities are out there. If potential acquirers just evaluate deals more carefully, companies could have as happy an ending as a company we advised when it was considering buying AOL last year. Despite all kinds of public statements about how AOL would be a great acquisition for someone, this company passed because

of numerous potential problems. The issue wasn't just price—which, in fact, was too high for a rapidly declining business—but also complexities in how Time Warner wanted to structure the deal. Talks were later revived, based on a far lower price and a far simpler deal structure, but those, too, fell apart, and Time Warner announced it was spinning off AOL. In the meantime, the would-be acquirer has been able to pick off AOL customers without having to pay AOL for them. The company's stock is at a 52-week high despite the bloodbath in the markets over the past year.

A stat that recently came to light about airlines buttresses the idea that a strategic stress test can give an M&A deal a two-out-of-three chance of success, rather than the historical one-of-three. In the aftermath of the crash of a commuter plane in Buffalo in February that killed 50 people, newspapers wrote about how hard it had been to reduce pilot error that led to crashes. The FAA just couldn't move the needle—for decades, 70% of crashes stemmed from pilot error. Then, in 1980, the FAA required the kind of devil's advocacy that we suggest for businesses. The FAA ended what it called the "captain as God" approach to flying and mandated that anyone in the cockpit challenge the captain any time there was a possibility that the captain was wrong. Almost immediately, crashes diminished. Now, fewer than 40% of crashes stem from pilot error. That shift almost exactly mirrors the 33%-to-67% change in success rate that we believe is possible with M&A. We don't think that's a coincidence.

Paul B. Carroll and Chunka Mui are co-authors of "Billion-Dollar Lessons: What You Can Learn from the Most Inexcusable Business Failures of the Last 25 Years" and principals of The Devil's Advocate Group, an alliance of critical thinkers that helps organizations stress test their strategies. For more, see our Web site at devilsadvocategroup.com. Or contact one of the authors at paul@billiondollarlessons.com or chunka@billiondollarlessons.com.