

Managing M&A Costs

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Total merger and acquisition (M&A) volume in the United States in the third quarter of 2005 increased 30 percent from the same period last year, according to Thomson Financial, a leading provider of business information. That's good news, right? Well, yes and no.

There are some vocal critics of this increased M&A activity, including former Secretary of Labor Robert Reich. In a radio commentary discussing the recent increase in M&A activity, as well as transactions that have occurred over the last 25 years, Reich said that "the shareholders of the companies that did the buying usually lost out." One of the reasons Reich cited is that "there are huge transaction costs in combining two big companies."

Is Reich right? Although empirical evidence might suggest that he is, it does not have to be that way. Let's take a look at how the principles of cost management can mean the difference between a successful

Merger and acquisition (M&A) activity increased in 2005, but vocal critics are decrying the huge transaction costs usually involved. Shareholders of the buying firms mostly lost out.

But it doesn't have to be that way, says the author, who has assisted scores of M&A clients over two decades. And he explains how to control M&A costs.

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acquisition and the kind of which Reich is so critical.

WHAT IS COST MANAGEMENT?

Cost management goes beyond mere cost cutting. It is a proactive process that focuses on aligning a company's projects with its long-term business plan and maximizing the efficiency of processes related to such projects. M&A cost management is the application of the principles of cost management to a transaction involving the purchase of a company. Specifically, it relates to: (1) the buyer's identification of all costs associated with an acquisition and (2) planning, organizing, directing, and controlling those costs, from the identification and evaluation of the target, to the negotiation and

closing of the transaction, to the integration of the target into the buyer's organization.

WHY IS M&A COST MANAGEMENT IMPORTANT?

M&A cost management is important, because without it,

precious resources are wasted. M&A transactions involve participants from a variety of disciplines, and therefore, it is virtually impossible to manage the process informally, unless the manager and the members of the buyer's acquisition team are highly experienced. Moreover, transaction costs are affected by a variety of factors, including:

- the size of the transaction;
- the complexity of the transaction (which will likely affect the amount of due diligence that must be done and the length of the negotiation of the transaction documents);
- the risk profile of the buyer (reducing risk usually involves more due diligence and negotiation);

- the deal structure (i.e., asset deals are more complicated to close than stock deals or mergers); and
- the magnitude of the post-closing integration.

Without good cost management, M&A transaction costs can spin out of control.

Inexperienced buyers often rely on their professional advisors to manage the transaction process for them. Unfortunately, such reliance is usually misplaced, because advisors fail to understand the task of cost management, or they consciously or subconsciously act in their own self-interest, without regard for the efficiency of the acquisition process. Consequently, relying on advisors to manage transaction costs means that costs are basically uncontrolled.

Having been involved in many M&A transactions over the last two decades, I've seen four failures that are principally responsible for high transaction costs in M&A transactions:

- The buyer failed to investigate the target adequately.
- The buyer failed to develop an acquisition plan.
- The buyer failed to stay involved in the acquisition process.
- The buyer failed to establish cost control measures.

WHAT SHOULD BUYERS DO?

In short, buyers should *manage the acquisition process*. A buyer should start with a clear objective, develop a plan for reaching that objective (including coordinating instructions for the participants), direct the course of the process, and have a

means for controlling what is going on.

Bob Meehan, the CEO of rePipe Inc., is an experienced businessman who has completed scores of M&A transactions. Meehan says that before anything else is done, the buyer should examine the target closely, perhaps even using forensic accountants. The purpose of the examination is twofold: (1) to determine whether acquiring it would advance the goals of the buyer's business plan and (2) to assess the condition of the target.

Meehan warns that if a buyer chases a "good opportunity" that is not a good strategic

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and cultural fit with the buyer, the results are usually disappointing. He strongly cautions that the analysis must involve operations, marketing, and other areas, in addition to financial analysis. Moreover, Meehan has reviewed countless prospective targets and has almost always found that things were not what they initially appeared to be, especially with regard to the financial statements. If the target is not a good fit, or there are serious problems with it, then the buyer should find out early and avoid spending money on a transaction that will not, or should not, close.

In developing an acquisition plan, the buyer should carefully select the members of the acquisition team and then develop detailed coordinating instructions and procedures to ensure that the members work together

as a team toward a common goal. Generally, the team will include accountants, attorneys, and possibly financial advisors, such as investment bankers. Each of these participants should have a lead person.

The accountants will be involved in the financial analysis undertaken to establish a purchase price. They should also coordinate with the attorneys when various representations and warranties are being negotiated, especially those concerning financial statements and taxes. And, finally, they are often involved in preparing financial statements as of the closing date.

Although it would be useful for the accountants to prepare estimates of the costs of these activities, it is far more important, from a cost management perspective, that the accountants coordinate their activities with the other members of the buyer's team.

The attorneys the buyer uses should have strong business acumen. If they don't, they can wind up spending a lot of time (and a lot of the buyer's money) on issues that have more theoretical than practical importance. Meehan says that if your attorney says, "That's a business issue," it is time to get a new attorney. Certainly, attorneys should have an understanding of the overall transaction, while still focusing on their principal role of legal advisor. It is a good idea to involve the attorneys early in the process, at least by the time the letter of intent is being drafted. Having a clear statement of the overall structure and assumptions of a transaction at the beginning of the process can significantly reduce the transaction costs. Alternatively, if important issues are not addressed at this

initial stage, they will be much more costly to deal with later.

Investment bankers may or may not be involved in the transaction. If they are involved, the buyer should carefully consider how they are compensated in order to assess their motivation. Moreover, Meehan advises that the buyer should not allow them to "drive" the transaction, because they usually focus only on financial aspects.

After each of the members of the team is selected, the buyer and the team members should assign tasks and establish a means of keeping their efforts coordinated. If the buyer's advisors have nothing to guide them other than their own experience, their efforts will likely become uncoordinated, even within their own organizations.

One means of organizing the effort is to have a good letter of intent (LOI). Although LOIs are nonbinding, they can greatly enhance the efficiency of the transaction. In my experience, LOIs ensure that there is a true "meeting of the minds" of the seller and the buyer. LOIs summarize and clarify the terms of the transaction for all parties and thereby enable them to focus on the deal points that they agree upon, as well as those that must be resolved in order to proceed with the transaction. In providing a summary of the transaction, LOIs help to avoid misunderstandings between the seller and buyer that could later cause unnecessary expense and delays.

Another step of the acquisition process that must be planned and organized is due diligence. It is likely that due diligence will continue right up to closing and will involve all of the buyer's outside advisors, as

well as key members of the buyer's organization. Consequently, it is imperative, in order to avoid duplication of effort and to ensure that the target is thoroughly examined, that the team members conduct due diligence in a coordinated manner. Each team member needs to know its role and to inform the other team members immediately upon finding anything of significance. Each member should also understand what information the buyer feels is important to a proper evaluation of the target.

Organizing the due diligence material is also critical to ensuring that it can be examined effi-

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ciently. Such organization should be performed by lower-level (i.e., less costly) personnel. I have seen many data rooms where highly paid attorneys spent hours slogging through unorganized boxes of material looking for something. That's not only inefficient, but it may also cause important points to be missed. If the target can provide due diligence materials electronically, then the efficiency of the process can be greatly enhanced, because software can be used to cull information from large digital data mines. With electronic due diligence, a person can sit at a computer and efficiently and effectively review more documentation in a shorter period of time than would be possible with a paper review.

Planning and control are also important with regard to the negotiation process. All of the

team members are involved in this process, not just the attorneys. Consequently, it is important to coordinate their efforts during this stage of the process as well. More important, however, is the need to avoid what might be termed "attrition warfare." On many occasions, I have seen attorneys argue over the language of provisions ad nauseam, often without coordinating with their other team members or their client. The buyer should not tolerate such conduct by its attorney. When an impasse is reached, the attorney should consult with the buyer concerning how the impasse should be

breached, rather than slugging it out with opposing counsel. The respective business persons of the buyer and the seller are often able to resolve disagreements more quickly than their respective attorneys can.

IMPLEMENTING CONTROL MEASURES

Not only can the buyer enhance the control of transaction costs by staying actively involved in the transaction process, but it can also implement a variety of control measures that will assist in regulating costs.

For example, the buyer could ask each team member to submit a budget for its fees related to the transaction. Although estimating the costs of some parts of the process (such as the negotiation of the definitive documents) is next to impossible, there are parts of the process (such as the preparation and delivery of the first draft of the documents) where the team members can estimate costs. In addition to these partial budgets,

the buyer should ask for weekly invoices from its advisors. If the buyer gets invoices only monthly, the costs could spiral out of control before the buyer is even aware of it.

Another control measure would be to establish milestones during the process, of which all team members are apprised. At each of these milestones, each team member would be expected to report on the progress of the transaction from the member's individual perspective. Such meetings would also provide additional opportunities for the buyer to coordinate the efforts of the team members, assess the progress of the transaction, and estimate the amount of transaction costs that the buyer has incurred to date.

Having a comprehensive plan for the acquisition process will also dramatically reduce the disruption of the buyer's day-to-day operations that is caused by the transaction. By ensuring that the members of the acquisition team act in a coordinated manner, the plan will reduce the number of ad hoc interruptions and requests for information and input from the buyer. Such interruptions and requests can cripple the day-to-day productivity of the buyer. If the buyer plans in advance the coordination of the acquisition process and the communication that is necessary among the team members, then the buyer can greatly reduce the disruptions it will experience. Disruptions in the day-to-day operations of the buyer that occur during a transaction are "costs," which the buyer should seek to manage, just as it seeks to manage legal and accounting fees.

Finally, the buyer must consider and manage the costs asso-

ciated with integrating the target into the buyer's organization. Unfortunately, most buyers fail to think about integration until very late in the acquisition process—sometimes as late as closing. By then, many options and alternatives are no longer viable. Before a buyer decides to purchase a target, the buyer should understand how the target would be integrated into the buyer's organization. In a recent book entitled *Achieving Post-Merger Success: A Stakeholder's Guide to Cultural Due Diligence, Assessment, and Integration*,¹ authors Carleton and Lineberry note that cultural

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incompatibility is consistently rated as the greatest barrier to successful integration, but that examination of cultural factors is unlikely to be a part of due diligence. They conclude: "What a conundrum! The greatest barrier to success of a merger or acquisition is the least likely to be researched during the due diligence process."²

If the buyer fails to plan for the integration of the target into its organization properly, it could experience a number of adverse effects. The buyer could wind up spending too much time and attention on the integration of the target and thereby lose track of its core business. The employees of the combined entity could become confused, lose motivation, and possibly even leave the company, resulting in a loss of productivity and an increase in costs. If the executives of the

combined entity lack a clear vision of the buyer's goals, then they will probably act in an uncoordinated manner. Finally, the buyer might suddenly discover that the combined business is not just bigger, but also different. It now has different customers, products, brands, facilities, and employees, each of which brings new and unanticipated challenges.

To avoid these adverse effects, the buyer needs an integration plan. In addition to a plan, Meehan advises having a separate integration team so that they can focus on this most important aspect of the transaction. The integration plan should include, as a key component, a method for integrating two distinct cultures and core values into one new enterprise. The uncertainties associated with this task make it especially difficult. For example,

if the buyer acquires one of its competitors, the employees might have a hard time making the transition from rivals to coworkers. Or, if the target was part of a large corporation with lots of resources and bureaucracy, the employees of the target may be shocked, following the closing, to find themselves working for an entrepreneurial, highly leveraged company with a very different culture. In addition, integrating two companies in connection with an international transaction is especially difficult, because the complexities caused by different corporate cultures are compounded by language and international cultural differences. If these integration challenges are not addressed, the buyer will experience a tremendous amount of confusion in its operations, and its costs will go up.

Exhibit 1

Key Steps of M&A Cost Management

- Carefully screen the target.
- Select an experienced acquisition team.
- Plan team activities so that they are coordinated.
- Prepare a detailed letter of intent.
- Manage the due diligence effort.
- Get a rough plan of negotiating costs and set milestones for review.
- Require feedback and frequent reports to avoid "attrition warfare" and reduce interruptions.
- Plan for the integration of the target well in advance.

In short, as is the case with other aspects of an M&A transaction, the buyer should plan for the integration of the target into the buyer's organization. There are many aspects of the transaction, such as employee retention and productivity, that will have a tremendous effect

on whether the integration, and in turn the entire transaction, are successful.

I have summarized the key steps of M&A cost management in Exhibit 1. In the final analysis, the focus of M&A cost management is to recall something that every good manager knows:

Failing to plan means planning to fail.

NOTES

1. Carleton, J. R., & Lineberry, C. S. (2004). *Achieving post-merger success: A stakeholder's guide to cultural due diligence*. San Francisco: Pfeiffer.
2. *Ibid.*, p. 14.

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