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Some problems with the practical implementation of M&A transactions

Mergers and acquisitions are one of the most complex and expensive business directions at the present. They have not lost their relevance in the business world for a century. But for countries such as Kazakhstan, which moved towards a market economy relatively recently, the processes of capitalization, expansion capital, successful business development and access to the world markets are particularly valuable. M&A transactions do not only contribute to a redistribution of property from inefficient to more efficient managers. They also contribute to the redistribution of capital within the various industries which has a positive impact on the overall economic development.

In addition, it is generally agreed that there are the following benefits of external corporate growth through mergers and acquisitions as opposed to an independent internal growth:

- Risk reduction to enter into new geographic or industry markets;
- In most cases, the achievement of investment profits through M&A transactions takes much less time than in case when a company prefers internal growth;
- M&A transactions allow to acquire not only the target company, but also its equally important intangible resources, such as business communications, consumer confidence, knowledge and practical experience;
- Reduction of competition through the acquisition of competitors.

Over the last decade, external (foreign direct) investment of the major international companies grew three times faster than domestic investment, more than half of which was carried out through M&A transactions. This demonstrates not only the intensification of competition between large companies and their motivation to enter new markets, but also shows that mergers and acquisitions have been still one of the priorities of the strategic expansion of capital.

However, most of the M&A transactions, both national and international scale, do not always have a positive impact on the economy. Thus serious problems include the development of monopolies or oligopolies in the individual national markets, increased market power and the implementation of restrictive practices for the foreign companies. In many developing countries, large foreign companies have become leading companies in the local market. This constitutes a danger of transition of national industries under foreign control. But even in such situation, supporters of M&A transactions note its good sides: M&A is not only a process of international companies entering the national economy and

contributing to its growth. They are also an approximation of the national economic and legal systems bringing them into conformity with international standards, as well as production and delivery of highly competitive products or services for the local markets, especially in developing countries.

The internal negative possible consequences of M&A for its parties include: the failure to reach expected results of M&A transactions in returning of spent forces and resources. Also M&A often turns out to be unprofitable for the parties, or leads to a destruction of the cost of capital.

Mergers and acquisitions are a high-risk, expensive and also a highly profitable type of investment projects. The potential of such transactions can be realized only with careful preparation, planning, transaction analysis and justification of its effectiveness. This means that the mere choice of the company's expansion through M&A does not give a positive effect and, moreover, is associated with numerous risks and can not be accurately predicted.

The example of the largest companies in the history of bankruptcy like "ENRON", "WorldCom" and "Global Crossing" - also the most aggressive companies concerning M&A transactions in the world - very sharply has raised the question of the effectiveness of M&A. Another example is the German automobile company "BMW". After spending 9 billion DM (4.1 billion dollars) on the British company "MG Rover" and six years of great efforts, in 2000 it was forced to sell "MG Rover" at a loss. A successfully operating "Daimler-Benz" could not display the level of a sustainability of its American acquisition "Chrysler". This is reflected in the financial results of the combined company, and, consequently, in the price of its shares, which resulted the companies again divided.

Many researchers and analysts now try to understand whether such large M&A transactions end in a failure just because of the wrong strategies or whether they were carefully designed as financial pyramids of their managers. It is possible that such pyramids, on the one hand, should hide the bigger mistakes and errors in the management's daily activities of companies. But on the other hand, they were designed to enrich the selfish interest of the management of the merged companies and external consultants at the expense of shareholders' money.¹

Whatever the reason behind this, in the cases of such large corporations as "ENRON", "WorldCom" and "Global Crossing", the problems of practical implementation of mergers and their ineffectiveness for the company's capitalization are proved by numerous facts and analytical studies on M&A transactions in various historical aspects, industries and countries.

According to a study conducted by "McKinsey" in most cases M&A transactions do not have a positive effect. It is argued that the proportion of such unsuccessful deals is about 70%.²

As noted by Russian scholar Yuri Petrenko, cost-effectiveness of mergers proves to be still very low in practice, both in the past and today. According to his opinion one should consider the following

¹ Н. Коница "Слияния и поглощения в конкурентной борьбе международных компаний" // Монография. Москва. 2005

² Г. Газин, Д. Манаков "Наука поглощений" // Вестник McKinsey. – 2003. – № 2 (4)

aspects:

- More than 70% of M&A transactions do not create synergies and even destroy company's value;
- More than 50% of the largest mergers and acquisitions lead to a decrease in shareholder value: in about 30% of the cases they have virtually no influence on it and only in less than 20% of the cases they create value;
- Generally, acquisitions do not create added value for the owners of the acquiring company which known as a “winner's curse”;
- In 60% of the mergers invested funds are not recovered;
- In 60% of the cases the combined companies are lagging behind in their development compared to other participants in the same market and therefore later on they are likely to re-divide into separate corporate units;
- In only less than 20% of the cases the combined companies achieve the desired financial or strategic objectives.³

Main problems of M&A transactions resulting in their failure:

1) The interests of individuals often prevail over the interests of companies

This ultimately negatively affects the outcome of M&A transactions. In this case it is due to the so-called “agency conflict”, first discovered in 1986 by Harvard University professor Michael Jensen and more known in the United States and Western Europe. According to this concept, a problem arises between managers and owners of companies with free cash flow, which ideally should be directed to the benefit of its shareholders. Free financial resources are invested by the management in the purchase of the target company. This is attractive for the management because the management of these companies cares more about their own welfare rather than about shareholders' interests. Most of these short-term M&A transactions are undertaken in order to get a profit on the side of the acquiring company's management immediately after the implementation of the merger. Such short-term profit usually comes along with a long term destruction of the value of company's share capital.

2) No careful prior investigation of all aspects of mergers and acquisitions (due diligence)

Such aspects are e.g. legal, financial, economic, marketing, human resource management, issues management, etc. This aspect, in my opinion, is the most fundamental element in ensuring the effectiveness of the M&A transactions, without which the conduct merger or acquisition has absolutely no sense.

³ И.Петренко “Условия реализации стратегии слияний и поглощений российскими предприятиями в промышленности” // Приложение к журналу “Экономические науки”. – 2006, № 3

Russian scholars Laili Zuhurova and Novikova allocate the following percentages to achieve synergies in the mergers and acquisitions:⁴

- a) In case of the absence of preliminary analysis: 6%;
- b) In case of implementation of surface analysis: 20%;
- c) In case of preliminary analysis of the target company: 31%;
- g) In case of the preliminary to more detailed analysis of the target company: 41%.

3) Improper formation of the team leaders

The research consultancy “A.T. Kearney” revealed in 2000 that almost 40% of the merging companies ignore to pay attention to issues of forming teams of experienced managers and rational planning time for this process. Usually, due to organizational confusion conflicts arise, many problems remain unresolved. Employees, customers and analysts who are soon tired of the uncertainty, begin to pay too much attention to rumours and wild guesses. The study by “A.T. Kearney” showed that in successful M&A transactions, the management for the new company has been identified within a week after the announcement of the deal, the next level of leadership was determined within 30 days, while middle managers were appointed within 90 days.

4) Incorrect choice of evaluating the company

This often leads to high cost of the target company. Usually there are 4 following methods of business valuation:

- a) market value;
- b) the investment cost;
- c) the liquidation value;
- d) the cadastral value.

In most cases of M&A transactions, acquiring companies are guided by the market value of the company at the date of purchase. But this kind of evaluation is often overstated in the general competition and does not reflect the real value of the target company. Regular adjustments of financial statements of the acquired company do not always reflect the reliability of follow-up evaluation of business. In connection to this, one of the most effective methods of the business valuation is that when the acquiring company has all necessary information about the target company in order to make its reliable investment evaluation. The acquiring company, as no one else is able to realistically assess its capabilities and predicts the future performance of the combined companies, but only with all necessary information about the target.⁵

A critical assessment of the value of the target company is extremely important, as high expectations of buyers may not be well justified. The success of M&A transaction can be determined by

⁴ Л. И. Зухурова, И.Я. Новикова “Российский рынок слияний и поглощений. Повышение эффективности сделок путем оценки инвестиционной стоимости компаний” // Финансы и кредит, 2007 г., № 22

⁵ С. П. Михайлов “Особенности слияний и поглощений в условиях российской экономики” // Экономика и управление, 2007, № 4

the size of the difference between the price paid for the object of the transaction and the size of the profit received as a result of buying the company. Naturally, if the object is overvalued and the price paid for it, too high, the advisability of purchase may be questioned.

5) Overly optimistic approach to the calculation of the expected synergies from the M&A transactions

This mistake can occur not only when assessing the value of the target company, but also when assessing the future level of income and determining the time required to achieve this income. As it known, the size of the profit received by the new owner is determined by both components: the transaction price and the size of the profits.

In turn, the second component depends strongly on the time spent on performing the M&A transaction. An optimistic approach to the assessment of future income of M&A transaction is not always appropriate. Therefore we should not apply an overly conservative approach to such estimates. It is advisable to choose a «middle ground» and periodically review and revise the approved plans of the integration period. The inability to effectively use the time to complete the M&A transaction, its preliminary analysis and subsequent integration of merged companies affect the revenues and may affect the buyer in the transaction costs on the M&A.

6) The economic situation and situation in the industry are not properly taken into account

An example is the recent purchase of Kazakhstan's second-tier bank “ATF” by Italian financial group “UniCredit”. The deal amounted to \$2.175 billion. Given the financial crisis on the world markets and liquidity problems of banks in the domestic market, the cost of purchase was inflated. Had the Italians waited just a bit longer, then quite possibly they would have paid a lower price.⁶

7) Inability to manage risks

Merging companies need to have a well thought-through risk management program, both before the merger and after.

8) Too much emphasis on reducing costs, too little on the development of the company

Many companies overlook the great opportunities for growth, such as mutual sale and sharing the results of research activities.

9) Too much emphasis on cutting jobs or closing factories

Often the owners of the acquiring companies try to get rid of the acquired company as quickly as possible, relying on short-term income through its resale, liquidation, etc. This is supposed to be the case in more than 60% of M&A transactions. However, as M&A practice shows, the most efficient and profitable M&A transactions work in the long term, when the acquired company continues to exist in the market and rapidly gains momentum due to new growth opportunities.

⁶ Ю. Феллер “Инструмент повышения стоимости бизнеса” // Resmi Advisor. Декабрь 2007 год Стр. 16-18. // www.ifd.resmi.kz/download/Resmi_Advisor_6.pdf

10) Absence of a detailed designed program of the integration of the two companies

Such a programme should aim at keeping key staff of the acquired company. Lack of attention to this question of smoothing the differences of corporate culture of the merged companies, the inability to reconcile a difference of methods and ways of managing the merged companies are one of the important parts for the success of a M&A transaction.

Different styles of leadership, personality differences and differences in the managerial decision-making are the most difficult tasks for 70% of the merged companies. Most of the leaders simply impose their corporate culture on the employees of the acquired company during the integration of the merged companies. This is not an optimal solution for achieving synergies. It usually leads to an outflow of skilled employees. This is a great loss for the buyer, because professional staffs are key intangible assets that can affect not only the value of the company, but also its further development.

The most common problem of inefficient M&A transactions lies in the lack of loyalty to employees of the acquired company, who fear to be fired. To relieve the tension among employees all the permutations should be completed as soon as possible. Management should inform employees about the events taking place in the company. Effective communication will not only retain valuable employees, but also attract new ones.

11) Inability to bring together information systems

As was noted by one of the Russian researchers, 50% of the success of the merger often depends on the choice of an information system.⁷

12) Lack of proper attention to potential customers, partners, suppliers and other counterparties of the acquired company

As an example, two companies, we call them Company «A» and company «B», participating in an M&A transaction, sell clothes under their own brands. Company «A» the buyer, works in the upper price segment. In order to diversify itself it acquires company «B» producing similar products, but in the middle or lower-price segment. In this case, company «A» will preserve the brand of company «B», because it is recognizable by the target consumer group and a lot of effort was spent on its establishment. Company «B» will be positioned as one of the priorities of the company «A», alongside the expensive brand of clothing. When planning the M&A transaction, company «A» has to take into account the possibility that its potential customers may abandon the brand, because they do not like the association with the brand producing cheaper clothes. It is quite possible that notwithstanding the success of the M&A transaction there is still a negative impact on core brand, which will entail a reduction in sales.⁸

13) Unrealistic plans for the merger

⁷ Горелая Н.В. «Оценка и анализ экономических эффектов при банковских слияниях и поглощениях» // Управление корпоративными финансами. 2004, № 5

⁸ Ю. Феллер “Инструмент повышения стоимости бизнеса” // Resmi Advisor. Декабрь 2007 год Стр. 16-18. // www.ifd.resmi.kz/download/Resmi_Advisor_6.pdf

Often many large M&A projects fail because of unrealistic implementation of integration plans, unhealthy ambition of top management and the use of unverified information or unproven technologies.

The above-mentioned shortcomings in the practical implementation of M&A transactions are the problems encountered in all countries, regardless of their level of economic development. However, international practice shows that in developed countries where mergers and acquisitions have been carried out for a century (like United States and Western Europe), the implementation of M&A processes is much more effective compared to developing countries with high levels of corruption and bureaucracy.

Many developing countries, in particular post-Soviet countries, are characterized by certain specific shortcomings in addition to the above mentioned problems, which include:

a) The low availability of skills able to conduct M&A transactions

The M&A market has not yet developed enough to equip it with qualified personnel and to make the merging companies understand why such expertise is necessary for the effective implementation of such transactions. Unfortunately, many companies typically do not use financial and legal professionals in the process of negotiating a comprehensive test facility of the M&A transaction and for drafting the agreements. Thus there is a risk of inadequate risk assessment and management.

The integration of the merged companies is in almost all cases conducted by the companies' staff members. In Europe and the United States the merging companies had long begun to attract external experienced consultants involved in M&A transactions from its initial stage to conduct a smooth integration process.

b) The imperfect legislative situation of the country where the M&A transaction takes place

This refers to:

- weak legislative regulation in the area of mergers and acquisitions' processes;
- protection of the rights of businesses owners, both from third parties, and from some government representatives;
- high level of corruption and bureaucracy in the country;
- sluggish development of corporate law and its incompatibility with accepted international standards;
- an active role of government in the activities of the private companies.

All these are major impediments to a civilized development of M&A transactions. It can also provoke corporate raids in the country, where a good example is the practice of Russia, Ukraine, Kazakhstan, Uzbekistan and other post-Soviet countries.

c) Lack of transparency in doing business in the country and in the ownership structure of companies

Scarcity of information available does not allow the acquiring company to review the information in advance. For example, in Russia, according to Nicholas Rudyk, there are no more or less objective quantitative data in Russia and the financial statements disclosed by Russian companies are pure fiction.⁹

The Kazakh market is also not much different regarding this aspect of transparency. This is supported by the absence of complete information about companies operating in the country. In addition, the opacity of mergers and acquisitions is demonstrated by the fact that there is not one systematically tracking of market trends of mergers and acquisitions. That analytical and statistical information prepared by audit and finance companies does not fully reflect the essence of all M&A transactions in Kazakhstan, and is focused mainly on large transactions.

d) Underdevelopment of the stock market

Developed stock market could help the companies and potential investors determine the market value of the company, and also for the companies to be transparent and open. As a result the mergers and acquisitions would be more effective.

e) The existence of a strong affiliation of companies with financial-industrial groups

This leads to reluctance to change the current situation and lack of development of good corporate governance.

f) Lack of both theoretical and practical experience of domestic companies in performing M&A transactions

g) A constant process of redistribution of ownership in the companies

Sometimes on paper the same company can change its owners several times over a period of several days. These transactions usually take place in order to launder money or to disguise or hide another transaction, often by illegal practices.

h) Shareholders and management of companies are not so much interested in the effective management

This occurs because the shareholders and management in M&A transactions more interested in securing personal control over financial flows and the withdrawal of the company's assets to private ownership rather than in smooth integration of merged companies.

i) A significant proportion of government capital equity of the largest and financially stable companies

This respectively leads to the multiple problems of the managing of companies. In most developing countries, especially in post-Soviet countries, governmental power prevails over the private sector, even in cases where the State is a minority owner of various companies.

j) Complete identity between company managers and its owners.

⁹ Н.Б. Рудык “Конгломеративные слияния и поглощения. Книга о пользе и вреде непрофильных активов” // Москва. 2005. стр. 192

The owner of the company is often also the manager of the same company. On the one hand, this precludes the emergence of agency conflicts that often occur between management and shareholders of foreign companies. But, on the other hand, this creates the perception that in a case of a merger with a competitor one is losing to a party paying for the M&A transaction.

k) A weak function of antitrust authorities

Monopoly and oligopoly in Kazakhstan, unfortunately, are not among the important problems for the antitrust authority. This is demonstrated by the activities of known Kazakh monopolistic companies which control a larger share of their market sectors. Among these companies there are firms of the telecommunications, transportation and shipping, banking, oil and gas, and mining and other industries.

Each of these deficiencies leads to a huge outflow of skilled personnel, loss of customers and suppliers, a noticeable decrease in productivity, inefficient management, and the high cost of buying company to restore the situation, and other adverse effects. All these effects ultimately do not justify the merger or takeover. Such reasons do not only fail to achieve growth in value of the newly established company, but also lead to its destruction. It is revealed only after committing the M&A transaction in phase of the post merger integration when it is possible to see a real performance of newly established company.

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