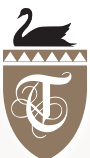
Synergy™ INSIGHTS
SUPPLEMENT

ENEMIES OF SYNERGY

This publication has largely focused on the positive aspects of synergies and how they are vital to doing the best buying and selling. But as we say in the title of this article, we want to look at some of the enemies of synergy, the pitfalls to avoid in doing strategic M&A. In the following pages we will give some examples.

Synergy Insights Supplement is a companion newsletter to Taylor Companies' business journal, *Synergy Insights*. For more information about *Synergy Insights*, please visit www.tay.com/publications.



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Deworsification

This is a term we first heard created by the most successful mutual fund manager of his day, Peter Lynch, who directed the Fidelity Magellan mutual fund between 1977-90. Magellan got consistently good returns and regularly outperformed the S&P for years. Lynch averaged a 29.2% annual return for the fund.

Lynch said one of the red flags he looked at for a company is if it diversified prematurely which, he said, many times led to "deworsification." Lynch said it was better to fully tap the core opportunity to the maximum before even thinking about moving on to something else.

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Exceptions to the rule is if the company's core markets are becoming obsolete or undergoing dramatic transformation. An example is the number of companies today that are becoming "Amazoned" as technology makes it increasingly difficult to compete. Amazon is the Sears of this age in that they have brought a new, more efficient business model to the fore that is more cost effective. The older Sears of yesteryear has been driven to bankruptcy as a result of being "Amazoned."

Perhaps the most famous example of a merger gone awry from being deworsified is the 2000 merger of Time Warner and AOL. It was a huge merger of $164 billion. First, they had $45 billion of write downs and then they had $100 billion of operating losses. Finally, AOL was spun out of Time at a mere pittance of the original value attached to it in 2000.

Time Warner, which was in entertainment and publications, combined itself with the most popular technology item of the day — the Internet. It did so shortly before the Internet bubble burst and Internet stocks vastly underperformed thereafter. It was a stark example of deworsification. Time Warner would have been much better off focusing on its core business. The decision to merge was enormously costly to shareholders of both companies.

Unless there are reasons to believe the core business is at risk, investments in the core business are the most sensible and logical for the following reasons:

- You know most about the competition, the market environment, the foundational technology, about manufacturing and the overall supply chain
- Speed of execution and a short learning curve
- Real synergies, whether in cost, technology or in sales, are always going to be easier to achieve

Regardless of these facts, a focus on growth within the core is almost always going to deliver the best value creation for your shareholders.

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Before considering diversification, a company should make sure they have pursued all significant acquisition or organic growth strategies that would create synergy with the company's existing core business.

Synergies that are commonly untapped before having to resort to diversification include:

- Applying or receiving know-how or technology from an acquired business
- Acquiring a powerful brand or an enduring franchise
- Acquiring manufacturing capacity or presence in overseas market you didn't have previously
- Obtaining from an acquired business, new products of services that the buyer can sell to existing customers
- Creating a one-stop-shopping opportunity for customers by obtaining key products or services from an acquired business
- Obtaining from an acquired business, new customers or distribution channels to/through which the acquirer's existing products can be sold
- Obtaining a key product or service from an acquired business that improves the acquirers image with customers or market analysts

Acquisitions in your core business can bring many things, some good and (if poorly executed) some bad, but what they always bring is speed and that in itself can bring significant competitive advantage. When a company engages in true diversification it is always important to remember that few immediate synergies are available. So if your company is convinced that diversification is required, remember that near adjacencies are always less risky strategically and tactically than far adjacencies.

Indigestion from Making Mega-Buys

The Harvard business professor, Michael Porter, published a study in 1987 in the Harvard Business Review that indicated up to 74% of deals do not work out as expected. Further studies by both KPMG and Bain corroborate this finding. Taylor would add to that thesis by stating that large acquisitions of several billion dollars or more frequently get indigestion after a big deal is done. **This result is so, especially when the acquisition target has a diversified offering rather than a single offering that fits cleanly as a synergistic bolt-on to the buyer's existing business.** The former is less likely to provide compelling synergies and, therefore, is innately a risky proposition.

> ***"My data paints a sobering picture of the success ratio of these moves. I found that on average corporations divested more than half their acquisitions in new industries and more than 60% of their acquisitions in entirely new fields. Fourteen companies left more than 70% of all the acquisitions they had made in new fields. The track record in unrelated acquisitions is even worse — the average divestment rate is a startling 74%."***
>
> **– Michael Porter, Harvard Business Professor**

One can look at the big deals done and see that it is like eating a big meal at Thanksgiving or Christmas and then falling asleep for having tried to absorb too big a meal. When a company acquires a smaller business in its core, the acquisition becomes an act of integration as the culture of the acquirer subsumes the culture of the acquired. However, when a company acquires a much larger entity, potentially

even larger than itself, that company is likely to have a strong and powerful culture of its own. So the acquisition now becomes an act of accommodation not an act of integration. The acquirer has to find a way to make the two cultures mesh and this is not always an easy task to do successfully.

This result manifests many times as underperformance over the following couple of years. When managements combine with each other after a big buy the cultures don't always successfully mesh and the different cultures and philosophies of business create problems. When considering such a transaction, first imagine that it is an international acquisition with two different languages and cultures. Like the Time Warner and AOL transaction, the bigger the deal, the bigger the headache, especially if you get it wrong.

> ***When managements combine after a big buy the cultures don't always successfully mesh.***

Taylor puts such emphasis on synergy so that the figurative acquisition meal can be digested properly and not cause the discomfort **which** so many deals do. It is important to integrate the deal properly and know which pieces need to be integrated first. As we mentioned above, it is important to know if the two companies have compatible business cultures. Cultural incompatibility leads to failed integrations and is a leading contributor to the high M&A failure rate. When large public companies are the target, the amount of due diligence which is possible is usually significantly lower than it would be in a private company. Moreover, it's essentially impossible to place contingent liabilities on the seller, say for example environmental, legal and technological challenges.

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Acquisitions have to be well thought out and integrated properly or the benefits will almost certainly not work out. That is precisely what Michael Porter found — **the large majority of deals did not work out effectively because synergy was not considered carefully enough.**

Too Many Divisions in a Modest Sized Company Creates a Lack of Focus

Taylor has seen this situation regularly. An example is a company with $2 billion in sales and perhaps five divisions that are not closely related. Many times it is the case that the company is not a leader in any of these divisions. At these companies, capex can suffer because the company does not have the confidence to fully capitalize any one of these divisions properly. The more capital intensive these divisions, the worse the problem. Taylor's solution is to generally **divest** one or more of these businesses starting with the most capital intensive one unless that is the company's most successful business. Tax leakage and the potential problem of "buy high, sell low" must obviously be addressed when considering this switch to an asset-light approach. So is the issue of so-called "stranded costs" which need to be dealt with aggressively in such cases.

With the company's permission, Taylor will engage in a consulting project that combines a SWOT (strengths, weaknesses, opportunities and threats) and synergy analysis to see which business units have greatest growth potential, both organically and inorganically, which leads to the recommendation to sell businesses that have neither, and acquire for businesses that have both. To see Taylor's way through this tangle of divisions, it needs to help decide where the company should focus most of its resources. Taylor looks for where there is growth, and correspondingly where there will be a higher value creation opportunities.

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After the synergy analysis process, Taylor looks to where the company would get the most leverage or, said colloquially, the biggest bang for the buck. This can result in Taylor recommending selling the weaker division and doubling down on the business's strengths. In the long term this can result in a PE re-rate producing improvements in stock price because the company has better focus and better opportunity to marshal its greatest resources for where the company can best serve. The beauty is that this is a win-win strategy both for the company, its customers, employees and investors.

There are any number of companies in this category that fit this description. Energy companies were one category where this occurred during the oil slump in 2014 and beyond. Companies often jettisoned their weaker divisions to focus on their core strengths. Similarly, retail companies that are under pressure due to Amazon's distribution power will ultimately need to do the same in order to focus on their stronger competitive areas.

Flat Profile

When Taylor first began actively pursuing big clients in the 1980's, it initially focused on new CEOs who had no positive bias towards traditional large investment banks, looking especially at CEOs who saw acquisitions as part of their strategy to grow and become more competitive.

When Taylor examined these new CEOs, it discovered a fairly common theme in their new company's stock price charts. They were in what we might call a flat profile. The chart was basically a horizontal line running for many years. The chart progression was many times as flat as a pancake. These companies were often ones trapped in a rut with high margin and low growth.

We have found very few companies that cannot be improved through a combination of imagination, creativity and relentless execution.

The usual challenge for the new CEOs that Taylor encountered was to break out of that flat growth profile. Acquisitions were a natural part of that need. Usually Taylor found that the acquisitions it helped make had a positive and stimulating effect on the company. But there was one pattern Taylor also found with these companies, which was a recurring one. When Taylor did its synergy analysis it found idea stagnation to be the root cause. A lack of drive was the outcome. Risk aversion, complacency and many times a lack of imagination and enthusiasm among the employees. In reality, we have found very few companies that cannot be improved through a combination of imagination, creativity and relentless execution. That is what we tried to inject into these new clients.

Sadly, in our interviews, the listless stock chart was reflected in unenthusiastic employees who naturally mimicked the poor opportunities at the company. After all, a company is reflected in the people it hires and how it inspires and encourages them. If it doesn't inspire or encourage them, the outcome will be very predictable and it won't be a happy one. Talented employees will not be attracted to stay with a company and talented new ones will simply not be attracted to join. Great employees want to work for great companies and a lack of growth opportunities at a company isn't a magnet for the talented. It's very much the opposite.

In summary, the flat profile in a stock chart often indicates a lack of imagination and enthusiasm in the leadership. It's then often reflected in the employees, while a growing, more entrepreneurial company has a more innovative flavor among the employees. As Jack Welch famously said, if I own a "B" company and put "A" employees (and leadership) in it, there is a good chance I will create an "A" company. If I own an "A" company and put "B" employees (and leadership) in it, there's a good chance I will create a "B" company as an outcome.

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Conclusion

Success in merging companies requires thoroughly understanding where the real synergies lie and how to achieve them during an acquisition. The company should have the discernment to reject deals that lack synergy, or it cannot effectively achieve and integrate them into the deal.

With that vision and capability always applied, the business will recognize or identify the blocks to synergy for what they are, and not allow them to stand in the way of synergy creation. Organizations that do not have objectivity and discipline, should not attempt acquisitions until they establish it.

We believe that if they hire Taylor to do synergistic acquisitions, the companies will have the opportunity to develop that vision and discipline along with utilizing Taylor's high success rate. It separates the figurative wheat from the chaff and successful companies from the potential failures.

Organizations that do not have vision and resolve, should not attempt acquisitions until they establish it.

WE WELCOME READER FEEDBACK

We are interested in your feedback and examples of synergy applied in acquisitions and divestitures with which you may have been involved. To share examples, or if you have questions, comments, or are interested in seeing a specific subject discussed, please contact us at SynergyInsights@tay.com, attn: Warren Bellis.

1667 K Street NW, Suite 200, Washington, DC 20006 • +1 202 955 1330 • www.tay.com

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