CROSS BORDER MERGERS AND ACQUISITIONS – A NEW CHALLENGE TO SOUTH AFRICAN MANAGERS

by

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OPSOMMING

Verkrygings en oornames oor die grense van lande stel besondere uitdagings aan die moderne bestuurder. Die omvattende transformasie proses waardeur Suid-Afrika die afgelope aantal jare gegaan het, het die deure na die wêreld vir Suid-Afrika oopgemaak. Die Suid-Afrikaanse besigheidsmiljeue sal noodgedwonge aan hierdie nuwe omgewing blootgestel word.

Een van die opmerklikste buitelandse tendense die afgelope aantal jare was die toenemde aantal verkrygings en oornames. Hierdie tendens het Suid-Afrika ook nie vrygespring nie. Dit moet egter in dieselfde sin vermeld word dat dit nou reeds duidelik is dat die meeste oornames en verkrygings meer waarde vernietig as wat geskep word. Suid-Afrikaanse bestuurders sal ook blootgestel word aan dieselfde faktore wat verkrygings en oornames fasiliteer en die faktore wat verantwoordelik is vir mislukking.

Die oogmerk van hierdie skripsie is om die kritiese faktore te identifiseer wat die sinergie, waarde vir aandeelhouers en integrasie van oornames en verkrygings oor landsgrense heen bepaal. Daar sal verder ook aandag gegee word aan die sogenaamde “sagter” aspekte van oornames en verkrygings.

Die redes en rasionaal vir oornames en verkrygings oor landsgrense heen word uiteengesit in hoofstuk 2. Konsepte word gedefinieer en groei, as een van die belangrikste drywers agter verkrygings en oornames word bespreek. Kritiese faktore om verkrygings en oornames te bestuur word in hoofstuk 3 aangespreek. Daar word volledig gekyk na aspekte wat voor, tydens en na voorgestelde verkrygings en oornames aangespreek moet word.

In hoofstuk 4 word finansiele oorwegings aangespreek en “Economic Value Added” geidentifiseer as een van die belangrikste finansiele dryers wat oorweeg moet word. Toekomstige neigings in die verkryging en oorname bedryf word in hoofstuk 5 aangespreek.

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"I am part of all that I have met;
Yet all experience is an arch wheretro'
Gleams that untravell'd world, whose margin fades
For ever and for ever when I move."
(Ulysses by Alfred Tennyson)

This dissertation is dedicated to all those whom I have met.

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CHAPTER 1: INTRODUCTION

1.1 South African background

South Africa has been going through a sweeping transformation process since the early 1990's. This transformation process unleashed new political and economic dynamics in the country which had far reaching consequences for all its citizens. One of the most important economical consequences of this process was trade liberalisation. The South African economy opened its doors overnight to a highly competitive international business environment. The sheltered economic seclusion characterised by the "apartheid era" was suddenly something of the past. The African National Congress government released its new macro-economic strategy entitled: Growth, employment and redistribution (GEAR) in 1996. It became evident that economic growth and job creation were the major challenges facing the new government. (Botha, 1998:6)

South Africa, as an emerging market, is becoming more confident of its strength in an international environment and is viewed by the international community as the gateway to Africa and therefore an attractive partner of choice. (Parsons, 1999:41) South African businesses will in this regard inevitably be exposed to international practices and trends. One of these international trends is the rampant occurrence of cross-border mergers and acquisitions. Ettorre (1999:8) explains this trend as follows:

"An astonishing $1,3 trillion in merger and acquisition activity took place in the United States in the first quarter of last year alone. That is a colossal urge to merge. Unfortunately, as the experts report, between 60 percent and 80 percent of mergers are financially unsuccessful. That is a colossal waste of resources and human capital".

The merger and acquisition trend is moving like a tidal wave into the global arena.

International merger and acquisition activity statistics are already staggering. After declining to a low in 1991, merger and acquisition activity increased to new hights in 1998. (Weston, 1998:1)

1.2 Merger and acquisition activity in South Africa

Economic power in South Africa is mainly concentrated in very few hands. (Ross, 1996:573) This fetish for control has manifested in the major financial institutions in South Africa following a buy and hold strategy which has resulted in a shortage of companies for sale. Controlling shareholders, primarily business families, took extreme measures to entrench such control. This factor, together with the economic isolation during the "apartheid era", played a dampening role on cross-border merger and acquisition activity in South Africa.

Trade liberalisation exposed the South African business environment to the global arena. Parsons (1999:41) is of the opinion that the ability of South African business to fully participate in the world economy and its opportunities is of fundamental importance to the growth potential of the "new South Africa". Trade liberalisation and the international cross-border merger and acquisition wave propelled new merger and acquisition energy into South Africa with record levels both in terms of value and volume in 1999. (Du Toit, 1999:43) The combined value of merger and acquisition transactions in 1998 alone was more than R200 billion. (Ferreira, 1999: 95)

Ross (1996:572) is of the opinion that mergers and acquisitions is probably the most controversial activity in corporate finance. Cross-border mergers and acquisitions will undoubtedly be on the increase in South Africa. The reasons for this trend are manifold. These include:

- South African companies will be forging new international alliances as part of a globalisation strategy. In order to survive in a new liberalised economy, these companies would have no other choice than to expand overseas. In tough times, they will be forced to seek international alliances.

- International companies view South Africa as the gateway to Africa. These companies will be on the lookout for attractive South African companies to establish a presence on the continent.
- The gradual lifting of exchange control will allow outward mergers and acquisitions by South African companies.
- The South African regulatory environment is coming more into line with those of major Western economies.
- The progressive dismantling of trade barriers as the country moves to comply with the General Agreement on Tariffs and Trade (GATT).
- The pressure to promote black economic empowerment and the willingness on the part of (white-controlled) businesses to aid this process.

1.3 Problem statement

Managing cross-border mergers and acquisitions is a daunting task. The international success rate appears to be low. The allegation has been made that three-quarters of major mergers and acquisitions do not even create shareholder value in spite of the strategic intent behind them. (James, 1999:1)

Cross-border mergers and acquisitions may fail because of a variety of reasons. These may notably vary from a lack of synergy and integration to cultural indifferences ("the human side"). Senior management often negates the impact that cross-border mergers and acquisitions have on employees of a company. The following is just one example of what is epitomised above:

"Mergers fail for many reasons, and to argue that a single cause is dominant would be incorrect. The "people" part of the merger plan is often left until it becomes a problem, and by then it is too late." (Miller, 1999:1)

Labelling a business "for sale" causes a blanket of uncertainty to descend on everyone in the company. South African companies and business managers have been isolated from the international business environment for many decades. In the "new South Africa", they will inevitably be exposed to their international counterparts with many years of experience in dealing with cross-border mergers in acquisitions. South African companies have often ignored the big global picture when focussing on this dilemma. Identifying and aligning strategic goals and objectives have not been achieved yet in South Africa.

1.4 Research objectives

The primary objectives of this dissertation are to identify the factors that are critical to determine the synergy, shareholder value and integration of cross-border mergers and acquisitions.

The secondary objectives are to research and analyse "softer" issues that form an integral part of cross-border mergers and acquisitions.

1.5 Limitations

The research done for this dissertation will be focussing on cross-border mergers and acquisitions and will only touch on the selected topics indicated in paragraph 1.7 below.

1.6 Research methodology

Literature reviews will be used as reference to develop a guideline from which South African businesses could evaluate and determine the synergy and other obstacles of a proposed cross-border merger or acquisition. Theory in the general, strategic and financial management fields will be used to formulate ideas on how to educate and approach this complexed field which is traditionally riddled with minefields.

Semi-structured discussions have been carried out with employees and managers of various national and international companies to assess the impact that cross-border mergers and acquisitions had on their respective organisations and more importantly, themselves. Information obtained from these interviews/discussions will be incorporated in the formulation of the above-mentioned ideas.

1.7 Demarcation of the study

The study will consist of the following six chapters:

Chapter 2: The rationale and reasons for cross-border mergers and acquisitions. In this chapter the concept of cross-border mergers and acquisitions will be defined. The rationale and benefits of cross-border mergers and acquisitions will be explored and growth, as one of the most fundamental reasons for cross-border mergers and acquisitions, will be discussed in detail.

Chapter 3: Making cross-border mergers and acquisitions work. In Chapter 3, the following phases of cross-border mergers and acquisitions are discussed:

- Issues to be considered prior to the proposed merger or acquisition. The issues of determining synergy, strategy and due diligence are analysed. A due diligence "check list" is proposed.
- Managing cross-border mergers and acquisitions during the merger or acquisition phase. Management issues such as culture, "sharing the throne", leadership and motivating towards one company's vision and goals are discussed.
- Successfully integrating the acquired or merged company with the acquirer after the merger or acquisition will then be discussed.

Chapter 4: Financial considerations. Determining intrinsic value, economic value added (EVA) and financing, the most important financial terminology used in cross-border mergers and acquisitions, are defined and analysed in this chapter.

Chapter 5: The Future. Future trends and their consequences for South African companies will be discussed in this chapter.

Chapter 6: Conclusion and recommendations. In Chapter 6, a summary of the major findings of the study will be given and recommendations made where appropriate.

CHAPTER 2: DEFINING CROSS-BORDER MERGERS AND ACQUISITIONS AND THE RATIONALE BEHIND THEM

"Many CEO's attain their positions in part because they possess an abundance of animal spirits and ego. If an executive is heavily endowed with these qualities – which, it should be acknowledge, sometimes have their advantages – they won't disappear when he reaches the top. When such CEO's is encouraged by his advisers to make deals, he responds much as would a teenage boy who is encouraged by his father to have a normal sex life. It's not a push he needs." (Buffet, 1994:1)

2.1 Introduction

Buffet (1994:1) proclaims that the sad fact of major mergers or acquisitions is the imbalance it creates between shareholders value of the target company and the acquirer. Mergers and acquisitions are usually to the benefit for the shareholders of the target company but usually reduce the wealth of the acquirer's shareholders. This chapter explains the reasons, benefits and causes of merger and acquisition activity. It is however important that these concepts be defined first. As will be shown below, the words mergers and acquisitions are frequently used but the distinctions are not precise.

2.2 Mergers defined

A merger is defined (Ross, 1996:574) as "a transaction whereby two companies combine, including but not limited to, a combination of their assets into one company." A new company is usually formed and the shareholders are all, or substantially all, of the shareholders of the original companies. The distinction between a merger and an acquisition is not always precise as the term merger is sometimes used in a transaction, which is in reality an acquisition.

Weston (1990:4) defines a merger in general as "negotiated deals that meet certain technical and legal requirements. Economists have however grouped mergers based on whether they take place at the same level of economic activity i.e. exploration, production or manufacturing, wholesale distribution, or retail distribution to the ultimate consumer. (Weston, 1990:5) Mergers may be categorised in the following categories:

2.2.1 Horizontal Mergers

A horizontal merger involves two companies operating and competing in the same kind of business activity. (Weston, 1990:5) They are usually embroiled in regulatory controversy because of their potential negative effect on competition. In 1991 the Allied and Volkskas Groups, UBS Holdings and parts of SAGE Financial Services merged horizontally to form Amalgamated Banks of South Africa (ABSA), which became the largest financial services group in the country with assets in excess of R85 billion. Weston (1990:5) argues that it remains an empirical question whether horizontal mergers take place to increase the market power of the combined company, or to seek to augment the company's capabilities to become a more effective competitor. The biggest ever horizontal merger was the Exxon – Mobil merger in 1999 with a combined value of $86 billion.

2.2.2 Vertical Mergers

A vertical merger occurs between firms in different stages of production and operation. (Weston, 1990:6). In the oil industry for example, clear distinctions are made between exploration and production, refining and ultimately marketing to the consumer. The rationale for vertical mergers is primarily driven by cost effective considerations. It leads to control of the value chain and consequently optimal economies in distribution.

2.2.3 Conglomerate Mergers

Conglomerate mergers involve companies engaged in unrelated types of business activity. (Weston, 1990:6) Three types of conglomerate mergers have been distinguished:

- Product-extension mergers that broaden the product lines of a company. These are mergers between companies in related business activities.
- Geographic market-extension mergers that involve two companies whose operations have been conducted in non-overlapping geographic areas.
- Pure conglomerate mergers that involve unrelated business activities.

2.3 Acquisitions defined

An acquisition is defined (Ross, 1996:575) as "a transaction in which an individual or company, known as the acquirer, gains control of the management and assets of another company, known as the target, either directly by becoming the owner of these assets or indirectly by obtaining control of the management of the company, or by acquiring the shares, or a majority thereof, of the target". The target company is therefore absorbed by the acquirer and usually ceases to exist as a separate entity. The term take-over is also frequently used to describe an acquisition. An acquisition can usually be made by one of the following two methods:

- Acquiring either part or all of the assets of a target company (an "Asset acquisition"); or
- Acquiring the issued share capital of the target company (a "Company acquisition" or "buy-out").

According to Ross (1996:576), financial analysts classify acquisitions in the following three types:

2.3.1 Horizontal acquisitions

This is the acquisition of a company in the same industry as the acquirer. These companies usually compete with each other in their product markets and are often geographic in nature. (Ross, 1996:576)

2.3.2 Vertical acquisitions

A vertical acquisition involves companies at different steps of the production process. (Ross, 1996:576) This can be either forward (towards the end consumer) or backward (in the direction of the suppliers of raw materials). One of the major vertical acquisitions in 1995 was when the Disney Corporation acquired Capital Cities/ABC for $19 billion. The strategic driver behind the merger was that there would be benefits of combining the programming capabilities of Disney with the distribution facilities of Capital Cities/ABC.

2.3.3 Conglomerate acquisitions

Conglomerate acquisitions involve companies engaged in unrelated types of business activity. (Ross, 1996:576) These acquisitions usually take place where the acquirer is diversifying risk or lowering the cost of capital.

2.4 Share purchase acquisitions versus asset acquisitions

The purchase of a companies shares and an asset acquisition are the two predominant methods to achieve cross-border mergers or acquisitions. They each has their own distinct advantages and disadvantages. The advantages associated with a share purchase are the following:

- The acquirer can deal directly with the shareholders of the target company and bypass the target company's board of directors and management.
- No shareholder meetings have to be held and no vote is required.

- Existing contracts need not be transferred and usually no consents have to be obtained from contract entities.
- If the company's assets are encumbered to provide security for a loan, the consent of creditors is not required.
- The acquisition agreement can stipulate a retrospective date so that the purchaser becomes entitled to profits earned by the target company prior to the date on which the deal is concluded, thereby boosting the acquirer's reported earnings.
- The acquisition of assets may involve costly transfer fees.

The following arguments however favour an asset acquisition:

- This type of acquisition requires a formal vote of the shareholders of the selling firm. The advantage is that there is no problem with minority shareholders holding out.
- Buying the company and transferring shares usually requires payment of stamp duties on the value of the consideration given for the shares.
- The buyer usually relies on warranties given by the seller as to the state of affairs of the company. When the seller is not a person or company of substance, it may be preferable to purchase the assets, since liabilities specifically assumed by the buyer will be the buyer's responsibility.
- If the acquired company has a large assessed loss, the buyer will usually buy the company. If however, the acquirer itself has a low or zero tax rate, it may rather choose to buy the assets, the profits emanating from which will be sheltered in the hands of the acquirer.
- Purchasing assets made up of plant, machinery, etc., will give rise to a substantial wear and tear allowance, especially if a value higher than book value is paid for these assets. This may enable the acquirer to make large claims against tax payable, thereby lowering the acquirer's effective tax rate.
- When the buyer borrows in order to finance the purchase, if assets are being purchased, interest on the loan is normally tax deductible. However, in the case of the purchase of shares, the interest would normally be

disallowed on a loan made for such purposes, since such interest is not incurred in the production of taxable income.

2.5 Cross-border mergers and acquisitions defined

Cross-border mergers and acquisitions are driven by competitive pressures for globalisation and facilitated by the liberalisation of markets world-wide. (Sebenius, 1998:2) Weston (1990:344) argues that the rationale behind cross-border mergers and acquisitions lies within the theory of the multinational enterprise (MNE) because a company that makes an acquisition in another nation thereby becomes a multinational company. Cross-border mergers and acquisitions can therefore be defined as mergers and acquisitions across the borders of two countries.

The MNE theory holds that a company uses internal managerial co-ordination rather than the external market when costs are lower or net revenue productivity higher. (Weston, 1990:346) The basic challenge to the MNE is that when it operates in a foreign country, its costs are likely to be higher and its revenue productivity lower than the indigenous companies with which it competes. Cross-border mergers and acquisitions therefore provide a mechanism to overcome entry barriers when deciding to do business in a foreign country.

The price for cross-border mergers and acquisitions however present significant challenges. For a cross-border merger or acquisition to be acceptable in this regard, the present value of benefits must exceed the present value of costs. If a potential target company is correctly priced, the present value of benefits should equal the present value of costs. In order to acquire the target company at a positive net present value, the acquirer must be able to buy the target company for less than the present value of its benefits. The subject of pricing will be dealt with in chapter 4.

2.6 Reasons for cross-border mergers and acquisitions

Fortune Magazine explaines that the main reason behind the current merger wave is the extraordinary abundance of financial capital available for investment. (Anon, 1999:24) Money is being transferred electronically almost immediately today. Globalisation and the liberalisation of world markets enable capital to be transferred from high supply to high demand markets like never before.

Jensen (1987:1) is of the opinion that the high level of takeover activity is caused by the following number of factors:

- The relaxation of restrictions on mergers and acquisitions imposed by antitrust laws;
- The withdrawal of resources from industries that are growing more slowly or that must shrink;
- Deregulation in the financial services, oil and gas, transportation, and broadcasting markets that is bringing about a major restructuring of those industries;
- Improvement in takeover technology, including a larger supply of increasing sophisticated legal and financial advisers.

Jensen (1987:6) furthermore states that the external take-over market serves as an important tool as a measure of last resort in creating organisational change, motivating the efficient use of resources and protecting shareholders when the corporation's internal controls and board-level control mechanisms are slow, clumsy or defunct. If a company's capital is not employed optimally by the board and senior management, it should be entrusted to those who can use it more effectively.

Many of the motives for cross-border mergers and acquisitions are similar to those for purely domestic transactions, while others are unique to the international arena. The most important reasons for cross-border mergers and acquisitions include the following:

2.6.1 Growth

The ultimate goal of any business is to maximise the market value of the existing owners' equity. (Ross, 1996:9) Growth is probably one of the most important motives for cross-border mergers and acquisitions. (Weston, 1990:350) Mergers and acquisitions in general provide instant growth and thereby rapidly enhancing the market value of existing owners equity.

Domestic markets may have become saturated for many South African companies. The local economy may have become too small or technological advances too big to accommodate growth. Cross-border mergers and acquisitions may enable these companies to improve their ability to compete abroad or to raise capital in a stronger foreign currency.

2.6.2 Technology

Technological considerations may impact cross-border mergers and acquisitions in the following two ways:

- A technological superior company may make acquisitions abroad to exploit its technological advantage. Information companies like Microsoft and Dell Computers have been doing this for years.
- Technological inferior companies may acquire or merge with a foreign company to enhance its competitive position at home and abroad.

Weston (1990:351) is of the opinion that companies with a technological advantage may be in a better position to exploit cross-border opportunities. On the other hand, the acquirer may deliberately seek a technological inferior company that is losing market share and thus market value. The acquirer can, by injecting new technology into the acquired company, improve its competitive position and profitability both domestic and abroad. One may also find that cross-border mergers and acquisitions occurs frequently by cash-rich technological backward companies attempting to obtain the technology necessary to remain viable as competitors on the world-wide scene. Companies from oil-rich but technologically backward countries have particularly used this strategy to improve their technological capabilities. (Weston, 1990:352)

2.6.3 Extend advantages in differentiated products

A company that has developed a reputation for superior products in the domestic market may find acceptance for their products in foreign markets as well. The entry of foreign products is likely to intensify competition in the markets in which it takes place and stimulate cross-border mergers and acquisitions.

Weston (1990:352) indicates in this regard that in the 1920's, motor vehicles were imported to Europe in large numbers before the industry was developed there. The United States had mass-production and cost advantages despite high foreign tariffs. This however changed as Germany and then Japan established themselves as high quality – low cost motor vehicle manufacturers. The markets however became saturated very quickly and this gave rise to increased merger and acquisition activity in Europe.

2.6.4 Government policy

Government policy, regulation, tariffs, and quotas can effect cross-border mergers and acquisitions in a number of ways. According to Weston (1990:353) these may include:

- Exports are particularly vulnerable to tariffs and quotas designed to protect domestic industries. The threat of such restrictions can encourage cross-border mergers and acquisitions, especially when the market to be protected is large. In Japan for example, a huge export surplus, which led to voluntary export restrictions coupled with threats of more binding restrictions, was a major factor in increased Japanese investment in the United States.

- Environmental and other regulations can greatly increase the time and cost required to build facilities abroad. Acquiring or merging with a company with existing facilities in place therefore makes good business sense.
- Changes in government policy and political stability can make cross-border mergers and acquisitions more or less attractive. In South Africa, the policy of apartheid had a negative impact on the domestic economy causing the divestiture of many foreign businesses.

Feinstein (1999:449) however indicates that the South African authorities will no longer be rubber-stamping mergers and acquisitions and that the following key elements will be scrutinised when considering mergers and acquisitions, which may have an effect on the South African economy:

- The dominance of both the acquirer and the target company in the market and the likelihood of abuse and its effect on pricing;
- The promotion of economic efficiencies, product choices and competition;
- The promotion of employment and social and economic welfare;
- The expansion opportunities for South Africa in world markets;
- Equal opportunities for small and medium enterprises in the local economy; and
- Promotion of the spread of ownership, particularly among the black community.

2.6.5 Exchange rates

The strength and weakness of the domestic versus foreign currency can impact the effective price paid for a merger or acquisition, its financing, production costs of running the acquired or merged company and the value of repatriated profits. Managing exchange rate risk is an additional cost to be taken into account when considering cross-border mergers and acquisitions. It is customary in the South African business environment to hedge foreign costs and expenditure by taking forward cover.

2.6.6 Political and economic stability

Countries like the United States excel in virtually every measure of economic and political stability and were one of the most important factors in attracting foreign buyers. (Weston, 1990:354) Political and economic stability can greatly increase the risk of what is already a riskier situation than purely domestic mergers or acquisitions.

The South African Government's GEAR strategy goes a long way in addressing foreign businesses' fears regarding political and economic stability. Foreign companies generally examine the following in determining the political and economic stability in a country:

- Fiscal and budget policies;
- Monetary policies;
- Exchange rate policy to keep the real effective rate stable at a competitive level;
- Exchange control;
- Tariffs and quotas;
- Tax incentives to stimulate new investment;
- Infrastructure;
- The availability of organised labour and labour laws;
- Crime.

2.6.7 Differential labour costs and productivity of labour

The labour climate in a country impacts on the country's economy as a whole.

High labour costs, unproductivity and restraining labour laws will all influence an acquirer's decision to buy or merge. Weston (1990:354) points out that declining productivity in the United States was one of the main trade barriers in that country. However, in the 1975-1980 period, declining dollar strength actually caused United States labour costs to fall, encouraging cross-border mergers and acquisitions of United States companies.

2.6.8 Diversification

Cross-border mergers and acquisitions can provide diversification both geographically and by product line. Weston (1990:355) states that international conglomerate mergers and acquisitions are relative rare because companies appear to be reluctant to add the risk of operating in a new product market to the risk of operating in a new geographical environment. Product diversification in the form of vertical integration is more common.

The South African economy, as an emerging market, is not perfectly aligned with first world economies like those of the United States, United Kingdom and Europe. A significant strategic driver for many South African corporations is to earn foreign income to reduce the risk of currency fluctuations and being dependent on the health of one single domestic economy. Weston (1990:355) is of the opinion that cross-border mergers and acquisitions can in this regard reduce systematic as well as non-systematic risk.

2.6.9 Resource-poor domestic economy

Companies operating in a resource-poor domestic economy are particularly motivated to acquire or merge with companies in other companies with ample resources at their disposal. This has been especially true for South Africa during the apartheid era where the country was isolated from almost all the major economies of the world.

2.6.10 Client base

Weston (1990:355) points out that long-term client relations (especially in the banking industry) is a major factor in cross-border mergers and acquisitions. If enough of a company's clients move abroad it makes economic sense for the company to expand abroad. Foreign companies may also wish to stay loyal to their long-standing, home-country banks.

2.7 Organic growth versus growth through cross-border mergers and acquisitions

It is important to point out once again that growth must be one of the most critical strategic drivers for any business' future. Cross-border mergers and acquisitions and organic growth each has its own strengths and weaknesses. The Atlantic Richfield Company (ARCO) followed the middle-way and embarked in 1995 on a combined strategy consisting of asset acquisitions and creating long-term organic growth. (Marston, 1999:1)

ARCO showed significant organic growth in its investment in Indonesia. They were active in Indonesian gas exploration since 1968 and developed considerable knowledge of the hydrocarbon potential over the last 30 years. During 1995-1997 ARCO increased its interests in Indonesia based on the knowledge gathered over this period of time. In 1998 ARCO made one of the biggest gas discoveries ever in Indonesia. Years of gathering information and gradual expansion therefore paid off. Marston (1999:1) points out that this example indicates that organic growth can create significant value if differential knowledge is obtained and operating costs are minimised.

ARCO decided to acquire Union Texas Petroleum (UTP) in 1998. They were looking for a company that would help to build critical mass in their core business and be fairly valued. UTP fitted both these criteria. The cost synergies available by combining ARCO and UTP were at the time approximately $85 million per year after tax. The full integration was achieved in November 1998 and has exceeded all the original cost savings.

Marston (1999:1) argues that when considering any merger or acquisition, it is vital to understand the impact of the key assumptions. He ventures the following opinion on when to decide on a organic growth strategy and when on a cross-border mergers and acquisitions strategy:

- If time and speed is important, corporate mergers or acquisitions will create the biggest portfolio changes in the shortest period of time.
- The biggest value creation opportunities may however come from carefully negotiated deals that may take years of work.

Schmidt (1998:1) agrees with this view and state that companies usually see mergers and acquisitions as a much quicker way of attaining critical mass necessary for reaching global markets than "old fashioned" organic growth. In 1998, ARCO bought and sold businesses with a total value of around $11 billion. They have learnt the following valuable lessons (Marston, 1999:5):

- Decide first on your strategic direction;
- Study the environment and determine the best tool for the strategy;
- Never neglect implementation and integration;
- Stay flexible;
- Good deals take time. Patience is very important.

Whether through mergers or acquisitions or organic growth, companies frequently get involved in new businesses primarily because they see the opportunity for synergy with their existing operations. In this regard, sustainable growth remains the core objective for the Sasol Group of Companies. The company declared that growth would be attained through sensible acquisitions, synergistic alliances and focused investment in existing businesses, as well as new-value-adding projects. (Cox, 1998:11)

2.8 Summary

Cross-border mergers and acquisitions have overwhelmed the business newspapers this year world-wide. In order to grasp the rationale behind cross-border mergers and acquisitions it is important to gain a clear understanding of the reasons that may lead to them.

Although the abundance of investment capital has been pointed out as a major incentive for cross-border mergers and acquisitions, it has been made clear that the search for growth is one of the most important drivers behind them.

It has furthermore been pointed out that although organic growth may provide excellent long-term results, cross-border mergers and acquisitions will provide the biggest portfolio growth in a much shorter time. It is however vital to understand the impact of the key assumptions before embarking on a mergers and acquisitions strategy.

The reasons behind cross-border mergers and acquisitions that have been discussed in this chapter will be further alluded to in chapter three.

CHAPTER 3: MAKING CROSS-BORDER MERGERS AND ACQUISITIONS WORK

> *"Always be well informed about the company that you wish to acquire – know about its industry and the countries where it operates. To be well informed is to be wise. Ask yourself frequently, "Why do I need this business?" And if at any time the answer to this question is because of position, conceit or self-promotion, walk away. The true answer to this question must be, "The acquisition of this company fits neatly into my plans and will increase my profits, while at the same time cutting my costs." (Niccolò Machiavelli)*

3.1 Introduction

Machiavelli expressed this view between 1516 and 1527 AD and it still holds as much truth today as it did back then. (McAlpine, 1998:46) Signing a cross-border merger or acquisition deal only signals intent. Management can get so caught up in publicity that it sidelines the whole rationale of the deal and fails to turn goals into reality. According to a recent study conducted in South Africa, "soft factors" like culture, communication and people-focus were notably absent among merger and acquisition failures. (Lloyd, 1999:50)

The ultimate goal in managing cross-border mergers and acquisitions must be to bridge both the value gap and the transition gap. The value gap refers to the difference between the value of the acquiring or merged company through the combined company and the actual value created. This part deals with financial considerations and will be dealt with in chapter four. The transition gap is the implementation of the merger or acquisition and will be dealt with in this chapter in three phases namely, pre-merger planning, managing during, and integration after closing of the deal.

The merger or acquisition process can be delicate and any one of the "seven deadly merger and acquisition sins" can sabotage a proposed merger or acquisition. (Lyle, 1999:13) Those sins are:

- A lack of a clear strategy and plan of action;
- Forced combination of disparate cultures;
- Changes that hurt positive work environments;
- Key people are scared of to other companies;
- Lack of attention to morale and behaviour in reaction to long-term goals;
- Failure to meet stated goals and objectives;
- Declines in production, sales and customer service and net income.

3.2 Pre-merger or acquisition planning

The most basic principle behind the proposed cross-border merger or acquisition is to be crystal clear about the logic of the deal. Pre-merger or acquisition planning therefore consists mainly of the following two proactive steps:

- Defining the strategy, strategic intent and synergy behind the proposed cross-border merger or acquisition; and
- Performing a detailed due diligence on the target company.

3.2.1 Strategy, strategic intent and synergy

Strategy is defined (Thompson, 1998:1) as "the game plan management has for positioning the company in its chosen market arena, competing successfully, pleasing customers, and achieving good business performance." Strategy therefore entails managerial choices among alternatives and signals organisational commitment to specific markets, competitive approaches and ways of operating. Thompson et al (1998:3) is of the opinion that good strategy and good strategy execution are the most trustworthy signs of good management.

Any acquirer should follow the following essential elements in the strategic planning process (Weston, 1990:149):

- Assessing changes in the environment;
- Evaluate the company's capabilities and limitations;
- Assess the expectations of all stakeholders;
- Analyse the company's competitors, industry, domestic economy, and international economies;
- Develop a sensitivity to critical external environmental changes;
- Formulate a vision, mission, goals and policies for a master strategy. Spell out clearly the objectives the company wants to attain in consultation with employees;
- Formulate internal performance measurements;
- Formulate long-range strategy programs;
- Organise implementation of all the preceding elements;
- Create information flow mechanisms and a feedback system for continued adjustment. Managers should be held accountable for reaching objectives within a specific time frame;
- Review and evaluate regularly.

A company exhibits strategic intent when it relentlessly pursues an ambitious strategic objective and concentrates its competitive actions and energies on achieving that objective. (Thompson, 1998:39) Strategic intent represents managerial commitment to achieving specific performance targets within a specific time frame. The strategic intent calls for action and results. Without a strategic intent, a company will not be able to compete internationally in a professional manner and will always remain in the mediocre category. The strategic intent will act as a yardstick for any proposed merger or acquisition's performance, progress and achievements.

According to Weston (1990:152), synergy represents the two plus two equals five effect. Synergy should be realistic. Usually acquiring companies take too many years to realise that the expected synergies never existed.

Cross-border mergers or acquisitions are more likely to work when a company chooses a partner that fits well, rather than one that is merely available. Similarities between the two companies are vital and particularly, similarity of outlook. (Anon, 1999:13) Lyle (1999:12) argues that the proposed merger or acquisition should lead to some logical result.

The major challenge facing management is to create a strategy, develop strategic intent, and determine possible synergies before embarking on the merger or acquisition road.

3.2.2 The role of due diligence investigations in cross-border mergers and acquisitions

In the context of cross-border mergers and acquisitions, the function of a due diligence investigation is to assess the potential benefits and liabilities of a proposed transaction. (Sher, 1999:15) The investigation inquirers into all the relevant aspects of the past, present and the predictable future of the target company. The ultimate goal of any due diligence investigation is therefore to limit any potential dissatisfaction with the transaction and to confirm in advance that the buyer will receive what it believes it is purchasing.

Due diligence investigations should place the acquirer in an equal bargaining position by informing them of the true state of affairs and enabling them to make sound business decisions. Sher (1999:15) concludes that the main reasons for conducting a due diligence investigation are the following:

- Assisting the acquirer to gain a better understanding of the target company;
- Providing information to the buyer to enable a proper evaluation of the target company;
- Helping the acquirer to find hidden treasures, avoid hidden pitfalls, and understanding the financial and economic picture that the numbers portray;
- Identifying some of the advantages or risks associated with the potential acquisition;

- Identifying any problems which may not be apparent to the buyer and which may affect the purchase arrangements and, in some cases, may even make the target an unsuitable merger or acquisition;
- Determining those matters which should be the subject of negotiations or on which the buyer should seek warranties and indemnities from the seller.

In the past, there has been a general tendency to treat a due diligence investigation as similar to an audit. Joselowitz (1993: 9) however points out that in a merger or acquisition of any size, it is unlikely that factors to be investigated will be restricted to matters of a purely accounting nature. Due diligence investigations conducted by auditors only have proved unsatisfactory for two reasons (Sher, 1999:15):

- Although the financial aspects of a proposed merger or acquisition should not be underestimated, one should remember that the buyer acquirers a composite entity. The target company comprises of assets of various sorts, people and systems. Multi-disciplinary skills are needed to assess the various aspects of the transaction.
- The investigation tends to look at the past and not the future. It is essential that a due diligence investigation also focus on the future prospects of the target company.

A team conducting a due diligence investigation should ideally consist of auditors, lawyers, computer and human resources experts. A due diligence investigation should be as extensive as the scope and extent of the risks associated with the merger or acquisition. This will be determined by the following factors:

- The purpose for which the investigation is carried out;
- The stage at which the investigation is carried out;
- The time the acquirer has;
- The degree of comfort required; and
- The cost the acquirer is willing to incur.

In the international business environment, parties will usually start out by entering into a confidentiality agreement. This would preclude any party to divulge any information obtained during the due diligence investigation.

In most due diligence investigations some areas will require specific attention. A general "check-list" of items to be reviewed during the due diligence investigation is herewith proposed and attached hereto marked Annexure "A".

3.3 Management issues during the merger or acquisition process

3.3.1 Aligning organisational culture

Gibson (1997:30) defines organisational culture as "what the employees perceive and how this perception creates a pattern of beliefs, values, and expectations". Organisational culture involves shared expectations, values, and attitudes that exert influence on individuals and groups. When the culture within two organisations are suddenly merged, these cultures often conflict because of the difference in values, norms and beliefs.

There is much greater possibility of conflicting cultures in cross-border mergers and acquisitions where often cultures of two nations are forced together. James (1999:1) is of the opinion that the potential gain of any merger or acquisition is at risk if internal cohesion is lost when the two cultures collide. Cultural differences may lead to misunderstandings, disagreements and confusion. Gibson (1997:59) identified the following cultural dimensions which managers should keep in mind:

- People's relationship to nature. Western cultures for example see God's will in a flood but eastern cultures will seek to deal with nature on nature's terms.
- Individualism versus collectivism. The American culture places a high premium on individualism. Most Eastern cultures do not.

- Time orientation;
- Informality;
- Language;
- Religion.

A company's failure to take steps to address these "soft" issues will turn the "hard" or real issues into an administrative nightmare. The vital management question is therefore how to get people from different cultures, which even may have been competitors, to build a new company that will grow and prosper?

GE Capital has distilled four steps business leaders can take to bridge the cultural gaps that may exist. (Ashkenas, 1998:165) These are:

- Meet, greet and plan (urgently). Orientation and planning sessions should be scheduled as soon as possible. These sessions will help to welcome the new employees and give them a chance to socialise with their new colleagues. An information exchange should take place and people are encouraged to talk about the positive aspects of their jobs.
- Communicate, communicate – and then communicate some more. A detailed communication plan must be created as early as in the due diligence phase. Forums for dialogue should be created. The assumption is that the more people know about what is happening, the more they will be able to accept their change and overcome their cultural differences.
- Address the cultural issues head-on. The company should construct a systematic process of cross-cultural analysis. This must eventually lead up to a "cultural workout". The focus during these sessions should slowly move from the past to the future.
- To move from the few to the many cascades the cultural integration process. The process of bridging cultural gaps should be spread beyond the management teams. All employees should be involved.

The best way to accomplish cultural integration is to get people together quickly to solve business problems and attain results that could not have been achieved before.

3.3.2 Leadership issues

Gibson (1997:272) defines leadership as "an attempt to use influence to motivate individuals to accomplish some goal." Mergers and acquisitions present major challenges when companies merge. The question is invariably asked: Who gets to occupy the CEO seat? With most mergers and acquisitions the answer is fairly straightforward. The CEO of the company that is doing the acquiring or initiating the merger becomes top dog. The other CEO either leaves or steps down to a lesser, albeit still powerful, position.

One of the biggest mergers announced in 1998, was the $70 billion combination of Citicorp and Travelers. The announcement shortly thereafter that the post of chairman and CEO would be shared between the two CEO's stirred debate whether a company of such magnitude can be effectively led by two strong-willed and high-profile CEO's. (Troiano, 1999:39)

Views have been expressed that the "co-CEO arrangement is a flawed concept which presents significant problems. (Troiano, 1999:41) These include:

- The people that report to the two CEO's have difficulty in trying to figure out to whom do you go with a particular issue;
- Responsibility for the other CEO's actions. Who is responsible?
- How does the decision-making powers work?

There is however examples of co-CEO partnerships that have worked well. Goldman, Sachs & Co. is a New York investment bank that had three such arrangements in the past and there are people that believe that this will be a new future trend. (Troiano, 1999:41) The traditional leadership model versus the co-leadership model however differs materially. Leaders should take note of the following differences:

Traditional Leadership	**Co-Leadership**
Information is tightly controlled.	Information is more freely disbursed.
General distrust of power sharing.	General encouragement of power sharing.
Top dog gets all the credit.	The limelight is shared.
I protect my flank.	I am committed to the success of the whole.
You are my subordinate.	You are my co-creator.
I am responsible for everything.	I am willing to delegate.
I am going to tell you.	I am going to ask you.
Chain of command is immutable.	Chain of command is flexible.

Figure 1. Traditional leadership versus co-leadership.

People from different cultures must, through effective and visionary leadership, be motivated to build a new company. The future of the new company will ultimately depends on principled centred leadership of the CEO and senior management.

3.4 How to integrate after the deal

Integration is the process by which one company melds with another after the deal is done. (Ashkenas, 1998:165) Cross-border mergers and acquisitions are anxiety producing events, which may *inter alia* involve job losses, new responsibilities and derailed careers. Most managers think only how to get this over with and not how to do them better the next time.

Integration is one of the most urgent and compelling challenges facing merger and acquisition activity today. GE Capital Services (GECS) has made more than 100 acquisitions in the past five years but with the difference that they view integration as one of their core capabilities and a competitive advantage. (Ashkenas, 1998:166). GECS has learned the following lessons from these acquisitions and its efforts to make them work:

3.4.1 Merger and acquisition integration is not a discrete phase

Integration does not begin when the documents are signed but is rather a process that begins with due diligence and runs through the ongoing management of the new business. GECS found that being sensitive to integration issues as soon as possible, preferably at the due diligence phase, helped to foster better decisions about whether to proceed with the merger or acquisition at all. GECS today begins with planning integration at the very first discussions. (Ashkenas, 1998:169)

3.4.2 Integration management is a full-time job

Integration management needs to be recognised as a distinct business function just like operations, marketing or finance. Integration is an ongoing process that needs to be managed. GECS initially tasked its business leaders to integrate the newly acquired or merged company because they had the most incentive to learn about the new company. This was however an unrealistic assignment because in most cases they also had other unites to run and was not dedicated fully to the new business.

GECS realised that a new role was born in the company and today they generally selects two types of people to be integration managers. The high-potential individual and the experienced hand. The high-potential individual is usually a future business leader with strong functional skills. The experienced hand is usually used for more complex mergers or acquisitions. This would be someone that knows GECS well and has proven management skills.

GECS found that in all cases, the integration managers that have been most effective have been those that have served on the due diligence teams. The integration manager has in all instances become a fully-fledged member of the leadership team.

3.4.3 Important decisions must be announced and implemented as soon as possible after the deal is signed

Creeping changes, uncertainty and anxiety that last for months are debilitating and immediately start to drain value from a merger or acquisition. Acquiring managers usually close a deal with a big bang ready to get on with managing the new company. Employees and shareholders of the acquired company almost simultaneously begin to ask the following questions: Who are these new owners? Can we trust what they say? Do we still have jobs? Why did our previous owners sell?

Most mergers or acquisitions involve restructuring, either to improve efficiency or to make sure that it fits with the acquired company. The most important thing on the "to do" list is to address employees' fears and uncertainty. Decisions about management, key roles, reporting relationships, layoffs, restructuring and other career affecting aspects of the integration should be announced and implemented as soon as possible. If the acquirer fails to do this it will send out a bad and demotivating signal. Restructuring should be done with respect.

The acquirer must be straightforward about what is happening and what is planned. Never tell the acquired staff that it will be business as usual when it never will be again.

By using the wealth of knowledge obtained in merger and acquisition integration, GECS created a model for integrating mergers and acquisitions known as the "Pathfinder Model". The model" is illustrated in figure 2. The model divides the process into four "action stages", starting with the work that goes on before the acquisition is completed and continuing all the way trough the assimilation.

"THE PATHFINDER MODEL"

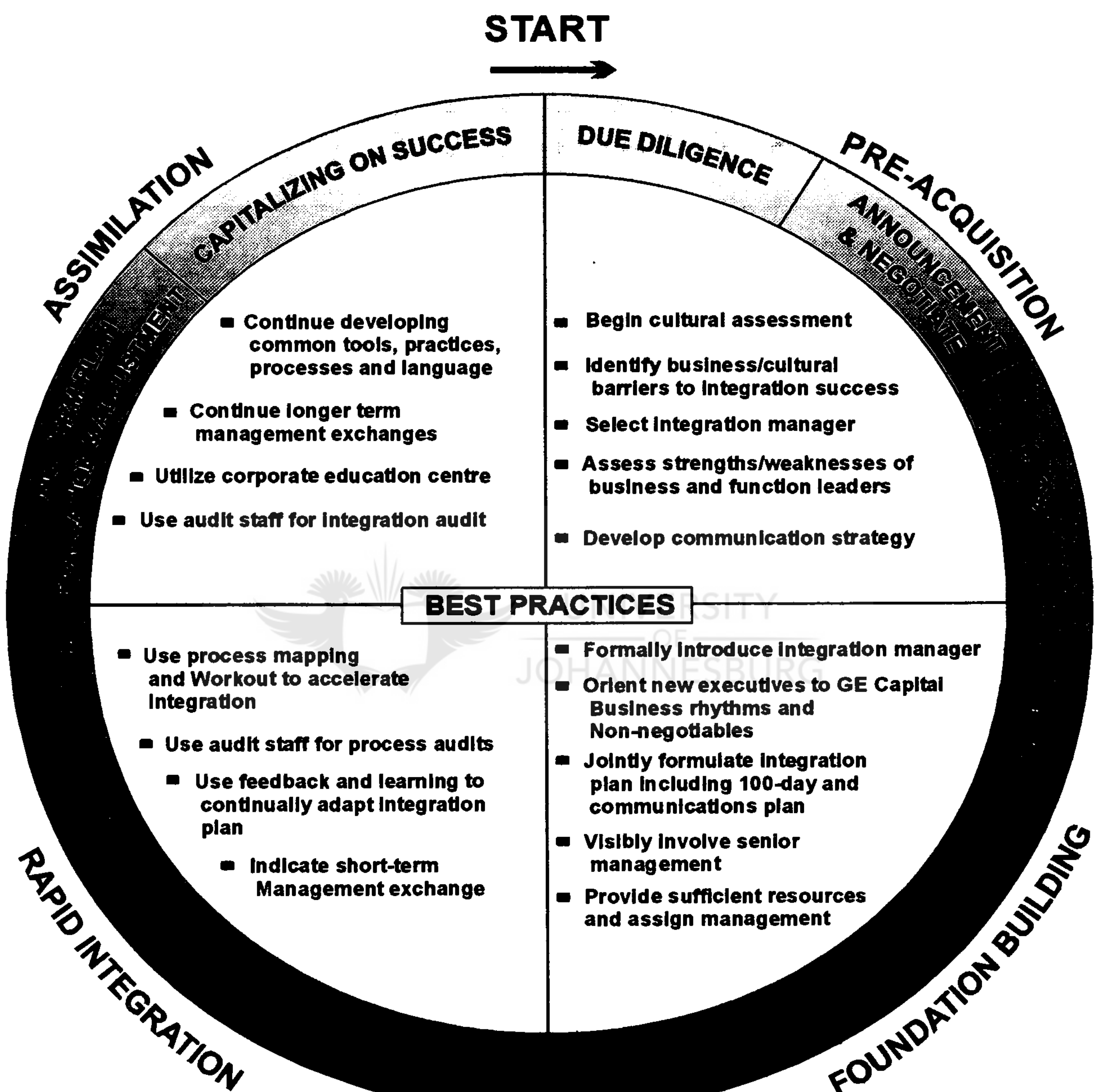

Figure 2: The "Pathfinder" Model for merger and acquisition integration

There are two or three sub-processes in each action stage. Each action stage includes several best practices and steps managers can take to support the process.

The most powerful way to move ahead with the integration process is to get the employees of the acquired company focused on the real work of growing the newly formed business. Integration managers could do this by managing the integration process, not the business. The following will assist any integration manager in this task:

- Facilitate integration by working closely with the managers of the acquired company;
- Create strategies to quickly communicate important information;
- Assist the new company to add functions that may not have existed before;
- Assist the acquiring company's managers to understand the acquirer's business;
- Educate the new management team about all aspects of the business;
- Explain and translate any acronyms that may exist in both companies;
- Help managers of the acquired company to understand the new culture and business customs;
- Help managers of the acquired company to understand fundamental changes in their jobs;
- Introduce new business practices;
- Control the flow of information between the two companies and avoid gossip.

3.5 Summary

It is self-evident that management needs to manage the natural resistance to change in a clear and effective way. The following are critical performance areas to integrating a merged or acquired company successfully:

- Clear vision;
- Dedicated and competent management;
- Communication;
- Cultural integration;
- Speed and implementation;
- Performance tracking;
- Clear and effective leadership; and
- Effective risk management.

The ultimate goal of the due diligence investigation must be to limit any potential dissatisfaction with the transaction. The due diligence investigation should furthermore not be treated as an audit and must also focus on the future prospects of the target company.

Companies, which fail to manage an effective integration programme, may expect attacks from competitors in during a period of great uncertainty. The most powerful way to move ahead with the integration process is to get the employees of the acquired company focused on the real work of growing the newly formed business.

It would be irresponsible to prioritise any one of the critical performance areas listed above as they all fit into a cycle without which any proposed cross-border merger or acquisition could hardly succeed. The financial rationale could however singled out as one of the most important factors which can not be managed effectively after integration if it is flawed from the beginning. The critical financial drivers behind cross-border mergers and acquisitions are described in chapter four.

CHAPTER 4: DETERMINING INTRINSIC VALUE, ECONOMIC VALUE ADDED AND OTHER FINANCING ISSUES

> *"Attend a press conference for one of today's megamergers, and it's hard to resist being swept up in it all: the two imperial CEO's and their soaring strategic vision; the solemn assurances that this is all for the good of the shareholders; the infectious camaraderie radiating from the podium. (Hey, he didn't sell just because he stood personally to make $30 million; he sold because he really likes the other CEO.) The press adores the big story, and Wall Street, never inclined to impede an oncoming gravy train, adds its strongest backing. It's all so positive, so full of good feeling, that you'd have to be a complete curmudgeon to spoil the mood by questioning the deal's price." (*Tully, 1999:43)

4.1 Introduction

Mergers and acquisitions all too frequently reduce the share price of the acquiring company. (Stewart, 1999:351) Many managers, when contemplating mergers and acquisitions, tend to focus on whether the transaction is immediately dilutive or anti-dilutive to earnings per share. Buffet (1994:1) explains this fallacy by comparing the future interests of a day labourer to that of a first-year MBA student. Should the two decide to merge their interests, the student would find that a "share-for-share" merger of his equity interest in himself would enhance his near term earnings significantly. But in the long-term, he would be destroying his equity's value.

Stewart (1999:352) is of the opinion that in order to protect shareholders and managers alike, the acquirer will want to quantify the likely value to be derived from a merger or acquisition and then pay something less. One of the most important reasons for merger or acquisition failure is overpaying. The buyer overpays for the benefits that are likely to arise from the combination, leaving the sellers with an attractive gain and the buyer with a loss. (Stewart, 1999:351)

Understanding the intrinsic value of a target company is as important for managers as it is for investors. When managers are making capital allocation decisions it's vital that they act in ways that increase per share intrinsic value and avoid moves that decrease it. This principle may seem obvious, but it is constantly violated (Buffet, 1994:1)

4.2 Economic value added (EVA)

Stewart (1992:742) defines EVA as "A fundamental measure of corporate performance, it is computed by taking the spread between the return on capital, and multiplying by the capital outstanding at the beginning of the year (or the average over the year if that was used in computing the return on capital). It is the residual income that remains after operating profits cover a full and fair return on capital (i.e., the cost of capital). In theory, a company's market value added at a point in time is equal to the discounted present value of all the EVA it can be expected to generate in the future."

Stern Stewart, the founders of the EVA concept, start with the assumption that a merger or acquisition is merely a capital investment, much like buying a factory. (Du Toit, 1999:48) Any such investment adds value only if it generates a return greater than the cost of capital employed. If it does not, the market will drop the price of the new company's shares until incoming investors do get a fair return on capital. If the acquirer for example pays a high price for the target company, the improvements needed to make the deal pay off are that much greater.

The most important reason to adopt EVA as the main financial goal in evaluating mergers or acquisitions is that it is the only measure to tie directly to intrinsic market value. EVA is therefore an internal measure which leads to the external consequences of building a premium (or a discount) into the market value of a company. Maximising the present value of EVA therefore amounts to maximising intrinsic market value.

An acquiring company must determine during the due diligence phase whether the target company has been increasing or decreasing EVA. EVA can be increased as follows:

- The rate of return on existing capital must be improved. Generating more operating profit without tying up more capital can do this.
- Additional capital can be invested in projects that return more than the cost of obtaining the new capital.
- Capital can be liquidated from substandard operations where inadequate returns are being earned.

Any company which is serious about creating shareholders value by means of EVA must ask itself what its true cost of capital is and how much capital is tied up in existing operations.

4.3 Analysing cross-border mergers and acquisitions

Net value added (NVA) is the starting point in valuing cross-border mergers and acquisitions. NVA is the difference between the total value received (by the buyer from the seller) and the total value paid (by the buyer to the seller) (Stewart, 1992:367)

$$\text{Net value added} = \text{total value received} - \text{total value paid}$$

When NVA is divided by the pro forma number of shares outstanding, it determines the change in the buyer's share price following a merger or acquisition. This principle is clearly illustrated in figure three.

The total value received is the intrinsic value of the seller's business plus any value conferred on the buyer's operations as a result of merging with the seller.

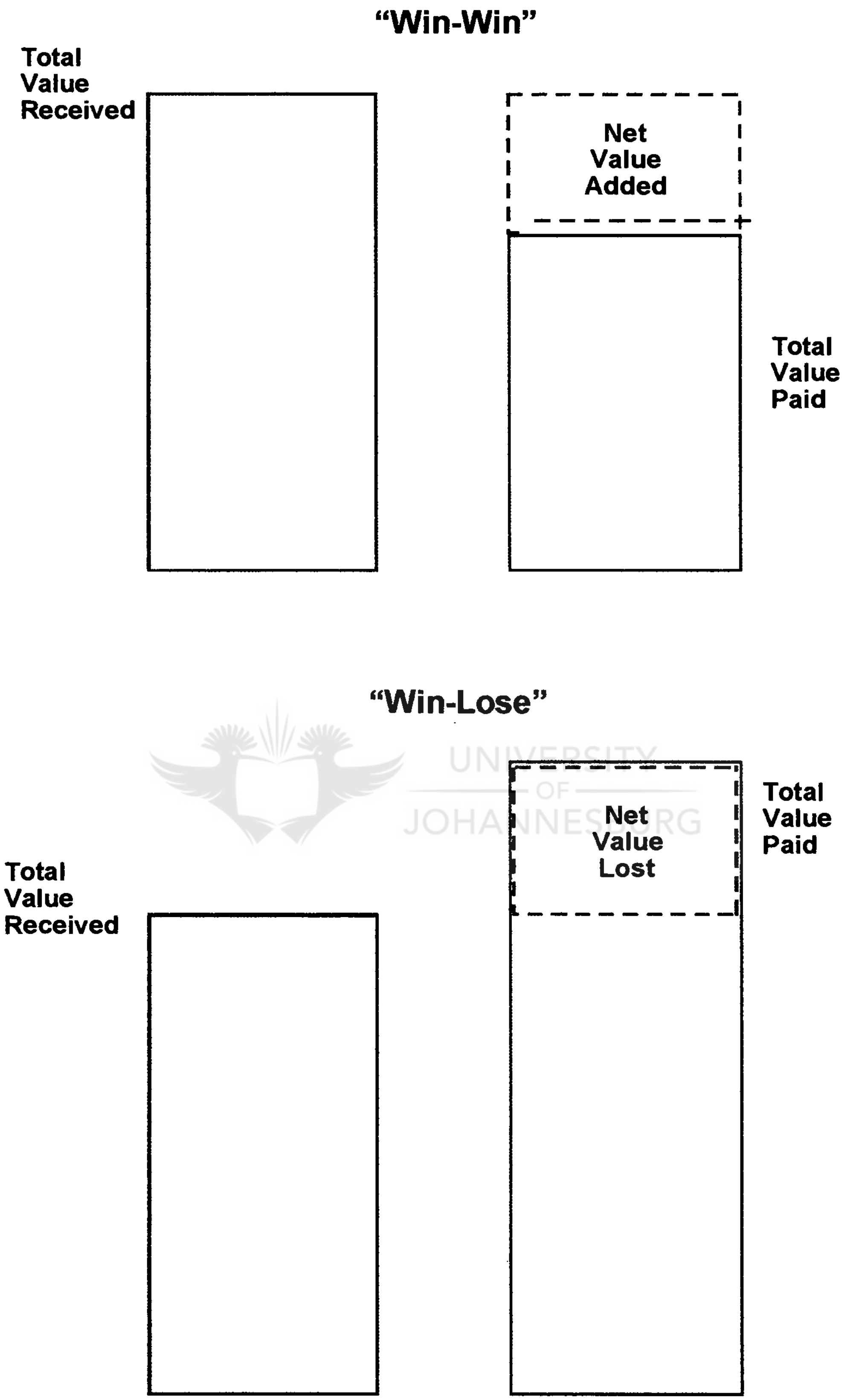

Figure 2 : Net Value Added or Lost

The total value paid is all cash used to compensate the selling shareholders, all debt issued, all of the buyer's equity issued, plus the market value of all seller liabilities assumed by the buyer.

Stewart (1992:370) argues that the perceived value of all synergies must exceed the premium paid for the proposed merger or acquisition and that the following two factors are therefore necessary for a merger or acquisition to be truly successful:

- There must be some truly commercial significance, that is, value must be created through the combination that investor's could not duplicate merely by holding both buyer's and seller's shares in their portfolio's.
- The premium negotiated must preserve some of the added value for the buyer. The fact that the target company itself is fairly valued should be ignored. Only evaluate the unique improvements in value that will come about as a result of the combination and pay something less as a premium.

4.4 Determining acquisition benefits

Warren Buffet observed that a strategic fit is not enough for two companies to merge successfully. (Tully, 1999:43) If the acquirer overpaid, good integration, strategic fit and a harmonious blend of culture do not matter. This wisdom can be clearly illustrated by examining the financial rationale behind one of the biggest mergers to date, the Exxon – Mobil merger.

Exxon's bid to acquire Mobil's shares at $99 per share, exceeded Mobil's share price by 34% (or $19,8 billion). Exxon was betting at that price that Mobil's assets are worth on average, one-third more as part of Exxon, than they were under Mobil's management. Based on Mobil's cost of capital of 9,1%, investors were anticipating yearly increases of 9,9% after-tax operating profits. But since Exxon is paying a $19,8 billion premium, they will probably have increase annual operating earnings growth to 12,9% just to break even. Exxon's shares are selling at about the same price as before the bid (approximately $74 per share). Exxon needs to increase the return on capital on its investment to 17,6% by 2003. Mobil's highest annual return on capital since 1993 has been only 12,2%.

Analysts (Tully, 1999:45) do not favour the odds that Exxon will indeed be able to accomplish this. They will definitely be able to save a lot of costs from combining operations and by using new size to strike better deals than their competitors, but rivals are also combining economies of scale which could limit Exxon's long-term competitive advantage.

Stewart (1992:375) proclaims that a value-driver model of valuation should determine the benefits of any proposed merger or acquisition. This model should ideally consist of the following components:

- Operating benefits that encompass synergies which will increase net operating profit after tax;
- Operating benefits that would enable the acquirer to invest more in attractive projects;
- Borrowing against the target company's unused debt capacity usually adds value;
- The tax benefits in utilising the target company's debt including reducing the combined weighted average cost of capital;
- Saving costs through economies of scale;
- The present value of all foreseeable operating, financial and other benefits, when weighted by the likelihood of their occurring.

4.5 Summary

If a company's share price dropped after it announced a merger or acquisition, it will most probably become a takeover target itself. (Stewart, 1992:351) In order to avoid the erosion of shareholders' wealth, an acquirer must ensure the following:

- Value must be created (i.e., that the combination have some operating, financial, or tax benefit that shareholders cannot duplicate);
- Management must negotiate a premium that does not exceed the amount of value created.

The notion of creating value consists mainly of the following components:

- Any investment that earns above the company's cost of capital creates value added for shareholders. Conversely, any investment whose returns are below the cost of capital, destroy value;
- The more capital that can be invested at greater returns above the cost of capital, the greater the value created;
- The longer a favourable spread can be maintained, the more value is created.

An acquirer can undo the effects of a subsequent decade of favourable business developments by paying a too-high purchase price. The hallmark of a successful merger or acquisition is when the share price of the buyer as well as of the seller increase after the press release.

CHAPTER 5: FUTURE TRENDS IN CROSS-BORDER MERGERS AND ACQUISITIONS

"There are many paradoxes in this dramatically changing world. I have identified the one I think embraces much of today's change and is the main focus of this book: ***The bigger the world economy, the more powerful its smallest players****."* (Naisbitt, 1995:5)

5.1 Introduction

The recent flood of the so-called "megamergers" was mainly caused because of size, relationships, and other structural considerations. Drucker (1998:99) is of the opinion that the present mergers and acquisitions wave is mostly defensive. He maintains that the industries that merge are industries that are shrinking. Their markets are usually overcrowded and they drastically need new markets.

The banking and oil industries are good examples. The global market is dominated by a handful of major banking and oil companies. There is not much new business to go around. The pharmaceutical industry is merging because their growth is in areas they don't understand. On the other hand, a rapidly emerging market mainly drives the mergers and acquisitions wave in the information technology industry. (Drucker, 1998:98)

Naisbitt (1995:13) is of the opinion that cross-border mergers and acquisitions is something of the past because competition and co-operation have become the operative words of the global market place. The most important reason for the growth of strategic alliances is companies avoiding getting bigger. Strategic alliances rather than merging or making an acquisition means that added value is gained without getting any bigger.

5.2 Reasons for merger and acquisition failure

Du Toit (1999:48) notes that fewer than half of all mergers and acquisitions add value. The shareholders whose company is bought end up richer and the shareholders of the buyer seldom do. Alexander (1999:22) points out that more than 50% of mergers and acquisitions in the United States were divested again within five years because of the following reasons:

- Acquirers consistently overpays for the target company;
- Synergy failure;
- "Bad parenting" This is the lack of the parent company to integrate the newly acquired company;

More attention is often given to the deal than planning and execution of the integration. It is clear that usually a combination of factors can be blamed for merger or acquisition failure. Overpaying may however be a detrimental factor that could create wealth. Drucker (1994:97) points out that one of General Motors' core competencies has been to overpay for well performing but mature businesses and then turn them into world-class champions.

The new "big" merged company may have its advantages. This is however no safeguard against the many disadvantages mentioned. Jarrell (1999:9) argues that some merged companies become so big that they lose focus, gain overhead and increase their expenses dramatically. Ultimately they can be less innovative and competitive than before.

It has already been pointed out that companies shows very little regard for the "softer" issues in managing cross-border mergers and acquisitions. One of the most important drivers, EVA, is often ignored when executives take strategic decisions.

5.3 Cross-border mergers or acquisitions versus strategic alliances

According to Naisbitt (1995:4) the world's trends point overwhelmingly toward political independence and self-rule on the one hand, and the formation of economic alliances on the other. The reasons thereof are:

- The removal of global trade barriers opened the way for small companies. In the past, only large companies could meet the massive capital requirements for expanding globally;
- Computers and telecommunications have turned out to be formidable weapons for small companies to get an edge on big companies. They can innovate faster and take advantage of other opportunities faster.
- The deregulation and globalisation of financial markets have given small and medium size companies access to capital they never had before;
- Quality can today be found and replicated everywhere and anywhere. The new game is speed to markets and innovation.

Strategic alliances will help to defend against overpaying and can be seen as a testing tool of potential synergy to clarify what is most likely to be real as opposed to illusory. (Alexander, 1999:24)

5.4 The South African scenario

South Africa has enjoyed a high volume of merger and acquisition activity over the last couple of years. The two largest deals announced in South Africa were also the largest in South Africa's history. They were:

- The merger of Anglo American Corporation (AAC) and Minorco to form Anglo American plc. The value of the transaction was R71,3 billion; and
- The merger of the financial services interests of AAC and Rand Merchant Bank Holdings to form First Rand. The entities involved in the merger –

Southern Life, First National Bank and Momentum Life – were capitalised at R59 billion at the time of the merger.

South African merger and acquisition activity is however unique in one way and that is the notable absence of hostile take-overs. (Ross, 1996:574) The reason for this is that the active shareholder base in South Africa is too small for any successful hostile take-overs. (Du Toit, 1999:46)

Katz (1996:574) however points out that as anti-trust laws become more prevalent in an effort to promote black economic empowerment, and as exchange controls are gradually relaxed, there will be a visible manifestation of shareholder deconcentration in South Africa. This will lead to more leveraged and management buy-outs for the benefit of staff at all levels. As more and more black economic empowerment companies are established, it is very likely that the available targets will become targeted by hostile take-over bids. While hostile take-over deals are dying out in the United States, South Africa is likely to see bitter fighting over the next few years as corporate founding families and proud CEO's hate to give up control. (Reed, 1999:18)

The so-called "megamergers" reduced the global competition gap to a handful of major players. Endless opportunities do however still exist for mid-sized companies which specialises. Strategic responses from these mid-sized players can be summarised as follows (Anon, 1999:4):

- They have created global splinters through superior intangibles such as brands;
- They created global franchises by developing and leveraging insider relationships, knowledge and positions;
- They created or entered into new but related businesses;
- They have combined a narrow product-market focus with a broad geographic scope.

Katz (1999:52) says that if the United States, with its strict anti-trust laws, has allowed such massive companies to merge, the South African Competition

Board should recognise that the appropriate market is the global market. Foreign exchange control is a major factor restricting South Africans to do business abroad. In this regard, South African companies are legally obliged to obtain the South African Reserve Bank's approval for all cross-border mergers and acquisitions. The Reserve Bank in turn then usually sets certain conditions regarding the repatriation of funds to South Africa. This requirement presents significant problems when negotiating cross-border mergers and acquisitions.

5.5 Summary

The acquirer must never loose sight of the strategic importance of a cross-border merger or acquisition. Some businesses may acquire companies only to add earnings to their bottom-line but this should not be the only determining factor to do the deal. In the short term the combined company's books may look good but a medium to long term strategic view is of critical importance.

South African executives may believe that the next decade will be dominated by a mere handful of global giants, and they all want their companies to become one, or at least merge with one. They want to reduce costs, be able to offer a full range of services or products, and want the geographic scale needed to serve customers globally. They must however remember that not many companies, especially South African companies, will be able to amass the financial power needed to compete in the global arena.

As the South African market ages and its markets become saturated with conventional products, those markets become mature and oversupplied. This will spark an aggressive pursuit of new markets in other countries.

It can be expected that smaller mid-sized companies will reposition themselves by either merging with one of the global giants, or by creating new and specialised, but still related businesses. Mid-sized South African companies do have in this regard a meaningful role to play. They must however realise that cross-border mergers and acquisitions involve high risks and high rewards.

CHAPTER 6: CONCLUSIONS AND RECOMMENDATIONS

6.1 Introduction

The problems relating to cross-border mergers and acquisitions identified in chapter one are threefold:

- Managing cross-border mergers and acquisitions is a daunting task with a low international success rate;
- Cross-border mergers and acquisitions may fail because of a variety of reasons;
- South African managers need to develop the necessary managerial skills in this field in order to be able to compete globally.

6.2 Primary objectives

The primary objectives of this dissertation are to identify the factors that are critical to determine the synergy, shareholder value and integration of cross-border mergers and acquisitions.

Conclusions

It has been pointed out in this dissertation that it would be irresponsible to prioritise any one of the critical performance areas when evaluating potential cross-border mergers and acquisitions. All the "softer" critical performance areas and the financial drivers fit into a cycle without which any proposed cross-border merger or acquisition could hardly succeed.

The financial rationale is however singled out as one of the most important factors which can not be managed effectively after integration if it is flawed from the beginning.

Growth is one of the most important drivers behind cross-border mergers and acquisitions. They can be vehicles to secure growth and the enhancement of market value if instant portfolio growth is desired. The major challenge for South African management today is however to determine the strategic intent and possible synergies of any proposed merger or acquisition.

Cross-border mergers and acquisitions more often than not destroy shareholder value. If a company's capital is not employed optimally by its board and senior management, it should be entrusted to those who can use it more effectively. One of the most important reasons for this is that buyers frequently overpays for the benefits that are likely to arise from the merged company.

Recommendations

In evaluating any proposed cross-border merger or acquisition, managers must have regard for both "softer" issues and financial drivers. A strategic plan for the combined companies must be developed as soon as possible. This plan should be reviewed frequently and must include all aspects of the business including its strengths, weaknesses, opportunities and threats. The logic behind the deal must be crystal clear.

The strategic plan should be clear on how growth and other critical drivers are going to be attained. The acquirer must never loose sight of the strategic importance of a cross-border merger or acquisition. A clear vision, mission, goals and policies for a master strategy must be created.

To avoid overpaying for a target company, management should identify all potential benefits and pitfalls and then estimate the value that influential investors will place on them. Any proposed cross-border merger or acquisition must have commercial significance. Managers should adopt the EVA concept as the main financial goal in evaluating cross-border mergers and acquisitions. The Economic Value Added (EVA) concept will provide the means for companies to take a more holistic approach to organisational performance management in the allocation of capital.

Value must be created through the combination that investors could not duplicate merely by holding both buyer's and seller's shares in their portfolios. The acquirer must clearly quantify the value to be derived from the potential merger or acquisition and then pay something less.

6.3 Secondary objectives

The secondary objectives of this dissertation are to research and analyse the "softer" issues that form an integral part of cross-border mergers and acquisitions.

Conclusions

The "softer" issues that form an integral part of cross-border mergers and acquisitions focus on people and the factors that influence them. These factors cover a broad spectrum and include culture, communication, leadership and human resources issues. A company's failure to successfully address these softer issues may lead to the overall failure of the merger or acquisition.

A due diligence can be a very useful tool in identifying the financial, legal and general fitness of a merger or acquisition target. However, it often fails to uncover the interpersonal dynamics ("softer" issues) that hold the companies together. The function of the due diligence investigation must however be to assess the potential benefits and liabilities of a proposed transaction.

Recommendations

Employees' natural resistance to change needs to be managed in a clear and effective way. Integrating a newly acquired company is one of the most important aspects after the deal has been done. The most powerful way to move ahead with the integration process is to get employees of the acquired company focused on growing the newly formed business. One of the most important integration functions is to address employees' fears and uncertainty as soon as possible. This is even more important where the cultures of two nations are forced together.

Cultural differences may be bigger and more difficult to deal with than expected. Understanding the newly acquired culture is a critical performance area. Conflicting cultures between newly merged companies must be aligned as soon as possible. The best way to accomplish this is to get all the employees from both companies together to solve business problems and attain joint results.

People from different cultures must, through effective and visionary leadership, be motivated to build a new company. The future of the new company ultimately depends on the quality of its leadership.

General

Cross-border merger and acquisition evaluation, implementation and eventually, integration, require high management skills, speedy execution and controlling rapid internal changes. The ultimate goal in managing cross-border mergers and acquisitions is to bridge both the value and transition gaps. There is a however a shortage of managers in South Africa able to make cross-border mergers and acquisitions work.

Cross-border merger and acquisition activity will increase in South Africa over the next couple of years as black economic empowerment gains momentum. The notable absence of hostile take-over activity in South Africa will soon be something of the past.

The new world trend of political independence and self-rule will lead to the formation of economic alliances. As a direct consequence of this trend, strategic alliances will gradually take the place of mergers and acquisitions. What makes strategic alliances so attractive is that they act as a safeguard against overpaying and a testing tool of potential synergy. Strategic alliances provide an excellent opportunity for South African companies to enter the global arena. The most important reason for the growth in strategic alliances is companies avoiding getting bigger. Strategic alliances rather than merging or making an acquisition means that value is gained without getting bigger.

ANNEXURE A

PROPOSED CHECK-LIST FOR POTENTIAL CROSS-BORDER MERGERS AND ACQUISITIONS

The check-list proposed in this annexure is divided between critical issues to be determined during the due diligence process (the "deal breakers") and secondary issues that may influence the purchase price for example but would not derail the consummation of the deal.

CRITICAL ISSUES ("DEAL BREAKERS")

History and business

When, where and by whom was the business established? Were there any changes of ownership since inception?

Description of capital structure and major shareholders.

Nature of original business and brief note of developments since.

Whether the business is dependent on a high level of research and development activity.

General nature of current operations & principal products.

Trade reputation.

Structure of group, subsidiary companies, overseas interests, etc.

Special trade agreements entered into.

Future plans, proposed new products, research and development.

Names of principal competitors.

Description of unions involved, any relationship, strikes etc.

Management (covering particulars of the directors & senior executives)

Name, age, years of service, qualifications and position held.

Experience before joining the company.

Present salaries and other forms of remuneration if not market related.

Details of any service agreements and pension schemes.

Policy adopted for training successors or obtaining new staff to succeed the present executives; whether suitable replacements would be readily available.

Trading results

Sales – levels, trends, order book, long term contracts, appropriate analyses by product and market, etc, if not already given under general information, commissions deducted, special discounts given, etc.

Other income – details of royalties, management and technical fees, service fees, rents, dividends on trade and other investments, etc.

Gross profits – analysis by product, division, branch, percentage margin on sales, mode of spreading profit on long term contracts.

Overheads – analyses by main categories, trends, etc.

The company's break-even point.

Depreciation and amortisation – basis, rates, treatment of investment of investment grants, position where re-evaluations have been made.

Treatment of inter-company profits, charges, etc.

Taxation – stock appreciation relief obtained, etc.

Dividends on all classes of capital, whether reasonable or, in the case of working proprietors, taken as remuneration, cover for dividends, any other appropriations during the period

Patents and trade marks

Particulars of important patents, trade marks, designs, secret processes. Details of registration, life, etc.

Basis adopted for writing off the capital cost.

Goodwill

How acquired, cost, amounts written off, current values.

Future prospects

Profit and cash flow forecasts and assumptions on which based, including:

Comment on the assumptions and bases used.

Comment on factors, which might affect the forecast.

Comment on long term prospects and discussion of any known significant changes since last audited accounts.

Broad details of work done on forecast.

SECONDARY ISSUES

Manufacturing

General description of the manufacturing processes.

Nature and amount of work sub-contracted to outside firms and the reasons for this policy.

Technology used, ownership and length of agreement etc.

Purchasing

Raw materials used; principal suppliers; origin of suppliers; whether prices are comparatively stable or volatile.

Terms of purchases and any significant forward purchase commitments.

Any inter-group transfer pricing must be fully dealt with.

Selling

A brief overall picture of the organisation's sales, promotion methods, exports methods, distribution, etc.

Broad analysis of sales by product, by major customers and between home and export.

Particulars of any major contracts unfulfilled.

The basis used in fixing selling prices.

Any controls on selling prices by government departments, trade associations, etc.

Whether sales are susceptible to changes in fashion, season, sanctions, etc.

Premises

Description of main premises.

The location of factories, administrative and selling offices or depots.

Site areas and floor space.

Any town planning restrictions or approvals for developing the present sites.

Accessibility to road, rail, air, sea canal transport facilities etc.

Details of any professional valuations.

Whether or not premises are in a development area.

Employees

Number of employees at each main factory and office analysed by departments, full time, part time, male/female.

Brief particulars of labor relations with management and unions; strikes experience and other disturbances.

Pension scheme arrangements.

Holiday pay arrangements & welfare services.

Recruitment policy; general availability of labor; training facilities; industrial training levy.

Trade investments

Date purchased; particulars of holding, percentage of equity held.

General review of income earned.

General review of underlying assets and attributable profits obtained from latest accounts.

Present market values; recent directors' valuations.

Type of business; names of directors and major shareholders if relevant.

Stocks and work in progress

Details of the basis adopted for valuing stocks.

Basis used in arriving at stock quantities.

How stock quantities have been verified and particulars of procedures in force.

Methods adopted for providing for slow-moving and obsolete stocks, adequacy of provisions.

Rate of turnover.

Debtors and prepayments

Analysis of the age rating of the trade debts.

Approximate number of accounts; details of any major balances.

Usual terms of credit given.

Details of the bad debt provision and bad debt experience.

Credit control methods.

If business is engaged in hire purchase trading, the basis adopted for taking profits on open contracts.

Details of other main receivables.

Dates of redemption of short-term loans and rate of interest receivable.

Marketable investments, deposits

Particulars of holdings and market values.

Details including surrender values of insurance policies held.

Details of income received.

Terms of withdrawal or repayment.

Bank borrowings

Details of bank overdraft facilities given as at the balance sheet date and subsequently.

Rate of interest charged.

Details of security given both at the balance sheet date and at present.

Creditors, provisions and guarantees

Approximate number of trade accounts; details of larger balances.

Names of main suppliers.

Usual period credit allowed/taken; whether this has been normally adhered to over the period covered in the report.

Analysis of major other items.

Details of main movements in the provisions during the period.

Hire purchase agreements.

Guarantees, contingent liabilities, discounted bills, litigation pending.

Taxation

Particulars of liabilities; stages reached in negotiation with Inland Revenue.

Particulars of important matters in dispute.

Comments on adequacy of overall provision; estimated deficiency or surplus.

Details of losses and allowances available to carry forward and of any available relief's not yet taken.

Any special wear and tear allowances being claimed.

Basis adopted for calculating deferred tax liabilities.

Any stock appreciation relief claimed and the treatment thereof.

Shortfall position.

Share capital and reserves

Summary of current authorised and issued share capital.

Rights of each class as to dividends, votes, liquidation, redemption, etc.

Arrears of preference dividend.

Share option schemes.

Particulars of share premium accounts, capital and other reserves.

Debentures, long term mortgages and loans

Amount of borrowing powers.

Rates of interest.

Security granted.

Date of repayments and any sinking fund provisions.

Legal and other matters

Risk and liability to income tax/surtax or capital transfer tax/estate duty.

Close company position.

Dividend stripping and depreciatory transactions.

Indemnities recommended from vendors.

Usual items in memorandum or article of association.

Contingent liabilities to balancing allowances and capital gains tax.

Steps necessary to maintain continuity of trade for tax losses.

Summary of any matter recommended to be referred to client's lawyers (deeds, etc).

Any Stock Exchange requirements.

The adequacy of insurance cover generally, including loss of profits.

Confirmation, by reference to file at company registration office, that all-requisite documents appear to have been filed.
Material contracts in the past two years other than in the normal course of business.

A ready reference of names of auditors, solicitors, bankers, brokers, etc.

The effects of the Government's price controls or other counter-inflation legislation of voluntary restraints on past and future profits.

Any threatened or existing litigation.

List and describe all material contracts.

Any shareholders agreements – right of first refusal etc.

Provide a full analysis of shareholders.

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