A Process Perspective of Acquisitions – Keys to Success

by

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Abstract

Mergers and acquisitions are not merely a vehicle for corporate control. They are a vehicle for corporate strategic redirection, renewal and a means to obtain new intangible resources – capabilities. Through a review of the literature and a case of an active acquirer, this thesis examines the strategic implications of mergers and acquisitions, the process perspective of acquisitions vis-à-vis an event perspective, and defines and explains how successful acquirers undertake the tasks comprising that process.

Thesis Supervisor: Arnoldo C. Hax
Alfred P. Sloan Professor of Management
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I would like to dedicate and acknowledge my wife, children and parents for their love, support, inspiration and tolerance throughout the thesis process.

To Arnoldo Hax, who extended my interest and knowledge of the fascinating subject of strategy and for his guidance and patience during the process.
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INTRODUCTION

The economic essence of most businesses is to achieve superior and sustainable financial performance. Superiority resulting from strategic positioning; sustainable in the sense that such positioning should not be easily imitated or substituted, and financial performance measured in long-term profitability. Moreover, the forces of globalization and social, political and economic revolutions that had opened entirely new markets in the world have changed the competitive environment in which firms operate. These, in turn, have led or forced companies to develop new strategic competencies and organizational capabilities if they want to survive. ¹

Having achieved these, businesses should be able to create customer bonding, i.e., to attract, satisfy and retain the customer and have a positive net flow of talent in terms of attracting, satisfying and retaining superior quality employees. This can be summarized as follows:

- Creation of economic value,
- Creation of the customer value proposition and
- Creation of the spirit of success. ²

In the process of adjusting their strategic agenda, there is a high likelihood that firms will engage in mergers and acquisitions (M&As)³; the primary purpose of which is to create value by improving overall performance. Within this context, it is important to consider an acquisition as a strategic alternative of the firm and not simply judge the soundness of an acquisition decision on the basis of what it would cost the company to develop that particular business from scratch. ⁴

In fact, every major company in the United States today, and, to some degree internationally, has experienced a merger or acquisition at some point in its history. Exhibit 1 presents the amount of mergers and acquisitions in the United States in relation to size of the economy:

5
Table 1. M&As as a percentage of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Dollar Amount of M&amp;A's (Billion)</th>
<th>GDP in Current Dollars (Billion)</th>
<th>M&amp;A's as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970-1979</td>
<td>244.3</td>
<td>16,648.0</td>
<td>1.5</td>
</tr>
<tr>
<td>1980-1989</td>
<td>1,360.6</td>
<td>40,659.5</td>
<td>3.3</td>
</tr>
<tr>
<td>1990</td>
<td>108.2</td>
<td>5,803.2</td>
<td>1.9</td>
</tr>
<tr>
<td>1991</td>
<td>71.2</td>
<td>5,986.2</td>
<td>1.2</td>
</tr>
<tr>
<td>1992</td>
<td>96.7</td>
<td>6,318.9</td>
<td>1.5</td>
</tr>
<tr>
<td>1993</td>
<td>176.4</td>
<td>6,642.3</td>
<td>2.7</td>
</tr>
<tr>
<td>1994</td>
<td>226.7</td>
<td>7,054.3</td>
<td>3.2</td>
</tr>
<tr>
<td>1995</td>
<td>356.0</td>
<td>7,400.5</td>
<td>4.8</td>
</tr>
<tr>
<td>1996</td>
<td>495.0</td>
<td>7,813.2</td>
<td>6.3</td>
</tr>
<tr>
<td>1997</td>
<td>657.1</td>
<td>8,300.8</td>
<td>7.9</td>
</tr>
<tr>
<td>1998</td>
<td>1,192.9</td>
<td>8,759.9</td>
<td>13.6</td>
</tr>
<tr>
<td>1999</td>
<td>1,418.1</td>
<td>9,248.4</td>
<td>15.3</td>
</tr>
<tr>
<td>1990-1999</td>
<td>4,798.3</td>
<td>73,327.7</td>
<td>6.5</td>
</tr>
</tbody>
</table>

Source: Mergerstat Review 1999, Los Angeles, CA
U.S. Department of Commerce - Bureau of Economic Analysis

These figures evidence the growing activity in M&As, likely fueled by the achievement of, for example, economies of scale, broaden geographic market scope and, competing globally in a more effective way. The so-called strategic reasons for M&A include:

- Growth
- Better and cheaper access to technology
- Product differentiation
- Extension of life cycles
- Government policy
- Political and economic stability
- Production factors arbitrage
- Follow clients
- Diversification
- Assure source of raw materials
Moreover, M&As are not just important vehicles for these reasons or more general vehicles for corporate strategic redirection and renewal. They are also a mean to obtain new tangible and intangible assets.

Other reasons include agency problems, regulations, anti-trust implications or inefficient management. M&As, as defensive countermeasures are responses to the inability of management to create sufficient investment opportunities internally and to the threat to the firm itself of being acquired.\(^5\)

There are several studies related to the short and long-term performance of merged or acquired companies. For the short-term defined, as three months or less, the studies generally find that target share prices rise around 30% following merger announcements, whereas acquirer share prices remain the same. In the case of long-term performance, defined as three years or more, the results are mixed according to various definitions.\(^6\)

The most recent studies, 1996-98, indicate a high rate of failure, citing causes such as cultural incompatibility, inability to implement change, slow integration and lack of alignment.

It turns out that, in fact, for many companies corporate acquisitions have become an ordinary activity, with staffs engaged in their evaluation, but not necessarily their integration. These staffs are generally engaged in economic analysis of potential candidates, rather than carrying out acquisitions or integrating acquisitions that have been already consummated.

The purpose of this investigation is to, analyze what makes a strategic acquisition successful, going through the pre-acquisition phases to the post-merger integration. The research includes the fundamental literature in the matter, handbooks and case studies prepared by researchers and academics. From the process perspective of acquisitions, the research is a case study of CEMEX, the third largest cement company in the world,
headquartered in Monterrey, Mexico. CEMEX has gone global through acquisitions in America, Europe and Asia.

NOTES

3 Throughout this thesis the terms Merger, Acquisition and the anachronism M&A are used indistinctly or otherwise denoted.
CHAPTER 1. STRATEGIC ISSUES ON ACQUISITIONS

A. Why companies engage in acquisition processes – Types of acquisitions

In today’s volatile business environment firms face challenges of the like that they never faced before. They have to realign themselves to effectively compete in this changing environment. Some powerful forces have been unleashed. Global competition has intensified. Technological change has has an impact on telecommunications and a wide range of media businesses. Deregulation has had an effect on, the airlines, banking, telecommunications, and even on the traditional and mature public utility industries. Moreover, computers and the Internet are changing the way businesses are conducted. Firms find now that they must adjust to massive changes in their environments and in the nature of competition, as well as in their relations with suppliers, workers, consumers and other stakeholders. These forces are likely to increase in the time ahead as the economy move toward even more globalization, causing geopolitical borders that before constrained the competitive domain, to disappear. Therefore M&A takes on even greater importance.

The M&A activity of the 1990s have been widely described as strategic in their orientation; vis-à-vis the 1980s,when, most of the M&A activity was strongly financially driven, mainly through leveraged buyouts (LBOs). However some academics contend that under the right conditions, LBOs are not merely deals and that debt and equity are not just different types of financial claims. Rather LBOs represent an alternative model of corporate ownership, governance and control. Contrary to what many thinks, temporary ownership by LBO firm offers an important bridge to better long-term performance.¹

A strategic acquisition is an elusive term and has defined in many different ways by different players in the field. However most of the definitions are seen as a synonym for "synergistic acquisitions". A simple, clear, broad definition of strategic acquisition is that it is intended to increase competitiveness and resulting cash flows beyond what the two companies could be expected to accomplish independently.² A deeper definition from a
resource based perspective of strategic acquisition involves two complementary capabilities, leading to a third, enhanced capability that enables the new firm to achieve long-term growth and increased profits.\(^3\)

Company executives involved M&As in the 1990s emphasize that they were looking ahead 10 years. Some spoke of augmenting their capabilities, others emphasize getting back to their core. Some companies report that they are adjusting to new laws, such as the, 1996 Telecommunications Act. Others are reacting to new technological developments. In the case of horizontal mergers in mature industries is when this kind of firms see their growth in revenue limited by growth in GDP or growth in population. For such a firm a way to achieve greater growth is by either merging with or acquiring a competitor in its home market or looking for acquisition opportunities abroad. This, in turn, could lead to a trend in certain industries to consolidate, even globally, by acquiring companies in the same industry, but in different countries as in the cases of the automobile and cement industries.

A list of strategic acquisitions would be seemingly endless. A central proposition of this work is that M&As are part of the broad strategic intent and process of the firm. Strategy is central to M&A analysis because, it provides the framework to achieve a sustainable competitive advantage. Under this assumption, M&As are an option as a vehicle to achieve such a position, not excluding other initiatives that the firm could take.

Economists have grouped M&As based on whether they take place at the same level of economic activity—exploration, production or manufacturing, wholesale distribution or retail distribution to the ultimate consumer. The element of relatedness is also important in defining economic categories of mergers. The following list provides an approach to the strategy behind the current trends in M&As\(^4\)

**Horizontal Mergers.**

Horizontal mergers involve two firms operating and competing in the same kind of business activity. Forming a larger firm offer the benefit of economies of scale, but this
notion is not sufficient to be a theory of horizontal mergers. This kind of merger is particularly important in industries that are underway of a consolidation; for firms competing in this kind of industries, staying ahead in the M&A game mean stay competitive. With every deal that actually is consummated, the industry changes, and is reshaped, with fewer but stronger players.

In many countries, horizontal mergers are regulated by the government to prevent negative effects on competition, such mergers decrease the number of competitors, making it easier for the industry members to collude in search of monopolistic rents. Some believe that horizontal mergers potentially create monopolistic power for part of the combined firm, enabling it to engage in anti-competitive practices. It remains an empirical question as to whether horizontal mergers actually take place to enhance market power of the combined firm or to augment the firm's capabilities to become a more effective competitor.

**Vertical Mergers**

Vertical mergers occur between firms in different stages of production operation. In the oil industry, for example, distinctions are made between exploration and production, refining, and marketing to the ultimate consumer. Vertical mergers can be for either forward integration or backward integration. Forward integration involves getting closer to customers, while backward integration means getting closer to suppliers.

On a broader base, there are many reasons why firms might want to be vertically integrated between different stages. There are, for instance, technological economies such as the avoidance of reheating and transportation costs in the case of an integrated iron and steel producer. Transactions within a firm may eliminate the costs of searching for lower prices, contracting, payment collecting, advertising, communicating and coordinating production. Firms that engage in these kinds of deals, generally seek to expand their own value chain.
From a traditional perspective, the efficiency and affirmative rationale of vertical integration rests primarily on the costliness of market exchange and contracting. The argument that uncertainty over input supply is avoided by backward integration reduces to the fact that long-term contracts are difficult to write, execute and police.

**Conglomerate Mergers**

Conglomerate mergers involve firms that are engaged in unrelated types of business activities. There are two types of conglomerate mergers: product extension mergers and pure conglomerate mergers. Product extension mergers broaden the product lines of firms. They are mergers between firms, engaged in related but not overlapping business activities. They are firms that serve similar set of markets. Such mergers are also called concentric or diagonal mergers. The pure conglomerate merger involves companies in unrelated business activities.  

Conglomerate firms differ fundamentally from investment firms in that they control the entities to which they make major financial commitments. Two important characteristics define a conglomerate firm:

- It controls a range of activities in various industries that require different skills and capabilities for such managerial functions as research, engineering, production and marketing.
- Diversification is achieved primarily through external M&As, rather than by internal development.

The following is the definition for the three sub-classifications for conglomerate mergers: financial conglomerates, managerial conglomerates and concentric companies:

**Financial Conglomerates.** These undertake strategic planning, but do not participate in operating decisions. They provide cash flows to each segment of their operations and exercise control, and represent the ultimate financial risk-takers.
Financial conglomerates can be compared to investment companies. They serve at least five different economic functions:

- They improve risk/return ratios for the holding company through diversification. This is more common in countries where the financial markets are less developed than those in the United States.
- They avoid an adverse run of losses that might cause bankruptcy. If the losses can be covered, the financial conglomerate maintains the viability of an economic activity with long run value.
- A potential contribution derives through establishing their financial planning and financial control programs. Often these systems improve the quality of general and functional managerial performance, resulting in more efficient operations and most important, better resource allocation.
- If management does not perform effectively, but the productivity of assets in the market is favorable, the management is changed. This reflects an effective competitive process because assets are placed under efficient managers to assure more effective use of resources.
- In the financial planning and control process, a distinction is made between performance based on underlying potentials in the product-market area and results related to managerial performance. If management is competent, but product-market potentials are inadequate, a shift in resources will be sought, by diverting internal cash flows from the unfavorable areas to more attractive areas from a growth and profitability perspective.

Managerial Conglomerates. These increase the potential for improving performance by providing managerial counsel and interactions on decisions. One theory holds that the generic management functions are readily transferable to all types of business firms. Those managers who possess the experience and capability to perform general management functions can perform them in any environment.
If the management transferability proposition is valid, it provides the general and simple basis for a theory of mergers. More specifically, it provides the strategic reasons for companies to merge or engage in the acquisition process. When two firms of unequal management competence are combined, the performance of the combined firm will benefit from the impact of the superior management firm, and the total performance of the combined firm will be greater than the sum of the individual parts. This combination reinforces the most general definition of synergy.

**Concentric Companies.** The distinction between general and specific management functions provides the basis for distinguishing a managerial conglomerate from a concentric company. If the activities of the segments brought together are so related that there is a carryover of specific management functions, such as research, manufacturing, finance and marketing or complementarity in relative strengths among these specific management functions, the merger is termed concentric. This transferability of specific management functions across individual segments has long been exemplified by the operation of large, multiproduct, multiplant firms in the global economy.

An implicit issue for each of these groups of M&As is growth. Current trends and phenomena, such as hi-tech and internet companies, bring success to some, also brings and creates new markets and players for each industry or sectors of the economy. The people who contribute to such successes expect increased compensation, promotions and new challenges. It is at this point where firms can differentiate themselves from their competitors in attracting the required talent. For these reasons successful firms might need to grow.

Growth brings inherent advantages, such as economies of scale and scope. Successful growth tends to build confidence and attractiveness in customers, employees, suppliers and in general to all stakeholders. It can also lockout a potential or current competitor.

Growth also presents risks. Some risks are similar to those of the existing business and can readily be anticipated. Others result from growth itself and can be difficult to identify.
and control. Most difficult are the adjustments that management must make to select, motivate and delegate to new managers and employees, while continuing to guide the business effectively. Some businesses in declining or cyclical industries or whose products and manufacturing processes cannot meet the state of the art may decide that the risks are too great. However, for such an industry, growth, both local and global, can have extremely positive payoffs.

There are numerous methods for achieving growth. Some direct and indirect examples are as follows:

- Add sales and advertising programs
- Increase market shares of existing products
- Find new markets for existing products
- Improve product design
- Improve product quality and performance
- Add products complementing existing products
- Add distribution facilities and equipment
- Add manufacturing facilities and equipment
- Develop improved manufacturing processes
- Add R&D personnel and facilities
- License technology
- Adopt employee incentive programs
- Reduce the cost of debt and equity capital
- Improve effectiveness of internal administrative, financial, and other support programs
- Resolve regulatory compliance programs, litigation, and other disputes hindering business progress

From a divestiture decision standpoint, some of the motives for divesting are the mirror images of the acquisition decisions; however, there are other motives, such as founders
selling because of retirement and companies being under legal reorganization as a consequence of bankruptcy. These categories are beyond the scope of this thesis.

**B. Structure and Competitive Positioning**

Firms can create value by transferring and applying strategic capabilities that lead to competitive advantage.

The fundamental responsibility of senior executives is to sustain and renew their firm’s capabilities and its ability to compete. Developing a shared view among the top management group of the role that acquisitions can play in a company’s strategic evolution and renewal is part of the broader challenge of developing a corporate level strategy. Around the 1980s, corporate level executives became accustomed to having well-articulated business plans that clarify how the firm would achieve competitive advantage. Typically, the use of business strategy tools and frameworks such as strategic segmentation, industry and competitive analysis, value chain analysis and experience curves support such plans. The end-result of this process of two-way communication is a set of well-developed and agreed on business strategies for competing at the business unit level.⁷

The first step in this process is to identify a strategic positioning or value proposition. The best way to compete, the business model, can vary from firm to firm as well as from industry to industry, and thus no one model is superior to another, in fact, each model is unique to a firm and is what gives the firm its a competitive advantage. The essence of positioning resides in the assessment of the uniqueness of the competitive advantage that differentiates the firm from its competitors and generates superior financial performance.

The importance of the shared view of the role of acquisitions noted earlier, is that a need or convenience for an acquisition can arise at any of the three perspectives of strategy: corporate strategy, business strategy and functional strategy.⁸
Corporate Strategy. This deals with the decision that, by its nature, should be addressed with the fullest scope encompassing the overall firm. These are decisions that cannot be decentralized without running the risk of committing suboptimization errors. Managers who operate at lower levels of the firm do not have the proper vantage point to properly make the difficult trade-offs between decisions that maximize the benefits of their own units, but, at the same time could adversely affect the corporation as a whole. Here is where a decision for an acquisition is ultimately made.

Business Strategy. This focuses on obtaining superior financial performance through a competitive positioning that allows the business to have a sustainable advantage over its competition. Two important aspects are the definition of the business scope and the identification of unique competencies, both of which are central to evaluating acquisition decisions, as will be discussed.

Functional Strategy. This involves consolidating the functional requirements demanded by the corporate and business strategies, as well as constituting the depositaries of the ultimate capabilities required for developing the unique competencies of the firm. Functional strategy is critical when integrating two companies because, it is here where the integration plan is executed. This is more evident in knowledge-based industries where talent and competencies need to be integrated.

An effective business model satisfies two criteria. First, the descriptive side of the model should be able to explain how businesses and firms achieve superior financial performance. Second, the normative component of the model should provide guidelines and tools that will help to create a winning strategy and to support its successful implementation.⁹

The Delta Model ¹⁰

In today's business environment, the conventional strategic options need to be expanded to explain and incorporate new sources of profitability and to provide a focused guide to the necessary resources and capabilities required to support the strategic options. The
traditional models, Porter’s Competitive Positioning and the Resource Based-View of the Firm, are incomplete in that they fail to explain sources of profitability and to act as a guide to superior strategic options.

The Delta Model (Exhibit 1.1) offers three different strategic positionings, each of which is focused on different actors and components.

**Exhibit 1.1 Strategic Options - The Triangle**

![Diagram showing the Delta Model](image)

- **Best Product.** This is based on the classic forms of competition of low cost and differentiation. Its relevant drivers are focused on the value chain of the product or service. A primary objective is efficiency of the supply chain, which is the system that delivers the product or service. Best Product positioning emerged from the industrial era and is the default strategic option for the majority of firms today. It is the most vulnerable position to new entrants because it is the position having the least customer bonding. If a new or substitute product to which it is feasible to switch attracts a customer, this inevitably would happen.

- **Total Customer Solution.** This is based on the customer economics creating the strongest bonding with customers of the three different strategic positions. A critical mean to
achieve superior and sustainable financial performance is by attracting, satisfying and retaining the customer, which is precisely what this strategic position seeks.

Instead of simply offering products, players in this position forge a set of services associated sometimes to a given product solving a wide array of customer needs getting to an individual value proposition tailor made for each customer. In this respect and in contrast to the typical attention paid to product market share, the more relevant performance measurement is customer market share. If the Delta Model is thought of as a dynamic and continuing process, we can see there, the evolution of many businesses. The traditional way to compete and excel in business was through either the best price or differentiation, defined in this context as a best product competitive positioning. But for a company competing in this position, a way to differentiate from its competitors is by offering something more or better, which lead to a Total Customer Solutions competition.

System Lock-in. This focuses on all the important players in the system that contributes to the creation of economic value in the industry in which the firm operates. Here the bonding goes beyond the customer. The objective is to attract and retain the so-called “complementors”, being a provider of products and services that enhances the own firm offering.

The issue is to examine the entire architecture of the system to determine how the firm could gain complementor share in order to achieve competitor lock-out and customer lock-in. System lock-in players attract, satisfy and retain customers by attracting, satisfying and retaining complementors. The value of the system grows with increasing participation, eventually entering an economic zone of increasing returns with growth.

Technology is frequently the key that creates the opportunity for System Lock-in. It creates new industries that offer the potential for new proprietary standards, which can lead to a System Lock-in position. More importantly, it creates a network of complex interactions among fragmented and specialized participants that almost mandates the use of common standards to ensure effective exchanges.
Exhibit 1.2 summarizes the essential characteristics of the three strategic positionings provided by the Delta Model.

**Exhibit 1.2 Delta Model Summary**

<table>
<thead>
<tr>
<th>Scope</th>
<th>Total Customer Solution</th>
<th>System Lock-in.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low cost /</td>
<td>Broad product / service range:</td>
<td>Nurturing Complementors:</td>
</tr>
<tr>
<td>Differentiation</td>
<td>• Bundling.</td>
<td>• Variety and number.</td>
</tr>
<tr>
<td></td>
<td>• Joint development.</td>
<td>• Open architecture.</td>
</tr>
<tr>
<td></td>
<td>• Outsourcing.</td>
<td></td>
</tr>
<tr>
<td>Scale</td>
<td>Customer:</td>
<td>System:</td>
</tr>
<tr>
<td>Market share.</td>
<td>• Customer share.</td>
<td>• Complementor share.</td>
</tr>
<tr>
<td>Bonding</td>
<td>Link to customers:</td>
<td>Link to system:</td>
</tr>
<tr>
<td>Link to product:</td>
<td>• Customer lock-in.</td>
<td>• Competitor lock-out.</td>
</tr>
<tr>
<td>• First to market.</td>
<td></td>
<td>• Proprietary standards.</td>
</tr>
<tr>
<td>• Dominant design.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


One could conclude that the pursuit of one strategic position is always more attractive than another and that there are winners and losers in every option. However M&As is an important vehicle through which any given firm could pursue a chosen strategic position. The clearest example is the Best Product position, where M&As can provide economies of scope and scale or can alter the structure of the industry by acquiring competitors.

Using the Total Customer Solution, MCI WorldCom, through acquisitions, has been able to expand the breadth of its services by focusing on the customer. General Electric also used the Total Customer Solutions for its jet engines business, where through GE Capital - which has been built, in part, through acquisitions; and the acquisition of companies engaged in service and maintenance of jet engines - has been able to offer a value proposition to its customers that the competition cannot.
GE also used a System Lock-in position. Selling its engines through GE Capital gives GE the required leverage to also be in the business of servicing and maintaining the engines.

This discussion leads to the elusive issue of synergy. Synergy is precisely where the role of acquisitions can be extremely important in pursuing strategic positioning.

C. Synergy

The word, a concept closely tied to M&As, is derived from the Greek word “synergos”, which means “working together”. In business usage, synergy refers to the ability of two or more units or companies to generate greater value working together than they could working apart.11

There are three basic kinds of synergies: technical economies, pecuniary economics and diversification economies.12

Technical economies. This refers to scale economies, and they occur when the physical processes inside the firm are altered so that the same amounts of inputs, or factors of production, produce a higher quantity of outputs. Four technical economies relating to mergers have been identified:

- Marketing and production economies are the most frequently cited synergies and are commonly associated with horizontal and concentric mergers.
- The economies related to a reduction in cost that comes with accumulated experience with a common technology.
- Vertical mergers may benefit most from scheduling economies that occur when two firms are joined at two different levels of production and productivity.
- All merger types can benefit from banking and compensation economies. Banking economies may result from a reduction in the outstanding cash balances required by banks, as the number of banking relationships is reduced through consolidation. Additionally there are economies related to leverage capacity and
credit rating. Similarly, a consolidation of compensation plans can lead to savings per employee for offerings such as health and life insurance.\textsuperscript{13}

**Pecuniary economics.** These are commonly associated with horizontal and vertical mergers and, to a lesser degree, concentric mergers. They are achieved through the firm’s ability to dictate prices by exerting market power achieved primarily as consequence of size. Unlike technical economies in which the average cost curve may be lowered due to genuine efficiencies in the physical transformation of inputs, pecuniary economies offer society no such efficiency gains. Rather, they merely represent a transfer of income from the less powerful to the more powerful.

**Diversification economies.** These are related most closely with conglomerate mergers and to, a lesser degree, with concentric mergers.

In the context of the different strategic positionings discussed earlier in this chapter these kinds of synergies are closely related to low cost and differentiation scopes, as well as being closely tied to the products and the value chain that deliver them.

The value creation that arises from a merger comes not just because the combined entity can enjoy reduced costs and charge higher prices for its products. It is also a result of an opportunity to utilize a specialized resource that arises solely as a result of the merger and its potential to create synergies.

As for specialized resources, for an acquisition strategy to create economic value, a distinctive competence or scarce resource must be matched to an opportunity in the environment. The synergies created in a merger come from the interaction and transferring of such resources. This leads to the Resource-Based view of the firm previously mentioned.

The Resource-Based view of the firm builds on four basic assumptions about a firm’s resources and capabilities as an element of competitive advantage:
• Unique competencies. Resources can be both tangible and intangible. These are converted into capabilities when the firm develops the required organizational routines to use them effectively. The uniqueness comes from the fact that such competencies can vary significantly across firms.

• Sustainability. This refers to the preservation of uniqueness. There are no threats of substitution or imitation. They must be valuable, scarce and difficult to imitate or substitute.

• Appropriability. Refers to the retention of the value created through the firm’s competencies inside the firm.

• Opportunism/timing. This involves offsetting the cost of acquiring resources and capabilities.¹⁴

A firm that is engaged in an on-going acquisition process obtains a heterogeneous variety of resources and capabilities that can be transferred across the various acquisitions through various vehicles and processes.

The Resource-Based perspective maintains that a firm earns profits from having competencies and firm-specific assets that are scarce and difficult to replicate. According to this view, the success of a firm comes not from being well-positioned in an attractive industry, but from having firm-specifics assets and competencies that are difficult to imitate, replicate and substitute.

Considering that these resources and capabilities or “knowledge assets” can be transferred from one acquisition to another, a firm with such capabilities of transferring has a significant potential for creating synergies in acquisitions. In such a case, the firm has a competitive advantage in the acquisition process itself. Firm-specific knowledge assets include reputation, patents and trademarks, specialized production facilities and installed computer base.

A firm’s competence involves its ability to integrate a variety of skills and knowledge among individuals, groups and organizations and across successive acquisitions, to
deliver highly perceived customer value. The post-acquisition integration process includes the creation, integration and application of knowledge in every area of an organization. The particular focus is on reproducing a sustainable competitive advantage for the firm.

D. A framework for acquisitions

In general, when we hear of M&As today, most of the times the reasons mentioned for a given deal are about synergy and focused in technical economies, also we would hear of many failures due to as many reasons. Some talk of cultural incompatibility, others about overestimation of synergies and the like.

What it is true is that M&A analysis and strategic fit are of a multidimensional nature. It is not enough to be compatible in one aspect or that the deal works in the numbers. What this document attempts to address is the complexity of M&As and the process nature of it and is at this point where the discussion goes deeper into the M&A process perspective.

The following framework (Exhibit 1.3) provides an analysis on different dimensions of the firms and industry.\(^\text{15}\)
Step 1. Industry attractiveness of acquired and acquiring firms before the acquisition. This explains the value generated by the economic activity of the industry participants, as well as their ability to share in the wealth created. The framework used to understand the
industry attractiveness is the Porter's Five-Forces Model. The industry structure is examined through the five forces represented by rivalry among competitors, bargaining power of suppliers, bargaining power of customers, threat of substitutes and threat of new entrants.

Although this would apply to any type of M&As, it is more critical in conglomerate mergers, where two firms in different industries intend to merge and one industry is unknown, to some degree, to the other. In the case of vertical mergers, these could be overlapping to some degree, but it is still useful to make such an assessment.

In horizontal mergers, one could argue the impact of industry attractiveness. There actually is an impact and most important in the case of cross borders mergers where industries can vary significantly across different regions of the world.

**Step 2.** Potential for industry restructuration. The question that needs to be answered is how the industry would look like after the combination. In horizontal mergers through industry consolidation, potential reduction in rivalry and bargaining power from suppliers and increased bargaining power with customers could be expected, along with a reduction in the threat of new entrants.

In vertical mergers, the structure could change in a way such as what has been happening in the telecommunications industry in the United States. The MCI WorldCom example described previously illustrates this. This company actually established a new trend in the industry that has been followed by its competitors.

**Step 3.** Current competitive position of acquired and acquiring firms. This establishes the basis on which a sustainable competitive advantage can be achieved. Two broad components should be examined. First, the mission of the firm would indicate where the firm is competing through the business scope in products, markets and geographies.
Second, it reflects how the firm is competing through the identification and assessment of unique competencies. The value chain framework provides a guideline for such assessment. It is divided into the following categories:

- Managerial infrastructure
- Finance
- Human resources management
- Technology
- Procurement
- Manufacturing
- Marketing and sales

**Step 4.** Potential improvement in the competitive position of acquired and acquiring firms if the merger takes place. Through a combined mission and new competencies the question of how the combined firm, after the merger, would look like relative to its competitors. This is ultimately where the synergy is assessed and valued. It is really two plus two equals to something more than four.

This also should also be a guideline for determining how large a premium is the acquiring firm willing to pay, if any.

**Step 5.** Organizational compatibility. This is closely related to culture and integration. When two firms merge, there is usually the assumption that if the numbers make sense and if synergies exist, then there is a fit between them. However, the notion that two different and probably disparate and separately trained group of employees, working in unique environments under varying circumstances, will automatically co-exist as a merged workforce is equivalent to wishes and dreams.

A framework suitable for assessing the organizational compatibility is one that goes to the factors that determines organization and culture. A model based on structural determinants includes.\(^{17}\)
- Company size
- Company age
- Industry
- Geographic localization
- Level of diversification
- Genealogy

The advantage for organizational compatibility is for horizontal mergers. Firms here have
greater chance to achieve organizational compatibility because of the fact that the
merging companies share a common business. Initially, this assessment is easier when, at
least at management level, they understand each other’s the industry, products and
markets and the language of the business. However, this could be counterbalanced as in
the case where competition is strong in the industry and two former competitors are
merged, especially at the sales force and customer service levels.

As to country attractiveness in cross border mergers, there is a myriad of factors to assess,
such as:

- Are there previous experiences of foreign new entrants in the industry?
- How do we evaluate the political and economic risks?
- Labor relations
- Environment regulations
- Relevant differences that affect the performance, compared with other
countries
- Business practices
- Repatriation of dividends
- Taxation
- Funding
NOTES

5 Adapted from J. Fred Weston, Kwang S. Chung and Juan A. Siu. Takeovers, Restructuring, and Corporate Governance. Prentice Hall, 1997.
10 The entire section on the Delta Model is based on Arnoldo Hax and Dean Wilde II. The Delta Model: Discovering New Sources of Profitability, 1999.
CHAPTER 2. PREACQUISITION AND ACQUISITION ACTIVITIES

The acquisition of another company is an inherently risky proposition. A successful merger or acquisition is the result of combining good conceptual preparation and analysis with timely execution and implementation.

The Watson Wyatt Deal Flow model provides a framework for conceptualizing the fundamental stages of the process. It consists of four major stages: formulate, locate and investigate, negotiate and integrate.¹

**Formulate.** In the first stage, the organization must detail its business objectives and growth strategy in a clear, rational and data-oriented way. Specific criteria, based on the objectives and strategy of growth through acquisitions, should be established to describe what a viable target company would bring to the parent organization. One aspect of strategy formulation that generally is neglected is the determination of a specific method for the merger transaction and the subsequent integration. Many companies perceive the M&A activity only as finding target companies and closing the deal. The definition of specific roles and responsibilities, as well as managing and leveraging the knowledge and capturing and transferring process are carried out in an improvised way.

**Locate and investigate.** This refers to investigating possible targets. Once a target has been selected, the firm perform due diligence, discusses later in this chapter. Regardless of the specific tactics employed, the investigation of the seller’s business should be a team-effort. The investigation should proceed in three separate, but coordinated areas: the business point of view, the legal point of view and the accounting and financial points of view.²

**Negotiate.** Initial financial and operational analysis leads to initial conversations between executive staffs. Successful negotiating tactics involve interpersonal relations as well as business, technical and financial knowledge. Deal teams are briefed by the due diligence team and together they formulate the final negotiating strategy for all terms and
conditions of the deal. Considerations include price, performance, people, legal protection and governance. The negotiations should also be conducted to develop the acquisition contract.

In conducting the negotiation, the buyer should constantly strive to determine the actual reason motivating the seller to sell the business. Although the reason given by the seller may be accurate, a Harvard Business School study conducting by interviewing executives engaged in acquisitions, indicated that in a great majority of instances, the seller did not reveal the actual reasons for selling – fear e.g., fear that the competition was growing too strong, fear that a product was becoming obsolete, fear that substantial capital outlays would be required to remain competitive, fear that a basic patent might be proved to be invalid. In very few of these instances did the seller tell the buyer the actual motivating force for selling the business.\(^3\)

**Integrate.** In general, this stage should be customized to each organization and adapted to each specific deal. This is the actual process of planning and implementing the new organization with its processes, its people, its technology and its systems. Integration refers to a combination of elements of two or more organizations resulting in wholeness. In determining how to resolve the myriad issues that arise at this stage, the merging organizations must carefully consider such questions as how fast to integrate, how much disruption will be created, how disruption can be minimized, how people can continue focusing on customers, safety, day-to-day operations and how to communicate with all the stakeholder groups.

The pace of integration is generally said to be among the most critical factors for successful M&As. In a 1996 survey of 100 human resources managers, the consulting firm of William M. Mercer found that the pace of post-merger transition correlates strongly with improvements in several measures, ranging from technological progress to employee commitment and retention. The survey defined rapid as "compared to your normal pace of operations".\(^4\) This stage is considered in chapter 3.
The reminder of this chapter focuses on those tasks exclusively related to M&As and which are complex and important enough to have an impact in further performance and successful integration.

A. Due Diligence

Due diligence is the process of investigation conducted by parties involved in a business transaction. It can be viewed as an essential exploratory journey that begins with the first conversation between the parties and may end as much as a year after the transaction closes. Due diligence in M&A transaction is not a finite event or period of time. There are varying intensities and rigor in the execution of this important investigative process. The most intense reviews usually occur between the signing of the letter of intent and the execution of the definitive purchase and sale documents.

When M&A is first envisioned, the focus is on whether or not it makes financial sense. In due diligence, legal and accounting experts are retained to identify potential fiscal, regulatory and tax-related liabilities of the target company. Concurrently, investment bankers are devising the financial strategy, determining where and how much capital must be raised to complete the transaction, while auditors are examining the books of the target to arrive at the most accurate valuation. Clearly, traditional due diligence is largely focused on making the numbers work. Company management will not pursue a transaction unless assurances are provided that a detailed examination of the target company’s financial affairs has been conducted. In the broadest sense, the goal of due diligence is looking at and beyond the numbers to identify hidden vulnerabilities.\(^5\)

To avoid these types of outcomes, successful acquirers redefined the process of due diligence by using a structured approach to assess both traditional and nontraditional components. This approach has several critical objectives:

- To identify risks and uncover potential liabilities before it is too late to do anything about them
• To quantify items affecting the sale price
• To ensure there are no “downstream surprises”
• To incorporate data into the negotiation process
• To facilitate a streamlined and effective launch of the integration-planning process

There are a number of ways that buyers attempt to protect themselves from unforeseen negative attributes of the company they are buying. The core of their risk management efforts centers on a thorough due diligence effort. Other risk management techniques include escrowing a certain percentage of the purchase price for a certain period of time after closing. This allows time for previously undiscovered items to surface. Lastly, there will be numerous representations and warranties in the definitive purchase documents that will allow recovery from the seller through offsets.

The purpose of due diligence is not to find deal breakers, but to provide an opportunity for all parties to verify the facts and circumstances as they understand them. Due diligence is expensive in terms of cost to the acquirers and of the professional opportunity cost expended by executives during the transaction process.

A team usually conducts the examination. The due diligence team can be made up exclusively of employees of the acquirer or the acquirer can outsource much of the investigation to external consultants. There is often a correlation between the size of the transaction and the use of outside professionals to conduct the due diligence. The main reason is cost. The smaller the transaction, the less the transaction can bear the cost of expensive outside services of consultants. Another determinant for this is the experience and availability of in-house personnel. There is the general recommendation that management play a major role in the investigation because it will learn first-hand information that is important both to the decision to proceed with the deal and to successful operation of the target after the acquisition. Management, in fact, should be the prime mover, setting the scope and taking the lead. By delegating the entire investigation to subordinates or consultants, management frequently overlooks a great deal of
significant information and misses the opportunity to get a "feel" for the target management and other qualitative concerns that are critical in the purchase decision.7

The scope of an investigation may range from a minimum effort reviewing available financial information, visiting the target’s facilities and talking to selling management to a maximum effort that involves a comprehensive investigation and audit. The depth of the investigation is a function of the size and relative significance of the acquisition candidate, price, availability of audited financial information, degree of inherent risk and time allowed. In the case of a hostile tender offer, to ability to analyze internal information on the target company may be limited. Consequently, the acquirer’s team may not be able to do much more than gather, compile and analyze available public information. But if the seller is a private company, the need for a full-scale investigation is much more critical.

Many of the most active acquirers will retain a large accounting firm to perform a material portion of the investigation, which, in turn, will be supported by a significant contribution from the legal team. Other professionals that may be utilized are computer and software consultants, quality control consultants, private investigation firms and environmental consultants.

The operative mind-set in any due diligence process should be full disclosure by both parties. The more open the parties are throughout the process, the sooner the due diligence can be completed and the determination made to conclude the transaction or part ways.

One way that due diligence may unfold is according to the following scenario. The shareholders of a company have reviewed their succession planning options and have made the decision to sell the company. M&A advisors have been engaged to market the company and negotiate with potential acquirers. They have prepared a marketing memorandum that includes substantial information that acquirers will need in order to determine their interest level regarding making an offer to purchase the company. The
acquirers have performed limited due diligence prior to making an offer. The offer is done after the letter of intent is signed and substantial and thorough due diligence is conducted.

It is important to note that due diligence is a two-way street. The sellers of a closely held business may have an important obligation to themselves to investigate the buyers of their business. However, it is usually much less intense and more limited in scope than the acquirer’s investigation. The buyers typically have more uncertainties to address because they are acquiring a complex operation entity with numerous moving parts, whereas the sellers are often receiving a known quantity - cash or near-cash consideration. The letter of intent will effectively charge each party to begin their investigations and will typically specify that each party bear the cost of their own due diligence efforts.

**Typical Steps**

A due diligence questionnaire submitted to the selling shareholders is the most typical way the process begins. It is often at this point that the shareholders disclose to another trusted employee or two that the owners have agreed to sell the company. The preparation of the reply to the questionnaire is often accomplished by a team-approach led by the owner, an outside CPA firm and the company’s chief financial officer. This will entail a substantial, time-consuming effort. It is often during this process that business owners learn things about their own company that even they did not know.

Once the information on the questionnaire has been collected, the buyer’s team will often visit the seller’s offices. The most common aspects examined by the acquirer’s team are as follows:

**Legal Matters.** Legal due diligence may include the examination of all material contracts of the target company. These contracts often include client contracts, office and equipment leases, software contracts and licenses, employment agreements, bank loan documents and shareholder agreements. The company’s corporate records will be examined, which include the articles of incorporations and the bylaws and minutes of
shareholder and board of director meetings. Certificates of good standing will usually be obtained from the secretary of state.

Of primary concern to an acquirer will be the company’s history of lawsuits. It will be reviewed for determination as to whether there is a pattern of continual violations or isolated suits of a frivolous nature. Any employee lawsuits must be satisfactorily explained as well as any legal suits with clients, vendors or various governmental agencies. The acquirer perception of the risk of contingent liabilities will affect the amount of escrowed purchase price as well as the timing of its release, especially if the transaction is structured as a stock sale.

Also, proper ownership according to local laws of operating assets should be ensured. In the case of industries based on exploration and usage of natural resources, particular attention should be paid to licenses and ownership for long-term usage of such resources. Intellectual property is another area that could be easily out of sight because of its intangible nature.

Financial, Accounting and Tax Matters. More than likely, the purchase price will be determined by using a multiple of adjusted earnings. The most common benchmark utilized by most acquirers is EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). The acquirer’s due diligence team should spend considerable time verifying the various components of the financial statements. There should be an attempt to identify and quantify all commitments and contingencies of the target company. Also trust cash accounts should be examined for accurate reconciliation and the corresponding obligations reflecting a current liability on the balance sheet. Accounts receivable and related bad debt reserves should be scrutinized for collectability. In addition, depending on how the transaction was structured, current liabilities and related accruals should be tested for reasonability.

Tax returns should be examined and verified as to compliance with the filing requirements of various taxing authorities. It would not be uncommon for the buyer to
request "as filed" tax returns directly from the Internal Revenue Service. Any recent tax audits should be reviewed and pertinent discussions should take place with the tax professionals who prepared the tax returns.

**Clients – Marketing due diligence.** Achieving the elusive strategic fit is typically marked by efforts of the combining companies to augment product lines, broaden geographic coverage, gain new distribution channels and penetrate entirely new markets. These goals relate directly to sales and marketing. Consequently, there is a greater need today for marketing due diligence, which is defined as an analytical methodology that assesses target company’s sales and marketing strengths and weaknesses to ensure success of strategic M&As. This process is critical for two primary reasons:

- It helps companies avoid the delays, missteps and resultant multimillion dollar losses that can result from inadequate strategic examinations of target companies and the markets in which they operate
- Marketing due diligence’s fundamental orientation toward revenue growth – as opposed to cost reduction – is necessary to ensure the true long-term success of the transaction

Depending on the nature of the business, this analysis may need to be prepared by product lines. The stability of clients should be investigated. One of the most fearsome techniques utilized in the due diligence process is the direct contact with clients by the acquirer’s team. The purpose of this activity is to inquire about the satisfaction of service levels that the seller has been providing and the likelihood that the client will be retained after a change of control. This contact usually occurs immediately prior to closing and under the specific supervision of the selling shareholders.

Sellers will want to edit and approve the script to be used in the dialogue with their clients. It is not uncommon for acquirers to utilize a quality assurance consultant or market research firm to contact the clients under the guise of a quality control survey initiated by the seller, previously agreed with the seller. What is not common is for the
potential acquirer to be allowed to contact the clients before the seller is reasonably assured that the transaction will close and the definitive agreement is negotiated.

**Management and Personnel.** During the due diligence period, there are many personnel issues that need to be addressed. Most acquirers will determine which key employees will be requested to sign an employment agreement and/or a non-compete agreement. Almost always, the selling shareholders will be required to execute a non-compete agreement. Unusual patterns of employee turnover must be explained to the acquirer. The principals of the selling company may additionally be subjected to a background check.

Still another factor is the cultural compatibility of the selling company with the buyer's organization. If the selling company has had more of a “maintain the current clients” mentality and the acquirer has a company-wide mantra of “growth, growth, growth,” there could be an intangible issue that needs to be reconciled. This issue comes down to the feasibility of a successful integration.

**Systems.** If the company is using a proprietary system versus one of the widely utilized system platforms, the level of systems due diligence should increase due to the unknown territory that is being charted. If the acquirer is going to convert from the proprietary system to one of the platforms it utilizes, the result will be minimized system due diligence. If an acquirer is going to utilize the target proprietary system and plans on growing the company, a primary concern will be the scalability and stability of the system.

**External Factors.** In addition to thoroughly examining the target company, an acquirer should assess a number of non-economic factors that affect the company and/or the industry. This may include performing an analysis of competitors and the general market conditions of the geographic marketing area, as well as the specific industry niches that the company serves. It is important for an acquirer to understand the external trends that are taking place that could have an impact on the business in the future.
External factors also include the employment climate within the hiring radius. Turnover is a challenge that many companies are experiencing. An acquirer anticipating rapid growth after the acquisition should be satisfied that a trained work staff could be maintained and expanded.

Re-Negotiation of Purchase Price. Just when the stressful negotiations appear to be culminating in the signing of a letter of intent, due diligence sometimes uncovers additional issues that need to be resolved. The most common occurrence is that the re-cast earnings (EBITDA) submitted to the buyer ultimately do not hold up under the rigorous scrutiny of the buyer's financial due diligence team. If there is a material difference between the EBITDA the buyer thought was being acquired and the EBITDA computed by the team, more than likely the result will be a downward adjustment of the purchase price. Sellers expect an increase if the re-computed EBITDA amount is materially higher after review.

Seller Consideration. There are a number of important attributes that a seller may want to verify about the acquirer before turning over the reins. It is long been assumed that the seller is thoroughly and specifically satisfied that the acquirer has the financial resources to close the transaction.

Part of the due diligence regarding the buyer would include discussions with the owners of other companies that the acquirer has acquired. The seller would want to be satisfied how the acquirer treats its employees and its reputation in the industry. Another reason for investigating the buyer is that the seller may have elected to accept a portion of the purchase price in the form of common stock of the acquirer.

Due diligence is a vital part of the acquisition process. The better the parties are prepared, the sooner the process will be concluded. The buyer will likely spend considerable funds to perform due diligence and the seller will devote an enormous amount of time to the process.
Exposure Areas

Some of the more typical areas where problems could arise during purchase investigations are:

**Inventory distortions.** Undervaluation of inventory by private companies minimizes taxes, but can lead to distorted earnings trends and potential. This could be also a source of transactions not included in the financial statements that lead to liabilities not recorded. On the other hand, overvaluation of inventory could be a sign of unrecorded obsolescence caused by product overruns, changing technology, new product development and matured or discontinued products.

**Litigation.** Very few companies are free of litigation, the most common resulting from product liability. This type of liability can surface well after the acquisition. In international deals, because of differences in legal systems and laws, it is crucial to have a local expert to study this issue. Another area especially important in international deals is related to labor laws, which in some countries limit the ability of corporations to effect layoffs. Litigation regarding the pledge of plant, equipment and land can also dramatically influence the viability of the acquisition.

"Dressing up" of Financial Statements before sale. These tactics include deferral of research and development expenses, repairs and maintenance, "release" of inventory reserves, unduly low reserves or estimates for bad debts, pension accounting, sales returns and allowances, warranties, slow moving and excess inventories, and undisclosed changes in accounting principles or methods.

**Receivables not collectible at recorded amounts.** Doubtful accounts, cash and trade discounts, dated receivables and sales returns and allowances may not be adequately reserved. Transactions affecting receivables different than those directly from customers can be also a source of problems. Mechanisms such as factoring can hide some problems from visibility in the financial statements.
Unrealizability of certain investments. Investments accounted for by the equity method and nonmarketable investments, according to accounting rules in United States, are required to be written down only for "permanent impairments" of value, not for temporary declines. Liberal judgements may have been applied to eliminate the recognition of permanent impairment.

Credibility and integrity of management. A private investigation may be needed to obtain sufficient information and background on target management to determine if it is right for the job.

Personal expenses in the financial statements of a private company. Personal expenses usually reduce reported net income. But such costs also can be used to affect trends and produce a favorable appearance that is misleading. Pro forma adjustments by the seller to eliminate such expenses can be overstated.

Tax contingencies. This represents one of the major problems in an acquisition because most companies tend to be very aggressive when preparing their tax returns. Additionally, as a result of previous steps for structuring the deal as a tax-free transaction, contingencies could arise in the future.

Unrecorded liabilities. This may include vacation pay, bonuses, sales returns, allowances and discounts, pension and postretirement health and insurance liabilities, claims items resulting from poor cutoffs and loss of contracts and warranties.

Related-party transactions. This is most often found in private companies. Related-party deals can have a material effect on the company under new ownership or on the historical trends presented during negotiations. Transfer pricing could also be a source of tax contingencies.
Poor financial controls. This includes poor pricing and costing policies that may affect the projections used for valuation, or reflect some other problems in the operating areas such as production and sales and delivery.

Regulatory problems. A lack of compliance with environmental laws has become a significant problem for many industries. Outside local experts should be retained in most cases to evaluate compliance. Other regulatory problems may exist in areas such as safety, taxes and labor issues.

Reliance on a few major customers/suppliers. The loss of a major customer can have a material effect on operations and profitability. High reliance on just one or few suppliers of a key component may threaten the future viability of the target.

Need for significant future capital expenditures. This includes plant relocation, expansion, replacement of aging property, plant and equipment, and new product development requirements.

Unusual transactions. Extraordinary actions such as sales of assets often improve the trend presented by the target. Also, the sale of a “jewel” before the sale of the target could be the case.

Other areas of importance that could be missed during this last phase are:

- Assessment of cultural barriers and issues of cultural integration
- Selection of integration managers and ensuring their participation throughout the due diligence process
- Assessing the strengths and weaknesses of business and functional capabilities of the target company
- Developing internal and external communication strategies
B. Valuation

Corporate finance is no longer the exclusive area of CFOs. Corporate strategy is no longer a separate realm ruled by CEOs. The link between strategy and finance has become very close and clear. Participants in the financial markets are increasingly involved in business operations through leveraged buyouts, hostile takeovers and proxy contests. At the same time, chief executives have made their companies into increasingly active participants in the financial markets through self-generated restructuring, leveraged recapitalizations, leveraged buyouts and share repurchases. Financing and investment are now inextricably linked. Throughout the world, privatization and the necessity of corporate efficiency in the face of international competition reinforce this theme.

This new reality presents a challenge to business managers - the need to manage value. They need to focus as never before on the value that their corporate and business level strategies are creating. In the quest for value, business managers find that they must consider such radical alternatives as selling the “jewels of the crown” or completely restructuring operations. And they need more systematic and reliable ways to search for opportunities in the turbulence resulting from the confluence of strategy and finance. For instance, as a result of restructurings, companies face unprecedented opportunities to acquire assets and businesses that may be worth more to them than to their original owners or other interested parties.¹⁰

It is at this point where it is generally said that business valuation is a mix of art and science. The bottom line is that a business is worth what a buyer is willing to pay for it. But, there are methods of estimating a fair price, several of which will be described in this section. It is not uncommon to value a business using a number of different methods and using an average, or more likely a weighted average that gives more weight to some methods than to others, of the various methods used.

An additional consideration is that a purchase price for an acquisition is determined by negotiation. When first considering the sale of a business, sellers are often uncertain
about an asking price, even though they are very familiar with every asset and operation. Buyers are often more uncertain because they are initially unfamiliar with the business being sold.

There are a number of reasons for valuing a business, other than buying or selling it. For example businesses can be valued for estate and tax purposes, dispute settlements and raising capital. In keeping with the purpose of this section, all valuation discussions will be primarily focused on valuing for buying and selling. However, in acquisitions, the methods can only help sellers and buyers in making informed decisions. If they are unable or unwilling to reach agreement through negotiation, there will be no acquisition.

Some considerations before valuation are:11

Fair market value. This is the price a willing seller would accept and a willing buyer would pay for a property, where both are equally well-informed and under no compulsion to sell or buy.

Value vs. price. Whatever valuation methods are used, the value of a business depends on the present and potential uses by its owner and by its potential acquirer. Even when a seller and buyer have the same data and use the same methods, they may reach widely divergent values and price terms. If the value to the seller is higher than the value to the buyer, it may not be possible to negotiate a transaction unless a compromise can be negotiated. On the other hand, if the value to the buyer is equal to or greater than value to the seller, it should be possible to negotiate a transaction if there is a mutual desire to do so. However, even in the latter situation, negotiations may not be easy. A seller, who perceives that its business has greater value to the buyer than the value in its present use, will often attempt to negotiate a price based on the potential value to the buyer. The buyer usually will resist this attempt and an acquisition will take place only if buyer or seller yields or a compromise is negotiated.
Going concern basis vs. liquidation basis. Businesses are ordinarily valued on a “going concern” basis that attributes greater value to the business than to the liquidation value of its assets. However, when ability to continue is in doubt or the liquidation value of assets is greater than the value obtained as a going concern, liquidation value should be used. Even for businesses that are going concerns, the liquidation value of assets may be essential to the availability of secured financing of the acquisition price and, therefore, may indirectly affect the negotiations by limiting the available financing.

Overall costs and benefits. When considering price, both seller and buyer should consider the true overall cost and benefits of the transaction, not only the price that will be paid directly by the buyer to seller. The seller should consider such factors as debt assumed and contracts for employment or consulting services by seller personnel as price increases and taxes that reduce net proceeds as price decreases. The seller should consider the effects of the sale on its retained business, if any. The buyer should consider its overall cost including debt assumed, employment contracts and other obligations undertaken, tax effects, loan financing, installation of new or upgraded facilities, additional working capital if programs to increase sales are successful, closing of unneeded facilities including severance pay, and integrating the organizational structure and personnel. However, the buyer can subtract from its cost such items as readily disposable unneeded assets, duplicate facilities and personnel, undervalued assets, access to new customers for its own unused manufacturing capacity, and entry to new markets without the need for extensive development effort and cost.

Methodologies
There are a wide variety of methods that are used by buyers and sellers and their advisers as part of the negotiating process in acquisitions. These can be grouped to four categories according to the nature of the business being valued and the economic rationale behind the potential acquisition:

- Market value
- Financial statements value
• Non-financial statement value or intangible assets based value
• Use of comparable transactions

**Market value.** In spite of their known imperfections, the stock markets arrive at remarkably realistic valuations over time. In forums where judgements are at the risk of real money, the stock markets have often been right when experts have been wrong. For public shareholders, stock markets are the primary source of liquidity. Accordingly stock market prices carry considerable weight in the valuation of companies whose shares are publicly traded.\(^{12}\)

Market values provide a point around which a deal is feasible and, by definition, is only available for publicly traded companies. In the M&A context additional features are considered, such as intangible assets, discussed below. Another limitation for market values is that short-term trends and events could influence them, while an acquisition is normally long-term.

**Financial statements value.** A variety of methods fall into this category, such as book value, liquidation value, replacement cost, capitalization of gross revenues, capitalization of historical earnings and price earnings ratios, as well as a sub-variety of methods based in cash flows and time value of money.

The general wisdom is that “cash is king”, and accordingly, financial and economic theory dictates the Discounted Cash Flow (DCF) model, based on net present value (NPV), is the optimal method for evaluating investment decisions. However, there are other measures that companies sometimes use when making investment decisions: payback period, book rate of return or average accounting return (ARR), and internal rate of return (IRR).\(^{13}\)

Exhibit 2.1 compares these methods as used in large U.S. firms and multinationals.
Exhibit 2.1. Usage of Investment Decision Methods

<table>
<thead>
<tr>
<th>Method</th>
<th>Large U.S. Firms</th>
<th>Multinationals</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>% Using Each Method</td>
<td>% Using as Primary Method</td>
</tr>
<tr>
<td>Payback Period</td>
<td>80.3</td>
<td>5.0</td>
</tr>
<tr>
<td>ARR</td>
<td>59.0</td>
<td>10.7</td>
</tr>
<tr>
<td>IRR</td>
<td>65.5</td>
<td>65.3</td>
</tr>
<tr>
<td>NPV</td>
<td>67.7</td>
<td>16.5</td>
</tr>
<tr>
<td>Other</td>
<td>2.5</td>
<td>3.2</td>
</tr>
</tbody>
</table>


These other methods have been proven to have some drawbacks that are overcome by the NPV method. With the payback period method, the essential problem is that it ignores the cash flows after the payback period and ignores discounting. Even if the cash flows are discounted, the first problem still persists. In the case of the ARR, the problem concerns the fact that it is not an economic measure, rather, it is an accounting measure subject to accounting criteria and rules, and thus accounting income can be very different from cash flows.

IRR is defined as the discount rate that makes NPV = 0. Thus, it takes into account the time value of money. However, it can be a misleading measure. In the case of a valuation where net cash inflows and outflows are intercalated across time - which can be the case when major capital expenditures have to be made after an acquisition - the valuation has multiple rates of return. In fact, there can be as many different IRRs as there are changes in the sign of the cash flows. The other important drawback is that when two possible acquisitions are evaluated, it ignores the scale and timing of different magnitudes of cash flows, making short-lived projects that require little up-front investment appear better than those that could add more value to the firm.14

The usage of the Weighted Average Cost of Capital (WACC) as a discount rate for the DCF technique has some limitations.15
• Since the discounting is done only once, the discount rate has to be adjusted to pick up all the costs and benefits of a selected capital structure. It bundles all financing side effects into the discount rate.

• When calculating WACC, the same capital structure is assumed for the entire life of the company being valued. This is especially misleading when valuing deals to be financed with debt, where leverage tends to reduce overtime.

• The cost of equity changes every time the debt ratio changes because of changes in risk resulting from leverage.

• To generate the weights to calculate WACC, book values typically are used, but even if market values are employed, they change every period of the valuation being done.

There is a modified technique to DCF called adjusted present value (APV) which allows decomposing where the value from an acquisition comes from. It also allows applying different discount rates to different items. APV is designed to value operations, or assets in place; i.e., any existing asset that will generate future cash flows. APV analyzes financial maneuvers separately and then add their value to that of the business. It first evaluates a business as if it was financed entirely with equity. Then the value associated with the financing program that is expected to utilize is added or subtracted. Presumably, the net effect of the program will be positive; otherwise, only equity financing would be used.

The general steps to evaluate a business using APV are:¹⁶

• **Step 1.** Prepare performance forecasts and base case incremental cash flows for the business to be acquired. The projections consist of expected incremental operating and investment cash flows – free cash flow of assets.

• **Step 2.** Discount the flows using an appropriate discount rate and terminal value. The rate is the opportunity cost of capital that could be earned by
investing in other assets with the same risk as the target assets if they were financed entirely with equity.

- **Step 3.** Evaluate the financing side effects. The more typical one is interest tax shields resulting from the deductibility of interest payments. The appropriate rate to discount these cash flows is generally accepted as the cost of debt based on the assumption that tax shields are about as uncertain as principal and interest payments. However, there may come a time when it can be afforded to make interest payments, but cannot use the tax shields due to lack of income to offset the deduction. This suggests that tax shields are somewhat more uncertain and thus deserve a little higher discount rate.

- **Step 4.** Add the items together to arrive at an initial APV. The analysis can be continued to obtain more insight.

- **Step 5.** Tailor the analysis to fit needs. It is at this point where this technique assumes more relevance for M&A deals, and even more important in cross-border valuations. This tailoring should respond to questions such as how much value is already in the business, how much is created by acquiring and merging the business, and how much value that is to be created will be paid over the seller at closing as premium.

The base line cash flows are derived from the current state of operations. The increments could come from margin improvement due to synergy, net working capital improvements, non-core assets sales, and higher steady growth due to synergy.

**Non-financial statement value or intangible assets based value.** The valuation approaches discussed earlier in this chapter are important in doing M&As. However, it is not possible to make a complete and sound valuation based in these values alone. There are elements of a business that are unknown or under - or over - appreciated by the markets and are not reflected in financial statements.
Among the assets of a business not directly appearing in its financial statements and sometime, but not always, reflected in market values are:

- Reputation, e.g., quality, service, and customer and government relations
- People, e.g., skills, motivation and good employee relations
- Intellectual property, e.g., patents, trade secrets, trademarks and copyrights
- Leading market shares
- Established distribution systems
- Franchise and distributorship agreements
- Government permits and approvals
- Access to raw materials
- Synergies (as discussed in chapter 1).\textsuperscript{17}

All of these business factors must be considered in valuing an acquisition and negotiating the price. It may be possible to quantify the potential effects of some of them in financial terms. Others must be left to the judgement of management and the process of negotiation.

Use of comparable transactions. This is not a method in and of itself. Rather it is an integrative view of various approaches and valuations for a given business. It indicates whether a potential acquisition price is reasonable. Buyers often consider statistics from similar past transactions. Common benchmarks include multiples of sales, EBITDA, EBIT, net income, cash flow and book value.

It is frequently worthwhile to consider industry specific criteria, particularly since some industries place major emphasis on special rules of thumb. These benchmarks reflect different underlying operating economies of industries. As an example, in mature manufacturing businesses, buyers focus on multiples of EBITDA or cash flow.

Some more specific examples are:
• Oil and gas industry. Assets are often analyzed by using multiples of proven reserves.
• Cellular phones. Prices are often measured in terms of POP a specifically defined index based on population density.
• Cement. Prices are based on multiples of cash flow and dollars per unit of installed capacity.

In the M&A valuation context, there is not a unique or universal and objective method to value a business. The issue of willingness of a buyer to pay and willingness of a seller to accept a given price explains why so many deals seem overpriced, but they could not be, given certain synergies or advantages that could arise from combining the two businesses. However, this is a critical issue, since it could determine the success or failure of a deal.

C. Structure and execution

There are four primary purposes for deal structures, each of which is independent of the other: business, tax, legal and regulatory accounting.  

Business purpose
An M&A can take three forms:

Statutory merger. This is a combination of two companies according to the laws of jurisdiction where incorporated. The effect is that a surviving corporation or new entity inherits all of the assets and liabilities, both known and unknown, of the combining corporation. The procedure involves the approval of both boards of directors and both groups of shareholders. According to the laws of various countries, there could be exceptions, as in the case of the United States, where, when one company or person holds at least 90% of a corporation no vote from shareholders is required.
**Acquisition of stock.** This involves the purchase of a controlling majority, as defined by the law in the country of incorporation, of one company’s stock by the other. The effect is that the target becomes a subsidiary of the acquirer.

**Acquisition of assets.** This involves the purchase of an identifiable set of assets and, in some cases, of specified liabilities of one company by the other. The procedure is the transfer accomplished by title transfer of each and every asset and approval of liability conveyance by creditors, when applicable.

Each of these has advantages and disadvantages. In the case of a merger, it is exposed to contingencies, whereas in the acquisition of stock, it is protected up to the value of the equity. In the acquisition of assets, it is fully selective and buy only and exactly what is needed. In the case of intangible assets, when acquiring tangible assets, it is extremely difficult, if not impossible to transfer such assets. In the case of controlling a set of assets, the acquisition of stock has the advantage that control can be achieved without having to pay the full price by acquiring a controlling stake.

**Tax purpose**

In general, each of the forms an acquisition can take, as discussed above, can be either taxable or not taxable under certain circumstances and according to law applicable where incorporated. However, where normally is more freedom or option to maneuver is in the case of acquisition of stock; a statutory merger, by economic essence is almost never taxable, on the opposite side, an acquisition of assets is almost never tax free.

Creativity and financial engineering are crucial to structuring a deal in a tax-free manner. This is not only left to the seller’s incumbency because a good structure in this sense can help lower the price of the target.

**Legal purpose**

This refers to all the legal steps and requirements that have to be satisfied before, during and after an acquisition, as well as notices. The central issue is timing, and it becomes
more crucial because when pursuing a deal, there are normally pressures and time constraints to close it, and it is not difficult to miss a step.

**Regulatory accounting purpose**

This varies from country to country according the laws and applicable General Accepted Accounting Principles (GAAP). But general financial accounting theory includes two ways for recording a transaction: 1) pooling, where the financial statements are added together and no goodwill or premium paid in the acquisition is recognized 2) the purchase method, where the assets are recorded based on their fair value with the excess being recognized as goodwill.

There are some technicalities that limit when a method can be used. This subject is beyond the scope of this thesis. However a few comments are instructive. First, acquirers tend to dislike the purchase method because of future charges to income statement as a result of goodwill amortization. Second, it is important to oversee these issues from the beginning, and especially in valuation and negotiation, because goodwill amortization, depending on the tax laws of where the company is incorporated, can be deducted for income tax purposes.

**NOTES**

CHAPTER 3. INTEGRATION

In chapter 2, integration was mentioned as a customized process for each deal. Moreover, as similar as any two deals may seem to be, they each involve a separate strategic and human dynamic that, in turn, makes each different. The process of joining two companies and melding their people, processes, technology, systems and products is a challenging and time-consuming task that must be carefully planned in light of the many obstacles each transaction presents.

The top management focus in M&A is generally in the realization of synergies and growth, and once the merger or acquisition is "blessed", the successful integration is mistakenly assumed to be easily attainable. The formation of a comprehensive integration plan and its attendant follow-through will ultimately determine the success or failure of the initial vision.

Integration means different things to different people under different circumstances. As definitions vary, approaches vary too. Therefore, only by identifying the motivation and strategic vision behind an individual merger or acquisition can a firm effectively devise an integration strategy and plan its successful implementation.

In M&A, integration is defined as two companies coming together to create an entirely new entity. However, most of M&As are not combinations of equals. The company driving the merger is typically making most of the decisions. So it follows that the concept of integration will be radically different, depending on whether one is the acquirer or the acquired.¹

In the context of the Resource-Based view of the firm, integration is an adaptive process of interaction that takes place when firms come together in an atmosphere conducive to capability transfer. Actual strategic capability transfer and, ultimately, value creation, depend on the ability to understand each other’s organizational context and to create this atmosphere, despite a series of problems that may arise in the process.²
Integration will also depend on the culture of the acquirer. A financial culture treats each acquired company as a separate entity. In such a culture, exemplified by the buyout firm of Kholberg Kravis and Roberts (KKR), the buyer adds value through imposing superior, top-down management strategies in a short period of time. Financial acquisitions are generally fairly diverse – conglomerates - and do not need to be integrated to yield good returns. A strategic culture, in contrast, treats each acquired company as a new member of its corporate family. In such a culture, exemplified by General Electric, the acquired company itself adds value to the acquiring company by integrating with the buyer’s existing operations. These kinds of acquisitions generally involve combinations of companies in the same or related industries – vertical and horizontal M&As.³

Despite this, every acquisition involves integration, even if the buyer promises extensive autonomy to management of the acquired business. As an example, financial reporting, budgets, cash management, taxes, insurance, personnel policies are commonly integrated in varying degrees, even if the acquired business has been successful and will have operational freedom.⁴

Integration should be planned at the highest corporate level. However, its implementation invariably occurs at every level of an organization. The employee population represents the fuel that drives the corporate engine. A cohesive workforce ensures that the engine runs efficiently.

A post-merger plan should, at least, outline when and how the major resources, assets, processes and commitments of the acquiring and acquired company will be combined in order to achieve the strategic goals of the newly combined company. Three minimum elements should be in the plan:

- Goals of the new company
- How integration of resources, systems and responsibilities will support those goals
- Priorities and timetable for the integration ⁵
A. The “Soft Stuff” – Modes of acculturation

Most of the research on mergers has focused on the strategic and financial fit between the acquirer and the acquired firms, though some research have focused on the organizational fit, dealing with issues of integration such as transfer of organizational, technology and management systems.

These lines of research, although essential to an understanding of mergers, leave other important aspects relatively unexplored. The role of socio-cultural factors involved in merging two organizations, as cultural entities have not been examined thoroughly. Some studies suggest that the degree of congruence between the preferred modes of acculturation for the acquirer and acquired company will affect the success of the implementation of the merger. These researchers have have adapted theories from cross-cultural psychology to explain the processes of cultural adaptation in mergers and acquisitions.

Culture can be defined in many different ways. Each of the definitions emphasizes a particular focus and level of analysis. With a few exceptions, the definitions of culture fail to recognize it as a multidimensional, multilevel concept. Most of the definitions of culture focus on the beliefs that members of an organization share. Although the term often is used as if organizations have a unique and widely dispersed culture, most firms have more than one set of beliefs influencing the behavior of employees. However, a firm may have a dominant culture with many subcultures coexisting and interacting. Understanding the culture of any organization involves identifying and deciphering the various subcultures and gaining insight into how they interplay to influence organizational behavior and decision-making.

Some studies attempting to identify the factors that affect the success of acquisitions note the importance of more subtle issues related more to organizational fit than to strategic fit. The organizational culture involves differences in managerial styles and
organizational practices. It also has been used to explain the success of some organizations.

In related mergers, the acquirer is more likely to impose its own culture and practices on the acquired company, and then initiating extensive interaction among the employees of the two firms. This interaction is termed as “Acculturation”, which is defined as changes induced in two cultural systems as a result of the diffusion of cultural elements in both directions. Although the notion of acculturation is considered to be a balanced, two-way flow, members of one culture often attempt to dominate members of the other. Therefore, change may affect the members of the acquired firm most strongly because they often are expected to adapt to the practices of the acquirer.

The various systems of both the acquirer and the acquired, such as those related to structure and technology, affect those members directly, who do not have the option of not acculturating and refusing contact. However, some members can choose not to accept the culture of the other organization by simply leaving the organization, or the acculturation process can be bypassed if most management members of the acquired company are terminated. Thus, in cross-cultural research, acculturation focuses both on the desires of the members of the culture that is being invaded and on the way in which these members adapt to the intruder.

The framework
Four modes of acculturation are used to define ways in which two groups adapt to each other and resolve conflict: integration, assimilation, separation and deculturation. The characteristics of the acquired and the acquiring companies determine which mode of acculturation will be invoked.

Integration. This is triggered when members of the acquired firm want to preserve their own culture and identity and to remain autonomous and independent. This leads to structural assimilation of two cultures, but little cultural and behavioral assimilation. Integration does not involve loss of cultural identity by either company, but it only can
take place if the acquirer is willing to allow such independence. The acquired company’s employees attempt to maintain many of the basic assumptions, beliefs, cultural elements and organizational practices and systems that make them unique, and at the same time, they are willing to be integrated into the acquirer’s structure. Overall, integration leads to some degree of change in both groups’ cultures and practices, but the flow of cultural elements is balanced because neither group tries to dominate the other.

Assimilation. As opposed to integration, assimilation is always a unilateral process in which one group willingly adopts the identity and culture of the other. Therefore in doing so, the members of the acquired firm abandon their culture as well as most of their organizational practices and systems, and adopt the culture and systems of the acquirer. This may occur in an acquired firm that has been unsuccessful and where organizational members perceive that their culture and practices are dysfunctional and hindering organizational performance. Overall, the acquired firm will be absorbed into the acquirer, and it will cease to exist as a cultural entity.

Separation. This involves attempting to preserve one company’s culture and practices by remaining separate and independent from the dominant group. It is likely to take place when members of the acquired organization want to preserve their culture and organizational systems, and they refuse to be assimilated with the acquirer in any way or at any level. Both employees and managers resist any attempt at adaptation and conciliation, and they try to remain totally separate from the acquirer. As long as the acquirer is willing to allow such independence, the acquired will function as a separate unit under the umbrella of the parent company. Overall, with separation, there is minimal cultural exchange between the two groups, and each would function independently.

Deculturation. Also known as “marginality”, deculturation involves both groups losing cultural and psychological contact within their respective groups and remaining an outcast to both. It occurs when members of the acquired company do not value their own culture and organizational practices and systems, and they do not want to be assimilated into the acquiring company. The result is that the acquired company is likely to
disintegrate as a cultural entity. This is accompanied by considerable collective and individual confusion, and by feelings of alienation, loss of identity and what has been termed acculturative stress.

Exhibit 3.1 summarizes which of the Acquired Firm’s Mode of Acculturation would take place, according with the perception of the attractiveness of the acquirer (A) and how much members of the acquired firm value preservation of their own culture (B).

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very Much</td>
<td>Integration</td>
<td>Assimilation</td>
</tr>
<tr>
<td>Not at all Attractive</td>
<td>Separation</td>
<td>Deculturation</td>
</tr>
</tbody>
</table>

In the case of the Acquirer Firm’s Modes of Acculturation, the type of strategy or degree of relatedness and the degree of multiculturalism will determine the preferred mode of acculturation.

If the merger is with a firm in a related business, the acquirer is more likely to impose some of its culture and practices in an attempt to achieve operating synergies. Multiculturalism refers to the degree to which an organization values cultural diversity and is willing to tolerate and encourage it. If an organization simply contains many different cultural groups, it is considered a pluralistic organization. If, in addition, the organization values this diversity, it is considered to be multicultural. If an acquirer is unicultural and, therefore, emphasizes conformity and rewards adherence to unique goals, strategies and organizational practices, it is more likely to impose its own culture and management systems on a new acquisition. If the acquirer is multicultural, it is likely to consider diversity an asset and, therefore, will allow the acquired firm to retain its own culture and practices.
Exhibit 3.2 summarizes which of the Acquirer Firm’s Modes of Acculturation would take place, according with the diversification strategy (C) and the degree of multiculturalism (D).

**Exhibit 3.2 Acquirer Firm’s Modes of Acculturation**

<table>
<thead>
<tr>
<th>C</th>
<th>D Multicultural</th>
<th>Unicultural</th>
</tr>
</thead>
<tbody>
<tr>
<td>Related</td>
<td>Integration</td>
<td>Assimilation</td>
</tr>
<tr>
<td>Non Related</td>
<td>Separation</td>
<td>Deculturation</td>
</tr>
</tbody>
</table>

This framework suggests that when the acquirer and the acquired agree on the preferred mode of acculturation for the implementation of the merger, less acculturative stress and organizational resistance will result, making acculturation a smoother process. The degree of agreement or congruence regarding each organization’s preference for a mode of acculturation will be a central factor in the successful implementation and integration of the merger. This congruence can take place even if the cultures and practices of the two organizations are considerably different.

Incongruence, which occurs when the two organizations do not concur on the mode of acculturation, is likely to engender high levels of acculturative stress and disruption for both individual and group functioning. This framework proposes that high acculturative stress will preclude successful implementation of the merger. The concepts of acculturation and congruence suggest that many of the problems associated with the post-merger integration of two firms can be avoided or managed if they agree on the mode of acculturation.

**B. Tasks**

In contrast to the topics discussed in the previous section, integration of processes, functions and systems is a more straightforward task, once the mode of acculturation is
resolved. The degree and scope in which these issues are combined or replaced will be unique in each deal as a result of differing circumstances and characteristics of the specific firms involved.

Establishing priorities

One important aspect is setting priorities. There is much that needs to be done to meld the organizations, but not everything can be done at once. Most acquired companies can continue to operate for a short period of time without any input from the acquiring company. The functions that do not require daily oversight, e.g. training, can be considered secondary priorities. Growth-focused acquisitions require that areas such as corporate information, marketing and sales be addressed very quickly. These departments and the people within them are on the front-end representing the company every day after stakeholders.

Corporate image and branding issues should be addressed promptly to ensure that the appropriate messages about the merged company are communicated. Advertising programs already in process should be evaluated and, if necessary, modified where possible. It is easy to want to put on hold or completely stop any marketing campaigns in process, but this could be an opportunity to immediately begin the promotion of the combined firm’s new image.

Communications programs should be instituted immediately for key employee retention. Concentrating on the potential savings or additional revenue instead of people could compromise future revenue streams, as well as those responsible for creating them. If retention programs are not rapidly developed, there is a risk of losing these people.

Customer retention is also critical to maintaining the value of the acquired company. Identifying key customers is a critical phase in the due diligence process. Contacting the most profitable customers should occur immediately after the closing takes place or even before if allowed by the seller.
Exhibit 3.3 provides general guidance for setting priorities:

<table>
<thead>
<tr>
<th></th>
<th>Low risk in Integration</th>
<th>High risk in Integration</th>
</tr>
</thead>
<tbody>
<tr>
<td>High savings and synergy</td>
<td>Do it!</td>
<td>Study it!</td>
</tr>
<tr>
<td>Low savings and synergy</td>
<td>Get around to it!</td>
<td>Forget it!</td>
</tr>
</tbody>
</table>


Common sense dictates moving quickly in areas that generate high savings and synergy, but are relatively easy to combine – quick hits. Areas that have the potential to produce high savings and synergy, but are relatively difficult to integrate, require careful up-front study, and should be the focus of transition task forces. Areas that have relatively minor impact on savings and synergy, but are somewhat easy to integrate, can be addressed less urgently. Finally, areas that produce little gain in savings and synergy and are difficult to combine, should be removed from immediate consideration because they involve potential conflict, and there are many other issues competing for attention.⁹

Communications

Any M&A deal involve significant amounts of communication. Its logic and timing must be sold to employees and outside stakeholders of both organizations. They are generally suspicious and confused and sensitive to rumors, which normally have little basis in fact. Thus, an essential task is to communicate honestly, clearly and frequently, praising and promoting progress achieved, and, at the same, time reminding participants of what still needs to be accomplished and its urgency.

Thus, the first step in an effective communication program is to create a communication plan during the due diligence and negotiation phases of the transaction so that employees and external parties are informed as soon as the deal is consummated. Keeping the
communication process going and making it reach broadly and deeply throughout the organization requires more than just sharing information bulletins, for example. It requires the creation of forums for dialogue and interaction that can help span the cultural chasm between the acquiring and the acquired companies.\textsuperscript{10}

The assumption is that the more people know about what is happening, the more they will be able to accept change and overcome their cultural and historical differences. This should not be seen as a substitute or a tool for dealing with cultural issues; as noted in section A, a direct approach to acculturation is essential as well.

**Integrating tangible and intangible resources**

Of all the issues involved in a merger, intangible resources are among the most precious and fragile.

In the context of the Resource Based view of the firm, the core of integration is the transfer and application of strategic capabilities. This can be accomplished in several ways: they may be given to the new firm, they may be shared for common use or they may be taught to people in the other firm. This capability transfer may be grouped as operational resource sharing, functional skill transfer and general management skill transfer.\textsuperscript{11}

**Operational resource sharing.** This is the most straightforward type of capability transfer. It can take place through giving or sharing. Some examples are combining sales forces and sharing manufacturing facilities, trademarks, brand names, office space and distribution channels. Value is created through economies of scope and scale.

**Functional skill transfer.** Often the long-term source of value creation is the effective transfer of functional skills between the firms. It involves a process of teaching and learning before skills could be transferred. The not easily imitated characteristic of strategic capability makes it difficult to transfer, especially of the skill-based variety,
because they are embedded in the skills of a group of people and in the processes and culture of firms.

The human interactions are mostly horizontal among managers at operating levels in both organizations. Because these managers do not have a direct hierarchical relationship, they are not often willing to participate, as in the case of vertical interactions. However, according to change management theory, the role of the networker can help to overcome this and even work as a tool during the integration. Such a role is described in terms of invisible leaders who connect people to people and activate the capacity of community.\(^\text{12}\)

**General management skill transfer.** The managers of the acquired firm are influenced on general management issues, resource allocation, financial planning and control or human resources management through coaching, direct involvement and imposition of systems.

This transfer primarily involves vertical interactions at the general management level between the acquired and acquiring firms, vis-à-vis functional skill transfer. Because of direct or indirect hierarchical relationship, managers are more willing to teach and learn.

Few subjects consume more time during acquisition negotiations than discussions of the future of the combined businesses and ways to achieve the synergies, which were the acquisition objectives. Sometimes, however, the plans for integration do not work as expected for several reasons:

- Acquisition negotiations are usually conducted confidentially between top management representatives, who tend to focus primarily on management and financial issues rather than on post-merger integration.
- Negotiations are necessarily at arm’s length and lack the cooperation needed for strategic operations planning.
- Concessions made during acquisitions sometimes impair future operating efficiency, such as restrictions in shutdowns and layoffs.
• After acquisitions, integration is sometimes delegated to operating officers and managers who had little or no participation in the evaluation and planning processes. While most will use their best efforts, some will see the situation as a threat to their position or as an opportunity to seize power. Some will be apathetic, especially if they feel that management should not have excluded them from the planning. This situation is more likely to be present in conglomerate acquisitions.\(^\text{13}\)

NOTES

CHAPTER 4. THE CASE OF CEMEX

A. Company overview and history

Founded in 1906, CEMEX is currently one of the three largest cement companies in the world, with approximately 60 million metric tons of installed production capacity. It has operations in 23 countries and, through its extensive network of distribution centers and marine terminals, it has trade relations with more than 60 countries around the world. Through its operating subsidiaries, CEMEX is involved in the production, distribution, marketing and sale of cement, ready-mix concrete, aggregates and clinker. In addition, the company is the world’s leading producer of white cement and the world’s largest trader of cement and clinker. The following is a chronological history of CEMEX.

1906-1966: The birth and consolidation of northern Mexico’s leading cement company. CEMEX was founded with the opening of the Cementos Hidalgo plant in northern Mexico, near Monterrey. In 1920, Cementos Portland Monterrey, the cornerstone of the company, initiated operations with 20,000 tons of annual production capacity. Cementos Hidalgo and Cementos Portland Monterrey merged in 1931 to form Cementos Mexicanos, now CEMEX. In the ensuing decades, the company forged a strong position in its home market.

1966-1985: Evolution from a local to a regional cement company. In 1966, CEMEX expanded to southern Mexico by acquiring Cementos Maya’s Mérida plant. The following year, CEMEX became a regional player by building new plants in Ciudad Valles and Torreón. CEMEX’s expansion in northern Mexico continued throughout the 1970s.

CEMEX established a national presence with the installation of new kilns at its Mérida and Monterrey plants. With the acquisition of a plant in León, in central Mexico, the firm added 500,000 tons of new capacity. In 1976, CEMEX took its first step into capital markets, with an initial public offering and listing on the Mexican stock exchange. Later
that year, the company began exporting cement and clinker, and with the acquisition of Cementos Guadalajara’s three plants, CEMEX became Mexico’s market leader for cement. In 1978-79, CEMEX installed new kilns at its Mérida, Monterrey, Torreón and Ensenada plants.

In the early 1980s, despite the severe economic downturn in Mexico, CEMEX continued its investments and expanded its export program. During this period, the company more than doubled export volumes.

1985-1992: CEMEX emerges as Mexico’s leading cement company. It began its transformation from a regional to a national cement producer with the signing of the GATT Agreement in 1985. Mexico became an open marketplace, and in order to compete in this new environment, CEMEX began to concentrate on producing and selling cement and its related products and to divest its interests in the mining, petrochemical and tourism industries. Today, the tourism properties are the only non-core assets that remain to be sold.

CEMEX acquired Cementos Anáhuac in 1987. This is the acquisition that gave CEMEX access to Mexico’s dynamic central market, bolstered its export capabilities, and added two plants and four million tons of capacity to its operations. In 1989, CEMEX firmly established a national presence through the acquisition of Cementos Tolteca, Mexico’s second-largest cement producer. Cementos Tolteca brought with it seven new plants and 6.6 million tons of installed capacity. With the Tolteca acquisition, CEMEX became Mexico’s largest producer and one of the ten largest cement companies in the world in terms of installed capacity.

1992-1999: Global diversification and CEMEX’s evolution into the world’s third-largest cement company. From 1985 to 1992, the firm successfully met the challenges posed by an open market and began looking for opportunities beyond Mexico’s border. The operational knowledge that CEMEX gained by integrating its acquired assets gave it a distinctive competitive advantage.
During this period, management identified the factors necessary for success in a global industry and applied these factors to CEMEX’s geographic expansion. The company’s development model is based on the premise that the scope and scale of a cement company’s operations are tied to increasing cash flows, profitability and predictability.

International acquisitions allowed CEMEX to geographically diversify its asset base and generate more stable consolidated cash flows. With a more predictable cash stream, the company was able to make investments to increase capacity and extend its global reach. The model also demonstrated that, as the company expands worldwide, it is better able to optimize and utilize capacity, making capital investments more profitable and increasing cash flows.

**B. Strategy shifts. Acquisitions as a strategy for protection and growth**

Taking advantage of CEMEX’s cash flow generation capacity, an investment portfolio was created in selected sectors of the Mexican economy with specific criteria. As of 1987, CEMEX was involved in the following sectors in the Mexican economy:

- **Cement.** 13.7 MM tons of capacity in Northern Mexico
- **Tourism.** Association with Marriott
- **Petrochemical.** Participation in Celanese Mexicana petrochemical projects
- **Mining.** Participation in Minera San Luis mining project

However, in 1986, the opening up of the Mexican economy was becoming apparent and unavoidable. CEMEX deemed it necessary to review its strategy, taking into account the threat from foreign global competitors, the expansion opportunities in the Mexican market and the need to compete in the international markets due to signs of consolidation in the cement industry. Exhibit 4.1 shows how the global players in the cement industry have grown in a ten-year period. Most of this growth has been achieved through acquisitions of local producers, frequently family-owned or government-run companies.³
As a result of the change in the competitive environment, CEMEX decided to concentrate on its core cement business by: 1) increasing market share via acquisition opportunities, 2) anticipating capacity expansion ahead of demand through competitive intelligence, 3) positioning itself in competitors markets and 4) fast development of ready-mix concrete integration.

The Tolteca acquisition mentioned earlier in this chapter gave CEMEX multiple benefits, among being the most important: 1) protection of the core business, 2) size to compete against international players, 3) a presence in the North Eastern Mexican market, 4) distribution synergies, 5) exporting capacity to the United States and the Pacific and 6) experience at integrating acquired companies. Exhibit 4.2 presents a map of Mexico that illustrates the geographic advantages of this strategic move.
Between 1984 and 1987 CEMEX acquired nine companies in the United States in the Sunbelt region formed by the states of California, Arizona, New Mexico and Texas. This gave CEMEX’s Mexican northern market natural geographic protection by having participation in the border markets. Exhibit 4.3 depicts a map of northern Mexico with the distribution and type of facilities acquired in these transactions.
Regarding the trading activity, CEMEX's worldwide cement distribution network allows it to smooth demand and price fluctuations across its various markets and to take advantage of imbalances between capacity and demand in various parts of the world. Thus, the firm is able to maintain high capacity utilization even when local markets are depressed, as has been the case in Venezuela for the last few quarters.\(^4\)

CEMEX's trading network plays a fundamental role in realizing the company's strategic objectives. It allows the company to maximize its worldwide production by identifying markets for its excess capacity and allowing it to explore new markets without the necessity of making immediate capital investments. Trading also permits CEMEX to earn profits from down markets by purchasing cement at low prices and either reselling it or using it in its own operations.

For CEMEX's international trading partners, there is no product more expensive than the cement that they cannot sell. Because of the firm's trading volume - the largest in the world - and its extensive international network, it is able to place suppliers' surplus cement on both long-term and spot bases. For example, the company's Asian partners relied on CEMEX to allocate their excess cement at least until the regional economic crisis subsided. In 1999, the company placed over four million metric tons of cement from Indonesia alone. Exhibit 4.4 shows CEMEX's model for trading as a strategic activity, as well as its interactions and advantages.

\[\text{Exhibit 4.4 The role of Trading}\]

Source: CEMEX
C. Becoming global by going local

Strategically, it was necessary to establish a position in CEMEX's global competitors primary markets, i.e., European companies, that concentrate most of their cash flows in Europe. However, few European countries still allowed access to new entrants due to industry consolidation, Italy and Spain. In 1991, CEMEX took the first positioning, acquiring two distribution facilities in Spain that gave it a 1% market share.

In 1992, CEMEX achieved a strong position in its global competitors' backyard when it acquired Valenciana and Sanson, Spain's two largest cement companies. With these acquisitions, the company became the world's fifth-largest cement producer, with 36 million metric tons of capacity. The integration of the Spanish operations was CEMEX's first opportunity to demonstrate its ability to turn around inefficient operations on an international level. These acquisitions gave CEMEX the capability to respond to any hostile actions from European competitors.

In 1994, with the acquisition of Vencemos, Venezuela's largest cement company, CEMEX began the integration of its South American operations. In addition to a leadership position in a high-growth market, Vencemos' operations on Venezuela's northern coast are ideally positioned for low-cost exports. That same year, CEMEX acquired the Balcones plant in Texas. In the four years that followed, operating margins for the plant more than doubled.

Next, CEMEX entered Panama and the Dominican Republic with its acquisition of both Cemento Bayano and Cementos Nacionales. Together with CEMEX's Venezuelan operations, these acquisitions laid the groundwork for the company's Caribbean trading network.

In 1996, CEMEX acquired Diamante and Samper, the second and third largest cement producers, respectively, in Colombia, giving it access to the naturally-protected from imports market of the so-called urban triangle formed by the cities of Bogota, Cali and
Medellin. Colombia is an attractive market because of its growth potential, infrastructure needs and relative economic stability. Because Colombia’s mountainous terrain makes importing cement difficult, CEMEX has been able to maintain a strong local presence in the country. The company’s service to principal inland markets, together with expert local management and technologically advanced operations, contributes to its strong position in this country.

CEMEX capitalized on the Southeast Asian crisis to establish a strong presence in two of the largest cement markets in the region, the Philippines and Indonesia. The company is now the second-largest cement producer in the Philippines through the acquisition of Rizal Cement and APO Cement. It also owns a minority equity stake in PT Semen Gresik, Indonesia’s largest cement manufacturer. These operations will provide the platform to develop a trading network comparable to CEMEX’s successful South American and Caribbean operations.

Southeast Asia shares many characteristics with Latin America and other developing regions, where CEMEX’s experience has generated consistent growth and returns. As with Latin America, the Philippines and Indonesia have low per-capita cement consumption (170 kg and 96 kg, respectively). Cement is the region’s preferred construction material, and bagged cement comprises 80% and 93%, respectively, of the Philippines’ and Indonesia’s total cement demand.

Southeast Asia is currently undergoing significant industry consolidation. For instance, in the Philippines, four global cement players, including CEMEX, are actively involved with significant investment in 87% of the country’s installed production capacity.

In 1998, APO Cement brought on line its second kiln, which uses the state-of-the-art dry process. When the first, older line was upgraded to this technology in 1999, APO produced three million metric tons of cement for the Philippines, utilizing the industry’s most efficient production process. In Indonesia, CEMEX signed an agreement in 1999 with PT Semen Gresik to export a minimum of 1.5 million tons of cement.\textsuperscript{5}
D. Strategy today

CEMEX is one of the most efficient cement producers in the world, and among its global peers, it is one of the most profitable (Exhibit 4.5). This competitive advantage has been achieved largely as a result of the transfer of technology throughout the entire organization, superior operating practices, an expertise in turning around newly acquired operations, and economies of scale achieved because of its position as one of the world’s largest cement companies.⁶

Exhibit 4.5 Operating Cash Flow Margin

CEMEX has a strong core business and has been steadily divesting its non-core assets in order to focus primarily on its cement operations. Most of CEMEX’s subsidiaries enjoy a dominant share in the cement and ready-mix markets, giving the company substantial pricing power in many markets.⁷

Geographic diversification and exposure to rapidly growing economies is likely to boost investment growth, with CEMEX and its subsidiaries and affiliates operating in both
developed and emerging markets worldwide. However, CEMEX has more exposure to fast growing emerging markets than its two most important global peers, Holderbank and Lafarge. Exhibit 4.6 presents information concerning the five worlds' largest cement producers in 1996.

Exhibit 4.6 Emerging markets presence of World's Top Producers (1996).

<table>
<thead>
<tr>
<th>Company</th>
<th>EBITDA Margin (%)</th>
<th>Installed Capacity 1</th>
<th>Emerging Capacity 1</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Holderbank</td>
<td>19.4</td>
<td>77.8</td>
<td>30.6</td>
<td>39</td>
</tr>
<tr>
<td>Lafarge</td>
<td>17.9</td>
<td>67.7</td>
<td>30.1</td>
<td>44</td>
</tr>
<tr>
<td>Cemex</td>
<td>29.6</td>
<td>50.2</td>
<td>35.0</td>
<td>70</td>
</tr>
<tr>
<td>Heidelberger</td>
<td>18.9</td>
<td>35.6</td>
<td>12.0</td>
<td>34</td>
</tr>
<tr>
<td>Blue Circle</td>
<td>22.0</td>
<td>19.6</td>
<td>6.9</td>
<td>35</td>
</tr>
</tbody>
</table>

1) Millions of metric tons per year.

CEMEX's current business strategy and growth model can be summarized as follows.8

- Leverage its core cement and ready-mix concrete franchise
- Concentrate on high-growth developing markets
- Maintain high growth by applying free cash flow toward selective investments that further the company's geographic diversification.

The fundamentals that drive CEMEX's business are as follows:

- Management expertise
- Core cement, ready-mix concrete and aggregates base
- Low operating costs
- State-of-the-art management information systems and production technology
- Versatile financial management and capital structure
- Developing-market experience and focus.
CEMEX's business portfolio of cement assets is primarily concentrated in high-growth, highly profitable developing markets. In the aggregate, these assets produce sustainable high growth for the company and its investors. CEMEX's diversification into these markets, many of which have complementary business cycles, allows it to consistently achieve a steadily increasing cash flow generation. Geographic diversification further allows the firm to capitalize on the benefits of these markets, including their strong need for infrastructure development.

CEMEX's proven investment strategy is simple. Any acquisition that it contemplates must satisfy three investment criteria. First, the asset must benefit from the company's management expertise and turnaround experience. There must be strategic and organizational fit. Second, it must not adversely affect CEMEX's current financial structure and ability to meet its stated financial targets. Third, the acquisition must offer superior long-term financial returns that exceed the company's weighted-average cost of capital.

Exhibit 4.6 is graphical representation of the above growth model.

Exhibit 4.7 The Growth Model
As a result of this strategy, CEMEX has achieved superior growth rates. Over the past 10 years, for example, the company’s EBITDA has increased at a compound annual growth rate of 25% in U.S. dollars terms. This strong operating cash flow enables CEMEX to maintain its position as one of the most profitable cement producers in the world.

E. Industry Analysis

Sections B, C and D provided some characteristics of the cement industry. The following analysis is based on the frameworks discussed in Chapter 1. The purpose of this analysis is to support the convenience of M&A for CEMEX and in general for any global member of the industry.

Porter’s Five Forces Analysis
The traditional or classic forms of competition and subsequently competitive positioning is suitable, since it is commodity-type industry and as discussed below, it is an industry that is not attractive at all for new entrants.

Providing customer solutions is also a suitable competitive positioning, since vertical integration is limited because the very different and non-complementary capabilities required to do so, i.e. producing cement capabilities and construction capabilities.

New Entrants. Barriers to entry are high and, as a mirror image, the same applies in the case of barriers to exit.

Capital intensive. Building a new plant involves capital expenditures of around $250 million dollars for a mid-size cement plant, which will produce about 1.5 million of metric tons per year (TPA). That size is required to achieve acceptable economies of scale. In the case of acquisitions, the amount required to buy a similar plant would vary significantly depending on the region, but in general stays at a slightly lower levels than those for building; with the advantage that the acquirer is also buying managerial capabilities, brand names, image, and reputation and an established market share. Also,
the time required for building such a plant would be one to two years, whereas acquiring a going concern could take only few months.

Asset specialization is extremely high. If a plant becomes obsolete, the market is not profitable or raw material reserves become depleted, it is more financially feasible to let the plant in place and shut it off than to dismantle and sell it as a junk.

**Bargaining Power of Suppliers.** The power of suppliers is typically low. The three most important costs in the cement production are fuels, electricity and maintenance. In the case of raw materials, it is more a matter of availability of reserves and exploitation than cost. Fuels are commodities that quote at international levels, additionally cement kilns can use different types of fuels and switching is fast, easy and cheap.

In the case of electricity, suppliers could have some power because of regulations and government controls in some countries. However, cement plants are large consumers and, particularly in emerging countries, they are considered to be basic industry and important employment generators. These give some power to negotiate for cement producers. Also, self-generated power is an alternative when electricity is very expensive or not reliable.

In the M&A context, by acquiring other companies, a cement concern gains access to a broader supplier base. Additionally it achieves higher purchase volume for some items that are bought internationally, such as computing equipment, and others, which are specialized for the cement industry, such as refractory bricks, gypsum and spare parts. In the case of other purchases that are made locally, the gain could come from either purchasing skills that are acquired or purchasing skills that can be brought to the acquired company.

**Bargaining Power of Buyers.** Buyers, even big constructors, do not have much bargaining power except when import penetration is high. Nevertheless, they usually prefer supply continuity, price stability and homogenous quality, rather than buying cheap imported cement from time to time. However, those same issues could make them switch to other
local suppliers if they are not well attended. Switching costs for them are very low, or even non-existent.

In the M&A context, there is not much to gain, because of the multi-domestic nature of the cement industry for global players. The customer base is highly dispersed, and because of the market characteristics and cost structure, a cement plant usually serves geographically close markets.

**Intensity of Rivalry.** This varies widely across regions because of the multi-domestic nature of the cement industry just mentioned. The characteristics for this type of firm include:

- Configuration of assets and capabilities: Decentralized and nationally self-sufficient
- Role of overseas operations: Sensing and exploiting opportunities
- Development and diffusion of knowledge and capabilities: Knowledge developed and retained within each unit.\(^9\)

These make competition different in each region in which a firm participates. Transportation costs and infrastructure could fragment a region or country in several different markets. Another feature that makes markets different is their location with respect of coasts where imported cement could penetrate at marginal prices.

The presence of international participants tends to increase rivalry temporarily, just after their entrance to a local market, as they attempt to gain further market share, and attack domestic producers to force takeovers and market consolidation, rivalry is reduced once their settle their positions and the market becomes further concentrated.

Exhibit 4.8 summarizes the Five Forces analysis as it pertains to the cement industry:
Exhibit 4.8. Five Forces Analysis for the cement industry.

**Barriers to Entry**
- Capital intensive (+).
- Economies of scale (+).
- Complex logistics and distribution (+).
- No switching possible (+).
- Low technological cycle (-).
- Not proprietary technology and available to everyone (-).

**Rivalry Among Competitors**
- Strong trends towards concentration (+).
- Demand predictable as a function of GDP and population growth (+).
- Growth limited by GDP and population (-).
- Allocation of excess capacity is difficult (-).
- Trend to commodity (-).

**Barriers to exit**
- Capital intensive (-).
- High asset specialization (-).

**Power of Suppliers**
- Specialized and oversupply of services - maintenance (+).
- No forward integration (+).
- Raw materials can be self exploited (+).
- High effect on suppliers profit (+).
- Fuels = commodity (+).
- Electric power can be self generated (+).

**Power of Buyers**
- Highly dispersed customer base (+).
- No backward integration (+).
- Big customers prefer service and integrated solutions over price (+).
- Low = 0 switching costs (-).
- Cost contributed to buyer - variable (-).
- Do not owe the distribution channels (-).

**Availability of Substitutes**
- No substitutes so far (+).

**Delta Model**
The cement industry, as a whole, is clearly positioned in a Best Product strategy. In inland markets where producers serve geographic niches, there is a de facto System Lock in position. In integrated and developed markets, there is the potential for Total Customer
Solutions, where cement firms offer integrated services in cement, ready-mix concrete and other cement-content products employed in finishing.

F. The acquisition process

In search of investment opportunities, CEMEX follows a continuous screening process in which executives examine various regions and countries in terms of their economic, demographic, political and industrial trends and developments. This approach is described as a 30,000 feet view; where conditions and characteristics of the country and industry are analyzed at a macro level.

There are some general criteria used by CEMEX in its strategy that is look for in such screening process. These criteria include the following.

- Focus on emerging markets with long-term growth expectations
- Markets where branding can be achieved and thus de-commoditize the product
- Complementary to current CEMEX’s business cycles to reduce cash flow volatility.

Once the targeted regions and countries in which to invest have been analyzed, the subprocess of identifying target companies to acquire begins; the first approach to the potential target company can be termed Pre Due Diligence (Pre-DD). At this stage, the first approach with management, shareholders or both is done, with the purpose of first, determining the feasibility of a possible sale, and second, make an initial assessment of organizational, cultural and operational fit. At this point, a decision of “go or not go” after the company is reached.

During the Pre-DD, a team of up to four executives performs an investigation at a macro level on the target company. It takes place at the target’s site when it is a friendly acquisition, which is typically the case. At this stage, the involvement of external
consultants in accounting and legal matters is frequent and key due to the possible lack of internal knowledge in country-related matters. The objective is to analyze some of the essential critical issues on a potential operation of this kind. These include financial analysis, tangible fixed assets, assessment of local regulations, and market conditions and projections.

**Financial analysis.** Study of capital structure to determine the kind and quality of debt and minority shareholders that hold an important stake in the company. Existence of contingencies on legal matters and taxes, underestimation on pension liabilities and in general of any other relatively important liabilities or overvaluation of assets.

**Tangible fixed assets.** This involves a check for proper ownership of key assets, mainly land, exploration and exploitation rights for raw materials. Ownership and pledges if, applicable; over plant, equipment and distribution related assets.

Also, a technical evaluation on the plants and other productive equipment is conducted for the purpose of arriving at a rough estimate of actual output and performance, as well as the potential need for additional capital expenditures to upgrade the plants and to take them to CEMEX standards of productivity, quality and automation.

**Assessment of local regulations.** This involves an evaluation of legal framework and implications in the context of the target company operating as a CEMEX subsidiary. The primary areas to assess are taxes, foreign investment, labor relations, environment and commercial and business laws.

**Market conditions and projections.** Market conditions are examined at a country and construction industry level. At this point the market for the cement industry is more deeply analyzed in terms of number of competitors, the distribution structure, regionalization of the market, the customer base of the target company, and consumer and market practices and preferences.
Initial projections are prepared to estimate an approximate value for the target company. These projections are determined assuming the current state of the company without potential savings and synergies that could be achieved in case of acquiring the company.

The acquisition and integration process (Exhibit 4.9) formally starts in the next phase – Due Diligence (DD).

Exhibit 4.9. Acquisition and Integration Process.
**Due Diligence (DD)**

DD is an investigative, quasi auditing, process which critical intensity takes place between a signing of a letter of intent and the closing of the acquisition or the intention of acquisition withdrawal.

Even though boundaries to such process are said to be those two events, the beginning and ending, but most strongly the ending, are diffuse. The process formally ends with the acquisition, but even after the integration is complete, some investigations that fit into DD activities are still performed. Also, references are made to the documentation gathered and prepared during the DD, when some not well-known or unexpected situations arise. An example of this is the case of tax inspections, where in general the length of open to inspection fiscal years is at least five years.

**Team**. About 20 executives form a DD team, each being an expert and fully experienced in at least one function of the business. The composition on each DD is unique and is determined by some of the target’s characteristics:

- Present situation of the company, both financially and operatively
- Relative size with respect to the local industry
- Relative size with respect to CEMEX
- Stake that is proposed to acquire – control or minority interest
- Physical location – country
- Character of the deal – hostile or friendly

The team is headed by an executive from a general management function with wide experience in the industry. Additionally, an inside enabler, who normally is the person who established the first contacts with the target’s management or was involved in the Pre-DD, supports the team.

The functions that are included on the team reflect the primary activities of the value chain, plus some of the support activities. In some cases the DD in a given supporting
activity can be performed from the headquarters or from any other remote place by having someone on the in-site team gather and send the required information.

**Process.** CEMEX's objectives in the DD are summarized as follows:

- Evaluation of the present conditions of the target at the acquisition time.
- Identification and analysis of opportunity areas and potential synergies that would be attained in case of acquisition.

This involves a thorough information gathering and preparation process in a very short period of time, ideally, no more than two weeks. One of the purposes is to review and reassure what is being bought and identify possible adjustments to the purchase price.

Over the years, CEMEX has developed a set of manuals and documentation for the acquisition task. It includes a detailed checklist with the minimum points to cover and the information that needs to be gathered, as well as a set of warnings and instructions for critical issues. This enables people with no previous experience in a process like this, to effectively participate at any moment and in any type of acquisition.

The opportunity areas and synergies are assessed using a benchmark of a defined set of indexes in productivity, quality and performance at the financial and operating levels, based on best practice at CEMEX and the industry in general.

In addition to the benchmarks, there is a more subjective issue, i.e., the compounded and combined experience of the participants, who, through brainstorming sessions and cross-functional discussions on their findings, develop a set of actions and ideas for savings and synergy.

**Post-Merger Integration (PMI)**
The PMI entails a value creation process. Value is obtained through savings, sales growth, operating synergy, improvement in the competitive position, and adoption of
CEMEX's best practices, which could include a practice of the recently acquired business and spread to the other CEMEX's business units.

The PMI approach is not a fixed set of procedures and processes to implement. It is tailored to the characteristics of the acquired company and CEMEX's needs. Exhibit 4.10 illustrates the four types of PMI in the context of two variables that, over time, have been proven to be key determinants in the PMI approach.

**Exhibit 4.10. PMI Approaches.**

<table>
<thead>
<tr>
<th>Control Level</th>
<th>Low</th>
<th>High</th>
</tr>
</thead>
<tbody>
<tr>
<td>Good</td>
<td>Coordination</td>
<td>Integration</td>
</tr>
<tr>
<td>Poor</td>
<td>Turnaround</td>
<td>Takeover</td>
</tr>
</tbody>
</table>

The low control quadrants represent a form of collaboration, since the company has not been acquired and CEMEX is a minority partner. The involvement is only to the point of specific assistance in specific issues. In the high control quadrants, a whole new or combined set of practices and processes are implemented.

The PMI process involves some risks, such as:

- Low morale and uncertainty of the personnel
- Decreased productivity
- Resistance to the change
- Loss key personnel
- Uncertainty from other stakeholders such as customers and suppliers.

To minimize these risks, fast implementation is helpful, but also keeping the employees of the acquired company clearly and continuously informed of what is going on, what is
expected and the time horizon for those objectives, as well as a systematic and organized approach to any organizational change, are beneficial

Team. The participants are executives and experts with wide experience in a specific area or function of the business. Their role is to lead and coordinate the various integration teams, for which there is one per function. The rest of the team is composed of personnel of the acquired company. Under specific circumstances, personnel from other CEMEX business units may temporarily form part of the integration team, with a role of supporter and internal consultant for a specific task or project.

The PMI leaders of each team also work as recipients of the acquired company and implement some of the “first day” measures, such as hold any new investment or hold new hires. Once the control of the new company has been taken, the PMI teams are formally launched.

That the DD and PMI teams overlap for a while for a transfer process of the analysis done during the DD, they also clarify any question about the company. Some of the members of the DD team get involved as part of the PMI team.

Process. The main objectives for the PMI are as follows:

- Achieve the opportunity areas and savings established in the DD
- Integrate the cultures of the acquired company and CEMEX
- Identify key human capital.

For any firm that acquires another, it is key to pay back the investment as soon as possible, thus the rapid implementation of practices aimed at increasing profitability and cash flows as a first priority. Integrating cultures is a means for identifying best practices, and takes advantage of CEMEX’s best practices and those of the acquired company by comparing the practices at the acquired company with the best practices at CEMEX.
When a new best practice is identified in a recently acquired company, it is immediately deployed to the rest of CEMEX.

The process and team formation also offers the opportunity to identify executive talent and competencies that should characterize an eligible executive for the future organization of the company or in any other of the CEMEX’s business units.

**New Organizational Design**
This is the point where a stable organization emerges, cultural norms start to consolidate, work teams form, and individuals adapt to the real and perceived changes involving them. Often, because of their smaller size, lesser complexity or relevance, some areas of the business are ready to have a new organization, while others are still under review and consolidation. Thus, structuring proceeds in some places well ahead of others.

In addition, in this phase, the new strategy, structure and processes in the acquired company begin to be perceived as part of it and runs smoothly as in other CEMEX’s business units, which have been operating as a CEMEX subsidiary for a longer period of time.

The stated objectives are:

- Identify the required practices to upgrade the company to at least those levels of the already consolidated business units
- Design the organizational structure that would run and perform those practices
- Identify and confirm the personnel who have the competencies and capabilities required for the new organization

For new or re-appointed managers and leaders the positive side of the process includes the opportunity to build a new team from the beginning or, alternatively, revamp and revitalize an incumbent team. The new leader can clarify a desired end state, focus his
team on critical issues, and engage them in formulating operating principles that serve as rules for the new team.

G. Challenges ahead

In an eight years period of time, CEMEX has evolved from a national company to a multi-domestic or multi-national company. Fast growth itself poses the challenge of having the required human capital to continue expanding and acquiring new operations and successfully integrating them, as it has been the case.

In the early stages of this process CEMEX relied on a small group of executives to conduct the acquisition process. However, as the company has grown and accelerated the pace of acquisitions, it can no longer afford to rely on a small group of executives to do so. It also cannot afford a lengthy period to integrate the new business units. Accordingly, CEMEX has recently reinforced the development of capabilities across the company in the acquisition process.

Until 1997, all of the CEMEX’s major acquisitions had been in culturally compatible environments – the United States, Latin America and Spain, as well as being compatible in its business practices and language. However, acquisition opportunities in these regions, according with CEMEX’s strategy, are almost exhausted.

The next big regions for CEMEX to invest in are Asia and Africa. The challenge here is to manage the differences and diversity that by nature these regions represent, in contrast with the American continent. America is rather homogeneous in terms of culture and business practices, whereas countries in Africa and most strongly, Asia are very heterogeneous, even in language.

Most of the CEMEX’s acquisitions have been majority stakes, with minority shareholders of a passive nature who hold their stake in cement companies as part of a broader portfolio. The first challenge here is about the price tag for a given investment; growth
and geographical expansion would be limited in the future because it is more expensive to buy large stakes in other companies, than it would be to acquire smaller stakes, but large enough that would give CEMEX, opportunity to coordinate and implement some of its practices.

The second challenge is expanding operations into unknown business environments such as Africa and Asia. When entering to an unknown or hostile business environment, it is key to have a proper local partner who knows the local industry and general business practices.

NOTES

2 For clarifying purposes some definitions are:
   **Hydraulic cement:** The most common type of cement. It has as many different uses as there are types of construction projects, ranging from small- to medium-sized private construction to massive public construction.
   **Portland cement:** The most frequently used hydraulic cement, composed of approximately 95% clinker and 5% gypsum or another component. There are 5 different types of this cement.
   **Ready-mix concrete:** Formed from cement, aggregates, additives, and water, which are mixed together in a central mix drum or in a ready-mix truck. Ready-mix trucks have special equipment to ensure that concrete remains in a homogenous state. The company can modify the concrete’s resistance, manageability, and finish by changing the proportion of water, sand and cement in the mix. Additives are also used to modify the concrete’s characteristics in accordance with the transportation time from the plant to the project, weather conditions at the construction site, and the project’s individual specifications.
   **Aggregates:** Sand and gravel, which are mined from quarries. They give ready-mix concrete its necessary volume and add to its overall strength.
   **Clinker:** An intermediate cement product. Limestone, clay, and iron oxide are sintered in a kiln at 1,450 degrees Celsius to produce clinker. One metric ton of clinker is used to make approximately 1.1 metric tons of gray Portland cement.
   **White cement:** Strategic, high-potential specialty cement, particularly suited for the world’s developing markets. It is used not only for decorative purposes, but also has a wide range of uses as a structural building material.
3 Cembureau, National Associations, Analyst Reports & Company Research
5 The entire Asia section is adapted from CEMEX’s fact book.
8 Adapted from CEMEX’s fact book.
CONCLUSION

Despite many cases and varying degrees of failure of M&As, they are here to stay for a long time. As the markets increasingly globalize, technology advances at a geometric rate and investors push firm’s management for increasing investment opportunities and growth. Managers around the world use M&As as a response to those and many other opportunities and threats.

The issue in mind at the moment when this research started was: If a majority of M&As, according with different criteria, fail, what makes the minority of them to succeed? A common feature in today’s successful acquirers is a process perspective of acquisitions and a close attention and management of the post acquisition life and activities of the combined firm.

From a process perspective, some researchers have observed that corporate acquisitions traditionally have been approached from a choice perspective. They suggest that the choice perspective be supplemented with a process perspective that recognizes the acquisition process itself as a potentially key determinant of the actual value realized in an acquisition.¹

Acquisitions are strategic and complex, affecting varied stakeholder groups and multiple actors whose involvement is temporally and functionally divided. Acquisitions are both discontinuous and fractionated. In fact, for many companies, acquisitions have become not sporadic events, but a continuous endeavor, with acquisition staffs generally engaged in economic analyses of potential candidates, rather than carrying out acquisitions or integrating acquisitions that have already been made. This misconception can lead to neglecting the acquisition process and post-merger integration.

There is a tension between strategic fit, typified by the economic analysis and the organizational fit, which includes integrating the operations of the two businesses. Organizational fit is much more ambiguous than that contained in economic analyses.
Strategic fit emphasizes strategic analysis and negotiation during the preacquisition period, focusing on the fit between the buyer and the target firms. Organizational fit, including the post-merger integration, focuses on how two firms can be integrated with respect to day-to-day operations, once an acquisition has been made. Organizational fit is key to capturing the economic benefits of the acquisitions. Issues such as the match between administrative practices, cultural practices and personnel characteristics of the target and the parent firms must be considered.

The strategic fit of an acquisition cannot properly be addressed, without understanding the processes of negotiating the acquisition and integrating the target into the parent firm as prerequisites of success.

Well-planned, well-integrated, well-executed mergers can and should make the result of a merger between two firms more than the sum of their individual parts. Putting organizations together properly depends significantly on learning - how to translate synergies from analysis into real gains, how to realize and deal with unintended consequences, how best to help people respond to stressful situations and how to deal with change and ambiguity. Effective learning requires ongoing examination of progress and a context that is supportive of learning by doing. In successful, integration missteps are treated as inevitable and as opportunities for learning.

The importance of learning in acquisitions relies on the fact that, from an organizational perspective, acquisitions are, to some extent, experiments whose outcomes inform practice even when they are unsuccessful.

Nevertheless, an objective and analytical evaluation of acquisition experiences is often difficult in firms. Few decisions compare to acquisitions in their propensity to label a manager’s career. However, the reputation of an acquisition matters because it becomes the basis for justifying or influencing future acquisition decisions.²
M&A's, more specifically integration, is about change. Integration presents a significant opportunity for change and learning, since the challenges and environment that an acquisition creates overcome some of the barriers for learning and change. It is a time when all the people are expectant and open to change due to the introduction of new management, processes and practices.

M&A's had become a vehicle for strategic redirection and renewal. But the most penetrating and lasting effect of a continuous endeavor in acquisitions is on the evolution, over time, of the firm's overall management approach. Bringing new capabilities, regions, markets, cultures and, in general, everything that comes with an acquisition, allows the firm's management to test and introduce innovations and ideas that can themselves be a source of competitive advantage.

NOTES