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PenderFund Capital Management Ltd.

# Why Do Some Mergers Fail?

— Tracy Tidy

Capital allocation is the most fundamental responsibility of senior management.  A company flush with cash has several options when it comes to deploying capital. It can return some of it to stakeholders through stock buybacks, raising dividends or reducing debt. It can also invest in the business through increased capex, or investments into research & development and working capital or it can engage in M&A. Mergers & acquisitions are the largest use of capital, yet it is widely accepted that over two-thirds of mergers fail despite their goal of increasing value. In fact, studies show most of the value accrues to the seller, not the acquirer in the transaction.

Despite the risks, a successful merger & acquisition can bring significant benefits to an organization. For example, in fast-growing industries such as technology, it may be cheaper in the long run to buy an existing business than attempt to build similar capabilities from scratch. Three examples of this type of strategic growth acquisition include Google buying Android for its mobile operating system to help it expand its search and ad business beyond the PC platform; Facebook (now Meta) acquiring Instagram with its large user base and advanced mobile strategy; and Disney buying Pixar for its animation technology. Through an acquisition the buyer may also obtain skilled talent, achieve synergies to optimize productivity or reduce costs, eliminate a competitor, or diversity their offerings or market reach. Where are we in the M&A cycle?

## Why Do Some Mergers Fail?

There are 8 common reasons why mergers fail:

1. Overpaying for a target
2. Poor cultural fit
3. A ‘Hail Mary’ merger to save the company or provide a distraction from business problems
4. Buying a target that’s larger or in an unrelated business
5. Buying at the peak of merger mania
6. Buying an unproven or ‘concept’ company with low visibility on profitability
7. Misaligned incentives
8. Poor integration

## 6 Factors that Increase the Chances of a Successful M&A

### Optimal Timing in the Merger Cycle

There are four phases of a merger cycle:

- During phase one, the economy is perceived as being in a recession and investors have little appetite for paying high premiums and they favour deals with payback times of only 1-2 years.
- Phase two sees more financing coming on stream. Mergers are still perceived as risky, but the deal volume is increasing.
- Phase three has the merger boom legitimized and those companies which don't engage are considered laggards. This spurs "catch up" activity as more companies jump on board which also means premiums are rising and the likelihood of value creation goes down.
- Finally, phase four is the late cycle of mergers which is marked by a growing number of failed mergers, reduced merger financing, and declining target quality.

1. Reasonable premium paid in both absolute terms and relative to net realizable synergies
2. The target is smaller and in a related business.
3. Management teams are aligned and incentivized to create value over the long term on a per share basis
4. The financing is done in cash or mostly cash
5. There is a good cultural fit
6. The M&A execution is done well

## Where are we in the M&A cycle?

Inflation and interest rates have risen rapidly through 2023, and along with them valuations have come down. With the higher cost of capital, fewer buyers are competing for assets which is reducing valuations in some cases, companies with weak balance sheets are facing distressed situations that may be resolved through a merger or acquisition.

Companies with strong balance sheets, a disciplined long-term focus, and a properly incentivized management team are the likely beneficiaries of the current M&A cycle.

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