



**HOW HUMAN BEHAVIOR  
INFLUENCES VALUE CREATION  
IN BUSINESS COMBINATIONS**

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### INTRODUCTION

The press regularly showcases examples of the role of mergers and acquisitions in creating shareholder wealth. In fact, over the past ten years nearly \$2 trillion has been invested in mergers and acquisitions and happily many have created significant shareholder wealth, but sadly, many have resulted in a loss of shareholder value. Why? Where were the advisors to these companies and how could these losses have been avoided? Is it purely the financial consideration of the transaction or does psychology and behavior influence the decision making process and the outcome?

How can we, as participants, advisors, and industry observers, be a resource to clients who seek to participate in value creating and value capturing transactions that meet the expectations of all parties? The experience and research of The Bigelow Company suggests that when properly crafted, mergers and acquisitions can and do create sustainable enterprise value, add to the wealth of a society, meet the expectations of sellers seeking liquidity, and can meet—and—often exceed the expectations of acquirers seeking growth and return on capital.

In our experience, there are as many as eight critical behavioral factors to be considered when advising clients considering a business acquisition or divestiture. The bankers of The Bigelow Company understand well the emotions, behaviors, and thought patterns of investors and, as well, appreciate the needs, wants, and expectations of sellers. Experience strongly suggests that the drivers of valuations and enterprise value are more a function of the investor / buyer's unique experiences, skills, resources, motivations, corporate DNA, and human behaviors, and less a function of some pre-determined average multiple of sales, earnings or returns on investment ratios.

Comprehension of these critical understandings and practices provides a level of assurance that the desired outcome will be reached, sustainable shareholder value will be created for the investor, and premium value and liquidity will be generated for the selling shareholders.

### EIGHT CRITICAL VALUE CREATING FACTORS THAT INFLUENCE THE VALUE AND OUTCOME OF BUSINESS COMBINATIONS

**First, the WHY of the Transaction Needs Water Cooler Alignment.** The business transaction that has been contemplated must be championed by all parties to the transaction, especially the respective CEO's, CFO's, and their advisors. The investors and the sellers should fully embrace and understand the

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specific market, business model, and psychological reasons for the transaction and be able to clearly articulate “at the water cooler” the qualitative and quantitative benefits of the proposed business deal. Advisors to the decision, be they accountants, lawyers or bankers, must also know the “whys” if together they are to succeed in meeting the expectations of the parties they are representing. The widely trumpeted mergers of Sears, Coldwell Banker, Dean Witter, and Allstate, had a well analyzed and documented basis in value creation but in fact were dismantled and significant losses of enterprise value occurred. One has to wonder if Wal-Mart would have flourished if Sears had not lost focus on its core business. If those responsible to execute after the transaction do not understand the “whys” and embrace the combination, it will likely fail to meet expectations.

**Second, Directors and the Operating Team are Onboard.** The acquirer’s Board of Directors should have agreed in advance on an investing for “growth through acquisition” strategy before the target acquisition or combination is proposed to the Board for initial approval.

Unlike the recent past, today’s more aggressive public Board governance practices do not allow a “rubber stamp” on investments the CEO wants to make. When the buyer or seller is a privately held or family owned company, all of the shareholders and critical stakeholders must be in agreement with the reasons for the transaction and understand the implications of legacy, liquidity, and life after the transaction. Without this understanding, there is a risk the deal will not close and the opportunity for a value creating combination may not reoccur for either the buyer or seller. Time alone does not assure a business will become more valuable in the future. In fact, history suggests that timing is a critical success factor, especially in periods of rapid change in technology and competition. Understanding timing considerations is especially critical for the private buyer or seller.

The acquirer’s operating team must, like the Board and senior management, be aligned with a “growth through acquisition” strategy and this strategy must be equal to or greater than possible internal growth. Proposing a transaction that is off-agenda is unlikely to gain support in execution and value will be lost to passive-aggressive behavior. Advisors and company Board of Directors will want to advance this kind of strategic questioning of management on the topic of growth or value alternatives and seek consensus before starting on a course of acquisition, investment or sale.

**Third, Don’t Assume the Investor Will Bet the Bank.** The new investment to net worth or market capitalization ratio of the investor should ideally be no more than 20% of the investment required to complete the acquisition; short of that there is a risk the transaction will not close, will not earn the cost of capital, and will be severely hampered in execution. There have been exceptions to this ratio

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but success has been limited. Even common industry mergers that have limited operating risk are vulnerable when the ratio of market cap to investment is breached. For example, Fairpoint Communications' (FP) investment in Verizon's (VZ) New England telephone business was 400% of their net worth. Fairpoint filed for Chapter 11 in 2009. The relationship of investment to net worth is especially important when selling shareholders are taking an earn-out or when they retain some investment in the selling entity. VZ wrote off their investment in FP.

**Fourth, Buyer Past Behavior and Corporate DNA Influences Value.** Before the buyer or seller's advisors approach any potential target, understanding past practices, behaviors, and decision making DNA of the target must be known. For example, the acquirer must have made several premium value acquisitions where each combination was successful upon integration. Past implementation success provides a high level of confidence that the transaction will close and that the value for the seller will be at a premium. Investors with the experience and skill to integrate have confidence in their ability to create incremental value and as a result, are willing to provide a significantly higher value to the transaction. First time investors or those with limited implementation success will often assign a lower value to a transaction due to their lack of confidence in the future value to be created. In this case, a "valuation gap" will occur and the combination may not close. Sellers and their advisors should avoid first time buyers or buyers without a track record of value creating integration. Exxon's (XOM) acquisition of Mobil at 12x EBITDA was a significant premium over Exxon's market multiple and premium over any other bidders. Happily, XOM's ability to extract value and create capital returns out of the transaction was far greater than the premium paid. XOM's return on capital has since improved from 20% to over 30%. Successful execution experience translates into a greater willingness to pay a premium price to sellers. Investor behavior and their corporate DNA drives value creation more than most industry observers realize.

**Fifth, Cash in the Bank May Create More Value than Cash from the Bank.** The buyer or seller's advisors will want to learn if the parties have sufficient cash resources on the balance sheet to close the transaction without borrowing significant additional funds. Typically the need for significant financing lowers the valuation.

Sellers need to be mindful that acquirers without readily available resources or credit lines cannot assign a premium to the combination and cannot control closing because of external decision makers. Investors requiring external financing will assign a value as a function of capital cost and the bank's willingness to lend, versus the true value the combination represents. Those who are advising sellers want to be aware that confidentiality may become unnecessarily breached if the seller's intentions are shared with buyers unable to

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consummate the transaction with available cash resources. There is an additional factor in value, and that is in process. Contrary to popular belief and practices, an auction process with “confidential books” and multiple buyers may depress value and compromise confidentiality. The “best” buyers may wait out the process, leaving the least able to participate.

**Sixth, Return on Capital Improves for Both Parties.** The chances for a timely closing and a premium value transaction are greatly improved when the combination creates true sustainable enterprise value and the return on capital for each entity is improved, resulting in enhanced financial metrics for the combined company.

One example is eBay’s acquisition of PayPal in 2002. While the street did not believe the acquisition would be value creating, it is worth noting that most of the eight value creating factors suggested here were in fact present. The purchase price of \$1.5 billion was nearly 40x EBITDA and yet it became accretive in three years and for 2009 PayPal’s growth and return on capital exceeds that of eBay’s! And then, there was the 2010 acquisition of PNC Financial Services’ back office operations by BNY Mellon at a valuation of 35x EBITDA! Another example of a high value multiple was Proctor & Gamble’s acquisition of Gillette at 12x. For several years, P&G’s return on capital averaged 23% but for the three years following the merger, Gillette’s average return on capital has dropped to 12%; maybe this is a growth versus profitability trade-off, but shareholders aren’t sure.

The combination proposed must have an expected high degree of future financial success in order to assure a timely closing and a premium value to sellers. Given the high level of scrutiny from banks and from Wall Street, the merger must be shown to be accretive within three years without questionable assumptions. Advisors who understand the need for an accretive transaction need to work cooperatively with all sides.

**Seventh, Culture Counts.** Understanding the cultures and the cultural fit of human capital on the combination is extremely important, especially in service organizations. Advisors, bankers, and Boards must determine if there is a cultural fit, and this determination must take place early in the discussion stage. Few behaviors will impede execution and destroy value more than a clash of cultures. This is critical when there are seller earn-outs, escrows, contingencies, stock or debt take backs in the transaction. There are several conspicuous examples of culture clashes that diminished value. One example is the famous Snapple Beverages culture clash. Quaker Oats purchased Snapple for \$1.7 billion and sold it for \$300 million just a few years later. The clash of the entrepreneurial Snapple culture with the button-down bureaucratic culture of Quaker Oats was too great. The loss of shareholder value when Snapple was sold exceeded \$1.4 billion.

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**Eight, Value Creating Behaviors Trump Negotiating Tactics.** Most often, successful high value transactions close keeping with the original terms and conditions because both sides wish this to be and only limited negotiation on key points needs to take place. Bidding contests, intimidation, mock auctions, and briefcase slamming tactics are a relic of past legal and investment banking practices. Successful combinations that create sustainable enterprise value are driven by mutual agreements, common expectations, and pre-determined outcomes. Experienced investors seek to add value for their shareholders not by low multiple acquisitions done with bare knuckle negotiations, but by creating combined strategic value. Oddly enough, issues of impairment occur more often on “bargain” purchases than on “high value” purchases. Transactions succeed or fail less because of the price paid and more because of the timely execution of the value creating opportunity the transaction represents. Investors in the past often said to sellers, “we are not about to pay for the value we bring to the seller.” Today’s investors expect to pay for the value they bring and it is the skill of the seller’s advisors to understand the behaviors that enable the value creating process to succeed.

#### **LESSONS LEARNED ABOUT VALUE CREATION IN BUSINESS COMBINATIONS**

There are many examples of successful transactions that embrace the kinds of value creating and value capturing behaviors referenced here. Unfortunately, there are also examples of failed transactions. Perhaps the most conspicuous example of value diminished is the Time Warner-AOL combination. As best we can determine, nearly every one of the eight critical success factors suggested here was violated. And were there any consequences? The value of Time Warner before the transaction was \$63 billion and after merging with AOL, the combined net worth was \$157 billion. Just nine years later in 2009, the value of the enterprise was \$36 billion; \$121 billion in enterprise value was lost. This did not need to happen.

## **ABOUT THE BIGELOW COMPANY**

Originally established in 1935, The Bigelow Company focuses exclusively on working with the most successful market leading private owner-managed companies in North America. Bigelow provides objective advice to its clients on matters of business strategy, ownership succession, and organizational succession, leading to the successful outcomes of value creation, and someday, capturing the value they have worked so passionately to build.

As we look together at the current landscape of uncertainty, perhaps only a few things are clear: once-successful behavior patterns will not be sufficient to survive, let alone flourish in uncertain future economic scenarios. Embracing change and understanding the options as a means to create increased enterprise value for all stakeholders is always important, but critical in times of uncertainty. Bringing about that change in private entrepreneurial organizations, where ownership and management control is frequently concentrated, can be daunting for advisors who are inexperienced in that domain.

Senior Members of The Bigelow Investment Banking Team have been active participants in successfully advising hundreds of companies in dozens of industries over multiple business cycles. Clients tell us this transferable “scar tissue” has provided them with invaluable insight on behaviors and strategies that enable enterprises to earn superior returns and a premium enterprise value.

Bigelow’s proprietary tools are based upon the artful query of entrepreneurs, investors, stakeholders, and their advisors. Because change creates opportunity, these tools illuminate ways for CEO’s, Boards, and other expert advisors to systematically understand behaviors, corporate, and personal DNA and the techniques needed for the allocation of resources to drive successful change and in turn create enterprise value.

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