HOW TO

Model The Strategic Aspect Of A Merger Or Acquisition

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Abstract

The following document explains how to model the strategic aspect of a Merger or Acquisition. Conducing a full audit of the purchasing company and its target will illustrate where the two organisations are competitive, where they are complementary (so, where there could be 'synergy') and provide some estimates into the possible economic performance of the merged operation.

Strategic Modelling Of Mergers & Acquisitions

One of the commonly cited reasons for failure of corporate merger is the lack of strategic compatibility between the purchasing and the target organisations.

During the pre-acquisition, due diligence, phase much effort is put into the financial dimension of the target company. However, questions relating to the degree of commonality between the two organisations at the product / market level may be sidestepped. One organisation may quite legitimately target another, although there is little synergy of product offering, or perhaps even a direct clash, simply because on paper 'the numbers look good'. (A classic example of an unsuccessful merger was the sale during the late 1980's of automobile manufacturer British Leyland by the UK government to Aerospace supplier BAE Systems – probably more for the short term financial inducements rather than any long term synergistic benefit to the buyer. As predicted by many, the relationship lasted little more than the statutory five years with British Leyland being sold on to BMW, and BAE returning to its core businesses.)

Conglomerate organisations may ultimately defend their right to target operations with little commonality, pointing to organisations, like Virgin Group, which have been spectacularly successful. However, targeting those organisations with *complementary* product offerings, reducing competition, increasing the customer base and improving the purchasing company's 'buying' capability are all legitimate reasons for merger – and under such circumstances the more that is understood about the nature of the target company's business the better!

An Effective Framework

The following approach, developed by Market Modelling Limited in response to requests from two US based clients, provides an effective framework for considering such issues. This is not a panacea solution that will guarantee the success of every merger or acquisition. Even after one has completed the financial due diligence and strategic modelling exercises to a professional level, it is still possible for mergers to fail because of cultural differences, over-ambitions expectations, miscalculation of costs, or lack of follow-through at the tactical level. However, undertaking such analysis means that executives will at least be able to prove that they have given adequate consideration to the 'strategic' dimension, and may approach the matter with more confidence.

The key stages (Diagram 1) are for the purchasing company to model its own capability in the marketplace, model the target, and then uniquely 'combine' both pictures to establish where the two companies compete (and, if so, who is likely to lead the field) and also where there are complementary product offerings. A final scenario that models the likely 'Merged

Venture' can also be developed, enabling the user to assess the overall content and size of the new portfolio, and whether the proposed venture is likely to add to the financial performance of the company, or whether there is little to be gained!

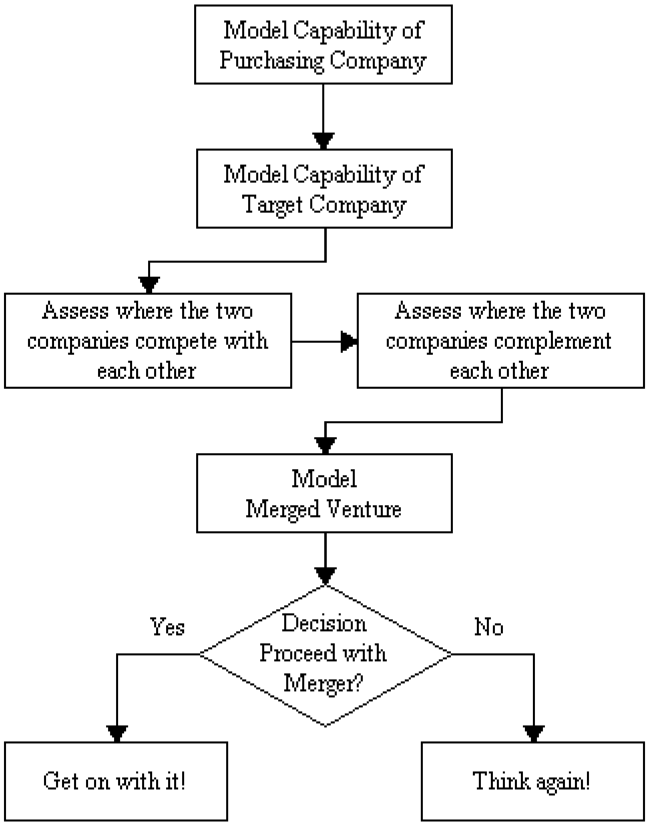

Diagram 1 - Modelling Mergers and Acquisitions - The Strategic Process

A wide range of well-known analyses that should be familiar to the strategist will help to make sense of the underlying data, including the Boston Matrix, Directional Policy Matrix, Perceptual Maps and Gap Analysis.

Stage 1 - Modelling the Purchasing Company

Let us consider a simple exercise. The purchasing company is a fictional supplier of computerised document management systems. As can be seen from the Segmentation Matrix (Diagram 2), in this example the company currently addresses three key 'public sector' segments within the UK, namely 'Education', 'Healthcare' and 'Local Government'. It has also identified 'Utilities' within the private sector as worthy of special attention. The company markets one product to all four market segments, i.e. 'Document Management Systems', and – largely for historic reasons – 'Systems Integration Services' to the Local Government sector. Because of the typically fragmented nature of project, the purchasing company has avoided selling Systems Integration Services to other segments of the market (marked 'Null' in the Segmentation Matrix) and indeed is currently contemplating whether this element of the portfolio should be retained or divested.

		Market Segments			
		Education	Healthcare	Local Government	Utilities
Products	Document Management Systems				
	Systems Integration Services	Null	Null		Null

Diagram 2 - Segmentation Matrix for the Purchasing Company.
Each Niche has been colour coded for clarity in later analysis.

Audit and Data

Having defined the purchasing company's range of products, services and market segments, a Marketing Audit should be undertaken. All five 'Niches' of the market are rigorously assessed for Attractiveness of Opportunity, taking into consideration issues such as 'Market Potential', 'Fit with Core Skills', 'Accessibility', 'Cost of Market Entry' and 'Competitive Intensity'. An example of a typical scorecard is shown below. Analysis of the data after weighting and scoring provides a view of the overall attractiveness of each opportunity. This topic is dealt with more fully in the associated publication 'How To Determine Market Attractiveness Using The Simple Multi-attribute Rating Technique (SMART)'.

Market Attractiveness Scorecard - Document Management Systems / Education		
Market Attractiveness Factor	Swing Weight	Score
Market Potential (£GM, Periods 2007 – 2009)	100	3,381,158.60
Fit With Core Skills (0 – 100 Scale)	70	65.00
Market Accessibility (0 – 100 Scale)	50	85.00
Cost of Market Entry (£)	30	125,000.00
Competitive Intensity (0 – 100 Scale)	20	50.00

Diagram 3 – Example Market Attractiveness Scorecard.
A similar scorecard will be required for each Niche.

A similar exercise is undertaken when assessing competitive position. Critical Success Factors, such as 'Product Design', 'Support Capability' and 'Price' – all of which are important to the customer – are defined as appropriate. Key competitors are also defined, including the target company, which is known to compete in some of the same market areas as the purchasing company. Completing the data set with weights and scores for each supplier provides an analysis of competitive position, together with an analysis of competitive strengths and weaknesses. This topic is dealt with more fully in the associated publication 'How To Determine Competitive Position Using The Simple Multi-attribute Rating Technique (SMART)'.

Competitive Position Scorecard - Document Management Systems / Education				
Market Attractiveness Factor	Swing Weight	Purchasing Company	Target Company	Supplier B
Perceived Use Value (0 – 100 Scale)	100	90.00	0.00	100
Perceived Price (0 – 100 Scale)	70	850.00	750	800

Diagram 4 – Example Competitive Position Scorecard. Note that in this instance both the Purchasing Company and the Target Company are operating in the same market space. A similar scorecard will be required for each Niche.

The Marketing Audit is completed with an independent view about the overall financial performance of the market and key suppliers. Trends (i.e. anticipated rates of growth or contraction) are also noted. Remember that the data should be amortised to the level of Product / Market Segment, so whilst published secondary research information may be a useful starting point, it is quite probable that any ‘off the peg’ figures will need to be recast in line with the boundaries of your market segments.

Market History And Forecast Data – Document Management Systems / Education					
	Year 1 Jan 2005 – Dec 2005	Year 2 Jan 2006 – Dec 2006	Year 3 Jan 2007 – Dec 2007	Year 4 Jan 2008 – Dec 2008	Year 5 Jan 2009 – Dec 2009
Niche Revenue (£)	4,000,000.00	4,345,000.00	4,719,000.00	5,124,350.00	5,563,390.00
Purchasing Company Revenue (£)	800,000.00	948,000.00	1,092,222.00	1,232,000.00	1,368,000.00
Target Company Revenue (£)	800,000.00	869,000.00	936,000.00	1,001,000.00	1,064,000.00
Supplier B Revenue (£)	2,400,000.00	2,449,000.00	2,574,000.00	2,772,000.00	3,040,000.00

Diagram 5 – Example Market History And Forecast Table

Analyses Of Purchasing Company

Once the data collection has been completed, a wide range of textbook analyses now becomes available to illustrate the current status of the purchasing company, including ‘Product Life Cycle’, ‘Share’, ‘Market Attractiveness’, ‘Competitive Position’, the ‘Boston Matrix’, the ‘Directional Policy Matrix’, ‘Perceptual Maps’ and ‘Gap Analysis’. In particular, the Boston Matrix (Diagram 6) reveals an interesting problem. That is, whilst two good ‘Cash Cows’ (representing Utilities and Local Government respectively) are capable of funding the newer and more highly focused opportunities in Healthcare and Education, the purchasing company currently finds itself in a trailing position in the market with those new opportunities:

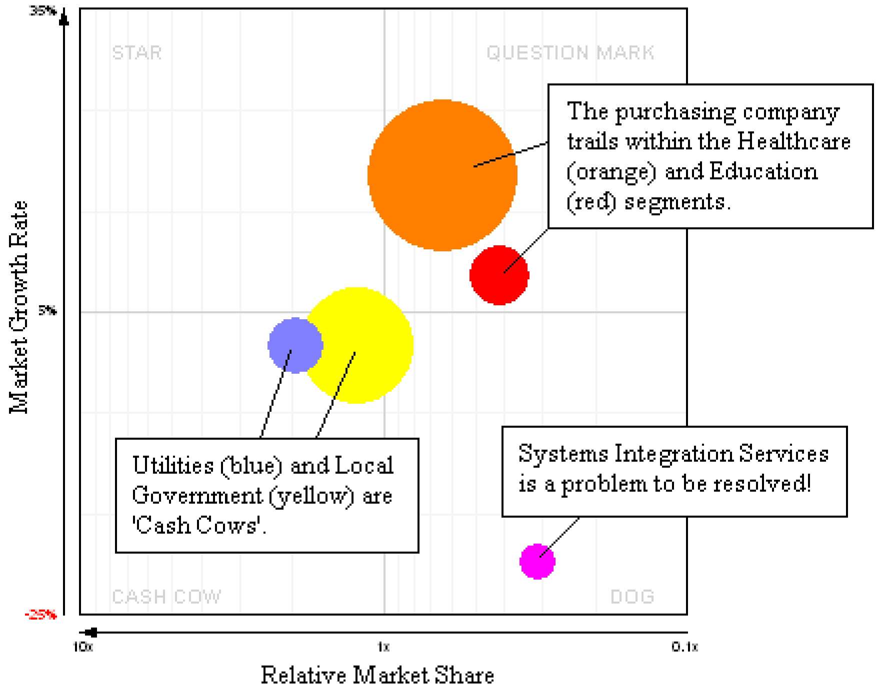

Diagram 6 - Boston Matrix for Purchasing Company. For details on how the Boston Matrix is plotted, see the associated publication 'How To Plot And Interpret The Boston Matrix'.

Moreover, the company shows a significant gap in performance between overall financial objectives and cumulative forecasts for all of its initiatives. Any proposed merger should at least be capable of addressing these two issues.

Stage 2 - Modelling the Target

Having completed analysis of the purchasing company, it is time to move on to the target, and a second model is now created, this time from the target's perspective. A thorough examination of the target is required, the necessary data most likely having been interpolated from a structured and detailed competitive intelligence exercise. The new model reflects the following:

1. The target competes with the purchasing company in the 'Education', 'Healthcare' and 'Local Government' segments. (Notice that the colour coding has been retained over both scenarios).
2. The target does not address the 'Utilities' segment, which has been deleted from the Segmentation Matrix.
3. The target does, however, address the 'Financial' segment that is complementary to the areas tackled by the purchasing company. This new segment has been added to the Segmentation Matrix.
4. The target only offers System Integration Services to the 'Financial' segment. Its presence here implies a level of expertise within the private sector that the purchasing company does not currently possess. The Segmentation Matrix for the target is shown in Diagram 5 below.

5. All data has necessarily been adjusted to reflect the position of the target and the incorporation of the purchasing company in relevant Niches, this time as a competitor.

		Market Segments			
		Education	Healthcare	Local Government	Financial
Products	Document Management Systems				
	Systems Integration Services	Null	Null	Null	

Diagram 5 - Segmentation Matrix for the target company.

As shown Diagram 6, which superimposes the Boston Matrices of both organisations, there are several areas where both organisations compete head-on. Notably, the target offers a better solution in the 'Healthcare' (orange) segment, which is perceived as a critical market area. It also possesses one sizeable 'Cash Cow' service, which should be capable of providing much required cash and one new non-competitive 'Star' opportunity in the financial sector, which will require funding through growth. Sadly, both companies trail in 'Education' (red), which is known to be a significant opportunity. Some comfort may be taken by combining revenues from both organisations, which will result in an improved competitive position relative to all other suppliers; if not, the purchasing company may have to find an alternative acquisition, or use its resources to develop a more competitive solution with which to address this area of the market.

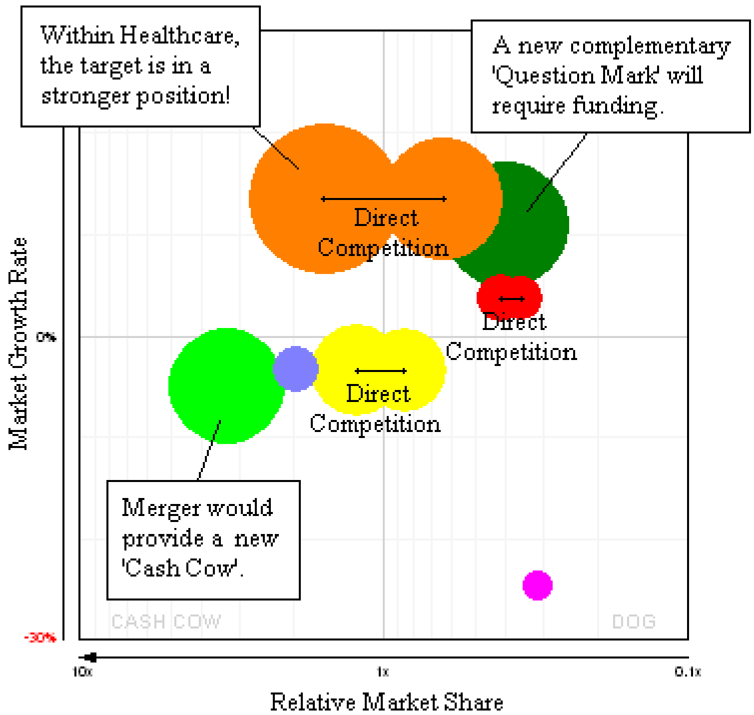

Diagram 6 - Superimposing the Purchasing and Target Companies.

Assuming that the relevant data has been collected, the Directional Policy Matrix (GE Matrix) may provide a popular alternative portfolio technique to the Boston Matrix.

Stage 3 - A Combined Operation

The final stage of the process is to generate a third and final Scenario that reflects a combined operation should the two companies merge (See Diagram 7). The Segmentation Matrix manifests the segments of both companies. The target, whose operations have now been effectively taken over, has been excluded from the Scenario and the projected sales of the target have now been merged with those of the purchasing company.

Since it is unlikely that the performance of the combined operation will exactly total the sum of the two companies working autonomously, the trends have been moderated. Assuming that the takeover will be rapid, all figures are adjusted from the current year.

		Market Segments				
		Education	Healthcare	Local Government	Utilities	Financial
Products	Document M'gment Systems					
	Systems Integration Services	Null	Null		Null	

Diagram 7 - Segmentation Matrix for the Combined Operation.

The Gap Analysis chart shows a much healthier picture with forecasts now exceeding objectives to the extent that some upwards revision to objectives from 2007 may be called for.

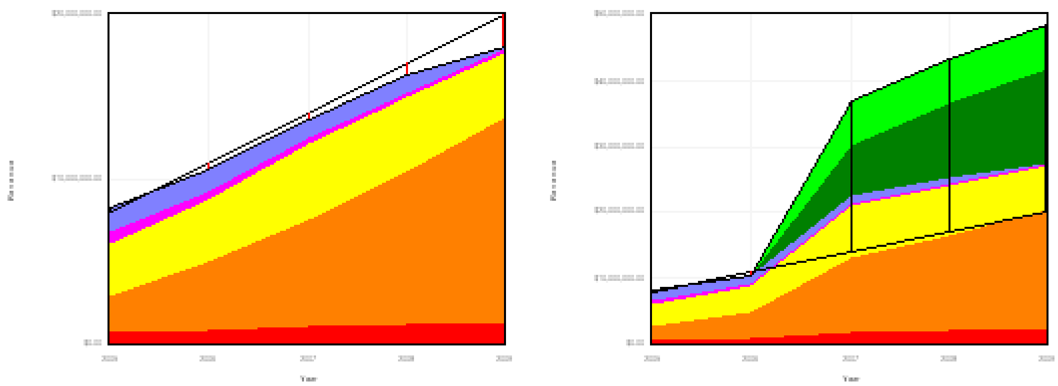

Diagram 8 - Gap Analysis - Before and After.
Notice (left) the Pre-Merger situation of the Purchasing Company. There is a negative gap between the black Objectives line and the Cumulative Forecast. Also notice the healthier Merged Venture (right), which shows a large positive gap.

An issue that the purchasing company still needs to address is what to do about Systems Integration Services. With 'Education', 'Healthcare' and 'Utilities' missing, the portfolio is incomplete. Until now the company has avoided these opportunities, but, as has been pointed out, acquisition of the target may bring some of the necessary skills on board and potentially generate cash to fund the new raft of initiatives. The purchasing company now has to decide whether it should:

1. Maintain the current portfolio, and see how it performs over the coming two years.
2. Divest the Systems Integration Services element of the business, effectively slimming down to a hardware supplier only. This may be a dangerous move. Apart from the financial knock that the company would take, it may find it necessary to offer Systems Integration Services, in order to present an adequate solution to the client – especially in the 'Financial' segment!
3. 'Open up' the services sector by investing in the three Niches that the company has hitherto avoided.

In order to reach a satisfactory decision the company would need (amongst other things) to undertake a further audit of those Niches and incorporate the required data about market potential, competition and market trend within the model.

Conclusion

This is not a panacea solution that will guarantee the success of every merger or acquisition. Even after one has completed the financial due diligence and strategic modelling exercises to a professional level, it is still possible for mergers to fail because of cultural differences, over-ambitions expectations, miscalculation of costs, or lack of follow-through at the tactical level. However, undertaking such analysis means that executives will at least be able to prove that they have given adequate consideration to the 'strategic' dimension, and may approach the matter with more confidence.