9 Managerial Motivation and Corporate Takeover

Introduction

If analysts could successfully measure the going-concern value of business assets based on their income potential using data drawn directly from published accounts, the valuation of one company by another for the purpose of takeover would present little difficulty. Unfortunately, even financial information based on GAAP data (generally accepted accounting principles) measures different assets in different ways, so that a value cannot be placed on a company as a whole. With the exception of property, fixed assets may be seen in balance sheets at their *net book value* (historic cost less depreciation) rather than market value. The inventory (stock) components of current assets may be valued at market value or cost, whichever is the lower. Moreover, intangible items, including brand names, and human resources may be ignored altogether. There are also the effects of synergy and the residual value of excess or idle assets to consider.

Fortunately, alternative approaches to share valuation are available to investors, which are not asset based but income driven. These utilise discounted revenue theory and the capitalisation of a perpetual annuity (using dividends or earnings) that can be made operational through a series of investment ratios. As we explained in the Chapter Eight, each may assist the analyst when determining the market capitalisation of equity and a price per share based on the maintainable yield for a company coming to the market for the first time. We shall now develop this concept further, through a series of activities concerning the most important strategic decision that corporate management is ever likely to encounter:

- How to value a business as a going concern in the event that it falls prey to takeover

Whereas companies seeking a stock exchange listing are motivated primarily by the need to finance expansion, which must satisfy the expectations of future shareholders, we shall discover that the rationale for expansion through takeover activity is more varied and complex. So much so, that it may run counter to wealth maximisation criteria and shareholder welfare.

First, we shall present an overview of the motivational factors that underpin the case for composite business entities and the problems which can ensue. The reasons why the majority of takeovers fail to match shareholders' expectations will also become clear.

Armed with this information, in subsequent Chapters we shall evaluate various methodologies for equity valuation once a company has selected another for acquisition. Finally, we shall review the case for managerial takeover activity from a shareholder perspective.

9.1 Objective Motivational Factors

Before a *predator* company pounces on a *target* company with a share bid, it seems reasonable to assume that management's over-arching objective for the takeover should be to:

Maximise current shareholders' wealth through a significant improvement in long-term earnings post-acquisition (the agency principle).

This normative objective should be supported by a comprehensive analysis of a company's strategic *commercial* considerations to satisfy *shareholder* expectations, which embrace:

Business areas
Resource areas
Influence areas

- *Business* areas are those sections of the domestic and global economy that receives the company's output.
- *Resource* relates to the firm's inputs of finance, assets and personnel.
- *Influence* represents those constraints upon the business and resource decisions of the firm which arise from legal limitations, societal pressures and the self-interest of internal and external non-managerial groups.

Given the wealth maximisation criterion of the predator firm and the *influence* constraints imposed upon it, the *business* motives (illustrated in Figure 9.1) commonly advanced by management to justify an acquisition programme are to:

(i) establish a balanced diversified portfolio of investment which will either maximise or stabilise post-tax earnings commensurate with risk

(ii) balance product life cycles

(iii) secure economies of scale and achieve synergy

(iv) avoid barriers to entry

(v) increase or maintain market share

(vi) increase or maintain the rate of growth

(vii) reduce competition

(viii) secure new products or services

(ix) guarantee outlets for existing products and services

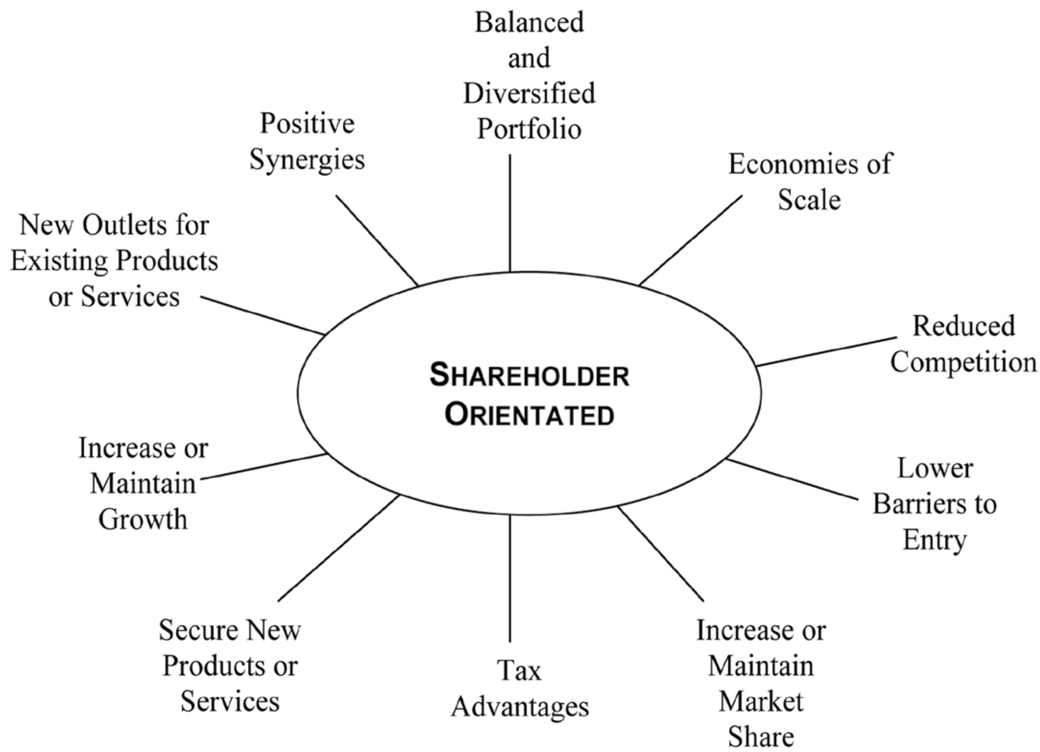

Figure 9.1: Objective Managerial Motives for Acquisition or Takeover

The greatest problem that confronts predatory companies is *resource* risk associated with their inventory supply chain. Three threats can be envisaged depending on the company's degree of market independence. One is a supplier's decision to switch its allegiance to another company. Secondly, a supplier may suffer financial distress because of takeover activity, which necessitates a rescue operation, or even its acquisition. Finally, there might be the possibility of a supplier being acquired by a competitor that requires a pre-emptive strike.

Other resource factors that could also justify an acquisition are the availability of excess funds from reserves, the sale of fixed assets or working capital, the benefits of tax advantages and the procurement of valuable personnel (workforce or management).

Now, assuming that a strategic analysis of corporate wealth maximisation objectives confirms the rationale for expansion, management's options are either an external acquisition, or internal investment. Two economic criteria should favour the former:

- Speed
- Cost

Obviously, there are trade-offs. Time must be compared to cost. Cost must be assessed in relation to benefit and the potential earnings that the takeover delivers.

9.2 Subjective Motivational Factors

If you Google the track record of corporate takeovers world wide, the literature reveals that its failure rate is substantial, characterised by mediocre acquisitions undertaken by inept management. Even at the millennium after a long bull run (before the dot.com and banking crises kicked in) Lane, Stewart and Francis (2001) reveal that post-merger indicators of investment performance, such as the return earned by shareholders from cash dividends and capital gains, are frequently worse than the average performance of other firms in respective industries.

A significant factor in determining the success of acquisitions is the establishment of a corporate strategy and a rigorous acquisition plan. Historically, a lack of pre-planning alongside a reluctance to quantify the benefits expected to be gained from a merger is a common theme throughout the literature.

For these reasons, a prerequisite for any acquisition strategy should be a *rational* consideration of the *objective* motivation based on shareholder wealth maximisation. However, a variety of other managerial motives exist that are not derived from commercial considerations. They are termed *subjective*, yet may be supported by an elaborate rationale

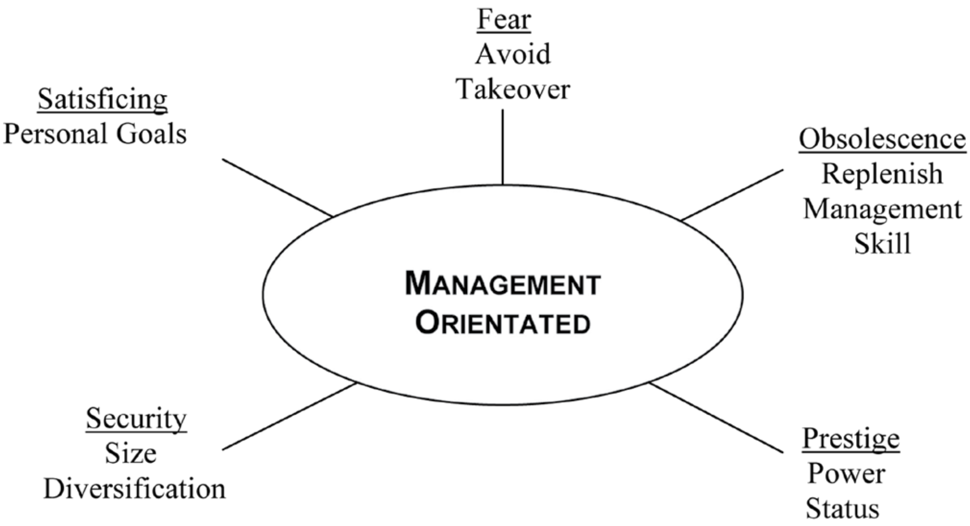

Figure 9.2: Subjective Managerial Motives for Acquisition or Takeover

As Figure 9.2 reveals, two such motives relate to *fear* and *obsolescence*. The former is premised on the belief that unless the company expands or diversifies, larger companies will destroy it. This sets in motion a process of accretion. Obsolescence is connected with ageing organisations that display increasingly rigid and systematised bureaucracies. The scope for individual initiative and spontaneity are stifled, which results in both an obsolescent organisation and an obsolescent management. One solution to the problem that can be traced back over decades is to buy in management through corporate acquisition, if only for its Chief Executive.

Unfortunately, both fear and obsolescence carry with them unconscious underlying attitudes. Fear initially leads to a denial of being afraid and then an attempt to "tighten up" the company and to turn it around. Obsolescence produces a defensive attitude of superiority, typically based on the firm's longevity and to a redoubling of effort. The effect of these underlying attitudes (and the fact that in a merger the acquiring company will be the dominant party) tends to produce a condescending attitude toward the acquired company and efforts to manipulate and to control it.

Controlling behaviour is the pivotal issue. The dominant organisation believes that it must incorporate the same processes and procedures in all of its components. But the imposed control systems may well stifle the very qualities of initiative and spontaneity that lay behind the initial acquisition. What may emerge is resentment, contempt and loss of innovative personnel, all of which necessitates buying in yet another completely new management group. However, the replacement executive might be more bureaucratic, given that their brief will be to re-control the organisation. This control focus on the part of the host organisation is therefore self-defeating.

Of course, fear and obsolescence are only partial explanations of the quest for corporate growth. As causal factors, they only apply to those companies who react to the growth of others. They do not explain the preoccupation with growth for its own sake, characterised by the "fast track" corporate sector associated with global conglomerate mergers, management buy-outs (MBO's) and the leveraged buy-outs (LBO's) of mature public companies by *venture capitalists* since the 1980s. Here, the desire for growth is premised on the belief that "size matters". Diversification through participation in several industries increases the chance of success. However, the downside is that without serious commercial considerations, diversification also increases the possibility of failure.

Given the separation of ownership from control and a lack of corporate governance, takeovers may also be instigated by management without shareholder consultation (a breakdown of the *agent-principle* relationship). Again, predatory management may be motivated primarily by growth for its own sake measured by size criteria (such as sales turnover, assets and number of employees) and a perception of increased *power, prestige and security* which this brings. Their concern for growth in earnings may be secondary or diluted by other personal and group goals, which leads to *satisficing* profit behaviour. On the other hand, responsible management who behave *optimally* should only be interested in shareholder wealth maximisation, evidenced by the growth of corporate stock values through improved earnings and hence dividends and capital gains.

Thus, power, size and prestige are intermingled managerial goals, which may be achieved in the *short-term* by a policy of acquisitions. But they may conflict with the security provided by the pursuit of shareholders' *long-term* financial objectives. Nor is this a recent phenomenon. As Maldanado and Saunders observed way back in 1981, acquisitions often fail because management satisfy their own interests, rather than those of shareholders.

A subject we shall reconsider in our final Chapter.

Summary and Conclusions

Subjective managerial motivational factors may be supported by an elaborate rationale. However, they are no substitute for normative *objective* goals based on a comprehensive analysis of a company's strategic *commercial* considerations. This should precede any acquisition to satisfy shareholder expectations post-takeover.

If a takeover is not part of a carefully conceived strategic corporate plan that reflects commercial factors other than earnings potential (for example *asset stripping*) the predatory company may inherit a poor return on investment, just like takeovers premised upon the *subjective* managerial goals of growth, prestige and security outlined earlier. As a consequence, investor confidence will evaporate rapidly and equity prices will tumble.

Selected References

1) Lane, K., Stewart, R. and Francis, S., "Merger and Acquisitions: What the Stock Market Wants to Know About a Merger", Strategic Merger and Acquisition Practice of Price, Waterhouse and Cooper (Philadelphia) 2001.
2) Maldanado, R. and Saunders, A., "International Portfolio Diversification and the Intemporal Stability of International Stock Market Relationships", *Financial Management*, Autumn, 1981.