[Management Services: A Magazine of Planning, Systems, and Controls](https://egrove.olemiss.edu/mgmtservices)

Volume 1 | Number 5 Article 3

11-1964

Neglected Areas In Acquisition Evaluations

David F. Linowes

Many mergers fail because managements, submerged by tactical details, do not take time—in time—for strategical planning. The major elements of such planning, particularly the use of personnel, are reviewed in this analysis of—

NEGLECTED AREAS IN ACQUISITION EVALUATIONS

by David F. Linowes
S. D. Leidesdorf & Co.

EVEN in the most casually managed companies many hundreds of hours are typically spent by accountants, economists, lawyers, and others in evaluating an acquisition before the merger is finally consummated. Yet it has been estimated that in approximately two-thirds of all acquisitions the acquired companies operate unprofitably for several years after the merger date.

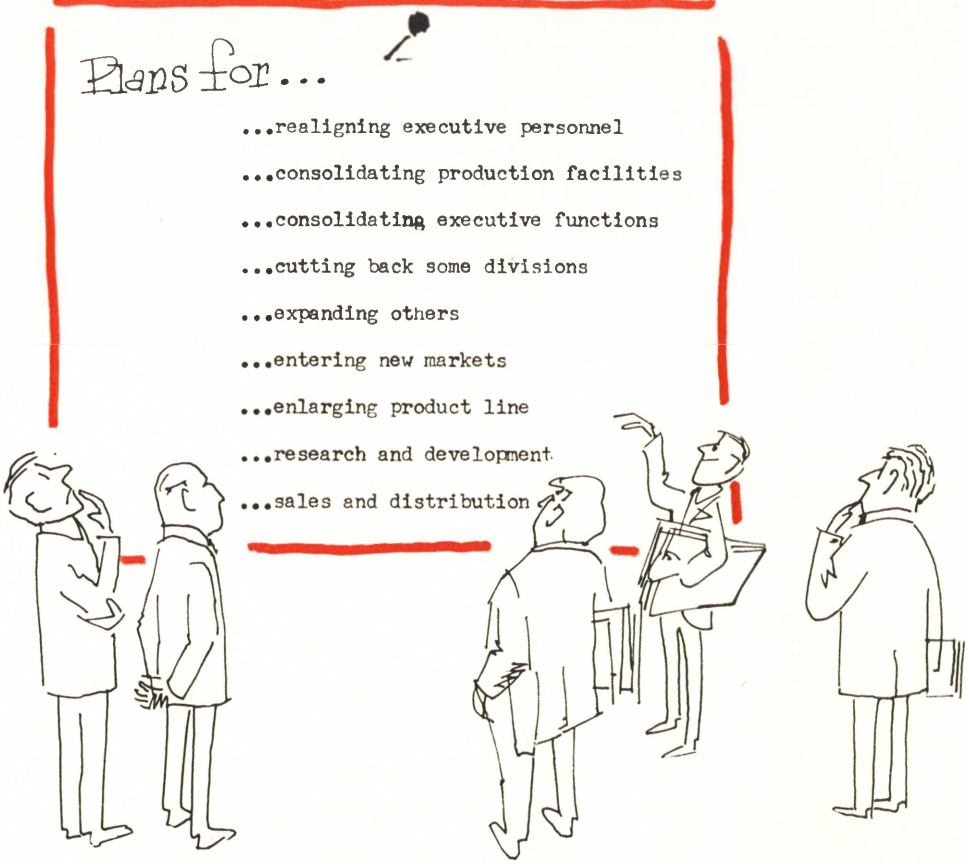
The missing ingredient in the overwhelming majority of acquisition situations is the planning of over-all strategy for the post-merger operations. The acquiring company must have a clear idea of just what it is going to do with the acquisition. Not only is early planning of great value in getting the merged enterprise off to a good start but it is also an indispensable part of the analysis of the desirability of the acquisition. After all, the real value of any acquired company lies not in itself but in its potential as a part of the acquiring company.

Unfortunately, there are so many facets to examine and weigh in a merger transaction and so few people available to do this work that in the great majority of cases practically all planning is on the tactical level. The immensely important strategical planning effort is postponed to a later date. That later date comes after the merger has been consummated—and then it is too late.

DAVID F. LINOWES, CPA, is a partner of S. D. Leidesdorf & Co. in New York City. He is currently treasurer of the American Institute of CPAs and a consultant to DATA International Assistance Corps. He has served as advisory committee member and lecturer of the American University Tax Institute. Mr. Linowes is a frequent contributor to professional publications.

Strategy vs. tactics

The tactical aspects of a merger transaction include the price negotiations, product analysis, evaluation of the company's status in its industry, the determination of asset values and liabilities to be assumed, legal matters, terms of payment for the purchase, and relationships with



The strategical aspects of a merger involve the long-term relationships between the acquired company and the acquiring company. Planning should be complete enough to carry the merged complex at least three years beyond the merger date.

retiring executives of the company being acquired. These tactical facets all involve questions whose answers are signed, sealed, and delivered on the merger date or within a few months thereafter. Too frequently all attention during merger negotiations is directed to these tactical matters at the expense of strategical matters.

The strategical aspects of a merger involve the long-term relationships between the acquired company and the acquiring company. They include plans for realigning executive personnel, plans for consolidating production facilities, plans for consolidating executive functions, plans for cutting back some of the divisions of the acquired company and expanding other divisions, plans for entering new market areas, plans for enlarging the product line of the company acquired, plans for consolidating the research and development laboratories of both companies, plans for consolidating the sales and distribution organizations of both companies, plans for instituting centralized or decentralized controls, and many other types of projections, all designed to carry the merged complex at least three years beyond the merger date.

All highly successful mergers have had substantial elements of this strategical planning. The fact that such planning has been done is often obvious from the announcements that are made at the time of the public disclosures of such mergers. These announcements set forth concrete plans for the operation and integration of the new facilities. The Ford Motor Company's acquisition of Philco Corporation is an example. Plans were stated at the time of the announcement of the acquisition and have been carried out.

This aspect of planning is not always identified as a separate aspect of a merger projection. In some form or other, however, it is essential. Ideally, to emphasize the importance of long-term merger planning, every evaluation of a merger should provide clearly for a separate strategical study.

Management

One of the most important ingredients of strategical planning is personnel planning, particularly the planning of the management organization. Many otherwise promising acquisitions founder because of the acquiring company's failure adequately to evaluate the management people for the long pull. Because this is also one of the most difficult tasks in strategical merger planning, much of the emphasis in this article will be on this subject.

The primary object of any business acquisition is growth, the kind of growth that increases material wealth for a business over a period of time. The organism for bringing about increment in wealth is a company's management hierarchy. Assets by themselves cannot create a net profit; they must be activated by an effective management team. No matter how valuable the physical plant may be or how protective the patents or trademarks may be, no profits can be created unless there is adequate management to convert these dormant assets into working mechanisms.

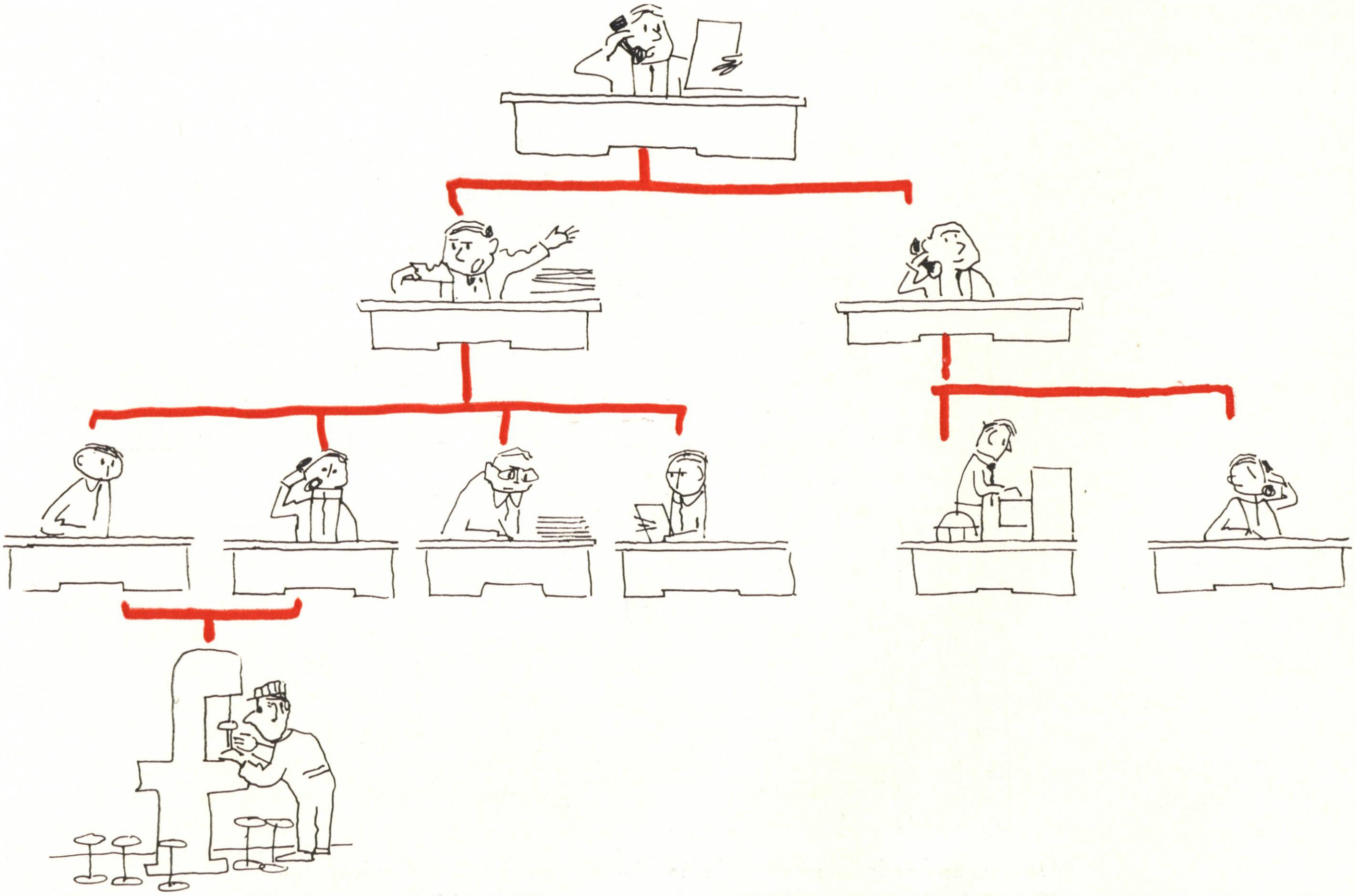
People are the tangible part of an organization. These people must be evaluated not only in terms of what they do and what they have done but also in terms of what they can do in the future, which means their intangible abilities.

It is not enough, however, to evaluate each executive in isolation. The relationships that exist among the various members of the management team may have a significant effect on the performance of each of them. Traditionally, these relationships are expressed in the form of organization charts, procedures manuals, and the like. In recent years behavioral scientists have demonstrated that the relationships which are formalized in this way are only one facet of the essential dealings that go to make up the working associations of the executive team. It has been proved that much management progress originates and is developed through the informal contacts one executive has with another, whether it be on the golf course, over cocktails, or walking to the commuter train.

How do we go about evaluating abilities and organizational relationships when measuring standards are inadequate or nonexistent? We do this by studying management people through what they have created within their own areas of responsibility. What is the make-up of the organizational team of people serving under an executive? Is it a successful team? Has the executive delegated work effectively? Are new ideas encouraged? Do things get done?

Creativity vs. order

To have capacity for future constructive progress a department must be dynamic and vital. If vitality and enthusiasm permeate the department, it is a good indication that the executive himself is dynamic and enthusiastic. In a progressive organization a spirit of constructive self-criticism pervades the air. Differences of opinion have a medium for outlet and are not suppressed in the interest of harmony. Honest, forthright expressions directed toward the department's ob-



The management hierarchy increases a company's wealth by converting dormant assets into working mechanisms.

Tomorrow's success depends on today's vitality and innovativeness . . .

jectives and its ultimate good are not stifled.

The current success of a department is directly attributable to the vitality and dynamism of the organization in the recent past. Tomorrow's success depends on the vitality and innovativeness that exist today.

These characteristics cannot be measured quantitatively, of course. Yet much can be learned by talking to and observing executives, managers, and submanagers.

Look into each executive's typical work day. Too much emphasis need not be placed on tidy surroundings and rigid schedules. A smoothly running office and a neat, orderly desk may be evidence of efficiency—but not necessarily.

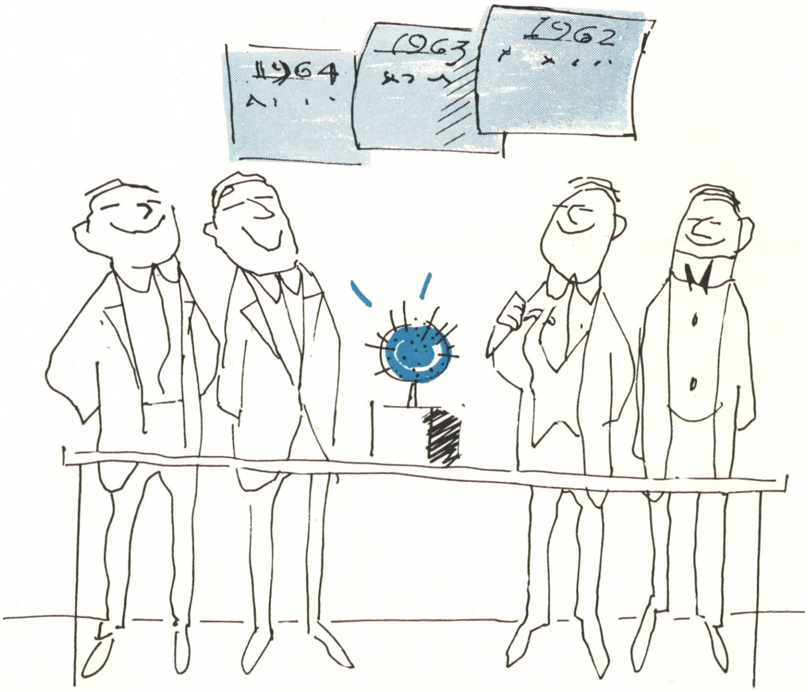
Take the case of the Y Electronics Company, which had been in business about four years when it was acquired by a much larger company. The Y Company had been started by a physicist and an engineer, each in his thirties, who had previously worked for a large, very successful electronics company. They had left their former positions to set up their own company to make a "new type" of electronic component for which demand was quite heavy and constantly increasing. The company had shown excellent progress, with sales and profits more than doubling in each of the three years immediately preceding the merger. At the time it was acquired it employed more than one hundred people.

The physicist president turned administrator kept the plant and office in immaculate condition. Cleanliness and orderliness were given top priority. Every item had its designated slot. The purchaser's representatives investigating Y Company were very impressed by the apparent efficiency with which the business was conducted—so much so that they completely overlooked assessing the creativity of the management.

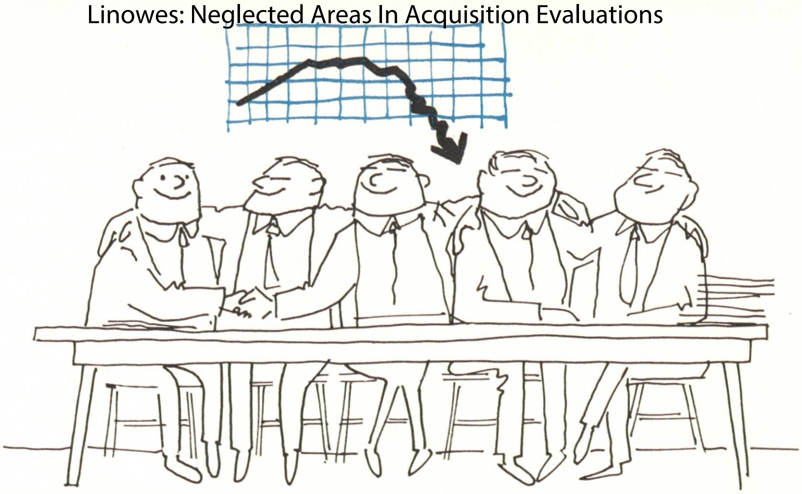
About a year and a half after the acquisition, however, sales leveled off. Many of Y Company's customers were setting up their own facilities to make the component, and sales resistance stiffened.

It was obvious that new products were urgently needed. But, try as they might, the young physicist and the young engineer could not come up with anything to supplement the lagging sales. They lacked the imagination and creativity to develop anything original. It turned out that the idea for the "new type" of component upon which their business was started was actually originated by another electronics engineer with whom they had been associated in their former employment.

Rising profits turned into losses within three years of the acquisition. The business was still conducted smoothly and everything was tidy—



Neatness and order are not evidence of efficiency if a company lacks the creative talent needed to come up with new products when required.



An executive who never differs with his superior is ineffective; so is the superior who puts harmony within management ahead of accomplishment.

everything but the profit and loss statement.

Some of the most effective management men find it impossible to work in neat, compartmentalized units of time. They have creative minds. While they are dictating a letter on one subject, they may get an idea on a completely unrelated matter. Creative people know that thoughts and ideas are fluid and evasive. In the middle of one project they frequently stop to make a note of an idea or direct a subordinate to explore a thought in a completely unrelated area.

Creative executives may have half a dozen balls in the air at one time. So long as they have the managerial ability to follow through—or arrange to have someone follow through—on the job that is most important at the time, this is healthy. On the other hand, an executive may have a plethora of ideas but lack the ability to apply them effectively to the work of his department. This is dangerous.

Relationships

Relationships between superior and subordinate can be very revealing. An executive who never differs with his superior is ineffective; so is the superior who puts harmony ahead of accomplishment. As someone has said, when two executives always agree, one of them is superfluous.

There is no room for "yes" men in industry today. Business is too dynamic. Our times and our technology are changing too rapidly. Every mind in a key position in business must be dedicated independently and cooperatively to its maximum practical capacity for the advancement of the organization.

Harmony at AB Corporation

Jones, the president of a large publicly held company, had come up through the industrial relations department. It wasn't planned that way, but when the sudden death of the corporation's youthful president left the field wide open, the board of directors turned to the then industrial relations vice president, who had been with the company for fifteen years. Everyone liked former public relations man Jones, and as president he was proud of the friendly air that soon dominated the entire executive hierarchy.

When Jones's AB Corporation was acquired by another company, it had a good history, a fine earnings record, and sales of about $40 million a year. President Jones had then been in office about a year and a half.

The policy of the acquiring company had always been not to interfere in the management of a company it acquired if things were going well. On the surface, the business appeared to function smoothly. All the executives were loyal and devoted to Jones. They always seemed to agree with any statement he made, and it was apparent that there was warm friendship between Jones and his management team.

However, the AB Corporation manufactured consumer products for a competitive market, and competition was keen. Gradually some of the sales of the AB Corporation began to slip. In response to inquiries from the parent company the president made the usual excuses of cut-throat competition, lowered demand for the product, and temporary slack for inventory adjustment by customers. His executive team always agreed with his analyses.

Within three years annual volume had dropped from $40 million to $20 million, and the long history of profits had turned into losses. Then the parent company sent in its own investigators.

They found that competition had run far ahead of the AB Corpora-

Appropriate study of the informal relationships among executives can give the analyst a clue as to where the decisions are really coming from.

tion's products. Product design was poor, and the promotion campaigns were ineffective. The sales vice president and the production and engineering vice president, both of whom had been there for many years, said that on several occasions they had tried to improve the product designs and the sales campaigns. Each time, however, President Jones had his own ideas and "because he was always so nice about it" they went along with him. Ever since Jones's assumption of the presidency his platform had been that harmony and friendship come first.

Careful, perceptive interviewing of the president and his executives during the acquisition investigation could have brought this lopsided operating philosophy to light. Then corrective action could have been taken before the business was so disastrously affected.

An executive worth his salt from time to time makes suggestions and observations to his superiors which will benefit the entire organization, not just his own department. A good executive does not find it necessary to run to his superior for important decisions – decisions for which he has full authority and responsibility.

Nineteenth hole

In one acquisition X Corporation, the acquired company, was organized in the traditional way, with the vice presidents reporting to the president and the president himself reporting to the chairman of the board. The company was well established in its field, supplying specialized fabricated parts primarily to the automobile industry. Orders were large, with the bulk of the volume coming from General Motors, Ford, and Chrysler.

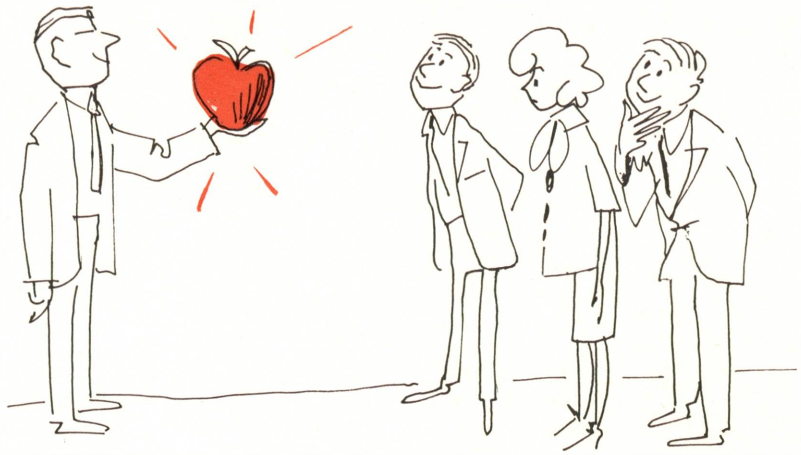
The key to getting business from these giants was to convince their purchasing and engineering departments that X Corporation's fabricated small products were as good as, or better than, its competitors' and that X Corporation understood the needs of the auto industry and was always prepared to fill those needs. The vice president for marketing, who had been with the company for more than twenty years, personally opened the preliminary discussions with the large customers and set the stage for his salesmen and engineers to follow through as each new automobile model design was completed. In the normal course of business the vice president for marketing reported to and consulted with the president.

As part of the acquisition reorganization the chairman of the board was retired, and he moved out of the community to enjoy daily golf in Florida. This was the only change in the executive management structure.

During the first year of merger sales held firm. But in the second year, despite the vice president for marketing's projection of higher sales because of expected increased auto production, sales fell off. And sales continued to decline in succeeding years.

Investigation disclosed that in past years the vice president for marketing had regularly played golf each week with the then chairman of the board. The board chairman had been with X Corporation for more than thirty years. Having come up through the marketing department, he knew most of the key people in the purchasing and engineering departments of the automotive companies and understood their problems and needs. He never lost touch with his old friends in the industry. At the weekly golf sessions—and especially on the nineteenth hole—the vice president for marketing and the chairman would discuss the work of the marketing department. By this means the chairman regularly guided the sales effort of X Corporation. With his removal from the company and the community, the vice president for marketing was thrown completely on his own—and he could not measure up to the task.

An appropriate study of the informal relationships among the executives could very well have brought to light the fact that all



The entire area of motivation is one that requires thoughtful analysis well before the acquisition is consummated. If the acquired company's incentive programs can not be continued, new ones must be substituted.

important marketing suggestions and decisions actually were coming from the board chairman. With this knowledge protective steps could have been taken before so much business was lost.

Although this method of research would not have been effective in the case just cited, it is often revealing to peruse some of the memorandums exchanged between an executive and his superior. Sometimes they give a clue as to where the ideas and decisions are coming from.

A review of office records is helpful in determining whether an executive sets objectives for himself and his department and then meets these objectives. It is the results of a department that count, not the personality of the executive or the friendly relations that may exist within the department.

Lateral relationships

It is also advisable to look into an executive's relationships with his colleagues, with fellow executives on the same level of authority as his own. An effective executive is respected but not necessarily loved. Respect comes from recognition that he has ability and integrity and makes a real contribution to the workings of his organization.

A good executive communicates well with his colleagues as well as with others. He is not so oppressed by the day-to-day operations of his own department that he does not have the time or interest to discuss strategic problems of the over-all business with his colleagues.

The good executive keeps his objectives foremost in his mind and bends and molds his means to respond to the needs of his colleagues so long as it does not interfere with the end product. In short, the effective executive is not a quibbler, and he always keeps his eye on the doughnut, not on the hole.

Motivation

Another area for investigation is that of executive motivation. What have been the primary motivations of the executives? If management was driven by a desire to build a good business so that it could be sold at a substantial capital gain, then after the merger there may be no further incentive to produce. Or perhaps the organization has been run by a dynamic chief executive officer who drove his men hard and made all the decisions. Will he continue to exercise such a dominant influence? Do you want him to?

In many instances executives are given incentives through stock options or other incentive compensation programs. If these executives are to continue with the company, it may be necessary either to continue these or equivalent incentive programs or to substitute new ones. The entire area of motivation is one that requires thoughtful analysis well before the acquisition is consummated. It should not be left to casual—or desperate—treatment many months after lower morale has set in.

Evaluating an organization, even as set down in charts, manuals, and records, is extremely difficult. When we recognize that for a full evaluation we must place substantial emphasis on the informal relationships among the executives, it immediately becomes apparent that such an evaluation is a formidable task.

Yet no one should be deterred from this task by its difficulty. To avoid weighing all of these facets in sizing up an organizational structure may be quite disastrous after the legal merger papers have been executed and integration of the newly acquired company begins. It is ironic that most companies spend more time evaluating the qualifications of individual executives whom they are considering employing than they do in evaluating the large group of executives that they expect to employ at one time through the acquisition route.

Evaluator

Generally, when an acquiring company attempts to evaluate a prospective acquisition, the acquirer calls in consultants who are specialists. The acquirer consults his auditors to verify the financial statements of the company to be acquired; he consults with lawyers to review the legal affairs of the corporation; he may consult with engineers to study the productive capacity and with marketing men to study the product demand.

The chief executive of the acquiring company then attempts to coordinate the findings of all of these specialists and at the same time tries to place a value on the company to be acquired. He does all this while attempting to project the feasibility of integrating this new acquisition into his own company's affairs. This is a horrendous task, which places a tremendous burden of responsibility on one executive and his tight group of intimate internal advisors. It is small wonder that so many acquisitions prove to be unsuccessful.

A company can improve its batting average in any acquisition program by adding the services of a generalist to those of such specialists as auditors, lawyers, engineers, and marketing men. The generalist can draw on the specialists' findings in evaluating the proposed acquisition.

A company can improve its batting average in any acquisition program by adding the services of a generalist to those of the several specialists. This generalist, after being informed of the objectives of the acquiring company and familiarizing himself with the general capacities and abilities of its executives, then proceeds to evaluate the organization and net worth of the company to be acquired. The generalist's evaluation is based on his analysis of the people and the profits, guided by the findings of any specialists who might be available to him.

It is important that the generalist performing this function be independent of the top management of the acquiring company and that he not be compensated on a contingent fee basis. This is so that his findings will not be influenced by the opinions and judgments of the chief executive officer of the acquiring company or by his own eagerness to "make a deal" and earn a fat fee.

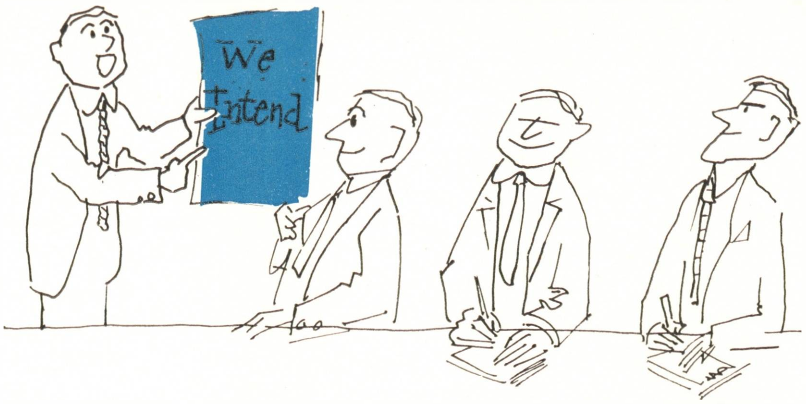
Above all, he must not be a "yes" man. A merger transaction must not be unrealistically dominated by a strong executive or a self-serving consultant; there is too much at stake. A misstep in a merger transaction can in a few months put in jeopardy an industrial empire that took decades—sometimes generations—to build. The Olivetti Company's acquisition of the Underwood Corporation is an example of how an acquisition can threaten the financial stability of a great industrial complex. This acquisition caused such a drain on the finances of Olivetti that a consortium of Italian financiers had to be called in to bolster its financial structure.

The generalist might be an accountant, a lawyer, an economist, an investment banker, or a man trained in some other business-oriented discipline. He may be an outside consultant or a full-time executive of the company. If he is an executive, however, he should report directly to a committee of the board of directors rather than to the chief executive officer. The important requirement is that he have authority and responsibility to evaluate in broad brush strokes. This evaluation would be made objectively and professionally and would be backed up by his own technical skills and those of the specialists with whom he consults.

This procedure makes it possible for the chief executive officer of the acquiring company and his colleagues to apply most of their attention to the task of evaluating the effects of the merger on the operations of both companies. Thus they can concentrate on the strategical aspects of the merger without being distracted by tactical questions.

Information

Those assigned to make evaluations of the seller's organization should be made—and kept—privy



Plans for the operation of an acquired company should be outlined to those concerned as soon as the merger is effected. This is the best way to avoid the demoralizing effects of rumors, uncertainty, and fear.

to the philosophy, objectives, and plans of the purchaser.

Tentative plans might call, for example, for the enlarging of the responsibility of a particular executive office in the acquired company. If so, the acquiring company should be satisfied that the executive occupying this position in the company acquired has the capacity to take on more responsibility. If it appears that he does not have the capacity, appropriate and timely arrangements will have to be made to replace him.

On the other hand, the acquiring company might be planning to abolish a department because the merger would create duplication of a function. If the executive heading this department is capable, adaptable, and innovative, thought should be given to absorbing him in some other function in the merged complex so that his experience and abilities will not be lost to the organization.

Plans and projections of this type should be completed before a merger is finally consummated so that the program can be outlined to those concerned as soon as the merger is effected. This avoids the demoralizing effects of the rumors, uncertainty, and fear that so frequently follow in the wake of a merger announcement.

Evaluating an organizational team requires close personal contact between the representatives of the acquiring company and the executives and managers of the company being acquired. Thus, considerable tact, a broad knowledge of business organization structure, and a pleasant personality are required to carry out this phase of the investigation.

Objections

The question may be raised whether such a study would not cause serious disturbance to the management personnel of the business. The answer is that it need not, provided it is handled properly.

First, such an organizational evaluation would not be undertaken unless the top managements of both the buying company and the selling company believed that it would be mutually advantageous for them to get together. Second, once the top management of a company has decided to sell and a serious potential purchaser has presented himself, all executives should be informed. This information cannot be kept secret in any event. If the executives and managers are not kept informed, they will have to rely on rumors to follow the progress of sale negotiations, and this can have a serious effect upon morale.

In merger evaluations it is essential to keep the objective in mind at all times. The objective is a successful, mutually beneficial merger. Both parties suffer when a merger is unsuccessful—through loss of profits after the merger and through the traumatic experiences of the personnel involved, which sooner or later have their effect on the operations of the business.

If the acquisition still looks desirable after completion of the organizational evaluation and other aspects of the strategical analysis, then the acquiring company should by all means go ahead. Whether the acquirer pays 10 per cent more or less for a company is relatively unimportant in the long run so long as the over-all strategy evaluation adds up to a plus factor. But if this strategical evaluation points up insurmountable problems or leaves too many essential questions unanswered, then the acquisition should be rejected even if it can be made at a discount.

It is an observable truth that a company priced at $20 million could be an excellent acquisition, in terms of both price and over-all business objectives, for one acquiring company, whereas the very same selling company at a price of $10 million would be an unsound acquisition for another company. This paradox will always hold so long as business philosophies and objectives differ and so long as human beings' personalities, abilities, and characters differ.