The Urban Myths of M&A: how unconscious biases affect deal success

Professor Scott Moeller
Founder and Director, M&A Research Centre
The Business School (formerly Cass), City, University of London

PCB PARTNERS

CASS BUSINESS SCHOOL
CITY, UNIVERSITY OF LONDON
EST 1894
Changing more than a name

royds withy king

INTRODUCTION

M&A DEALS USUALLY FAIL. OR DO THEY? SEPARATING TRUTH AND FICTION IN THE WORLD OF M&A IS OFTEN NOT EASY.

One conundrum is the determination of whether the deal will be or has been an excellent one for shareholders, managers, employees, customers, the community or any other stakeholder.

From the 1970s to the 1990s, somewhere around 70% of all deals failed, no matter whether you defined failure by the increase in stock price, market share, earnings or turnover. But around the turn of the millennium, this rate of failure changed dramatically, and the most reputable studies now show that the success rate is around 50% -- the same odds as guessing correctly the flip of a coin.

Improved? Yes. But although not an impressive standard for an activity that drives much of corporate growth, it certainly doesn't merit the label that 'most deals fail'. However, this perception of M&A deal failure – the so-called conventional wisdom -- remains.

PROFESSOR SCOTT MOELLER

Scott Moeller is the Director of the M&A Research Centre, The Business School, City, University of London and teaches Mergers & Acquisitions, Corporate Finance and Private Equity in the MBA, MSc and executive programmes.

Scott is a frequent commentator on business issues on television (BBC, CNN, Bloomberg, CNBC) and in the press (Financial Times, Sunday Times, Independent). He is widely published, and one of his books received an award in the United States as one of the top 30 business books of the year in 2008.

Before becoming an academic, Scott worked at Booz Allen & Hamilton Management Consultants, Deutsche Bank and Morgan Stanley in a career that spanned 24 years, three continents and four countries. Scott has held a number of board seats throughout Europe, Africa, Asia and the Americas.

IS THE MYTH BACKED BY RESEARCH?

It gets even worse, to some people. One hears from experts who talk about failure rates as high as 90%. Now that's an 'urban myth' run wild, because when our researchers in the M&A Research Centre at The Business School recently looked at the 10,000 largest M&A deals since the Great Recession of 2008, we found a result not too different from that coin toss: 53% added value.

An academic study entitled 'Urban Legends: Why do people believe them?' argued that urban legends 'are often intriguing tales of woe and corporate misdeeds with appalling details that excite - and sometimes incite - their audience. While often containing just a shred of truth, or perhaps none at all, they are generally accepted as factual and enjoy rapid dissemination.' It appears, so that study argued, that some people get pleasure from passing on stories of failure.

The scholarly M&A world is not immune to this temptation either. One best-selling book about M&A deals was entitled 'Deals from Hell' and the importance of the topic was underscored in the book's foreword written by the longest-serving chairman of the United States Securities and Exchange Commission, Arthur Levitt. It contained ten lengthy chapters about ten of those 'deals from hell'. But with over 25,000 deals annually, could this be just anecdotal and not necessarily representative?

The business and popular press also likes to remind readers about deal failures. When discussing a newly announced deal, reporters will often question whether the deal will end up like one of those well-known cases of deal failure, whether that be AOL's $182 billion 'merger' with Time Warner that was the largest deal ever and lost 97% of its combined shareholder value, RBS's $98 billion purchase of ABN Amro that ended up putting the bank effectively into state ownership or HP's $11 billion acquisition of Autonomy that led to an $8.8 billion write-down.

STUDIES SHOW THAT THE DEAL SUCCESS RATE IS AROUND 50% - THE SAME ODDS AS GUESSING CORRECTLY THE FLIP OF A COIN.

EXPLORING THE WHY

So yes, there are some massive deal failures. It is important to consider why. Contributing to, or perhaps even causing the failure of, deals such as these were management errors from one or more of the many behavioural biases that psychologists say we all struggle with in our day-to-day lives.

Each of those large failures included, amongst other errors, management hubris and overconfidence. What do we mean about overconfidence? Perhaps some examples from outside the business world would be helpful as a start. For example, studies in psychology have shown that what people think will happen 98% of the time will actually only happen 60% of the time. Similarly, people are overly optimistic and have an unrealistically rosy view of their own abilities and prospects. In this regard, another famous study showed that 90% of car drivers surveyed felt they were an above average driver!

Boards, chief executives and senior managers are not immune to this. They exhibit this bias of *excessive optimism* and *overconfidence* when they tend, for example, to overestimate potential synergies and underestimate the risks associated with deals.

BOARDS, CHIEF EXECUTIVES AND SENIOR MANAGERS EXHIBIT THE BIAS OF EXCESSIVE OPTIMISM AND OVERCONFIDENCE WHEN THEY TEND, FOR EXAMPLE, TO OVERESTIMATE POTENTIAL SYNERGIES AND UNDERESTIMATE THE RISKS ASSOCIATED WITH DEALS.

THE OVERCONFIDENCE BIAS

Overconfidence bias comes into play when decision makers feel that they know how to do a deal because they have what they believe to be excellent experience having done something similar previously. Along the way, they ignore advice from experts (more about that below) and the data which shows that half of all M&A deals do not deliver the projected results. Chief executives don't get to the top of an organisation by failing but by being successful, and they believe they can extend that success into the M&A world.

A classic example of this was a series of acquisitions which started with Quaker Oats buying Stokely-Van Camp, owner of the sports drinks company, Gatorade. That deal turned out to be one of Quaker Oats' most successful diversifications as under its new ownership, Gatorade grew tremendously. In talking about the deal, the CEO admitted that reports were correct that he had bought the company based on 'his taste buds' rather than a more serious market and valuation analysis. From this success, he said that he could control the outcome of another large drink company purchase.

This all ended badly as a number of years later WIlliam Smithburg, the CEO, bought another drinks company, Snapple, for $1.9 billion, similarly telling the market that he relied principally on his gut feelings about Snapple and following a woefully inadequate due diligence process. That, reportedly, included the CEO bringing a case of Snapple into the boardroom and suggesting that the board should approve the deal if they liked the taste of the product. Less than three years later, and after significant operating losses, Snapple was sold for only $300 million.

Most M&A deals, when publicly announced with great fanfare, declare that they will achieve significant cost and possibly revenue synergies and indeed the target company valuations depend on these synergies. McKinsey reported in 2005, however, that 70% failed to achieve the stated revenue synergies and 40% failed to achieve the expense synergies. This demonstrates the overconfidence of senior managers. In our recent research in the M&A Research Centre we've heard executives saying things about their deals such as, 'I must say we are quite successful and that gives us confidence - which is the most important thing,' The deal-makers 'are indeed very confident', another executive told us, 'and great believers in their businesses. They don't like to give up because it is predominantly their own ideas that they tend to unconditionally follow; it's like a football coach: even if the team loses, the coach keeps believing in it.'

THE CONFIRMATION BIAS

Overconfidence isn't the only psychological bias impacting M&A deals. Indeed, there are other psychological biases that affect human behaviour and there's no reason to think that many, if not most, of these would subconsciously or consciously influence executives during the acquisition deal process. Wikipedia lists almost 100 different such biases (although, admittedly, many of these overlap). In addition to the overconfidence bias, our research has found two others that have the greatest relevance to mergers and acquisitions: confirmation bias and the illusion of control.

Confirmation bias describes the situation in which people seek information that agrees with their existing beliefs. In other words, it's a cognitive bias whereby one tends to seek information that confirms preconceptions and to ignore new information that contradicts those initial beliefs. In an M&A deal, this bias manifests itself especially during the due diligence phase of an M&A deal.

What happens then is that preconceived views and expectations influence the final decision about the deal. Bad news is ignored, as is any other information that does not conform to the initial deal premise. Good – or confirming – news is given too much weight or used as evidence that those initial plans were correct. One comment we commonly hear after a failed deal is that 'even if the information is not so useful or even contradictory, the CEO would try and push the deal if he or she really thinks it is a good deal and believes in the idea.' Or perhaps, as one manager told us, 'The team working with the CEO will want to give her information that supports her view. This is only natural. They will avoid telling her things she doesn't want to hear.' Another said, 'It's more difficult to prove to the company president that he's wrong than to find some information – any information – to support what he wants to do.'

In certain cases, these executives and the deal team get 'emotionally attached' to the deal. This feeds the confirmation bias. It was noted that in most M&A transactions, managers' overly optimistic belief in a certain merger or acquisition would influence acceleration of the transaction, regardless of the underlying features of the transaction. One advisor told us that 'The CEO and management team would have invested a huge amount of time on a particular deal, so they naturally get emotionally attached to it and they subconsciously want it to be completed.'

PRECONCEIVED VIEWS AND EXPECTATIONS INFLUENCE THE FINAL DECISION ABOUT THE DEAL.

There's definitely a correlation with the amount of time and money that is invested in the deal at an early stage, perhaps even before it is publicly announced but more so when it's already public. The more investment (time, money and other resources) in a deal, the more likely the executives would try to identify reasons to continue with it even if there was new conflicting information which showed that it should be terminated.

Confirmation bias can also be present in making the final 'go / no go' decision due to time pressure. In speaking about this, a senior executive told us that 'it would be extremely disappointing to walk away from the transaction at a late stage, so there is a natural effect of ignoring that late bad news.'

> **WITH CLOSE TO 50% OF ALL DEALS FAILING – AND THE URBAN MYTH THAT IT IS EVEN MUCH WORSE THAN THAT – ONE REASON FOR OVER 25,000 M&A DEALS BEING ANNOUNCED EVERY YEAR IS THAT THE BOARD AND CEO BELIEVE THAT 'THIS TIME IT WILL BE DIFFERENT'.**

THE ILLUSION OF CONTROL

The third bias of particular relevance to M&A is the so-called *'illusion of control'*. This is when people overestimate their ability to control events, for instance when they feel that they control outcomes that they really have no influence over. This factor overlaps with the overconfidence bias above. In an M&A deal, for example, executives will overestimate the extent to which they can control events and ignore or downplay the external factors that can have a large impact on integration plans.

Evidence suggests that there is a strong presence of an illusion of control in the senior executive decision-making process. With close to 50% of all deals failing – and the urban myth that it is even much worse than that – one reason for over 25,000 M&A deals being announced every year is that the board and CEO believe that 'this time it will be different'. Or perhaps they believe that the company is large enough to influence the success and 'beat the odds'. As one executive told us, 'When they get it wrong it is because they BELIEVE they can get it from A to B, but they lack knowledge, lack judgement to see that their strategy is flawed.'

That and similar statements confirm the strong presence of illusionary control as an innate CEO characteristic. However, our M&A research has shown that the success of a deal is ultimately decided after the deal closing when the whole organisation must pull together to operate as a combined new firm – and instructions alone from senior management are not sufficient to make this happen.

This is both frustrating and helpful: frustrating because an honest assessment of the team's ability might show where there are shortcomings that could be filled by outside M&A advisors, for example, but helpful because knowing this, one can plan for the need for external and therefore independent advisors to be a control on these biases.

Thus during our conversations with deal-makers, investment bankers and accountants they elaborated on the control element and decision-making processes in large deal-making institutions. The CEO's role in the decision-making process may be critical, but there's a need for collaborative decisions and teamwork in complex acquisitions – and yes, every M&A deal is complex. 'Sometimes it is top down, but sometimes it's a bottom up approach; thus you can't actually say that it is all in the CEO's hands as he or she thinks it is,' as one integration manager told us.

MORE FACTORS AT PLAY

There are, of course, many other factors that affect M&A deals. Of the list of 100 behavioural biases listed in Wikipedia, one could probably make a case and provide an example for each where an M&A deal has been impacted. As one M&A advisor told us, 'Don't believe it for one minute when someone claims that the acquisition decision was solely for the financial reasons stated. There are always egos involved. CEOs and boards do deals for personal reasons.'

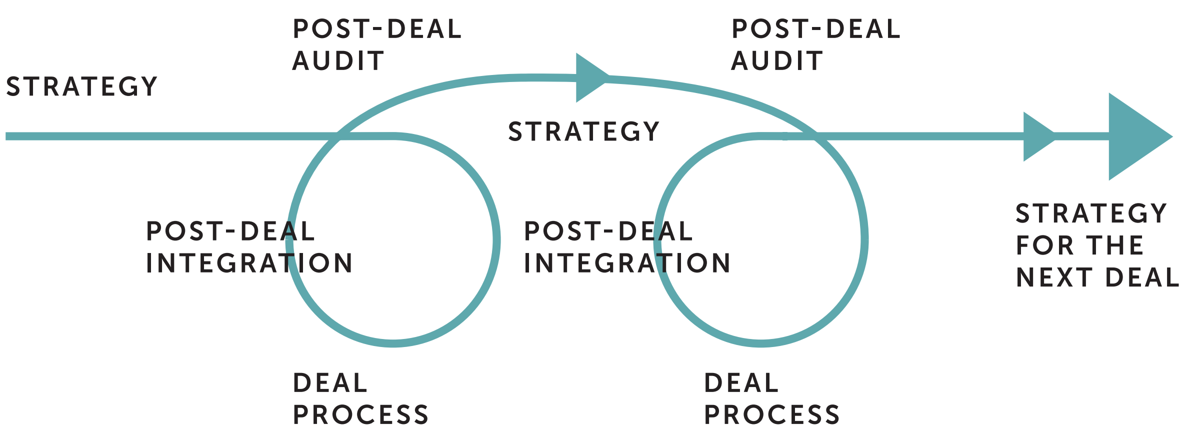
These biases persist even when the architects of the deals are made aware of them. This is especially relevant today, with the coronavirus pandemic likely to be felt for many years to come but with no one sure what impact it will really have. Despite this headwind and uncertainty, the third quarter of 2020 was one of the strongest quarters of M&A activity on record.

Knowing that inherent human biases will be introduced into the M&A deal process is the first step in designing a better process to alleviate, at least to some degree, the negative impact of those factors and, in fact, to channel them to assist, rather than impede, deal success. CEOs and boards need to recognise and understand better their own biases. Then it may be possible to improve the success rate of M&A deals so that no one will ever again believe the urban myth that the current failure rate of M&A deals is 70%.

OF THE LIST OF 100 BEHAVIOURAL BIASES LISTED IN WIKIPEDIA, ONE COULD PROBABLY MAKE A CASE AND PROVIDE AN EXAMPLE FOR EACH WHERE AN M&A DEAL HAS BEEN IMPACTED.

APPENDIX 1: STAGES OF A TYPICAL TAKEOVER

SELLER'S PERSPECTIVE (IN AN OPEN AUCTION)	BUYER'S PERSPECTIVE:
1. Corporate strategy development to determine if the division or company should be sold. 2. Organisation for the merger / acquisition: select project leader; form different teams; identify outside advisors; develop 'long list' of potential buyers. 3. Preparation of the expected pricing and deal terms leading to a high-level information memorandum. 4. Discussions with the potential buyers. 5. 'Short list' stage with limited due diligence inside the seller. 6. 'Preferred bidder' stage with almost unlimited due diligence and strict confidentiality agreements exchanged. 7. Deal finalisation: • arrange financing • approval by common stockholders, if necessary • file papers and obtain any necessary regulatory approvals • closing.	1. Corporate strategy development: determine if acquisition or merger is the appropriate strategic move; develop a list of possible candidates and conduct external due diligence on these. 2. Organise for the merger / acquisition: select project leader; form different teams; identify outside advisors. 3. Specific deal pricing and negotiation: • identification of final acquisition candidate(s) • valuation and pricing • negotiation between both managements. 4. Structuring and approval (if the deal has not already been publicised, this is the stage where it will be communicated to the public): • structure the deal • due diligence within the target (if allowed) • arrange financing • approval by common stockholders • file papers and obtain any necessary regulatory approvals • closing. 5. Post-deal integration (integration planning should start at Step 1). 6. Post-acquisition review.



Source: Moeller &Brady, *Intelligent M&A*, Second edition, 2014

APPENDIX 2: SIX COMMON BEHAVIOURIAL BIASES ASSOCIATED WITH M&A DEALS

Of the dozens behavioural biases present in M&A deals, the below six - including the three detailed in this White Paper - are most common.

OVERCONFIDENCE / EXCESSIVE OPTIMISM

DEFINITION

People make mistakes more frequently than they believe and view themselves as better than average, also overestimating how frequently they will experience favourable outcomes.

PHASES OF M&A DEAL WHEN PRINCIPALLY OBSERVED

Deal design

Integration

EXAMPLE

Ignoring data which shows that most M&A deals do not deliver the projected results and that they usually fail.

CONFIRMATION BIAS

DEFINITION

People attach too much importance to information that supports their views relative to that which runs counter to their views.

PHASES OF M&A DEAL WHEN PRINCIPALLY OBSERVED

Pricing

Due diligence

EXAMPLE

Ignoring data which shows that the estimated synergies are not achievable.

ILLUSION OF CONTROL

DEFINITION

People overestimate the extent to which they can control events.

PHASES OF M&A DEAL WHEN PRINCIPALLY OBSERVED

Integration

EXAMPLE

Ignoring external factors (personnel, competitors etc.) that can have an impact on integration plans.

ANCHORING

DEFINITION

The tendency to rely on an initial or presented figure and making inadequate subsequent adjustments when new information becomes available.

PHASES OF M&A DEAL WHEN PRINCIPALLY OBSERVED

Pricing

EXAMPLE

Using the current market capitalisation as the starting point for valuation and pricing negotiations.

INFORMATION AVAILABILITY BIAS

DEFINITION

People rely too much on information that is readily available and intuitive, rather than that which is less salient and more abstract, thereby biasing judgement.

PHASES OF M&A DEAL WHEN PRINCIPALLY OBSERVED

Due diligence
Pricing

EXAMPLE

Conducting due diligence from existing firm sources and not 'digging deeper'.

AFFECT HEURISTIC

DEFINITION

Basing decisions primarily on intuition, instinct and gut feeling.

PHASES OF M&A DEAL WHEN PRINCIPALLY OBSERVED

Deal design

Pricing

EXAMPLE

Rapidly deciding to proceed with a deal prior to full due diligence, planning and analysis.