Enterprise Risk Management and its Role in Implementing a Winning Acquisition Strategy

"Winning bids are made by winning bidders"

A*uthor Unknown*

"Is there such a dynamic as The Winners' Curse?"

Richard H. Thaler

Is an acquisition strategy a positive endeavor for an insurance company? Is it a strategy *necessary* for the survival of some companies? In these difficult times, even for companies that have a track record of success in this arena, is an acquisition the answer? This report explores the various thought processes that companies go through when they consider an acquisition strategy, explores what activities need to take place in order for an acquisition to be seen as successful, and reflects on the role of enterprise risk management in improving the likelihood of success.

Success: According to Whom?

A property isn't valued on the same terms by a buyer and a seller. Buyers and sellers are trying to accomplish different things relative to their particular situations:
- The buyer is trying to enhance his business (ideally strategically, not just financially … although improving one's financial position at this point time looks very appealing!); on what criteria will the buyer's acquisition be viewed a success?
- The seller is trying to either raise capital or increase focus; on what terms will the seller's divestiture be viewed a success?

What can buyers and sellers do to increase their respective chances of success? What role can/should ERM play in these transactions?

Acquisitions as an Element of Corporate Strategy: Various Perspectives

What is the mind–set companies have as they consider acquisition activity?

"We see the opportunity to make suitable acquisitions at the right price as just another way of meeting our corporate objectives"

"We see acquisitions as crucial to achieving our objectives"

"We are an acquisition specialist"

"Our strategy is to make acquisitions and then integrate them effectively"

Which is of these approaches is right for you, if any … and, if so, under what circumstances? Given that acquisition activity in the aggregate has an uneven track record of success, how can acquirers improve their likelihood of success? Have the myriad of risks involved in such complicate endeavors not been understood and dealt with effectively, causing the majority of acquisitions to fall short of expectations?

Companies' conversations with rating agencies have often revealed 'curious' expectations of acquisition activity:

"The deal is 'fully priced,' but we did not overpay"

"The deal will work because there is overlap"

"The deal will work because there is no overlap"

"Cultures are similar despite apparent differences"

"Although not accretive, it's non-dilutive"

"Growth & profit objectives will be met through synergies"

Enhancing an Organization's Business Model, in General and via Acquisition, to Better Meet Goals and Objectives

Can an Acquisition Be a Driver of Positive Change?

Existing business model → Clear business case for an acquisition → Enhanced business model

A well respected expert on business strategy and planning, Russell L. Ackoff, presented the concept of 'idealized design" … the best conceived business model a company can put into place. Does an acquisition help a company make its business model more effective? For this to happen, it must be supportive of the following:

- Mission, Vision: Is the acquisition consistent with the company's strategic direction?
- Profitability: EPS, ROE, EVA; is the acquisition accretive to financial results, and if not when will it be? Are there dynamics/risks that could prevent attainment of the stated financial objectives?
- Competitive dynamics: Will additional market share provide the ability to dictate competitive terms? Given how fragmented the life insurance industry is, can the largest companies (as large as they are) alter competitive dynamics more in their favor? Does the acquisition enable the company to compete more strongly against powerful competitors?
- Market share: Are economics of scale gained? Is less desirable (unfavorably priced) business being acquired? As said, since most insurance business segments are so fragmented, even after decades of consolidation activity, does market share even matter?
- Is a company's business profile materially enhanced?
- Is favorable diversification gained? Is focus lost?

Does an Acquisition Make a Company a More Successful Competitor?

- Expanding distribution
- Expanding geographic coverage
- Achieving business growth, scale
- Acquiring/enhancing functional capabilities
- Increasing profits and capital

Execution of an Acquisition Strategy Goes Through Several Stages and Involves Many and Varied Complex, Interrelated Business Issues (they must be performed well, and there are numerous junctures where things can go awry … suggesting that many potential risks need to be addressed, and more effectively than they typically are)

- Defining the business case

- Considering the corporate strategy and the resulting (ideally enhanced) business model
  * Fit vs. conflict
  * Synergies; potential synergies are frequently overstated
  * Diversification

- Assessing market opportunities and competitive dynamics
  * Products
  * Distribution
  * Markets/segments
  * Brand/reputation

- Financial impact
  * Earnings
  * Capital
  * Economic value
  * Assessment of an appropriate price

- Investments
  * Asset classes
  * Loss positions
  * Liquidity

- Operational fit (or problematically, the need to 'fix' the target's operations)
  * Technology
  * Administration
  * Core competencies

- Integrating the target: melding the two organizations so that they can perform effectively <u>together</u>, while mitigating risk, volatility and confusion to the greatest extent possible

Q: Is an acquisition strategy a core competency of your company … can you execute such a transaction successfully?

<u>Due Diligence Performed on any Acquisition Target:</u> A Critical Activity on the Strategic and Tactical Levels

- Valuation, impact on future financial results
- Management/staff
- Profitability of new (potential), existing business
- Competitive market position; product management, distribution capabilities
- Synergies: strategic, operational, financial, market/product/distribution
- Investments
- Expense structure (opportunities for increasing efficiency and/or cost reduction)
- Technological capabilities or possible lack of fit
- Contractual obligations
- Areas of risk or uncertainty

Many acquisitions are viewed retrospectively as failures. A lack of accurate evaluation of/objectivity about prospective acquisition targets (using 'rose-colored glasses' leads many (most?) acquirers to have unrealizable goals for their transactions, and as a consequence the end results (strategic, financial or otherwise) do not meet expectations. There is a considerable level of risk to the acquirer if the due diligence process is not conducted with sufficient accuracy and objectivity.

<u>Evaluating the Capabilities of an Organization to Execute Successful Acquirer:</u>
Being a successful acquirer requires a number of skills and mind-sets:

- Knowing one's own corporate vision, mission, strategy and operating model, and how acquisitions complement them
- Having a disciplined approach: evaluating fit, paying an appropriate price based on economic value, both current and future
- Performing careful, accurate and objective due diligence on the target company and management counterparts … *caveat emptor!*
- Executing timely, well planned and orchestrated integration activities focus on achieving a favorable operational model and attaining a satisfactory level of cost savings; a number of companies that acquired positive reputations as acquirers were in fact poor at integrating their acquisition(s), causing their organizations to implode
- Managing the staffs and corporate cultures sensitively. There is considerable amount of research that identifies human resource related issues as the most prevalent causes for acquisition failure; personalities (egos), conflicting management styles and cultures, and different compensation structures are all too common. Proactive conflict resolution is critical to steer the resulting entity past these pratfalls. Open and continuous communication is critical.

<u>The General Lack of Success from Acquisitions is Attributed to Mismanaging One or More Critical Aspects of the Transaction with Material Risk</u>

Strategy
- Incompatible cultures
- Incompatible business models
- Synergy non-existent or overestimated

Due Diligence
- Acquirer overpaid
- Foreseeable problems overlooked
- Acquired firm too unhealthy
- Overlooking aspects of the target where excessive divestiture or liquidation might be required

Implementation
- Inability to manage target
- Inability to implement change
- Clash of management styles/egos

Conclusion

An acquisition is arguably the most difficult business endeavor a company can undertake. This report discussed a considerable number of elements involved in acquisition activity; they are all complex, and there are many junctures in the process where a number of these elements can go awry or reach adverse conclusions, either derailing transactions that could have otherwise been successful or ‘proving’ the efficacy of transactions that upon closer scrutiny could not have succeeded and should have been avoided.

Studies of acquisition activity across all industries (not just insurance) have consistently found that approximately two-thirds of these transactions yielded unsatisfactory results. One could observe that this is not surprising, as there are so many steps along the way that can turn into insurmountable roadblocks. Considering the myriad of factors that must be performed well, it is clear than sound, pragmatic risk management throughout the process and beyond is critical in order for acquisition activity to succeed.