

The Acquisition of Companies as an Instrument of Practical Industrial Management

**by
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Hardly a day passes in which the press does not describe acquisition battles like a thriller to draw our attention. In December 1988 it was the battle for RJR Nabisco which hit the headlines. An investor group led by KKR eventually won in front of a widespread audience with its US \$ 25 billion bid. The financial intelligence manifested, the ability to mobilize large sums of money internationally, the skilful use of tax benefits and the courage of financial investors are all remarkable. The arguments used by those propagating such models are well-known: the need to change traditional structures and to serve shareholders' interests first. Such acquisitions are nevertheless not the basis for this paper. Instead, emphasis is placed here on acquisitions made for the purpose of achieving medium- and long-term industrial goals. As a result, the acquisitions concerned are those made for reasons such as the desire to obtain access to new technologies, to establish joint R & D efforts, to expand into new markets, to secure supplies of raw materials or to minimize costs.

1. Reasons for the Increasing Importance of Acquisitions

Developments during the 1980s make the increasing importance of acquisitions easy to understand.

- Technical change has taken place very quickly in many industries. New product developments have to be realized faster in order to maximize the time advantage until the competition forces cost reductions through lower pricing or in order to keep pace with technological progress.

R & D efforts have also had to become more economic in order to ensure that products can be produced at prices which are competitive enough to permit sufficient market penetration.

- The production process has had to make maximum use of automation and process modernization in order to maintain cost advantages. Modernization leads to greater productivity but also to some extent to increased capacity which has to be sold in the market.
- In the marketing area it has become increasingly important to provide customers with full service, to use existing distribution channels for complementary products and to gain faster access to new regional markets than in the past.

The rapid pace of technological change and the increasing internationalization of products and markets demands from companies the ability to react quickly in order to realize new developments rapidly and to secure new markets ahead of the competition. In contrast to the 1960s and 1970s, this is often no longer possible alone. The most critical bottleneck is the fact that adequate numbers of suitably trained staff are not available and cannot be built up within the prevailing time constraints. This prevents the realization of goals solely via internal growth. Cooperation and acquisition have thus become important alternatives. This applies to companies which already trade with one another or which are able to realize synergies from future ties. It also applies to adjacent technologies and complementary products and markets.

Further advantages of acquisitions compared with internal growth - in addition to the limiting factors labour and time - are as follows:

- No increase in total capacity.
Growth has slowed in many industries. Additional total capacities cannot be absorbed by the markets and would only lead to lower overall price levels.

- Advantageous purchase prices compared with cost of internal growth.

Acquisition prices can often be seen in a different light when compared to the alternative of realizing the same goals via internal growth. This applies equally to both production facilities and to brand-name companies.

- Easier and more secure clearance of barriers to entry.

The purchase of an existing company represents the acquisition of an established network of customer and supplier relationships. One should not underestimate the resistance of the market to efforts to develop an equivalent network via internal growth. This resistance can arise in technological or legal terms or can be caused by the overall structure of a given market.

Against this background, acquisitions are increasingly the better alternative to the long and laborious process of internal growth. This trend has gained momentum, as the Federal Cartel Office statistics reveal:

Year	Number of Acquisitions
1985	709
1986	802
1987	887
1988	1,159
1989	1,414
1990	1,548

The years 1985-1987 depict an increase at the rate of 10 % per annum. This rose to 30 % in 1988. This sharp rise is of interest because the Federal Cartel Office statistics are an indicator for the overall market. It seems fair to assume that the rate of increase in the level of acquisition activity for companies under the lower limit for registration requirements is even faster than for the registered transactions. The Federal Cartel Office figures only

reveal the picture at the upper end. Despite the absence of reliable overall statistics, there is sound evidence that the total level of acquisition activity is growing rapidly.

One important cause is preparation for the open market within the European Community as from 1992. This prompts corporate entities to review the extent of their presence throughout the Community. This applies equally to large and to medium-sized companies. British and French companies, in particular, are increasingly resorting to industrial cooperations and acquisitions as part of the preparation process. In addition, North American, East Asian, Austrian, Swiss and Scandinavian companies are also endeavouring to secure an adequate foothold within the European market. This is especially the case in areas such as road haulage which to date have been subject to price regulation or concessionary licensing. A similar situation applies to markets for products in which national norms or dependence on demand from the public sector have long served as a barrier to entry. Examples are the telecommunications, food and beverages and financial services industries.

Reference is made in this context to a survey conducted by KPMG in 1988. Under this survey, 650 companies in different industries throughout Europe were interviewed concerning their plans in preparation for the open European market after 1992. 64 % of the companies surveyed expected to obtain commercial advantages from acquisitions in other Community countries.

In addition to these particular causes for the rising level of acquisition activity, the structure of the German corporate landscape also ensures an increasing supply of acquisition opportunities.

Only some 0.1 % of all German companies are joint stock corporations and only a portion of these are publicly-quoted on a stock exchange. In comparison, England has six times as many publicly-quoted companies as

Germany. Privately-held companies represent the vast bulk of German corporate entities. The ownership question within such privately-held companies is reviewed with each generation change. Frequently, the wealth of the owning families is almost entirely concentrated in the company. It is becoming increasingly difficult for family owners to solve the succession issue. In this context, it is important to note that, after more than 40 years of uninterrupted growth, a generation change is imminent in the numerous family companies founded in the immediate post-war period. Our own observations reveal that the owners of private companies have become more receptive and at an earlier stage to the concept of equity ties with a larger group in order to secure the achievements of the past decades for the future.

2. The Food Retailing Industry as an Example

The food retailing industry has been the subject of a large amount of acquisition activity and is thus a useful example for an illustration of the considerations leading to the adoption of a strategy of external rather than internal growth. It is well-known that the key costs of the food retailing industry are

- the cost of the goods sold and
- handling costs.

Statistical surveys have shown that the cost of goods sold is 1-2 % lower for the largest German food retailers compared with the next largest group. Bearing in mind the size of recent acquisitions such as Massa, Deutscher Supermarkt and Werhahn-Handelsbetriebe with total sales of between DM 2 billion and DM 3 billion, the purchasing advantages are very substantial in absolute terms and relate to both the total sales of the acquired company as well as those of the acquiror.

Handling costs are even more significant. These comprise the warehousing, logistical, point-of-sale and ancillary costs. Where optimal systems are acquired or can be introduced by the acquiror, these can lead to cost advantages amounting to up to 10 % of total sales. General overhead costs are also spread over a larger sales volume.

In addition to the above, food retailers are aware that greater market share leads to greater influence on overall market prices and thus generally to more stable profit levels. Cost and purchasing advantages therefore have a greater impact.

Concentric acquisitions by food retailers have to be viewed differently. These are diversification steps into adjacent fields. An example is diversification into the retailing of household electronics. A number of acquisitions in this direction have taken place recently:

- Kaufhof has acquired Saturn
- Hertie has acquired Schaulandt
- Leibbrand has acquired Diehl
- Coop has acquired Egger.

In such instances, existing or new products are marketed in specialist stores that sell to the same consumers as the parent organizations. Advantages of this external growth have been described as arising from location, cost reduction and access to qualified personnel. By acquiring an established retailer, the purchasers also avoid the risks involved in endeavouring to build up a competent reputation with consumers.

A third category of motives for acquisition are prevailing restrictions. In this context, it is important to note that internal growth via constructing and opening additional sales outlets with the economically favoured size of more than 1,500 m² per outlet is often impossible, as the local authorities are virtually totally unwilling to grant new planning permission for such

uses. The introduction of much more stringent requirements under § 11 (3) of the Building Use Decree has made large new retail outlets practically un-realizable. The alternative has therefore become to acquire other retailers with suitable sites in the desired locations. Furthermore, it can probably be assumed that the restrictive retail closing hours in Germany have encouraged the concentration trend within the retail trade.

In spite of the high degree of concentration realized in the German food retailing industry in recent years, it nevertheless has to be borne in mind that the concentration process in this area is even more advanced in other European countries and that the degree of concentration in Germany is in the lower third of the European league. Research undertaken by Nielsen shows that the degree of concentration is significantly higher in France, Belgium, the UK, Spain and in Switzerland than in Germany.

The same picture repeats itself among food manufacturers as the suppliers of the food retailing industry.

Food manufacturers in other countries which already possess high domestic market shares try and realize further growth by expanding their activities into new regional or national markets. The acquisition of established companies in the target markets in this context is considered attractive for the following reasons:

- The acquisition of companies producing the same products with established brand names in their local markets eases the introduction of the acquiror's own products into the target market. This image transfer greatly reduces the risks inherent in trying to establish products sold under a brand name still unknown in the relevant market;
- in addition, limitations on shelf space and the number of brands sold by food retailers make acquisition the better means of market access. Retailers often only offer two to three brands of any one product. In

order for its products to be listed by food retailers, a new entrant to the market therefore needs to acquire one of the top two to three brand names for its product; and

- changes of supplier are very uncommon in the German food retailing industry. Within any one year, only some 2 % of all suppliers lose contracts with the food retailers. A similar portion of the overall number of suppliers obtains a new listing.

Food manufacturers are also subject to external restrictions which encourage the acquisition of established brand names.

The manufacturers of branded foods primarily use television as their main means of advertising. This will also remain the case in the foreseeable future. A classical advertising budget normally has a TV element of around 40 %. Since the availability of television advertising time in Germany is limited (advertising time on the ZDF channel is almost completely double-booked), this represents a practical restriction on establishing a new brand name via internal growth.

3. The Individual Stages in the Acquisition Process

In terms of their methodology, there are two main approaches to realizing an acquisition strategy. One is the systematic or deductive method and the other is the reactive or inductive approach. The inductive approach depends on the availability of companies in the open market place. In such instances, the potential buyer makes its intentions known publicly (broadcasting) and contacts brokers, consultancy firms and banks in the hope that appropriate opportunities will be shown to it. The disadvantages are obvious. Acquisition opportunities of this nature are coincidental and the buyer has no influence on the time at which the potential candidates become available. As a result, the acquiror seldom has the possibility of si-

multaneous comparison of one acquisition opportunity with another. In addition, a decisive disadvantage is that the initiative comes from the seller. In the case of the deductive alternative, the reverse applies.

Under the deductive approach, entire markets or industries are viewed at once. Companies are identified which, for example, use particular technological processes, manufacture specific products or have given distribution channels. These companies are then systematically surveyed in terms of their suitability and are then listed according to priority. This is done by entering the strategic goals of the acquisition efforts into a matrix and comparing the surveyed companies on this basis. This matrix shows which of the potential acquisition targets fit best. In conducting this analytical work, the buyer is forced to give thought to the likely benefits to be derived from a link and to identify the contribution that the buyer itself can make in the event of an acquisition. Such conceptual work represents an excellent preparation for the subsequent approach phase, as it is exactly the matter which can be presented at the first meeting.

Discussions regarding overall market trends and the benefits of a possible link are especially important for approaches to potential acquisition targets in countries with large numbers of privately-held companies. Although it is most certainly true that this deductive method is no guarantee for success, it does ensure that the timing is determined by the potential acquirer and that any acquisition realized is likely to be more successful due to the conceptual preparation undertaken in advance.

Finally, there are a number of well-accepted principles which nevertheless remain totally valid.

An acquisition target should be large enough to make a genuine contribution and to warrant the necessary management effort. At the same time, the target should not be so large that it might endanger the future of the buyer should the expected synergies not arise and the integration be un-

successful. Additionally, acquisitions should only be made at points in time when the core business of the acquiror is in a healthy state. Only then can the management of the acquiror devote sufficient time to the acquisition and the financing of the transaction be unproblematic.

Acquisitions should always be executed by the buyer's very best management staff and this engagement should go beyond the closing date. The realization of widespread synergies to the benefit of both the purchaser and the acquired company is only possible should excellent management staff be committed to the project over a longer time period.

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