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The Merger Mystery

Why Spend Ever More on Mergers When So Many Fail?

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3. Incentives for Advisers

> Probably the single most important word in the corporate finance business is 'no'—when said to a client to explain why his deal will not work and cannot be backed. But it is a word which can cost a firm clients since it is one which thrusting entrepreneurs and captains of industry are not accustomed to hearing. (Terry Smith 1996)

The Scale of Advisers' Fees in M&A Transactions

Table 3.1 summarises the fees and other transaction costs incurred in the merger of Belgian ABInbev and South African SABMiller to form a dominant international brewing combination with 170,000 employees. The total M&A transaction costs for the two businesses were around $2 billion (2.5% of deal value); but part of this was Stamp Duty (transaction tax), so professional fees summed to about $1.5 billion, some 1.9% of deal value. Towards half a billion of this was spent on advice from banks and management consultants; three-quarters of a billion for arranging the borrowing used to finance the deal. The rest went to lawyers, PR consultants and accountants. The outcome of the deal has not impressed commentators who have studied the merged firm's financial performance.[1]

A similar pattern was reported for the £24.3 billion purchase in 2016 of Arm Holdings by SoftBank: £96 million (about 0.5% of deal value) to banks for their advice to the two businesses ('for a few weeks' work,' according to Vincent 2016a), and another 0.5% for arranging borrowing.[2]

1 Massoudi and Abboud (2019) report that three years after the deal, ABInbev's shares 'sit 26 per cent below the level they were at in October 2016 [...] The world's biggest brewer is still carrying $106 billion of debt taken on to pay for the deal' — with businesses being sold off 'to chip away at the debt'.

2 We recognise that fees for deals which go ahead have to be set at a level sufficient to cover the adviser's other activities and expenses such as negotiations with potential clients which do not lead to engagement.

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In 2020 advisers were brought in again as SoftBank proposed to sell Arm to the US firm Nvidia in order to reduce its borrowings.[3]

Table 3.1

Transaction costs: ABInbev/SAB Miller merger

$ million	ABInbev	lead firm	SABMiller	lead firm
Financial & broking	135	Lazard	113	Robey
Fees for raising debt	725			
Legal	185	Freshfields	76	Linklaters
PR	20	Brunswick	9	Finsbury
Accounting, etc.	15		4	
Management consultancy, etc.	180			
Other costs				
Stamp duty	475	HMRC		

Source: Massoudi, A. (2016) 'ABInBev-SABMiller deal to yield $2bn in fees and taxes', *FT*, 27.8.16.

As we have recognised above, in a sector characterised by huge numbers, such as finance, it can be hard to take in numbers ending in so many zeros. A yardstick can help. Collins (2019) provided one for the aborted bid by Sainsburys for Asda. If a deal is aborted the transaction costs are typically much smaller as a proportion of the deal value—an important point in our discussion below of conflicts of interest. Nevertheless, as Collins (2019) pointed out, they were the equivalent of 'the margin on £2.3billion of sales', which gives a sense of the time and effort required 'as the (mostly poorly paid) staff in Sainsbury's supermarkets try to generate sales to pay the fees'.

Another useful yardstick is to compare the sums derived from this work by the advisers' employees with average incomes. Just as with the executives in the previous chapter, performance-related pay is an

3 The proposed deal was abandoned in February 2022 in the face of opposition from competition authorities.

important component of the employees' incomes: staff bonuses are related to getting the deal done and to the fees so generated. The banks supplying such advice offer rich rewards to their staff in M&A. In the US and the UK, the most active centres of M&A transactions, rookies start with pay three or four times the median annual salaries of the whole national workforce. Senior staff ('managing directors') are eligible for very large bonuses related to the fees they earn for the bank, and their pay can reach three hundred times the national median pay.[4]

If deals do go ahead, the feeling of wellbeing does sometimes 'trickle down'. Vincent (2016b) notes: 'When five Barclays bankers dined out on a deal in 2002, they paid 500 per cent over the odds for three bottles of Petrus, a Montrachet and an Yquem. Plus two pints of lager. Their waiters split £5,500. Nice work if you can get it.'

The Dilemma for the Adviser

Put yourself in the position of the investment banker earning your living through M&A advice. Suppose the executives are eager to go ahead with a deal—for some of the diverse reasons outlined in the previous chapter. But in the light of your knowledge of the two businesses and the sector and the market conditions, you have serious doubts about the gains to be had by shareholders from the proposed merger. How vigorously do you try to persuade your client to abandon her aspiration to expand her business in this way? If she does give up, you can only claim reimbursement for the staff time and expenses in compiling the advice ('only' as represented in the Sainsbury's example above). But if the deal goes ahead, payment will typically be in the form of a substantial success fee calculated as a percentage of the deal value. Moreover, there will also often be lucrative fees to be won for organizing the funding of the deal. Clearly, the adviser's direct financial interest is generally served by the deal going ahead, not by it being aborted.

There is also a relationship to safeguard. If the client executive's longer-term strategy is to grow by M&A, do you want to lose the opportunity to build the relationship while completing the deal, and to secure a favoured position when advisers are being arranged for the

4 https://corporatefinanceinstitute.com; https://mergersandacquisitions.com; https://arkesden.com; https://www.statista.com; https://ons.gov.uk.

next M&A deal or other banking services? Under CEO Jack Welch, GE was on average completing about four deals a month over the final two decades of last century (Gryta and Mann 2020, p. 17). His successor continued the M&A strategy. Crooks (2018) reports on the fees earned from the acquisition programme of GE since 2000:

> The dealmaking was great for GE's advisers. Banks that worked with GE on its deals, including Goldman Sachs, JP Morgan and Morgan Stanley, earned hundreds of millions of dollars for their advice since 2000, data from Thomson Reuters show. Coupled with the work Wall Street offered underwriting debt, equity and loans for the group, GE proved a critical client. Since the turn of the century, it has paid more than $6bn in fees, according to the data provider.

The incentive for bank advisers not to deter potential acquirers from going ahead is reinforced by the way 'success' is measured by the media. Just as the kudos of business executives is reinforced by rankings based on the size of the business rather than its profitability (Chapter 2), so also the rankings for M&A advisers are based on the fee income secured by the banks.[5] Completing the deal brings not only the immediate financial benefit, but also the glamour of heading, or rising in, the fee rankings. And that in turn raises your visibility to would-be acquirers looking for an adviser to drive through a deal.

A Surprising Insight into How Much Work Expert Advisers Sometimes Do on a Deal

The interaction between M&A advisers and acquirer executives takes place behind closed doors. But aspects of that relationship were revealed for the RBS/ABN AMRO case by a UK Parliamentary Committee (HoC 2012). The acquirer failed during the financial crash 12 months after this deal was completed, and received a 45-billion-pound government bailout. The parliamentarians—in the case of this excerpt from the transcript, Jesse Norman—were exploring the case with distinguished financiers, including Sir David Walker, whom the committee had asked to review the case on their behalf:

5 E.g. ig.ft.com/wall-street-fees. Some use another scale measure (to which fees are closely related)—deal value: mergermarket.com, dialogic, and *WSJ*.

Extract from a transcript of part of a meeting of the House of Commons Treasury Committee discussing the failure of RBS (HC640)

January 24, 2012

Q83 Jesse Norman: Yes, thank you. Did you see the report from the advisers that they would have given to the directors?

Sir David Walker: There was certainly one major report. At the time when the board were first considering the ABN AMRO acquisition possibility, which was probably about February/March—I don't know the precise date and my recollection is not clear—there was a report, the thrust of which was supportive of this being an attractive opportunity, something like that.

Q84 Jesse Norman: That report would have modelled the financial effects of the takeover?

Sir David Walker: No, I don't think it did. I don't think that question had been posed. I think the question that was posed was, "Here is an opportunity. Is it interesting for us?" It was at a fairly high level I recollect.

Jesse Norman: But there must have been some projection of the financial benefits. The board must have had some advice as to what the financial implications of buying an institution worth €71 billion were, for its own balance sheet, for its own liquidity, for the status of its own operations.

Bill Knight: I am sure they did. You should bear in mind, of course, that €71 billion was the total price. RBS's share of that was 38%.

Jesse Norman: Yes, it was about €27 billion.

Bill Knight: Yes, that is right, so it was actually much smaller.

Jesse Norman: But the board was, nevertheless, buying into a transaction of the larger size and one would have expected that the portions it was buying would have been in substance modelled pro forma into its own P&L, into its own financial statements, into its own capital requirements.

Sir David Walker: My belief is that although they had that advice at the beginning, which was generic, rather high level advice—saying, "This is an interesting opportunity to pursue"—most of the arithmetic, the pro forma stuff of the kind you refer to, was done within RBS in the ensuing period, and the focus of the adviser was in the execution of the transaction, not advice on the way it could be done.

Q85 Jesse Norman: Does that mean that the adviser never actually gave the advice that what you might call a traditional financial adviser would give, "Is this a good transaction for you"?

Sir David Walker: It depends what you mean by "traditional financial adviser". I think the error of omission there, and it is what leads us to make a specific policy proposition, is that in situations of this kind if it were to happen again it should be the norm that independent advice is taken, which is not remunerated on the basis of success with the transaction.

Jesse Norman: That is what I am trying to get at.

Sir David Walker: Yes.

Q86 Jesse Norman: A final question: how would you assess the quality of—

Chair: A very quick question and a very brief answer.

Jesse Norman: Very quickly, but it is rather germane. Did you have a chance to assess the quality of due diligence that would have been given on the purchase by the advisers?

Sir David Walker: No.

Jesse Norman: Or indirectly come to a judgment on it?

Bill Knight: The due diligence done by RBS was inadequate.

Chair: Was?

Bill Knight: Inadequate. There is no doubt about that.

Jesse Norman: Could you just describe it a little bit more so we can get a sense, don't forget we haven't seen any of it and we would like to know just how inadequate it is, the kinds of things it covered or did not cover.

Bill Knight: It was famously, in April at least, two lever-arch files and a CD. That is what is referred to in the—a very minimal amount of information was given, so it was largely based on published information, the reports to the board. The PWC report [...] clearly concludes that this was inadequate.

Q87 Jesse Norman: So the punch line is that the transaction of €27 billion was made by the board without independent financial advice on the back of thoroughly inadequate due diligence by Merrill Lynch for which they, and other advisers, would have been paid well north of €100 million or €200 million. That is the punch line of what you are saying?

This excerpt relates, no doubt, to an extreme case; but it is revealing in three respects. First, it is consistent with other evidence on the remarkable scale of fees paid to M&A advisers for apparently modest amounts of work (we noted above that £96 million were paid in the acquisition of Arm Holdings 'for a few weeks' work'). The advisers would hardly be unhappy if the deal went ahead and this fee could be claimed. Second, the advisers were seemingly not expected to, and did not, complete a thorough analysis of the prospects for the deal.[6] And third, the independent members of the RBS board, representing shareholders, had not sought independent advice on the merits of this proposed expenditure of €27 billion of shareholders' money, RBS's share of the deal. We return to the role of non-executives on the board in the next chapter.

The Revised Sequence

> They think up deals and egg you on, so they can make a fat profit
> Joe Hyman, Chairman of Viyella International. (Kynaston 2001, p. 373)

The language of investment banking conjures up an image of a potential acquirer identifying a target and then seeking the services of professional advisers—banks, lawyers and other professionals—to advise on and then implement the strategy which the potential bidder has devised. This is the 'accepted sequence' of textbook market economics: businesses respond to the autonomous demands of their customers. But in his 1966 Reith Lectures, Galbraith had proposed an alternative concept—the 'revised sequence' whereby powerful businesses actively devised products and used their sophisticated marketing operations to persuade customers to buy them (Galbraith 1967). The revised sequence accounts for part of the M&A market.

An historic US example of a banker actively promoting merger is provided by JP Morgan, who, early in the twentieth century, famously initiated mergers to combine the three major steel producers into US Steel, so that it controlled 70% of US steel production (Tepper and Hearn

6 Currently, companies listed in the UK are required to provide detailed financial information in (Class 1) cases where the acquisition is large relative to the acquirer's size. This would be compiled by the investment bank adviser, but responsibility for the underlying financial data would rest with management.

2019). His other amalgamation initiatives included the formation of Northern Securities Company, which dominated the railroad industry. In the UK, the revised sequence was firmly established forty years ago. Kynaston (2001, p. 605) describes the approach of the 'hot competitive force in the takeover field'—Morgan Grenfell: '[...] in the corporate finance department, where from 1979 there was a systematic policy of targeting companies that could potentially be persuaded into launching a takeover bid.' England and Kerr (2020) describe the same approach by bankers—of pitching potential cheap takeover targets to investors who had spare cash—during the COVID 19 crisis. 'We are presenting every opportunity we can to the Gulf and Singapore', a London-based banker said, 'They are all going to get great deals right now'.

We were reminded of this by experience with one of our very bright graduate students. He took a year out from the M&A department of an investment bank to pursue one of our Master's programmes. One of the courses he joined was in financial reporting. The course had been built around a very detailed analysis of the latest accounts of a single listed company. One of us had invested a lot of time in background research on this business and the quirks and puzzles in the accounts of this specimen firm.

After the course the student returned to his investment bank. In no time at all, even before the next year's cohort of students had got to grips with our case company's latest accounts, news came that the company was being taken over. It emerged that the adviser to the acquirer was the employer of our former student. We later discovered that his first project on returning to the bank had been pitching our case company to a client as an attractive means of expansion.

From the teaching point of view, this unfortunately meant going back to the drawing board to create a fresh new course around a different company, hoping that none of the class would repeat this process.

Special Purpose Acquisition Companies (SPACs)

The revised sequence has in recent years been taken to a new level by the use of SPACs—special purpose acquisition vehicles. Whereas in the original revised sequence the financial institution identifies an existing company to pitch to another company as a potential acquisition—to generate fees from the transaction—a SPAC is a shell company which lists on a stock exchange, raises money for an acquisition, and then searches for a private company to buy, bringing it onto the stock exchange.

Wolf (2021b) paints an unflattering picture of SPACs:

> These are vehicles for the acquisition of unlisted companies and so a way around initial public offering rules. They are modern versions on a vastly bigger scale of the company allegedly created during the early 18th century's South Sea bubble, 'for carrying on an undertaking of great advantage, but nobody to know what it is'. That bubble ended badly. Will this time be different?

In the US, SPACs raised over $55 bn in 2020 (Aliaj, Indap and Kruppa 2020); but volumes were much lower in the UK (Hodgson 2020).

Aliaj et al. report that typically the sponsors of the SPAC begin with a 20% stake in its equity, costing just $25k. Their share diminishes when an acquisition is undertaken. But one investment banker sold part of his original $25k stake for $60 million. And Aliaj et al. quote the hedge fund leader Bill Ackman describing the SPAC structure as 'one of the greatest gigs ever for the sponsor'. Because of the favourable purchase of equity at a discount by the sponsor(s), the sponsors can still gain even when the acquired business falls in value. The *Financial Times* reported that the majority of SPACs organised between 2015 and 2019 were trading below the price at which they had been listed (Tett 2020).

Other Perks for the Advice Industry

A participant in one of our finance courses came up at the end of a class and said, 'I've paid a lot of money to come on this programme, and I expect a handsome pay-off. How can I use the material in the course to recoup my fees? I don't care whether the scheme is legal, provided that I can be sure of getting away with it.'

We declined to answer. But one answer could have been 'the ever-vexed area of frequently perpetrated, infrequently prosecuted insider dealing, still the classic white-collar crime' (Kynaston 2001, pp. 775–76). In the M&A field, special opportunities arise in relation to the premium typically offered to target shareholders. If you bought shares in the prospective target when a deal was first seriously mooted, and sold them at the time of the deal, you might make a return of, say, 30% over a few months. Who has the information to make those trades? One group includes the professional advisers who prepare the campaign, documentation, etc. before the deal is announced. This is not to suggest that professional advisers in general lack integrity. But the path of the typical target's share price in the weeks up to announcement of the deal is consistent with some insiders taking advantage of this opportunity.[7]

The regulators (in the UK, the Financial Conduct Authority) are wise to this: 'suspicious trades occurred before 30 per cent of takeover announcements in the UK in 2009 according to FCA statistics' (Binham 2016, p. 18). Binham gives examples: a group of City professionals were alleged to have made insider trading profits on acquisitions including that of Scottish and Newcastle by Carlsberg and Heineken (£4.4 mn in profit) and Ncipher by Thales (a profit of £724,000). Two of the group were convicted and jailed.

FT Reporters (2016) had fun with a pun, when relating a case of information 'leakage' to a plumber ahead of M&A: 'A former Barclays director [Mr McClatchey] stands accused by US prosecutors of allegedly committing insider trading to pay for home improvements', by passing inside information on upcoming mergers to his friend, who was a plumber.

> The plumber, Gary Pusey, has pleaded guilty and agreed to cooperate with authorities.
>
> The government alleges that Mr McClatchey, who worked in a back office role, gave tips to Mr Pusey, 47, ahead of at least 10 separate transactions before they became public, including deals involving Petsmart, CVS and Duke Energy.
>
> In exchange for the tips, which allegedly earned Mr Pusey $76,000 in trading profits, the plumber made cash payments totaling thousands of dollars to Mr McClatchey by occasionally placing cash in a gym bag or handing the cash over directly to Mr McClatchey's garage, it is alleged.
>
> He also provided a free refitting of Mr McClatchey's bathroom...

Some economists have argued that insider dealing is an efficient method of keeping markets informed of the true value of a firm's shares when a potential acquisition was in the offing but had not been announced. The counter-argument, associated particularly with Nobel Laureate George

7 Though it is unlikely that the prime movers in M&A, such as CEO or lead advisers, would take part.

Akerlof (1970), is that if the market is rigged to benefit insiders, outsiders will be deterred from investing and the economy will be deprived of the risk-sharing, liquidity and other benefits of large markets.

For a long time, insider dealing was not seen as an offence in the UK, and was considered a legitimate perk for people working in the financial markets. As Kynaston reports (p. 594): 'in June 1980—at long last—insider dealing became a criminal offence, though few were holding their breath that any such criminals would be put behind bars.' But monitoring by regulators and by employers has continually increased, so that the risk of detection and punishment will have deterred some would-be dealers.

If there are adviser-insiders who have invested in target shares, their gain will be maximised if the deal goes through, selling when the shares reach their peak. The prospect of a lucrative premium is realised on completion of M&A. For an inside trader, whether or not the deal will produce operating gains does not matter.

But similarly, the legitimate opportunities M&A generates for the community of bankers and other professional advisers are very lucrative, whatever the outcome for shareholders and other stakeholders.

In 1940 Fred Schwed wrote a classic book on financial investment with a telling title. In it he tells the story of 'an out-of-town visitor being shown the wonders of the New York financial district. When the party arrived at the Battery, one of his guides indicated some handsome ships riding at anchor. He said, "Look, those are bankers' and brokers' yachts."

"Where are the customers' yachts?" asked the naive visitor—the words Fred used as his book's title. Endorsing the reissued book in the twenty-first century, Michael Bloomberg commented, 'The more things change the more they stay the same.'[8]

8 In the 2006 edition.