Geoff Meeks and J. Gay Meeks

The Merger Mystery

Why Spend Ever More on Mergers When So Many Fail?

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11. Exemplars of Failure

> Carillion's rise and spectacular fall was a story of recklessness, hubris and greed. Its business model was a relentless dash for cash, driven by acquisitions, rising debt, expansion into new markets and exploitation of suppliers. It presented accounts that misrepresented the reality of the business, and increased its dividend every year, come what may. Long term obligations, such as adequately funding its pension schemes, were treated with contempt. Even as the company very publicly began to unravel, the board was concerned with increasing and protecting generous executive bonuses. Carillion was unsustainable. The mystery is not that it collapsed, but that it lasted so long. (HoC 2018)

Before we turn to possible measures to reduce the extent of failure in the M&A market, it may be helpful to bring together most of the strands of the argument so far. Two cases already mentioned, one from the UK, one from the US, epitomise the activities which we have argued are associated with mergers that fail.

Carillion

In the UK case, the UK Parliamentary investigation produced a lucid account of this strategy and its consequences, from which the quote above is taken and from which most of our account is drawn (HoC 2018). Paragraphs from that report are referenced as HoC1, HoC2, and so on.

The story combines major acquisitions, financial failure, monopolistic/monopsonistic pressure on customers and suppliers, misinformation, moral hazard, huge costs to parties other than its executives and advisers, and influence at the very top of government. When it failed in 2018, Carillion was the second largest construction

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company in the UK, with extensive activities overseas. It had built its position with M&A, heavy reliance on debt, and large, risky contracts.

One of the strands of our critique—in Chapter 1—was the disappointing outcome of much M&A. No better example could be offered than Carillion's diversifying acquisition of EAGA. Acquired in 2011 for £298 million, this subsidiary had by 2016, the year of its parent Carillion's death, generated cumulative losses of £260 million (HoC6).

Carillion offers a reminder also of Adam Smith's characterisation, in Chapter 1, of businessmen as engaged 'in a conspiracy against the public, or in some contrivance to raise prices'. Carillion grew not just by diversified M&A [EAGA], but also by the acquisition of major rivals in the same industry, to eliminate competitors and secure higher prices in large contracts—including Mowlem in 2006 for £350 m, and Alfred McAlpine in 2008 for £565 m.

This concentration of the industry exposed a major customer to the risks created by management. The UK government was such a customer of Carillion. When the contractor failed, work stopped on some 450 construction and service contracts with government. The public bore considerable costs as a result of Carillion's risk-taking, while shareholders' losses were capped by limited liability (Chapter 5). As one example of moral hazard, immediately the company failed, the government had to commit an extra £150 million just to maintain continuity in delivery of some services, and major projects such as hospital building stalled.

Carillion's risk exposure was exacerbated by its heavy use of borrowing—a preoccupation of Chapter 5. Borrowing rose from £242 m in 2009 to £689 m in 2016, when the debt-equity ratio reached 5.3 (HoC78). But ordinary borrowing was augmented by two sources of 'borrowing' which were on terms even more favourable than those already available to business generally because of the subsidies to borrowing provided by the tax system and the artificially low interest rates resulting from asymmetric monetary policy (Chapter 6). These sources were actually provided interest-free: and costs arising from the downside risks fell heavily on two interest groups: Carillion's suppliers and the members of the company's pension funds.

Chapter 5 reported on Carillion's monopsonistic power, achieved partly though M&A, which allowed it to demand from its suppliers interest-free funding which, as it turned out, carried very high risk. Suppliers had to wait up to four months for payment. And consequently, when Carillion failed, it owed around £2 billion to 30,000 suppliers, who 'will get little back from the liquidation' (HoC), and some of whom were likely themselves to be bankrupted as a result.

Carillion enjoyed a second source of funding on highly favourable terms: the members of its employee pension funds. Chapter 5 illustrated with BHS the way that obligations to a target's pension funds can be taken on by the acquirer, effectively reducing the outlay required to complete the merger.

When Carillion went into liquidation in 2018 it was responsible for thirteen defined benefit pension schemes. Responsibility for these schemes had mostly been accumulated in the course of M&A. For example, when acquiring Mowlem in 2006, Carillion assumed responsibility for the target's pension scheme (which had £33 million fewer assets than pension obligations); in the case of the scheme acquired with Alfred McAlpine in 2008 the shortfall was £123 million. Had the acquirer not taken responsibility for these schemes, the seller would have had to pay to clear the pensions deficit, and would presumably have demanded a corresponding extra sum from the buyer. In effect then, as in the BHS case, assuming responsibility for a target's pension scheme reduced the immediate purchase consideration for the acquisition.

Had Carillion taken out an extra loan to recompense the target for insuring the pension liability, Carillion would have had an extra interest bill in subsequent years. Instead, it had an obligation to make good the deficit—eventually. However, the adviser to the Trustee appointed to represent the interests of the pension fund members reported that Carillion had 'historically prioritized other demands on capital ahead of [pension] deficit reduction in order to grow earnings and support the share price' (HoC30). And the Chair of the Board of Trustees commented that Carillion's finance director regarded funding pension schemes as a 'waste of money' (HoC31). The parliamentary report argued that the Pensions Regulator was 'feeble' in allowing Carillion to neglect the pension fund.

After Carillion's failure, the national Pension Protection Fund had to assume responsibility for the pension scheme. Members received pensions from the Fund, but at a lower rate than they had been promised.

And the pension cuts still left the Fund with a shortfall of some £800 million to be paid from its reserves and from levies on its members (other employers with defined benefit pension schemes).

The CEO and finance director of Carillion escaped such losses: they were not members of the company's defined benefit pension scheme. Instead, they received annual contributions to personal 'defined contribution' schemes. The contributions in respect of 2016 were £231,000 and £163,000 respectively (HoC34; Carillion AR 2016, p. 66).

How did Carillion's stakeholders fare?

In truth, dividends should have been discontinued well ahead of the collapse. The executives masked the dire state of the company: in reporting the company's finances they were found by the parliamentary committees to have deployed creative accounting such as Chapter 9 describes.

Goodwill arising from M&A (which totalled £1.6 billion in 2016: HoC122) should have been impaired when expected profits did not materialise (Ford 2018). The impairment would have reduced profits and distributable reserves. But the executives exploited the discretion we discussed in Chapter 9 to delay any impairment. This, in combination with under-reporting (by around a billion pounds: HoC79) of losses on contracts, inflated reported earnings: Carillion had exploited the creative accounting opportunity outlined in Chapter 9 of front-loading the profits from multi-period contracts, and, when the profits were not sustained in the later years of contracts, had (finally) to make a provision in 2017 for £729 million. This device had enabled it to report higher distributable reserves, without which the continued growth in dividends would not have been permissible. During the tenure of finance director Richard Adams (2007 to December 2016), dividends to shareholders rose by 199% while (wholly inadequate) recovery payments to the under-funded pension schemes increased by just 12% (HoC18). Board members owned shares in the business and were direct beneficiaries of this policy. So—moral hazard in action—shareholders' interests were defended when the crisis deepened, at the expense of trade creditors and pensioners.

Consistent with Chapter 3, advisers' interests were protected too. Three days before the company was declared insolvent, resulting in huge losses to most creditors, Carillion took urgent steps to avoid their advisers (accountants, lawyers, etc.) being out of pocket, paying them £6.4 m (HoC127). If they had not rushed to do this, the advisers would have had to join the long queue of creditors hoping that the liquidators might eventually be able to pay them some portion of their claim.

The CFO, Mr Adams, who had been responsible for the company's finances since 2007, and will have been able to see the writing on the wall, made a well-timed departure from the company in December 2016. As the crisis had deepened, pay for the CEO and Mr Adams had increased sharply: from £1.8 m in 2014 to £3.0 m in 2016 for the two together (HoC61). Then Mr Adams sold all his shares in Carillion between March and May 2017, at an average price of 212 pence. By mid-July, as information on the firm's finances reached the market, the share price had fallen to 57 pence. The parliamentary committee described these as the 'actions of a man who knew exactly where the company was heading once it was no longer propped up by his accounting tricks.' (HoC105)

The reputations of most of the senior executives and non-executive directors of Carillion fared less well than their bank accounts when their actions were reviewed by the parliamentary committee. But this case also suggests that reputational damage endures less long than we expect, and that the political influence which often comes with leadership of a large business (Meeks, Meeks and Meeks forthcoming) can be surprisingly resilient. Overseeing the culture of misinformation and misaligned incentives at Carillion as senior non-executive director from 2011 and chairman of its board from 2014 was Philip Green. This Philip Green is not the same as Sir Philip Green of the BHS pension furore we discussed in Chapter 5 (we have re-checked this ten times as the coincidence seems hard to believe). Mr Green had also been at the centre of one of our important cases in Chapters 9 and 10, Coloroll. Coloroll was the serial acquirer which used grossly misleading accounting in the course of takeover—especially the notorious reorganisation provision—to create illusory profits, boosting its share price, and facilitating the next acquisition on unduly favourable terms. It too collapsed, leaving large debts unpaid and the pension fund in deficit, soon after reporting large profits. Mr Green was Coloroll's Managing Director. Following that episode at Coloroll, the Pensions Ombudsman made a finding of breach of trust and maladministration against him in 1994 (HoC60).

These achievements had earned him influence at the very top of government. In 2011, the year he joined Carillion's board, Mr Green was appointed adviser to the Prime Minister, Mr Cameron, on corporate responsibility (HoC60), and he held that position until 2016, alongside his powerful role at the head of Carillion.

GE

Our second example, GE, has appeared at several points in earlier chapters. It has almost every component of the explanations we have offered for ill-fated M&A: huge expenditures on M&A, sustained over decades, leading to a collapse in share price; high-powered financial incentives for the CEO; lucrative fees paid to financial advisers; heavy reliance on debt leading to government bailout; tax avoidance, creative accounting, and feedback loops.

In the last two decades of the twentieth century Chief Executive Jack Welch averaged roughly four acquisitions a month, about a thousand in total. His successor, Jeff Immelt, continued the strategy, acquiring some 700 businesses in his seventeen-year tenure.[1] In the early years this programme was accompanied by rising reported profits, and the stock market valuation of the business reached $600 billion in 2000; but by 2018 this had fallen to $98 billion (Edgecliffe-Johnson et al. 2021).

Messrs Welch and Immelt were well rewarded for their work: between $450 million and $800 million for Mr Welch while working at GE, and $168 million for Mr Immelt in his last eleven years to 2017.[2] Perks were generous too: we noted in Chapter 2 that Mr Immelt took two executive jets on his business travels. And they enjoyed the security afforded by enviable market power. For example, because of their dominant position in aircraft leasing they were able to insist on a 'GE only' tying policy when negotiating leases; they secured 65% of the market for large aircraft engines; and made money in aviation while their airline customers were struggling (Dissanaike et al. 2022).

Chapter 3 reported the benefits received by the banks which advised on, and raised funding for, GE's acquisitions. Banks including Goldman

1 Gryta and Mann (2020). They also divested a smaller but significant number.

2 Estimates by the *Wall Street Journal*, reported in Gryta and Mann (2020, pp. 319–20).

Sachs, JP Morgan and Morgan Stanley received more than $6 billion in fees from GE in the years of its decline since 2000.

Much of GE's expansion was accompanied by borrowing, with the attendant risks discussed in Chapter 5. The finance arm, GECS, had borrowings of over $200 billion in 2000.[3] The associated risks became evident in the financial crisis of 2008: GE had to call on government support—$139 billion of loan guarantees. It also had to resort to emergency sales of shares, at large discounts to recent prices—diluting the equity of existing shareholders.

(Legal) tax avoidance, the subject of Chapter 6, was also part of GE's strategy. Its Annual Report for 2011 explains: 'Our consolidated income tax rate is lower than the US statutory rate primarily because of benefits from lower-rated global operations, including the use of global funding structures [...] non-US income is subject to local country tax rates that are significantly below the 35% US statutory rate' (GE 2012, p. 37).

Chapter 10 reported GE's use of the creative accounting devices elaborated in Chapter 9, which flatter reported earnings, and assist the smoothing of earnings, an effect which finds favour with the stock market. This supported the feedback loop described in Chapter 10. Inflated earnings bolster the share price. This improves the terms on which an acquisition can be made. Then the acquisition itself creates fresh opportunities further to flatter earnings. Edgecliffe-Johnson et al. (2021) quote the director of the Securities and Exchange Commission's enforcement division: 'GE bent the accounting rules beyond the breaking point'.

3 GE (2001). For the business as a whole, borrowings equated to 46% of total assets (Dissanaike et al. 2022).