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I N D E X

(PANEL 2 EXCERPT)

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PANEL 2
MOTIVATIONS FOR MERGERS AND KEY SUCCESS AND FAILURE FACTORS

MR. PAUTLER: Okay. If we can come to order, we'll continue this morning with Panel 2. It's going to be moderated by the Adjunct Professor of Marketing from Vanderbilt University, and more well-known to us as the Director of the Bureau of Economics at the FTC, David Scheffman. Dave?

MR. SCHEFFMAN: Thanks, Paul. Let me give you an idea of where we are on the road map. We had a session this morning that looked at sort of the macro view, what the evidence indicates about what the overall effect of mergers are on average or on the economy. Now, we're getting down more to the nitty gritty.

This panel is going to consist of consultants that do M&A consulting and a business school professor who teaches and researches strategy and also is involved in consulting. They will talk about the details of why mergers occur, what we can tell about whether they work or not, and what we mean by whether they work or not.

We have an outstanding panel. We're going to begin with Pankaj Ghemawat. Pankaj is one of the most important figures in business strategy as an academic researcher. Michael Porter is rightfully credited with introducing economics into business strategy and Pankaj, who joined the Harvard Business School as the youngest full professor there ever, has continued that tradition and has done a lot of important work in publications on business strategy. He also contributes to this tremendous national resource we have: the Harvard Business Case Study. Having taught MBA students for many years, the case studies have been an essential resource, and they have also been very useful to us at the FTC. When we get a case in an industry, we can look and see if there is a Harvard Business case on it.

Pankaj has led the Business Strategy Program and Competitive Analysis at Harvard Business School, and has consulted with many, many companies.

Our second panelist today is Mike Shelton. Mike Shelton is Associate Principle in McKinsey's Chicago office and he's the leader of the McKinsey post-merger management practice.

For those of you who don't know about M&A consulting -- and I don't know nearly as much as these folks do, but it used to be, back in the old days of business consulting, around the time my former colleague, Bruce Henderson founded Boston Consulting Group, that consultants gave strategic advice to companies. In fact, it was that strategic advice that led to many of the mergers that Mr. Scherer analyzed during the '60s and '70s that didn't turn out very well.

Where merger consulting has gone is to a greater focus on implementation, on implementing the deal, and Mike is certainly going to talk about that. He has 19 years of consulting experience, and has been with McKinsey since 1998. So, he has very extensive experience in M&A consulting.

The third panelist, Mark Sirower, is a corporate development advisor with the Boston Consulting Group and a global leader of BCG's M&A practice. He's also a Visiting Professor at NYU's Stern School of Business. He's taught M&A at the Wharton School at Penn. He has written some very interesting books and articles on mergers and acquisitions. He will conclude our panel and presentations, and then we will have discussion amongst the panelists and questions from the floor.

So, we'll begin with Pankaj.

MR. GHEMAWAT: Thank you, David. Well, good morning and I appreciate this opportunity to talk to this very distinguished group about mergers. Since it's just after rather than before a break, I think it's reasonably safe to mention that of all the speakers today, I probably have the least to do with mergers of anybody on any of the panels here. My sort of contact with mergers and the little writing that I've done on mergers really stemmed from a client that I had been involved with for a while, and in 1999, I found this company, which was generally pretty analytical, generally very thoughtful about its investment decisions, deciding to make a big leap and do a big cross border merger. I was sufficiently staggered by the reasoning involved to write a Harvard Business Review article with the non-judgmental title, the Dubious Logic of Global Mega Mergers, and I suspect that that's the reason why I've been invited here today.

As shown in the slide on the bottom of the first page of my handout, I'm going to be talking about things a little bit more from the nitty gritty perspective that David mentioned. The one thing that I should stress is that I'm sort of more used to talking to audiences interested in business policy than in public policy. So, while I will try and reframe things appropriately as we go through the various paces, I may not always have the mental agility necessary to do that, and so, if you can sort of translate appropriately, that would be useful as well.

In any case, my brief for the 15 minutes of fame, or however one describes this that one has today, was to cover a fairly broad territory and of the various things that I talked about with David, these are things that I figured I could at least touch on in passing in the course of 15 minutes.

First question is a paradox or partial paradox of why managers' assessment of the success of mergers generally tends to be much more positive than their assessment of the financial success of mergers.

Second, there's the issue flowing from the first question of what exactly do managers mean by merger success?

Third, can we actually get a little bit beyond simple advice to get the cash flows right, in terms of thinking from an ex ante perspective of what's likely to drive success versus failure?

And finally, David also expressed some interest in having me talk very briefly about bases of value creation a little bit different from what the FTC traditionally focuses on; in particular, bases for value creation that go beyond cost savings and just market power to jack up prices, and I'll try and do that as well with a couple of examples. So, that's the agenda.

To start off with measures of success, we do have this partial paradox of why it is that when you ask managers how well the mergers they've participated in have done, you generally get positive reactions, and when you ask them specifically about financial success, you get much more muted reactions. Now, some of this is not much of a paradox. If you go and ask somebody who's just been responsible for investing a big chunk of his company's net worth in a merger, it is relatively unlikely that they are going to go out on a limb to stress the extent to which the merger failed to accomplish their objectives.

But even if one discounts that particular hypothesis, it does seem that there are some differences in terms of how researchers have traditionally defined success versus what business managers tend to think about when they think about the extent to which a merger has succeeded or failed.

So, this morning, earlier this morning, if we think back to our first panel, much of the discussion really focused on -- well, actually, there was less focus on stock price performance than I had expected and a little bit more discussion of accounting measures of profitability. But it is worth sort of thinking about reasons that managers will give you or reasons that you can infer if you talk to them about why they undertook particular efforts or what they regard as indicators of success in the efforts that they've undertaken.

In addition to stock price performance and accounting measures of profitability as measures of success, the slide on the top of page 2 of my handout has a miscellaneous list under the "others" category. This list is by no means meant to be complete. It is more to give you a flavor of the different kinds of considerations that managers might bring to bear in assessing merger success. Even if they aren't making their assessments on an entirely self-serving basis, why might there be a bit of wobble between how academic researchers look at the problem and what managers might report?

First, under the other category is the idea that there is the possibility of exploiting overvalued stock. Now, of course, no manager that I've ever met has ever sort of regarded his or her company's stock as overvalued, so this is more traditionally framed as we have a strong currency and we want to use the currency while it's strong sort of argument. Functionally equivalent, I suspect, to exploiting overvalued stock. But there might be some nuance differentials there.

Notice that to the extent that one believes this, this does have somewhat strong implications, and I think Steve Kaplan alluded to these. This does have some implications for the use of stock price performance studies to try and infer, even over a three-year time period, how well or how poorly a merger has done.

A second common kind of motivation and the one that really stood out to me when I was looking at the merger games that were on in a bunch of globalizing industries is this idea of maintaining or improving market share position. So, if you take, for instance, the sort of very elaborate minuet that was going on in the worldwide aluminum industry back in 1999, where first Alusuisse, Pechiney and Alcan announced that they were going to combine in APA, and then very quickly Alcoa announced that it was going to be buying up Reynolds. If you talked to the people involved, it's a little bit hard to resist the conviction that certainly the desire to retain the position or build up the position of the world's largest aluminum producer played as large a role in these combinations or attempted combinations as did any sort of quantification of cost savings, et cetera.

Third, and I think this sort of falls in the category of something that we want to treat, perhaps, most seriously of these other reasons, is the idea that you can't really look at mergers as one-off transactions. In some sense, to the extent that a merger should be or is part of a carefully crafted strategy that cuts across multiple domains, a manager might very well regard a specific transaction as actually having been successful based largely on the contribution that it makes towards the implementation of that chosen strategy.

And then finally, there's achieving a strategic transformation. People wait long times before they get to be CEOs, and so, one can find lots of sort of interesting examples of people stepping up to the plate and deciding that for better or worse they're going to transform the company and using their ability to actually do that as a measure of merger success or failure.

This list could be added to, and as I said earlier, should not be inferred to be complete. But it does sort of suggest a couple of things. One is -- if we're trying to understand merger motivations in particular, we probably want to go beyond just the measures of performance sanctified by research tradition and start thinking about what some of the motivations are for the people who are actually responsible for making these decisions, subject, of course, to your concurrence, what these people say about why they're engaging in some of these mergers.

I think the second point that's sort of worth mentioning in this context is that while some of these explanations listed under "others" certainly seem to make sense from the perspective of a value maximizing or profit maximizing private enterprise, there are others that at their outer limits start to verge on, if not self-indulgence, perhaps one could go so far as to say fantasy. Therefore, it's useful to try and think, well, not just what reasons do managers actually articulate when you ask them why they're engaging in particular mergers, but whether it's possible to devise some kind of framework for thinking about whether these promised gains, whatever they happen to be, are actually likely to be realized.

Since I have five minutes left and only about three-quarters of my presentation left to go through, let me try and speed things up.

Very simply, the traditional advice in terms of sort of ex ante assessment of mergers is along the lines of try and see if you can do the discounted cash flow analysis properly. If that turns out to be positive, you should go ahead, and if it turns out not to be positive, you should not. In the field of strategy, we like to think that we've sort of gone some distance trying to think about the economic primitives that are the underlying drivers of the cash flows that you should be plugging into your cash flow models to figure out whether value is likely to be added or not.

Very simply, when I work with companies or when I try and teach my students about mergers, we spend a fair amount of time actually trying to think about what the different components of value from a firm's perspective might be, and decomposing those into things that we think business strategy has had something to say about. The slide on the bottom of page 2 of my handout helps illustrate this.

I'm not going to explain the logic of this beyond noting that value is the product, roughly speaking, of volume and margins. If we decompose margins, at least one particular way of doing it that has a certain amount of precedent in strategic practice, as well as an internal logic, is to think about how attractive an industry will be on average - Mike Porter's work on industry attractiveness. Then think about deviations from that average by trying to think about whether a merger is, in fact, likely to improve your relative cost position or your relative differentiation position in ways that are likely to make your margins, as a particular company in a particular industry, differ from the average industry margins.

This is a very cunning device whose subtlety may not be entirely apparent at first glance. The items listed in the slide on the bottom of page 2 of my handout are all helpfully alphabetized so that my students can remember to think through factors A through G as they think about merger assessment.

Rather than spend more time talking about the subtlety of this, let me just sort of give you an example using the slide on the top of page 3 of my handout. This is a company that I spent a fair amount of time studying. In response to a question that was raised earlier, it's actually part of a study that I'm doing of mergers in the cement industry overall. Cemex probably dramatizes, in a cross border context admittedly, some of these potential gains, in line with the template on the previous slide, that it might be worth thinking about if one's really trying to cast one's net broadly to figure out the potential for value creation through a merger.

Accelerating growth, back in the late 1980s, Cemex wasn't even the largest player in Latin America. If they hadn't embarked on an aggressive program of mergers, they would probably have stayed smaller than Votorantim, which was the largest player in the America's at that point, and which, since it ran out of space to grow in its domestic market of Brazil, really engaged in an unprofitable strategy of horizontal diversification as opposed to growing within cement.

The important point here is that if you believe, as I do, that Cemex has some important firm-specific capabilities in terms of cost reduction within the cement industry, and given their reluctance to add lots of new capacity to markets they were entering, because they did not quite have shutdown economics, mergers were, in some sense, essential to trying to apply their cost reduction expertise to a broader capacity base than just the capacity that they controlled within Mexico.

Second, in terms of cost reductions, clear examples of some cost reductions associated with reductions in operating costs through post-merger integration, scale economies and IT. One interesting feature of the cement industry in general, though, and a reminder that our usual assumption that cost savings are good, other kinds of things not so good necessarily, is that the big cost savings that the big cement players have actually gotten by acquiring players in other countries really stem from taking advantage of financial distress in local markets.

So, if you look at the Asian crisis, basically all the cement majors paid about $100 to $110 per ton for a capacity that was valued at typically between $150 to $200 per ton, and while that's probably good for the cement majors, certainly when we're taking a global federalism kind of perspective, it's not clear that that should be treated as a significant source of value creation. That was really just redistribution going on between the distressed sellers in these local markets, and the buyers who happened to be multi-market players, not quite as exposed to the regional downturn as the people whose capacity they were buying up.

Example of differentiation, willingness to pay, this is sort of mixed. You can think of some cases in which some of what they were trying to do to raise willingness to pay would probably fail an antitrust test of is this good. So, Cemex operates the biggest trading network in the industry, even though it's not the largest player. And as far as one can tell, this trading network is used partly to ensure that flows of cheap imports get diverted to markets where Cemex does not have a major presence of its own to defend. Good from Cemex’s perspective, hard to sort of argue that this is a very good thing from the perspective of poor customers suffering in Cemex-dominated markets.

On the other hand, you may find this remarkable, but within the cement industry, there’s recently been a move towards branding cement, and this is particularly important in emerging markets. Before we dismiss this as somebody just getting a little bit too carried away by their marketing courses, it’s sort of worth remembering that one of the major problems in these markets is the adulteration of cement, which frequently leads to collapses of buildings, fatalities, et cetera. So one can see, in Cemex’s brand-building campaign, which again you presumably need some firm-specific skills to be able to pull this off, they’ve had a chance to apply this to markets outside Mexico, places like the Philippines. They’re starting to do this in India. There’s a potential for some significant consumer gains associated with actually having quality assurance and a product that seems less likely to simply have been diluted with sand than the typical bag of cement that you might purchase in an emerging market.

The big thing that seems to be going on here overall is very much what you people really care about. There is significant evidence of multi-market collusion in this industry, and so, if one looks at EBIT margins, which are the standard measure of performance here, and just correlate those with the share of local market capacity held by the top three global players, you end up with a R-square of about 60 percent.

So, that’s suggesting that, again, the story is somewhat mixed. We can see some good things that are associated with what’s been going on around these mergers and we can see some bad things that are associated with these mergers.

I think forestalling risk is relatively obvious. This is simply the idea that in a very cyclical industry there are some advantages both in terms of exposure to competitive attack and in terms of exposure to local country risk associated with operating in multiple markets. If you buy the point that cement players typically do not have shutdown economics in new markets that they get into, mergers presumably are the most obvious way of tapping these kinds of risk reductions.

And finally, there are some examples of learning benefits. So, Cemex, back in the early 1990s, acquired Valenciana in Spain just before a big downturn hit the Spanish market. They were forced to rummage around in Valenciana’s files to figure out if there was any way of salvaging the solution. This is where they figured out that it was feasible, in fact, to use information technology to really achieve significant cost reductions in the Spanish operations that subsequently have ended up flowing back into their operations in Mexico and being applied to their operations in other countries.

So, this is an atypical case because I suspect that the number of different levers that Cemex has pulled to actually tap gains from mergers are a little bit broader than those available in the case of the typical combination, and for the typical combination, one can talk about a whole bunch of problems that arise that make the Cemex case a little bit less representative. Typical combinations usually don't manage to achieve an acceleration of growth rates; often exaggerate cost savings; often miss out on the diseconomies of scale, scope and complexity associated with more complex product lines than simply cement; and don't have quite the same ability to enhance willingness to pay, et cetera.

I realize my time is up, so let me just sort of talk you through one counter-example case and then wrap up. I said the Cemex case is atypical. Just to give you a sense of variation, let's compare Cemex with another merger that I've spent some time looking at, Daimler/Chrysler. The interesting thing about Daimler/Chrysler was that apparently at the initial meetings between Shrimp, the CEO of Daimler, and Eaton, who was the CEO of Chrysler, the early discussions seemed to have been entirely focused on achieving tax benefits or making sure that the potential of tax benefits of the merger were not somehow dissipated away.

So, that's where they decided that the merger would be a stock swap, that it would be a pooling of interest type merger and that the entity would continue to be incorporated in Germany to take advantage of German tax laws, carry-forward, et cetera.

But remarkably enough, there actually does not seem to have been any discussion at the level of these different functional elements that I've talked about in terms of where the savings were going to come from above and beyond the tax economies, until at least a year or a year and a half into the merger's process.

And also remarkably, when you actually quiz Daimler-Benz executives about the strategic logic of the merger, what you see over and over again, because I've seen them quizzed about this in multiple fora, what you see is the slide saying the world is getting more concentrated, only four or five or six big auto players are going to survive, and the merger was clearly essential for us to be one of them.

I actually had a very lively session with Daimler-Benz's top management where I pointed out that our own concentration data on the auto industry, using a Herfindahl Index so we could leverage some of Ray Vernon's old data, indicated that the big problem in the auto industry has actually been that concentration has declined more or less continuously since the mid-1950s (as shown in the slide on the top of page 5 of my handout), and therefore, if you thought that you were going to get huge gains associated with buying up a competitor, well, you have to put that against the fact that concentration levels in the auto industry worldwide are at levels that we hadn't seen for the last 40 or 50 years, and that led to a big theological dispute about, well, should we measure number of competitors or should we make some attempt to weigh the number of competitors by their market shares. I suspect that we probably have more of a common understanding in this room on what the right way of resolving that particular debate is.

The slide on the bottom of page 5 of my handout is my last slide. So, I think in conclusion, I'd just sort of like to stress four things. First is -- and this stood out at the end of the previous panel as well -- we can talk about averages, but it's also worth remembering that there is enormous variation in outcomes, and digging deeply into that variation typically requires more of a clinical or case study or whatever else your preferred terminology might be, in terms of approaches, so that there is some value to supplementing large-sample analysis with detailed studies of individual cases.

Second, I'd argue that a lot of the work that is done, especially the large-sample work, takes a very transactional focus on mergers and acquisitions, and particularly when you look at serial acquirers like Cemex. It's very, very hard to assess their strategy without really considering in some depth both how their industry is evolving and what their overall strategy is as opposed to simply asking, well, did it make sense for Cemex to buy this particular cement company.

Third, in terms of analysis of benefits and costs, I do think that it's worth sort of thinking beyond the traditional categories of cost savings and increased market power to at least make sure that one's done one's due diligence on some of the other categories of potential gains that I talked about.

And lastly, it's sort of worth remembering that practice can be improved greatly, which probably has some implications for, as the FTC goes into the discovery process or something else, this may have some implications for what you should expect to find when you look at some companies. Certainly, not all companies can be expected to have analyzed these issues in quite the depth that would benefit them and, perhaps, even benefit society as well.

Let me stop there. My apologies for running over.

MR. SCHEFFMAN: Okay. Next we have Mike Shelton from McKinsey.

MR. SHELTON: Hello, everybody. As seen in slide 1 of my handout, I want to spend a little bit of time today just talking, first, about some research that consulting firms have done. What we've done is look over consulting firms overall and just get an overall perspective for you of some of the viewpoints.

Second, to focus on where the value is in these deals, and then third, to bring to life just one example of a success. And David asked me, the last time we had talked, he said, there's no shortage of organizations that you can pick about how they failed in a merger. So, it would be good to see one that was really successful. So, that's what I'll end on.

If you look at my experience, I've been involved with over 50 mergers in terms of going through the implementation of integrating the two organizations. So, I do tend to come from the perspective of the deal's going to happen, now what can you really do to make sure that we make this successful. So, I'll try to bring some real tangible issues as we talk about the values of a deal.

I've always felt and been told, over the last 10 years, you need to start every M&A, mergers and acquisitions, presentation with a slide that shows an arrow going up, just to reflect, I think, subliminally that M&A is here to stay and that they're always growing. Now, unfortunately, the last year and a half, you see, in slide 2 of my handout, this tail going the wrong way. But nonetheless, if you look at 2001, and I know that 2002 is even going a little bit down, but it's probably about equal to the 1995, 1996 times, those years were the top year ever before. So, while we have seen a flip down, there's still just a tremendous amount of mergers going on.

If you look at different consulting firms and businesses that have done research, generally overall you see somewhere in the neighborhood of 60 to 75 percent of mergers fail from the perspective of the studies that are going on, and a lot of different organizations have done studies. Slide 3 of my handout has just some of the samples. But this is what you're seeing in the businesses and in the research and in the newspapers.

If you look at them overall, what are these studies saying? As shown in slide 4 of my handout, these studies, overall, in terms of the failures, they're saying about 30 percent of the failures are due to poor deals. Basically, you just pay too much. These synergies were unrealistic, the prices were too high. Seventy percent of them, usually when you look back at these, they reflect back at the implementation. Whether it is some of the softer issues like the communications or the cultural differences or if it's customer loss or if it's just poor implementation going through the actual merger.

I'll go ahead and flip through some of the different studies just to give you highlights of what we've seen. First, about two years ago, McKinsey did a study and this study really focused on performance and performance ethic. As seen in slide 5 of my handout, the key finding in this study is that 65 percent of the mergers failed. And then the focus for companies that did the mergers well, one, they were able to maintain the performance ethic of the stronger company throughout the merger. So, in other words, in most organizations, when you have two companies with two performance ethics, one of them tends to lower the other, and because of that, the overall organization tends to not achieve as well as it did. The second major result was being able to retain the key people.

KPMG did two studies, one in 1999 and one in 2001. In their most recent study, referenced in slide 6 of my handout, they indicated that 70 percent of mergers failed. They did that based on shareholder value, really looking at pre-deal and then to a year afterwards and trying to compensate for the other "noise" that takes place during that whole year. The results that they found there were basically focused on how well the integration was managed.

But then if you look at their study from two years prior to that, referenced in slide 7 of my handout, they found that 83 percent of mergers failed. So, if you look at KPMG's results, they're basically saying that mergers have been improving even over the last couple of years. And what they had shown as reasons for organizations that had been successful, back in 1999, was really a much better job in terms of evaluating the synergies, in terms of focus on due diligence.

The organizations that did well, also, were able to select a more comprehensive leadership team, management team that was able to drive the organization forward, and then finally they focused more on the cultural and communication issues.

A.T. Kearney did a study in 2000. During that study, they looked at a three-year period in terms of shareholder value, and, again, trying to take out the noise of everything else that was going on within these mergers. That's a very difficult thing to do. As shown in slide 8 of my handout, they found that 58 percent of the mergers had failed. The main two issues that they found for organizations that were successful were, one, in terms of leadership issues, and two, that organizations that failed had an over-emphasis in the cost early on, and because of that, they lost opportunities in terms of growth.

Mercer Management Consulting was the only company that actually showed in the 1990s that more mergers succeeded than failed, and they had contrasted those to the 1980s, where they had shown that there was only a 37 percent success rate. Theses findings are shown in slide 9 of my handout. Again, in that particular study, they looked over a three-year period. I won't go into the Coopers & Lybrand study.

But if you look overall in terms of where the value is, and the deals, we've talked about this mostly in the morning in terms of whether or not it's the economies of scale or the economies of scope. We've talked about Daimler/Chrysler before in terms of market power and we even mentioned about Cisco before in terms of access to R&D or to products.

But, generally, in terms of the sources of value, we see four major sources, whether it's the cost synergies that you try to go after, the revenue synergies, looking to improve the management or operational improvements. These are shown in slides 11 and 12 of my handout.

In terms of the values and who benefits from this, there are three major categories, shown in slide 12 of my handout. First, there's the increase in shareholder worth. When you look at shareholders, from all of the perspectives, from the different studies that we showed within the consulting firms, you'll see one thing different from some of the comments that were made in the morning. In terms of the overall perspective, it's always from the acquiring companies because whether or not they're from the overall economy's, the target company ended up with more value in the organization. But obviously that's irrelevant to the shareholders of the acquiring company. The acquiring company is never going to go forward and do a merger just because it's good for the shareholders of the target.

So, who overall can benefit from a deal? One, obviously, the shareholders overall. Oftentimes, the shareholders don't see the money because the value actually goes back to the company, and so, it's reinvested into the company in order for the organization to be able to succeed and move forward long-term.

Also, there are three benefits that customers oftentimes see, and I know that that's a particular interest that the FTC has. One is price reductions. Second is efficiencies that they are able to gain due to the mergers.

And then finally new opportunities, and the classic indication of new opportunities was when Mattel bought Fisher Price. Fisher Price had a certain understanding in terms of hard plastics. Mattel had jungle gyms that were not made of hard plastic. A whole new product emerged from that of hard plastic jungle gyms that moved forward.

When an organization looks at the value, basically, they look at four particular areas, as seen in slide 13 of my handout. One that is oftentimes overlooked is just ensuring that the business momentum is maintained. Always when you look at the deal, the total synergies of the deal are much less than, for example, in this case, the 2003 business goals that the organization has. Second, capturing the near-term synergies in terms of the redundancies, the economies of scale. Third, organizations that are successful spend a tremendous amount of time focusing on the unfreezing aspects in terms of the skills that can either be shared between the two organizations or basically taking two organizations and improving those to a level that wasn't sustained before.

The classic example of that is Novartis, where you had two really average pharmaceutical companies. The CEO really moved the two organizations together saying, the purpose of the merger was to use that as a catalyst event to upstage and increase the performance of the combined organization, and they were successful in doing that.

And then finally, oftentimes, the value comes from a strategic change, in other words, a business being able to go into an area that it would not have been able to do if it wasn't for the merger.

So, in looking at overall, what do you need to do or what do organizations, once they are going into a merger, how can they be more successful in actually integrating the two organizations? I won't go through all 10 of the items mentioned in slide 14 of my handout because of time, but let me pick out a couple of them.

One is in terms of making sure that you focus on the business momentum. Again, with regard to any integration that takes place, the key is not to focus on the integration overall, but to pick out the areas where there's real value in the deal and then make sure that your most talented people are focused on those areas. Losing sight of, in this case, your 2003 goals, can dramatically decrease the success of the merger. The merger will suffer, even if you capture all your synergies, if you lose some of your key clients, if you lose some of your momentum.

An example is a large Fortune 500 paper company that merged a couple of years ago. The CEO had indicated the major failing that they had was losing their number one client, and he said that was just clearly because of a lack of focus because so many people were focused on the integration. That's one of the key things that organizations need to be focused on.

Second, in terms of number four here, the unfreezing opportunities. Lots of organizations like Novartis, that I had mentioned in the past, have really been able to take advantage of the merger, not just because of the natural synergies, but being able to use that as a catalyst event to upstage your overall efficiencies or performance within the organization.

Number five here, in terms of moving quickly, organizations that tend to fail tend to not be able to make their decisions quickly. So, put a management process in place to ensure fast decision-making. Oftentimes we'll say, come up with decisions that are 70 percent solutions that are 100 percent executable. If we make the wrong decisions, we'll turn around and fix them later, but we have to be able to move quickly, because as soon as you announce the merger, your competitors are going to be reacting in specific ways, especially in terms of your people and your customers. So, you have to be able to react fast.

One other one in terms of cultural change. Some of the more practical ways we've seen organizations deal with culture, the ones that are successful at it, identify the cultural issues up-front and then focus specifically on them. A classic example where organizations fail in terms of culture is their performance ethic. Two very strong organizations that manage their people or control their people differently will have a very difficult time integrating and will not be successful because they don't take that into account.

And let me be very specific with that. If you have an organization that focuses on operations in terms of controlling their people, think about somebody like a Microsoft. When they look at their organization, they'll look at the operations and they'll be very specific and the management will focus very hard on the operational goals, on their business plans in terms of whether or not they're going to be successful. Another organization focuses very much on values. Where a third organization could focus on finances, and in terms of finances, as long as you make your numbers, we're not concerned about how you get that done.

So, how a company focuses on those controls between those three specific areas, if they try to integrate without compensating for that, we'll find that they're not successful.

On the other hand, organizations incent their people very differently. Some organizations incent because they have the values, like a Southwest Airlines, we have the values that people believe and want to work for our organization versus some organizations that incent purely on incentives, and others on the opportunities that they bring for their employees.

Organizations that try to combine their two companies, with regard to those three aspects, if they don't take that into account, they're not going to be able to integrate their different management processes and retain their best people.

And I will end with just one success story, shown in slide 15 of my handout. Very briefly, BP/Amoco ended up with a market cap organization of over $200 billion. They were able to go into different areas that they had not been able to go into before; for example, natural gas, going into the Far East and becoming a stronger player in terms of some of the best retail markets. And some of the specific things they were able to accomplish during their merger, one was they were able to cut 20 percent off of their cost base. Very specifically with that, in the first 100 days, they were able to reduce their headcount by 10,000 people, which resulted in their stock price increasing over 11 percent.

Sir John Brown, the CEO, very much led the integration and was very visible throughout it, and at the end of the day within the first year, they achieved $2 billion in cost savings, which was a year ahead of the expectations that they had sent to the marketplace. So, they were 12 months ahead in their initial synergy capture.

I'll turn things over to Mark.

MR. SCHEFFMAN: Okay, thanks, Mike.

MR. SCHEFFMAN: Mark?

MR. SIROWER: Good morning. Let me try that again. I just got back from a couple of days in Cleveland, that's where I grew up, and we say things like, is it cold enough for you? It is quite cold in here.

(LAUGHTER)

MR. SIROWER: Good morning. Great. That's what I like to hear. Well, thanks to Pankaj and Mike and Paul Pautler for putting this program together. I thought I'd start out with a couple of jokes. Well, maybe they're not so funny, but they're quotes from CEOs at the time some major deals were announced -- just to give my remarks a little bit of context.

The first one is from Bernie Ebers. This is right after the MCI board voted to accept the all-stock WorldCom offer as opposed to the $34 billion all-cash offer from GTE. Some of you might remember this one. During the investor presentation someone asked Bernie the following question: so how much is this really going to cost? And Bernie responded, not a red dime is needed, and if I ever needed any money, my investment bankers are sitting two seats to the left -- which was greeted by uproarious applause.

There's another here, this one is from Barry Diller, and this, I think, says a lot about the lack of PMI, post-merger integration, preparation that's often present when mergers are announced. But this is what it sounds like when a CEO answers questions from the press or from analysts. I think it was Steve Lipin at the Wall Street Journal who asked Barry Diller, then CEO of QVC, why he was offering to pay a 33 percent premium for CBS and whether there were any synergies. This bid for CBS came shortly after QVC had lost its bid for Paramount to Viacom. Mr. Lipin asked, why is QVC offering a 33 percent premium for CBS? And Barry Diller said, there are some synergies here for sure. I don't know where they are yet. To say that now would be an idiot's game.

Now I'm sure Barry didn't mean it, but this is what you never want to say to public markets. And I hope that when I'm finished that I've sort of captured how telling these quotes are and I've shown what regulators ought to be looking for early on, to see if a company is really prepared to deliver on what it is promising, especially around that golden synergy promise.

I'm going to cover several things in my 20 minutes. I'm first going to sandwich Mike Shelton's review of studies between a couple of my own. I don't have any slides, but I've handed out my book, The Synergy Trap, and some articles, so you should at least have more weight than anyone else.

The first is a study from The Synergy Trap. That study looked at acquirer shareholder returns from deals from 1978 through 1990 and then tracked them over time for four years. And then, a recent study that we did at The Boston Consulting Group that was published in Business Week Magazine, the October 14th cover story, looked at 302 major deals worth over $500 million from mid-1995 through mid-2001. And there are three levels of analysis and results in these studies.

The first level is, how do these deals perform, on average, for shareholders of the acquirer, and more specifically, what's the split between winners and losers?

Well, in both studies, we found a significantly negative mean return on announcement, and roughly the same 65 percent negative return, 35 percent positive return split, in both the Synergy Trap and the Business Week study. This is a result that was actually found many times before, detailed in an appendix in the Synergy Trap. That is, several prior studies in the financial economics literature found this same negative initial return for acquirers, with a 65/35 negative/positive split. And these findings are also consistent with the later studies that Mike reviewed.

But let's go into these averages and de-average them a bit. When I say 65/35 negative/positive, I'm referring to the stock market reaction to deal announcements. Given the reality that no one manages an on-average deal, and Pankaj made a very good point that there's so much variation around these averages, when we delve inside the simple averages we find some very interesting things. One of the things that we find, and Steve Kaplan alluded to it earlier from one of his studies, is the importance, the predictive power, of the initial stock market reactions to deal announcements. This represents the second level of analysis in my findings. And here's how we investigated whether these initial investor reactions told us something about the future.

In Synergy Trap and this most recent study published in Business Week, we formed two portfolios of companies based on investor reactions at the time of deal announcements; one portfolio of those companies where investors reacted positively initially and one portfolio of companies whose investors reacted negatively. So we had a positive reaction portfolio and a negative reaction portfolio. And what we found is some pretty strong evidence that investors understand the economics of deals, and the chances of success, right from the beginning.

In our most recent study of 302 large deals, the positive reaction portfolio had an average initial return of about positive 5 percent; the negative portfolio about negative 9 percent. And then we just tracked these portfolios over time. And isn't it interesting that the means of those two portfolios remain pretty much the same over time. So, even at the end of a full year, the positive portfolio return is still positive and the negative portfolio return is still negative, and the mean one-year total shareholder return on these portfolios is roughly the same as the initial reaction returns. Investment bankers hate to hear this kind of evidence because what do they tell their acquirer clients when their stock price falls on the announcement of a deal? Oh, it's just a short-term reaction, it doesn't mean anything, we're in this for the long term. Well, surprise, surprise.

What's even more interesting is what you find when you actually get into the data a bit deeper, the third level of analysis -- because we do know some of these companies turn around from their initial reactions. Well, it turns out that 70 percent of the negative reaction companies are still negative a year later, and about 50 percent of the positive reaction companies are still positive a year later. So indeed some initial reactions get reversed but clearly the majority of investor reactions are indicative of what will be said about success or failure down the road, especially given a negative reaction. Now, along this third level of analysis, we'd certainly want to know the returns to the majority of acquirers whose longer-term returns are in the same directions as their initial reaction.

In other words, what about those companies whose stocks react positively or negatively on their merger announcements and then actually deliver, so to speak, on the initial expectations of investors, thus confirming the initial positive or negative expectations? And it turns out that the positive portfolio winners, those companies that start out positive, deliver on their promises, and then maintain a positive return over the course of a year, actually have a total shareholder return, industry-adjusted a year later, of roughly 33 percent. Again, this is the result from the most recent study of major transactions.

The negative portfolio losers, that is the 70 percent of companies that start out negative and confirm those negative expectations a year later, have a total shareholder return for that first year of a negative 25 percent. That means there's a 58 percent total shareholder return difference between those companies that start out positive and stay positive, deliver on expectations or at least confirm expectations, and those companies that start out negative and confirm those negative expectations.

What's the big implication of this? Well, it seems like investors do a pretty good job of listening carefully to what senior management teams tell them when they bring deals to market. This gets me to why I wrote the Synergy Trap several years ago. Two specific reasons. The first one is what seems to be this gap between what investors see and what company executives see. And I often say it this way, geez, if investors can get it right, well, shouldn't we expect companies' officers and directors to get it right? So, what are the things that investors are looking at that companies seem to miss? Well, we need to understand what we, as consultants or as regulators, can look for early on to get a sense of whether companies will likely deliver on their promises.

The other reason I wrote Synergy Trap was I sort of got tired of what I call the key success factor approach to acquisitions. You so often hear, don't pay too much, manage the cultures right, and have a strategy -- real motherhood and apple pie stuff. And I turned it on its ear a bit and I asked, well, what does it mean to have a strategy? How do you even measure synergy so that we can price it? Because if you can't measure synergy, then you can't price it, and then you know it's a dead-on-arrival deal or at least it's a value-destroying deal from the beginning -- because you’re paying the purchase price upfront for something you can’t define. And finally, is there going to be an operating model in place that can actually turn that business case or that strategy into real value?

So, let me go through those three issues. Is there a strategy? How do you measure the benefits? And would there be an operating model in place? I’m going to focus on the second and third issues.

I’m not going to say too much about the first one because Pankaj did a nice job on that. But I always have this overall rule of thumb when I’m looking at a potential deal. Is there a strategy there? I’m always asking, is there something that a company is going to do that’s tough for competitors to replicate? I don’t care how innovative something might be -- they might talk about great new products, for example –- but if it’s easy to copy, it’s unlikely to be worth much value, particularly on these visionary deals about changing the industry landscape and that sort of thing. It’s often vision without strategy. So, I’ll leave strategy with that.

Now, the issue of measuring synergy is really important for today. I’ll take it first from the investor perspective and then an FTC or regulatory perspective, because I think from the investor perspective it’s very clear how you just have to measure synergy. It’s a little bit less clear from a regulatory perspective, and let me go through this.

When I was an academic, even back as a doctoral student for that matter, I was troubled by a lot of the academic work on measuring changes in performance following mergers, particularly in the management field where the success of deals was measured simply by comparing post-merger performance to pre-merger performance. I always thought this made absolutely no sense from an investor perspective because a lot of the so-called improvements, beyond pre-deal performance, are already priced in the shares of both the acquirer and the target. I thought, how could you not look at the amount of performance that's already priced, as the appropriate benchmark for measuring post-merger performance. In other words, what were investors already expecting these companies to do before they were put together as a new enterprise?

And that led me to define synergy as operating gains over stand-alone expectations, and that if you didn't take into account those stand-alone expectations, you basically got one big synergy trap. You'd get there post-merger, you'd start getting some cost savings or revenue gains and you'd say, well, geez, I'm still not making money from an investor perspective -- my stock price is still down. Well, that's because you paid for something that was already priced into your shares, and worse, you paid a premium -- more money than anybody else in the world thought the target company shares were worth -- for gains that were actually already priced by investors.

I published a paper with Steve O'Byrne in the Journal of Applied Corporate Finance a few years back that focused on this issue of post-merger benchmarking. We found if you benchmark post-merger performance correctly, initial market reactions are actually a very good predictor of the actual operating gains over and above, or below, what was already expected that will likely result from mergers. So, I believe that from an investor perspective it's very important to measure synergies as operating gains over stand-alone expectations already priced.

But, from a regulatory perspective, where the issue is measuring efficiencies, it's a little bit less clear. For example, suppose you take the AOL/Time Warner deal and you look at the pre-offer share price of AOL. Well, there may be performance gains priced there that will never happen, ever. And yet, there may be some efficiencies in the deal, depending on the benchmark. The question is, are the performance improvements that are priced there in shares, a realistic view of the future without the merger? From an investor perspective, you've got to consider them. And when you buy another company, you're fixing the price of that target company, and the embedded expectations, once you pay for it. The target's price can't fluctuate once you buy it. I mean, you're really promising these gains to your investors. And the acquirer has generally been telling investors that its own shares are undervalued, so acquirer management has actually been promising those embedded expectations as well.

But, I think, from the government's perspective, you've got to come to terms with what the right benchmark is. It's either going to be the combined current performance of the acquirer and the target without future expectations that is the appropriate benchmark -- and a regulator asks, well, can the new company beat combined current performance? Or you have to pick a benchmark that has something to do with what those companies would look like without doing the deal. And that's a little bit less clear to me. From an investor perspective, it's very clear. You look at the stock prices and see what performance is already expected and then you frankly ask, can I beat it? But from a regulatory perspective, that seems to be a huge issue. Maybe we can talk about that in Q&A.

Which gets me to the third issue I said I'd talk about here, which is the operating model that must be in place. This, I think, is much more clear. Specifically, what are the signals that you would look for from a management team if you were a director or if you were someone from the FTC interviewing management of a company on whether they were prepared to really deliver on what they were promising.

One of the articles that I've handed out is a piece from Directors and Boards Magazine where we talk about something we call the PMI Board Pack. For any major integration effort there are generally four stages. First, you have to set the direction, and that's what I'm going to focus on next. Then you gather data and build a fact base on how both companies operate. Then you make the decisions on that fact base, and then you implement those decisions. Whatever major integration effort you look at, you'll generally find those four phases.

Now, let me talk about five specific pieces of evidence of readiness that you could look for from a senior management team to see if it has really set a direction that will allow the company to deliver on promises. The first one is a calendar and phasing of major activities over the course of the integration effort. Is there some calendar showing one or two months for gathering data, two months on making decisions, et cetera? We need to see some sort of tight calendar that indicates when key activities will be completed and, down the road, when the board of directors is going to revisit the performance of what they've approved.

Second, is something we call high-level shaping decisions. Is it clear what the new senior management team is going to be and what the key reporting relationships are going to be? Are there any integration issues that are going to be deliberately postponed or taken out of the initial integration effort? Is it clear, as Mike said, what are the major drivers of value on which large amounts of attention will be focused? Presumably those factors drove the deal in the first place. And, also, what is the new organization structure and what are the new business units?

Let's take the AOL/Time Warner deal for a moment. I believe very, very little of this was sorted out. When the deal was announced, you had little idea what the new organizational structure would be, what the new business units would be, and that contrasts dramatically with a merger like Pepsi and Quaker, an exceptionally well planned large deal, which I'll close with.

The third component of readiness is a tailored integration approach, where you're really setting expectations for the organization during the integration process. One of the things that, unfortunately, is a fact of life in mergers and acquisitions is uncertainty. You want to do some things early on to try to take out some of that uncertainty, which we believe comes under the heading of how we approach the integration. So, what's the tone? Will it be managed as a merger or as an acquisition? Obviously, well, as you might recall, this issue was one of the big failures in the Daimler/Chrysler integration. How fast is this going to move? There are different degrees of speed, and senior management ought to understand what different degrees of speed mean for the integration. Some things can move more quickly than others. Finally, how will decisions be made, who will be involved in those decisions, and how and to whom will they communicate those decisions? These are things that are perfectly realistic to have in place, at least to set some broad guidelines and expectations for the organization, before the deal is done.

And now, parts four and five are really where the rubber meets the road in pre-merger integration planning. So, number four is integration structure, teams, and resourcing. Mike Shelton did a nice job of talking about the need to preserve momentum, what I've called the performance that was already priced in the shares of both companies; you've just got to preserve that. And one of the things critical to understand in post-merger integration is that the PMI is actually a discrete structure. It's a living, breathing structure that goes on separate from the operation of the individual businesses.

And the senior management team, particularly in large deals, has to have a view of what that structure is going to look like. Who's going to be housed in that structure? There's a picture of a typical structure, by the way, in the PMI Board Pack article that's available to you. This leads to teams and resourcing. So, who is going to sit in the senior steering committee? What's the hub -- who's going to run the hub and really manage the entire integration effort? Approximately how many teams are we talking about throughout this PMI structure? If you don't see a view of that in the management team, you can bet they're in no position to run the integration, because that's where the work gets done. It's within that PMI structure.

And one of the easiest sort of no-brainer questions is just ask management, how many people from your organization or the combined organization are going to be involved in this effort? If it's a big deal, say above $5 billion, they should have a pretty good view of this. Is it 1,000 people, 2,000 people, 5,000 people? Is it 10,000 people? If there's not a fairly clear view of just how many people are going to be involved in this effort, you know they're not going to hit the ground running.

Finally, number five in my list of five components of readiness is the business plan, and here's where the definition of synergy is crucial. When we talk about the business plan that has to be in place before you do a post-merger integration, we know there has to be clarity about the base case, and the base case is essentially the combined forward plan without synergies. Now, presumably, in a good deal, the combined forward plan will discount back to the combined pre-deal market value. When it doesn't, you know you've got a big hurdle to deal with from the beginning, particularly if you've paid a premium.

But, essentially, you need to see that the management team has an idea of what was already promised to investors and also to employees for that matter, because the employees are going to have to deliver on this thing. And believe me, they have a certain set of expectations themselves.

So, is there a base case in place that allows a new forward plan to be constructed? Then, any efficiencies that management claims will result from the merger can be overlaid on top of that base case. Can you observe the amount of improvement over the base case that management expects in year one, year two, year three? You should be able to see those numbers, maybe not with great detail underneath it, but at least some high-level view.

So these are the five components of readiness you as regulators can look for if you have an insider view, if you're actually able to sit with management or examine the deal documents. In short, you can ask very specific questions.

Now, suppose you're a complete outsider and all you can look at is the investor presentation. Here are the three things that I believe you can look for, to determine whether any significant synergies are going to occur. I think PepsiCo's acquisition of the Quaker Oats Company is a great example of a company that really had their ducks in order right from the get-go and you could see it in their investor presentation. I'll go through this very briefly in a moment. But what are the three things?

First, is trackable improvements. One of the things I criticized about the HP/Compaq deal announcement is, you just cannot go to the markets with a two and a half billion dollar synergy number as management did, and be believed. Two and a half billion of what? When? You really have to break it down. It's an asymmetric information problem. If you don't break big synergies numbers down into components for investors, they just assume you don’t know. So, look for trackable types of improvements.

Second, is a story that reduces uncertainty, rather than injecting uncertainty, for the employees who have to deliver. I thought another problem with the HP/Compaq announcement was that management injected tremendous uncertainty into both organizations. Management stated that 75 percent of that two and a half billion dollar synergy number was going to come from workforce reductions and those reductions weren’t going to happen fully until the end of the second year. And the amount of headcount reductions was going to be 15,000 people. But that was 15,000 people over a combination of 11,000 job cuts that had already been announced at both organizations before the deal. So, HP/Compaq management injected about as much uncertainty at announcement as would be possible in a merger.

And then third, and this is less important from a regulatory perspective or an efficiencies perspective, but it might send a strong signal: the PMI plan must be tied to the economics of the transaction. And that’s where most of these investor presentations fall apart. You can just see there’s no link between what management is promising and the value that they paid for the deal.

So, let me just quickly outline the Pepsi/Quaker example -- for me, it’s a benchmark to hold other investor presentations against. PepsiCo's investor presentation had two major parts. First was a review of what was already promised to investors, and management went through the growth issues by several measures, such as EBIT and revenue growth. They went through about three or four different performance measures and basically said, here's what we've already promised you -- now here's how we're going to go beat it. And that was the second part of the presentation.

They broke down the announced $230 million of synergies into components. They stated the top line improvements and then what the flow through would be to pre-tax operating profit. And they detailed the cost savings. Every component had a reasonably detailed logic that backed up the numbers.

Forty-five million would come from the Tropicana-ambient business because of the strength that Gatorade, a Quaker brand, would bring to PepsiCo; 34 million from selling Quaker snacks through Frito Lay; 60 million through procurement savings; 65 million from savings in SG&A and logistics and hot fill manufacturing; and 26 million of corporate redundancies. And management stressed several times that these were conservative estimates and they were not going to include the potential of the Pepsi network to add to Gatorade sales.

And by the time the deal actually closed, PepsiCo actually increased synergy estimates from 230 million to 400 million, with a detailed analysis of all of those changes in a day-long investor presentation.

If you're not seeing that kind of preparation, then that should send up some big red flags, particularly if they're visionary deals and you only hear talk about changing the world and great new products or services, with single number synergy estimates. It's a pretty good bet that those efficiencies aren't there. And those are my comments. Thank you very much.

MR. SCHEFFMAN: Thanks, Mark. Some brief reactions from the panelists to anything they've heard before we open up to questions?

MR. SHELTON: Personally, let me pass on any queries and see if we can get more quickly to the Q&A.

MR. SIROWER: Yes, I would suggest that. I didn't sense the huge differences, as we had, in the first panel.

MR. SCHEFFMAN: Okay. We'll start questions from the audience or are you all frozen? Susanne?

MS. TRIMBATH: I would just like to hear, in particular, from Mike and Mark. It seemed to me that you had different definitions of synergy. In the base of that pyramid that you showed, Mike, your definition of synergy looked a lot like cost reductions to me as opposed to the more classic definition of "one plus one equals three." The things that Mark talks about seemed more like the classic definition. I'd like to hear from the two of you a little bit more about how you're defining synergy and how you think you might differ on that.

MR. SHELTON: We look at it from the viewpoint of what should the acquiring company look at as synergies moving forward in terms of capturing, and from that, it is a perspective of both cost synergies, revenue synergies, synergies that you can get -- in other words, transforming or sharing best practices, as well as negative synergies that come from a merger because of lost opportunities, specifically around when you lose customer share, you lose revenue, you lose key talent. So, that's how I would define synergies.

MR. SIROWER: I'm not sure we're really apart on this. The question is, what's the benchmark? Actually, Mike brings up a really good point about the possible negative synergies. At BCG, we call it the synergy matching principle. For anything good you're going to get, there may be some costs that result from it, too. You've got to net those out when you value the premium you are willing to pay for the deal. The benefits and costs for those benefits also help you lay out the roadmap for the integration efforts.

But you have to be clear about what the base case is first. You have to look at what these two companies look like together line by line going forward, so you can then measure and track the performance gains over the base case going forward, and those gains will break down to revenue synergies and cost synergies.

MS. TRIMBATH: So, a cost synergy is one plus one equals one?

MR. SIROWER: Well, once you lay out the base case, which is what you already expect, you overlay the synergies on top of that. So, in my view, that's the only sensible way to do it; otherwise, you're jumbling forward plans that are already there and you haven't separated it from the new stuff. If you're trying to incentivize someone to get performance gains, you've got to make sure they achieve what they've already promised to do as an independent company, and you're overlaying the additional benefits on top of that. You want to make sure there are tangible benefits for managers who really achieve those synergies.

MR. BOWER: Joe Bower from Harvard Business School. I guess the question that intrigues me is based on your more general findings. They indicate that a lot of the mergers don't work out. Suppose we stipulate that those numbers are more or less right and that two-thirds of the deals don't look good from the perspective of the acquirer. And now, let's take a public policy perspective on that. Does that mean that you should have a predisposition to let mergers go ahead because, in fact, they're not going to achieve the objectives that the managements had in mind anyway?

MR. GHEMAWAT: I think this is sort of just harking back to Steve's presentation this morning. If the major reason the mergers don't work out is that the premium was too large, then presumably, this is sort of a matter between shareholders of acquirer versus acquired company, and at least I personally have trouble seeing a public policy rationale for intervention in that particular regard. I think the general issue that comes up is that, sort of the wobble between the private benefits from a merger and the social consequences is actually fairly substantial. Therefore, I would suspect that probably there should be more attention to sort of trying to figure out where the sources of wobble come from. There's obviously the private benefits from the merger to the parties, and that presumably one could deal with by looking at it from a public policy standpoint by looking at both the acquirer and the acquiree, rather than worrying about the distribution of gains between them.

There may be externalities on the rest of the industry, which seems to be another useful, separate pasture to focus on. Then there's probably some other sort of implications above and beyond that that might also be worth factoring in. But we were talking primarily, or at least I was talking primarily, about the private benefits from mergers. To go from there to -- we know mergers destroy value for the acquirers, so let's stop them. I would certainly stop well short of such a conclusion.

MR. SIROWER: Yes. These debates often get muddy because you mix up levels of analysis. I mean, we have the macro level of analysis. Are mergers good for the economy?

And I believe the answer, after 20 years of evidence, is yes. You add the two sets of performance together, the gains to acquirers and the gains to targets, and you get a positive number. That's a different level of analysis from whether the officers and directors of acquiring companies are doing as good a job as they should.

And so, when you go to that next level of analysis, there are a lot of things we learn about acquirers that lose money versus those that seem to do really well. So, there are two very different levels of analysis, and I would agree with both Steve and Pankaj that from policy perspective, you don't want to stop mergers.

MR. BOWER: Let me follow up because, in a way, I think that's ducking. Let's just take as a category an area that Pankaj has studied, which are the consolidations, the global mega mergers. Basically, they don't seem to achieve the objectives that managements had in mind. Then why should we worry about them from an antitrust perspective? My impression is that what happens in those mergers is that the managements enter into them, perhaps with anti-competitive objectives. But they don't succeed. That, in fact, what happens is they form the merger and then, by God, competition takes over and you get very positive outcomes from the point of view of the economy and you get the results that you are talking about from the perspective of the firms and their managements. That's a question.

MR. GHEMAWAT: I don't know whether I should stand up to respond to it so that I don't get further charged with ducking. Clearly, a lot of these mergers have elements of that. At least my understanding of BP, with some of its mergers, yes, it was probably sensible to require some constraints in what they were going to be doing on the West Coast of the United States, because otherwise, after acquiring ARCO, these guys were going to end up with substantial market power in that regard.

I think it's hard to take some of the very largest deals and separate them very cleanly into this is primarily a market power-driven merger versus this is primarily a cost efficiency-driven merger, and that's where I think things start to get a little bit muddy. But, certainly, if things are driven primarily by market power and if it turns out that these market-powered gains are greatly overestimated partly due to the diligent work of people at this agency and elsewhere in Washington, then it's sort of shareholder beware. But we don't necessarily need to alter very much what's happening with the process. I'm just not quite that clear that that's the only thing that's going on in any complex transaction.

MR. KLEINER: I'm Thibaut Kleiner from the European Commission. Chairman Muris, this morning, started with saying we had a chicken and egg problem in this whole debate because basically firms didn't come up with good data or information about efficiencies and, therefore, efficiency claims couldn't be integrated very well by authorities in their analysis. But then, listening to what has been said so far, I'm not sure we're escaping this trap and this problem. The first panel has explained that it's not clear whether efficiencies are there or not.

What you are telling us is that you need to go very much into the details of how to integrate the two companies and really to have a very precise view about how to do it if you want efficiencies to be realized. But then the question is, how do you get this information ex ante? How are you able to make precisely your calculations so that you can come up with these good ideas and synergies? So, how is it possible from a public policy point of view, then, to escape this kind of information gap where you don't have the right data to present efficiency claims?

MR. SHELTON: A merger is a risky deal, and it requires a lot of execution done properly by the management. I think it would be very difficult and I would really question if we would run public policy to try to estimate, first, how well management's going to do, and then based on that, to make a decision. So, I think whatever public policy we come up with can't be contingent on guessing right whether or not management's going to execute.

MR. SCHEFFMAN: Let me chime in because I think maybe we're talking past one another. Mark eloquently advocated, as I think all the literature on merger outcomes indicates, that integration is really important and that planning for integration is important. So, the issue is what should we see on that? -- and, I should say, we don't see very much. We'll talk about this somewhat tomorrow. It maybe there are antitrust risks. Remember, we're looking at a deal before it can be consummated and maybe they can't do full due diligence.

So, we actually don't see much on integration planning in the documents, and we get all the company documents in a typical deal. Is that because with your clients you say not until the deal is consummated can you do it, or are we seeing deals that are remiss?

MR. SHELTON: Well, I would actually say, the companies that do this best do a tremendous amount of integration planning beforehand, and they're pushing up against what you're allowed to do pre-regulatory approval.

So, while I would say many companies don't do as much planning, the companies that are doing it well are doing a large amount.

MR. SIROWER: Yes, except I'd just break the issues down a bit. You're looking for two different things. One is, is there a real business case there supporting the deal? Is there a real strategy? And then, is there any evidence of the planning or the operating model that's going to take that business case and turn it into the value that's built around that business case? So I think there are these two separate but essential pre-closing issues. Is there evidence of a real strategy or business case, and are there the components of just what absolutely must be in place to turn that business case into value?

We regularly work through long merger approvals, long regulatory processes, and it's amazing how much work can get done without violating any sharing of information constraints. All these different building blocks that Mike talked about and that I talked about need to be in place before companies can successfully go forward with the integration -- it's just that simple. And all you're doing by not having them in place is introducing more and more uncertainty to the organization, the people who are going to eventually have to deliver on the business case. And so, the best people with options simply don't believe that the deal has much chance of working and they start looking for other opportunities.

MR. GHEMAWAT: My colleagues on this panel have talked about best practice. The one thing that I'd sort of stress once again, huge variation in practice. So, if you can't find the documents, it may be that somebody is playing a strategic game of non-exposure, but it may also simply be shear ineptitude in terms of actually thinking through the issues, and that possibility should not be ruled out before inferring sinister intent from the non-production of the documents.

MS. DETWILER: Thank you. Alice Detwiler with the FTC. This follows up -- Dave's question touched on this a little bit. It was clear from both Mike's and Mark's presentations that the speed of decision-making and the speed of integration planning by itself was a key factor in the success of the mergers and in realizing the synergies that companies had predicted, and that's probably a very intuitive proposition to any business person. But it's useful to explore that since this audience is mainly regulators and it has implications both for the Hart-Scott review, since that's often a key source of delay, and also for the rules on pre-close integration planning, which we'll be touching on in Panel 5 tomorrow.

I wonder if you could just explore that for a moment and explain why it is that the passage of time itself and the need for quick decisions can have that much of an impact.

MR. SHELTON: Well, what organizations are generally finding is that as soon as you announce a merger, that, one, the marketplace is looking for establishing ideas of whether or not you're achieving the synergies or whether or not you're likely to. And the marketplace, the analysts and other shareholders are very tough on organizations that cannot prove that they are moving towards those synergies. So, that's one.

Two is that competitors are reacting. So, in an organization, especially when it takes a year to gain approval or nine months to gain approval, your competitors are moving already to try to counteract whatever strategies you're putting into place and you're in almost a hold pattern. And so, a lot of things are done to try to find out how can we make up for that and what can we do, even though we can't share the information that we need to keep up with the competitors.

And the third is in terms of talent that recruiters have learned that as soon as you announce a merger, you go after that talent because, again, they're in a vulnerable period of time, and because of that, you're able to extract that talent during that time. And your competitors are doing the same thing to your customers. So, you're in a very defensive position, needing to move very quickly.

MR. SIROWER: I would just add to Mike's comment on recruiters going after talent. We know several cases where competitors have held job fairs immediately after announcement, or soon after announcement, at the airport hotels close to the headquarters of both companies. So, it's clear that there are those competitors out there that are aggressively trying to poach talent.

But one other detail around post-merger integration. Mike said something about trying to make decisions -- how did you say it -- decisions that are 70 percent --

MR. SHELTON: Seventy percent solutions that are 100 percent implementable.

MR. SIROWER: I'll give you our version, it's very similar. You essentially want to take actions that are generally right, but not specifically wrong. One of the greatly underestimated issues about post-merger integration is the sheer number of decisions that are required. Take big pharma deals, for example. We've counted up to 10,000 non-routine decisions that have to be made during the integration process.

Well, the longer you put off decisions, the greater the chance of important decisions getting out of sequence. Another problem in PMI is that the 80/20 rule doesn't really work all that well. You know, focus on the 20 percent of things that get you 80 percent of the value. So, where there are 10,000 non-routine things that have to get done, you can really get yourself into a lot of trouble by ignoring the details. These things just have to get done and decisions have to be made, all the way down the line. For example, imagine the merger of safety teams in a large pharma deal. Decisions have to be made on everything from pre-clinical trial reporting to first time in man to labeling issues on new drugs. All of these little nitty gritty activities just have to get done and decisions have to made.

And the longer you put them off, the more disarray, the more people get upset and irritated about the uncertainty. But I would close my response with the really big internal factor you deal with, the longer you put things off -- just plain fatigue. I mean, people just get tired. They're doing their regular jobs, they're maintaining what they're already supposed to do, and you're asking them, in many cases, to put another 50 percent of their time into the integration effort. The longer that deal doesn’t close, the longer all the things that still have to get done just weigh on people. So, whether you go out six, eight, nine, 10, 12 months, you’ve got a lot of fatigue in the organization and people know they’ve got the whole implementation effort ahead even after the deal closes.

MR. GHEMAWAT: Just two caveats to that, if I may add, partly because given where we are. I’d like to stress, once again, the general importance of taking a rule of reason as opposed to a per se approach to these things. One is that -- particularly in the context of cross border mergers it really varies, and while Cemex has done very well with an aggressive integration strategy, Holder Bank has done relatively well with a strategy of just buying stakes in local companies around the world, and over time, sort of figuring out other ways to tap some of the benefits associated with that. So, it really depends on the strategy. They don’t have a strategy of centralizing that much, and therefore, they don’t feel that need to have the PMI team in there.

The second sort of also depends on competitive dynamics. My guess is that obviously from EchoStar’s perspective, the first best thing would have been to buy Direct TV right away. But I’m not sure that they’re entirely unhappy with the fact that the review process has been dragging out given some of the contractual provisions that they have with Direct TV in terms of being able to essentially stop their momentum in the market, look at all their books, et cetera.

And so, again, even within a purely domestic context, I have a feeling that given that they couldn't have their first best, this is probably close to their second best in terms of a protracted regulatory process.

MR. PETIT: I am Laurent Petit, Merger Task Force, European Commission, Brussels. Consulting firms have shown that the vast majority of mergers fail, at least from a financial perspective, essentially because they fail to deliver on their promises. Does that mean that, from an antitrust agency perspective, we have to be extremely careful and maybe reluctant to take into account their "hopes and dreams" whenever they come to us and they talk about possible efficiencies?

MR. SIROWER: There are two issues. What's being paid versus what's being promised? And are there really any efficiencies in the deal? You can have a deal that has a lot of efficiencies, but just not worth what's being paid -- but it's still good for consumers. It's a better, stronger company from a competitive perspective and consumer perspective, but it hurts the acquirer's shareholders because management paid too much.

So, that's why, I think, one of the things you have to come to terms with is what is the appropriate benchmark you should use to measure whether there will be performance improvements or efficiencies. Is it their current performance? Is it the improvements that are already priced in the shares of both companies, or is it the amount that management is promising based on the total price that they're paying for the deal? I certainly don't think from an antitrust perspective you look at the total promises that are priced by the market plus the premium being paid.

I think you either pick the current performance or you pick the performance improvements that you try to estimate would be there if the two companies didn't do the deal, and you look for evidence on how they will beat that.

MR. SHELTON: If I could add on to that with one other comment. One thing you definitely want to appreciate is that the competitors are going to react very aggressively to it, and when the company initially lays out its plan, it's oftentimes not taking that into account to the extent it needs to. They're generally in a very difficult industry environment to begin with. So, you're in very uncertain times.

MR. SCHEFFMAN: One more question. Neal?

MR. AVERITT: Neal Averitt, FTC. A lot of the disagreement in the discussion seems to have built from the initial observation that about two-thirds of mergers are financially unsuccessful. Could the members of the panel give us any further guidance by subdividing that data into smaller universes of acquisitions in the first place? In other words, do you see significantly different success ratios in large mergers or mergers with high market shares or mergers that have some identifiable characteristic that might tell us something about where we should be focusing?

MR. GHEMAWAT: Well, my contribution to the response to that question would be a suggestion to read Joe Bower's very interesting typology of different mergers, which does sort of have the myriad of really slicing things up by their business purpose as well as uncovering some variations in the success rates. I think that some kind of taxonomy along those lines, what are the industry dynamics, what's the business purpose, is probably the single most fruitful way to go in terms of sort of getting to a more nuanced understanding of what lies beneath the averages.

MR. SIROWER: And, again, I want to emphasize when we talk about the success studies, we're combining issues. Let's think for a moment, why would an acquirer's share price go up or down around the announcement of a deal. It's not just about the potential synergies. It's the benefits minus the premium, synergies minus the premium. So, even if you have a typology of deals as Pankaj suggests, you still have to look underneath any success studies carefully and tease out projected synergies from the up-front premium offered. It may be that a deal offers tremendous synergies but at an even more tremendous price. So just using a typology of deals may not get you to a better understanding of which deals will produce more efficiencies than others.

I go back to what I said earlier, you want to make sure that there's a real strategy in place and some logic around how they're going to get any gains from that strategy. That's a separate issue from the price that they're paying. Both of those get combined when we look at merger studies.

MR. SCHEFFMAN: Well, thanks very much for a very interesting panel and good questions. We'll see you back again at 2:00.

(Whereupon, at 1:00, a luncheon recess was taken)