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The greatest risk

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A fog of paralysis and fear covers the capital and M&A markets. Worldwide public-company M&A transactions fell to 1,489 in the second quarter, the lowest level since 1993. This has dire and lasting consequences. An active M&A market is part of a dynamic process continually reallocating resources toward more optimal use.

Prospective acquirers' and sellers' pinging of each other to test fits and whether and where M&A will support their strategies can by its very nature seem chaotic and fraught with risk. Consumers and investors are the ultimate beneficiaries of this inherently messy process. This is because it redeploys assets to businesses and sectors where they are more efficiently employed, better managed and more highly valued.

An acquisition strategy whose paramount objective is avoiding mistakes is flawed. Except for bet-the-enterprise M&A such as the NationsBank-**Bank of America** and **Hewlett-Packard Co.**-Compaq Computer Corp. mergers, a strategy recognizing that aggressive and frequent acquirers will experience some disappointments will create more value than a strategy calculated to minimize visible failures. Myopic risk avoidance may be the greatest risk.

The current environment presents a fantastic window of opportunity for active and discriminating acquirers to extend and deepen their offerings and to expand their market footprints. This is particularly true in the technology sector. The valuations of a host of public and private technology companies with attractive product, client, brand and people assets are depressed.

Two hundred public software companies have market capitalizations below $10 million. Even more private software companies languish in the valuation doldrums, confronted with a closed public market and skittish corporate buyers.

Acquisition opportunities stem from established businesses not maximizing the value of their resources, and from a backed-up pipeline of venture capital-backed companies. With the IPO window closed, M&A exits for VC-backed firms fell to 159 totaling $3.8 billion in the first half of the year, compared with 202 for $12.9 billion in first-half 2001, and 230 for $69.2 billion in first-half 2000.

From 1995 to 2001 more than 11,000 U.S. businesses were funded by venture capital. Many will, through organic growth and/or M&A, become successful public companies.

Small ventures innovate. In contrast, large, successful, well-established companies — such as **Alltel Corp.**, **Fiserv Inc.**, **Metavante Corp**. and **Visa International** — in the bank technology sector have difficulty creating and commercializing genuinely new products and cultivating new markets. But they can and do acquire, to expand their offerings' breadth and to enter new markets. They refine acquired products, incorporate them in richer offerings, and often scale up and more efficiently operate fledgling businesses created elsewhere.

When entrepreneurs and venture capitalists perceive an opportunity, invariably far more companies are launched and funded than the market will support long-term. Having several score of companies develop competing products for a market where ultimately only a few — or none — survive as freestanding businesses produces superior results, notwithstanding some burned investors and inconvenienced clients.

The enterprise marketing automation (EMA) space is illustrative. In the 1990s, dozens of EMA businesses were launched. Many folded. More will. Out of this messy competitive white water, however, came real value. In many cases, it is now being realized — appended to broader, better-capitalized offerings.

Annuncio was acquired by **PeopleSoft Inc.**, Intrinsic by **SAS Institute Inc.**, Prime Response by **Chordiant Software Inc.** and Paragren by **Siebel Systems Inc.** Prime's implied enterprise value was only several million dollars. Its investors chose to transfer their bet from a strong point solution to a customer-relationship management suite provider established among large banks and insurance carriers.

It can be difficult, however, to objectively value technology acquisitions, unlike a consumer loan portfolio. It is critical to understand a tech acquisition's rationale and value — whether it stems from the technology, product, clients, distribution and/or management — and have a living plan to realize it.

Intuit Inc. is an exemplar of employing M&A in support of its ever-adapting strategy. It takes calculated rifle shots, none of which bet the enterprise. Intuit acquired OMW and American Fundware to strengthen its presence in the construction and government verticals, Eclipse to serve the wholesale durable-goods business, CBS Payroll to fortify its small-business payroll outsourcing business, and most recently Blue Ocean Software, putting it in the help-desk-and-PC-inventory-management space.

General Electric Co. is the most acquisitive U.S. company, having made 71 acquisitions between Dec. 1, 2000, and June 13 of this year. It is masterful at operating its portfolio of businesses with ruthless efficiency. Operational competency is the right stuff within the GE system. However, like most large corporations, the system does not create or innovate terribly well.

Unsuccessful acquisitions are an inevitable by-product of an active M&A market. Some fault investment bankers and other advisers for bad deals. But while voracious i-bankers' M&A rationales can be notoriously self-serving, ultimately management is to blame for bad deals. CEOs are the masters, investment bankers the servants.

The rationale of the HP-Compaq merger, for example, was flawed. However, whatever the fault of the four-legs-good, two-legs-bad thinking attending the merger, no one — not the i-bankers, the lawyers or the consultants — pulled the trigger. When on a Churchill Club M&A panel HP counselor Larry Sonsini said we will not know whether the merger was successful because there is no control case, he was pre-emptively defending HP CEO Carly Fiorina, not **Goldman, Sachs & Co.** In a Panglossian world, investment bankers' reward system and motivations would be exactly aligned with shareholders'.

In the current environment CEOs often worry too much about the sins of commission and not enough about the sins of omission. Value-accretive acquisition opportunities therefore are not being realized. When we start to see more M&A deals — good and bad — it will be a sign that valuable assets are being successfully redeployed to higher-value uses.

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