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AUGUSTO SALES

WHY MERGER TALKS COLLAPSE
An exploratory study about the contributing factors to
'wedding cold feet' and deal making failure in Mergers and Acquisitions
from the perspective of active deal making professionals in Brazil

Rio de Janeiro
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AUGUSTO CESAR SILVA SALES

WHY MERGER TALKS COLLAPSE – AN EXPLORATORY STUDY ABOUT THE CONTRIBUTING FACTORS TO 'WEDDING COLD FEET' AND DEAL MAKING FAILURE IN MERGERS AND ACQUISITIONS FROM THE PERSPECTIVE OF ACTIVE DEAL MAKING PROFESSIONALS IN BRAZIL.

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AUGUSTO SALES

WHY MERGER TALKS COLLAPSE: an exploratory study about contributing factors to ‘wedding cold feet' and deal making failure in Mergers and Acquisitions from the perspective of active deal making professionals in Brazil

Master's thesis presented to Corporate International Master's program, Escola Brasileira de Administração Pública, Fundação Getulio Vargas, as a requirement for obtaining the title of Master in Business Management.

Advisor: Professor Dr. Marco Tulio Zanini

Rio de Janeiro
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I dedicate this work to my wife and family for tolerating my physical and mental absence during the weekends in the last couple of months.

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ABSTRACT

SALES, Augusto. **Why merger talks collapse:** an exploratory study about contributing factors behind ‘wedding cold feet' and deal making failure in Mergers and Acquisitions from the perspective of active deal making professionals in Brazil. One basic question encouraged this study: after all the effort, expectations and money usually invested in *dealmaking*, why are so many transactions simply abandoned, even when the benefits are clear for the business, shareholders, customers and employees? Thesis (Master in Business Management) - Escola Brasileira de Administração Pública e de Empresas, Fundação Getúlio Vargas, Rio de Janeiro, 2014.

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Keywords: Brazil, Merger Talks, Mergers and Acquisitions, M&A, M&A Failure, Deals, Deal Making, Deal Breakers, Strategy, Due Diligence, Negotiation, Integration

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SUMMARY

1 **INTRODUCTION**

1.1 OVERVIEW

Coffey, Garrow and Holbeche (2002) affirmed that M&A represents a ‘marriage’, not always of two equal partners.[1]

In fact, the sequence of events that usually culminates in the marriage of two companies resembles well the typical sequence of events that brings a couple together. It all starts with some sort of flirting, then the relationship starts to evolve and gets a bit more serious, leading to the engagement period, commitment and eventually marriage, followed by the day after, honeymoon and life goes on (or not!).

If a merger can be illustrated by a marriage, then the purpose of this study is to understand why brides are left at the altar and which factors are behind ‘wedding cold feet’ in mergers and acquisitions.

M&A activity is a relatively well studied phenomenon in management spaces, by both academics and practitioners. These studies have contributed to shed light on issues such as the alignment between deal making and strategy, critical success factors in mergers and acquisitions, managing the acquisition process, conducting due diligence, valuations and post-deal integrations. Other interesting topics include CEO overconfidence in M&A processes and the question of why transactions fail to create value. However, very few attempts have been made to study the “No-deal” phenomenon or why merger talks fail to reach the completion phase, which is the process of actually signing the sales and purchase agreement, commonly referred to as the “SPA”.

In summary, one basic question encouraged this study: after all the effort, expectations and money usually invested in *dealmaking*, why are so many transactions simply abandoned, even when the benefits are clear for the business, shareholders, customers and employees?

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[1] Coffey, J., Garrow, V. and Holbeche, L. Reaping the benefits of Mergers and Acquisitions: In search of the golden fleece. Butterworth-Heinemann, 2002

This exploratory study examines contributing factors to deal making failure from the perspectives of active deal making professionals in Brazil. The study does not attempt to cover hostile deals or management buy-outs.

1.2 THE NO-DEAL PHENOMENA: THE ILLUSTRATIVE CASE OF PUBLICIS AND OMNICON MEGA MERGER

The mega merger between the two gigantic advertising groups Publicis and Omnicon is a good example of a deal that on paper appeared exceptional but collapsed before completion. The transaction was officially announced[2] on July 28, 2013 and nearly one year later negotiations were terminated.[3]

The press release announcing the transaction, dated July 28, 2013, highlighted a number of sensible factors supporting the deal rationale:

> *"Merger of equals to create Publicis Omnicom Group, a best-in-class communications, advertising, marketing and digital services company with combined 2012 revenue of $22.7 billion / €17.7 billion. Combined market capitalization of $35.1 billion / €26.5 billion:*
>
> - *Brings together iconic agency brands, offering clients industry-leading breadth of services, global reach and the most highly recognized and awarded talent*
> - *Jointly led by Omnicom CEO John Wren and Publicis Groupe CEO Maurice Lévy as co- CEOs*
> - *Provides compelling benefits for clients, employees and shareholders*
> - *Publicis Groupe and Omnicom shareholders will each hold approximately 50% of the new company's equity*
> - *New entity expected to be listed on the NYSE and Euronext Paris and included in S&P 500 and CAC 40"*

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[2] Press release 28/07/13: Omnicom and Publicis Group to merge, available from http://newsflash.publicisgroupe.net/uploadedDocs/20130728_280713_Publicis_Omnicom_Gruop_EN.pdf (accessed on May 16, 2014)
[3] Press release 05/09/14: Publicis and Omnicom agree to terminate proposed merger of equals, available from http://newsflash.publicisgroupe.net/uploadedDocs/20140509_09-05-14_PRESS_RELEASE_ENG_FINAL.pdf (accessed on May 16, 2014)

The document explains with a good level of detail that the two companies were seeking economies of scale and revenue and cost synergies by integrating the two businesses as well as leveraging their talent pools, thus creating tremendous value for the shareholders. Aside from immediate gains, the US$35 billion transaction would result in the largest advertising company in the world dethroning the market leader, WPP.

Theoretically, although the combination of assets, income statements and cash flows looked promising, analysts were skeptical about the corporate culture gap between the two companies, particularly focused on the stereotyped differences between the French and U.S. North-American cultures.

Martin Sorrell, CEO of the biggest rival, London-based WPP, spoke to Bloomberg about the transaction, classifying it as "an extremely bold, brave and surprising move" (…) but showed a very skeptical sentiment about soft factors: "time will tell if the cultures will click and whether clients and talent benefit – and how the $500 million of synergies will be generated without job cuts".[4]

However, ten months later the companies failed to get through the "engagement" phase and never actually got to the altar. Again, the wedding metaphor is used to illustrate the merger.

As reported by The Telegraph, Publicis CEO, Maurice Lévy said to the press: "we got divorced by mutual consent: neither side is at fault; and no compensation has been paid." (…) "It was a wonderful project that would have created the world's number one [advertising] group." (…) "It is quite painful and unpleasant to have to give up. But there was a price I was not willing to pay: the soul of Publicis."[5]

In fact, it seems like Publicis left Omnicon at the altar after a long engagement period.

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[4] Publicis to Combine with Omnicom to Create Top Advertiser, available from http://www.bloomberg.com/news/print/2013-07-28/publicis-to-merge-with-omnicom-to-form-biggest-advertising-firm.html (accessed on May 16, 2014)

[5] WPP targets Samsung after Publicis-Omnicom deal collapses: French and American bosses behind the failed $35bn merger go from champagne toasts to 'egg on faces', says Sir Martin Sorrell, available from http://www.telegraph.co.uk/finance/newsbysector/mediatechnologyandtelecoms/media/10819876/WPP-targets-Samsung-after-Publicis-Omnicom-deal-collapses.html (accessed on May 16, 2014)

The Telegraph complements the analysis of this transaction collapse by unveiling that Mr. Lévy denied that a clash of egos had played a role in his, and Omnicon's CEO John Wren's, failure to complete the $35bn deal.

As illustrated by the Publicis-Omnicom deal, it is interesting that although merger talks are usually backed up with a robust set of numbers crunched by internal teams and external advisors, and in most cases with a compelling story justifying the strategic rationale, when the deal is called off very little information is shared by the parties with the public, including investors and regulators. In comparison, when the deal is completed and the sales and purchase agreement is signed, usually a good amount of information is reported, synergy numbers are supposedly validated, and strategic rationale is confirmed. The same cannot be said of merger talks that are abandoned and deals that fail to go through. Usually, very little data is released and companies tend to refuse to give detailed information about the factors behind the failure and justifications tend to be unclear and subjective.

According to various media reports[6] covering the Publicis-Omnicom deal, the failure was attributable to a combination of factors, from the peculiar incapacity to reach a practical agreement of who would be the CFO of the new merged company to real-life tax complications. However, a number of analysts observing the deal negotiations reported that corporate culture clash was perhaps the main factor contributing to the deal's collapse. A lot of energy was spent; the companies were in serious negotiations for about one year and invested approximately US$100 million in professional fees to consultants and advisors.

[6] At Odds, Omnicom and Publicis End Merger; available from http://dealbook.nytimes.com/2014/05/08/ad-agency-giants-said-to-call-off-35-billion-merger/?_php=true&_type=blogs&_r=0; Fait Accompli: How the Publicis-Omnicom Merger Died, available from http://www.adweek.com/news/advertising-branding/fait-accompli-how-publicis-omnicom-merger-died-157592; Omnicom-Publicis merger collapses: Raft of disagreements between two sides leads to failure of efforts to create world's biggest advertising group, available from http://www.theguardian.com/media/2014/may/09/omnicom-publicis-merger-collapses; Publicis and Omnicom Call Off Mega-Merger: Deal to Create World's Largest Agency Company Crashes and Burns, available from http://adage.com/article/agency-news/publicis-omnicom-call-mega-merger/293119/; Battle for control destroyed $35-billion Omnicom-Publicis merger, available from http://www.reuters.com/article/2014/05/09/us-omnicom-group-publicis-groupe-idUSBREA4713R20140509; The Lesson From The Omnicom-Publicis Fiasco: Big Is Not A Strategy, available from http://www.forbes.com/sites/avidan/2014/05/11/the-lesson-from-the-omnicom-publicis-fiasco-big-is-not-a-strategy; Omnicom, Publicis Scrap $35 Billion Merger as Cultures Clash, available from http://www.bloomberg.com/news/2014-05-09/omnicom-publicis-abandon-35-billion-global-advertising-merger.html; O que impediu um final feliz para Publicis e Omnicom, available on http://www.valor.com.br/empresas/3543752/o-que-impediu-um-final-feliz-para-publicis-e-omnicom; Fracassa a fusão entre Publicis e Omnicom, available from http://www.valor.com.br/empresas/3542016/fracassa-fusao-entre-publicis-e-omnicom -- (all accessed on May 16, 2014)

2 **OBJECTIVES**

2.1 OBJECTIVE, RELEVANCE AND STRUCTURE

The objective of this study is to shed some light on factors behind the collapse of merger talks. The study is relevant since very little research has been done on the No-Deal phenomena and the results of this study could be further explored by researchers and M&A practitioners in creating a framework that would enable companies to detect deal failure at the beginning of the process or even avoid it by taking specific preventive measures.

This study is structured in the following way: the first section is an introduction, where the topic, objectives and justifications are introduced. In the second, the theoretical references are presented in which literature relevant to the topic will be discussed, along with an overall view of the M&A process and its phases, followed by a third section that refers to the research method adopted. In the fourth section a data analysis discusses the results achieved and, the final section presents the main conclusions drawn from the study.

3 **LITERATURE REVIEW**

3.1 OVERVIEW OF MERGERS AND ACQUISITIONS ("M&A")

3.1.1 **Introduction**

Mergers and acquisitions have been seen as a corporate strategy which has received wide acceptance and become a frequent alternative to foster corporate growth. Productivity and operational excellence also represent important drivers of profits, but in an environment where executives are pressured to generate increasing earnings, organic activities (internal development) tend to offer limited growth opportunities, forcing companies to seek inorganic growth strategies, particularly mergers, acquisitions and joint ventures.

For the purpose of this study, the terms "Mergers and Acquisitions", "M&A", "Transaction", "Deal" or "Merger" will be used interchangeably to denote any combination of two or more companies in which the assets and liabilities of a company are absorbed, merged or combined into a buying firm or new entity.

To understand the No-Deal phenomena first is necessary to understand the M&A journey in terms of its definitions, statistics, motives, processes and later move on to highlight the reasons for which merger talks collapse even when on paper they seem logical, with their potential to significantly create value if well executed.

3.1.2 **Key motives behind Mergers and Acquisitions**

The motives for pursuing a transaction are numerous and generally acquisitions are at the center of any expansion strategy debate. Mergers and acquisitions are justified for several reasons and they should be aligned to an organization's srategic plans on a case by case basis.

In a research study commissioned by KPMG and released in 2012, 162 deal makers were anonymously interviewed and asked to speak about recent transactions and the motives behind them.[7]

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[7] KPMG, A New Dawn: Good Deals in Challenging Times, 2012

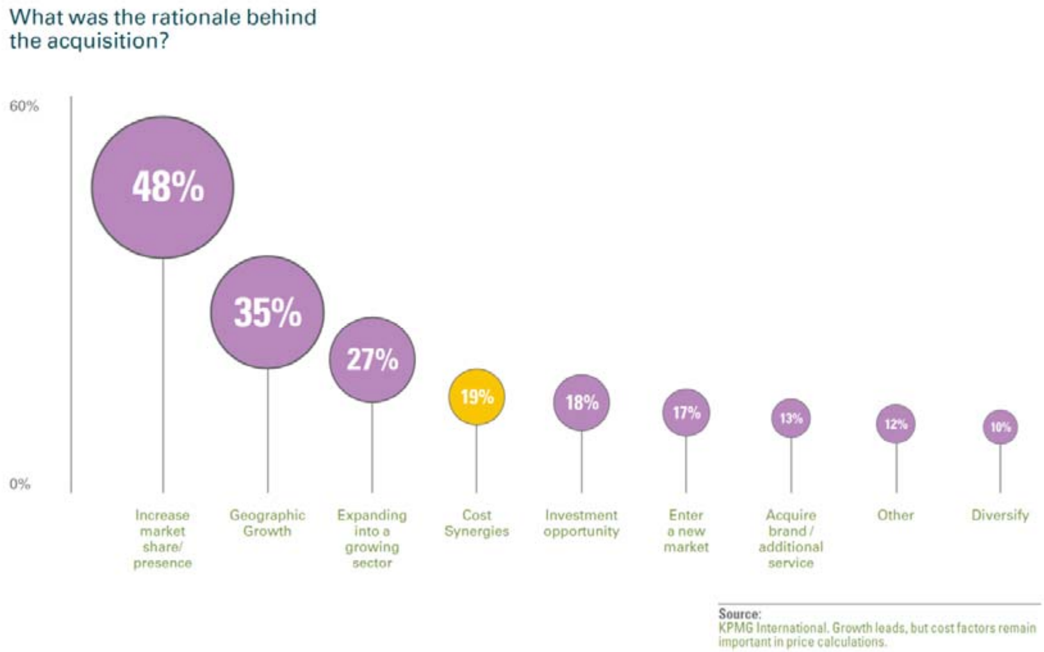


Figure 1 - What was the rationale behind the acquisition

Source: KPMG, A new dawn: Good deals in challenging time, 2012

Based on the survey, respondents said that M&A is mostly driven by five main factors:

1. **Growth aspirations**: increase market share, geographic growth, expand into growing sector, enter new market, new brand or service, acquire IP/new technology;

2. **Synergies**: intention to capture synergies (e.g. cost synergies);

3. **Transformation agenda**: use M&A as a catalyst for corporate transformation (transformational strategy);

4. **Risk management**: using M&A to diversify investment portfolio and reduce risk;

5. **Opportunistic**: take advantage of investment opportunities.

The variety of reasons for chasing acquisition targets is further explained by Hubbard (2013) who lists analogous or complementary reasons [8] for starting M&A talks:

1. **Acquisition of resources**: new products, technology, brands, talent management and natural resources);

2. **Vertical integration**: merging participants of the value chain;

3. **Market entry**: entering and expanding in new markets and geographies;

4. **Following a client**: partnering with a client to enter a new geography

5. **Economies of scale**: merging in the name of size

6. **Enhance market share**: looking for market dominance

7. **Tax incentives**: mergers can offer tax advantages

8. **Competitive differentiation**: achieving differentiation by doing mergers and acquisitions

Harari (1997) also enumerated a number of reasons given by executives to justify a mergers and acquisitions[9]:

1. **Synergies**: capturing synergies by merging

2. **Cost-savings**: saving costs by absorbing internalizing some activities via M&A;

3. **Economies of scale**: saving by achieving sizable operations;

4. **Cross-business**: capturing cross selling opportunities

[8] Hubbard N. A. (2013) Conquering Global Markets: Secrets from the World's Most Successful Multinationals, Palgrave Macmilan, UK
[9] Harari, O. (1997) Curing the M&A Madness. Management Review; Jul/Aug 199; 86, 7; p 53-56

5. **Distribution channels for products**: acquiring new distribution channels for existing products

6. **Products for distribution channels**: acquiring new products to be distributed using existing channels

7. **Bigger is better**: the notion that a size brings bargaining power and market dominance

Jensen (1982) identified another set of reasons that include:

1. **Access resources or supply:** in an environment of scarce or controlled supply, putting the hands on the source of raw materials can be a key differentiator

2. **Technological expertise**: acquisition of technology can be accelerated via M&A;

3. **Acquisition of talent**: sometimes M&A allows to capture new talent professionals;

4. **Geographical expansion**: relying on M&A to enter new geographies;

5. **New products:** using M&A to acquire new products;

6. **Diversification**: Managing risk via diversification

Porter (1980) goes beyond typical value creation motivations for acquisitions and includes the chance of irrational desire of an acquisition target attributable to the idiosyncrasies of its management.[10] In other words, pure vanity, eccentricity, and the need to demonstrate power can all be attributed.

These authors have detailed a number of factors that can be categorized into five main common realms:

[10] Porter, M. Competitive Strategy: Techniques for analyzing industries and competitors. Free Press, 1980

1. **Growth agenda**: geographic expansion, new products and brands, increase market share, “bigger is better”;

2. **Operational efficiency**: cost reduction, synergies, economies of scale, distribution channels, transformation, acquisition of talent;

3. **Risk management**: diversification, access to resources, guarantee supply, vertical integration;

4. **Opportunistic deal**: investment or divestment opportunity, tax benefits; and

5. **Irrational**: eccentricity and vanity.

Alam, Khan and Zafar (2014) conclude that the basic concept behind transactions is the fundamental assumption that two companies together are of more value than those two companies when they are separate stand-alone entities[11].

This notion is also shared by Haspeslagh and Jemison (1990). They agree that “the essential task in any acquisition is to create value that becomes possible when two organizations are combined”. The authors go on to further explain that the value created by a merger is distinct and “would not exist if the firms operated separately”, closing the loop saying that “the analysis, negotiation and internal selling of an acquisition candidate and ultimately premium offered are all predicated on this central idea” of value creation by business combination[12].

[11] Alam, A., Khan, S. and Zafar F. Strategic Management: Managing Mergers and Acquisitions. International Journal of BRIC Business Research (IJBBR) Vol 3, Number 1, February 2014
[12] Haspeslagh, P. and Jemison, D. Managing Acquisitions: Creating Value Through Corporate Renewal, Free Press, 1991 (Article adapted – Source: Strategy: Process, Content, Context)

3.1.3 **M&A in Brazil**

The present-day professional M&A market in Brazil was forged in the middle of the 1990s when the Plano Real ("Real Plan") promoted macroeconomic stabilization, reduction of inequality, inflation control and contributed to set the basis for the existing regulatory framework in different areas of the economy. As the Brazilian economy continued to strengthen, the country became a fertile land for mergers, acquisitions and joint ventures.

Many sectors in Brazil are under consolidation, which leads to increased M&A activity. The number of transactions grew consistently over the seven years prior to 2013, from 363 in year 2005 to 798 transactions last year.[13]

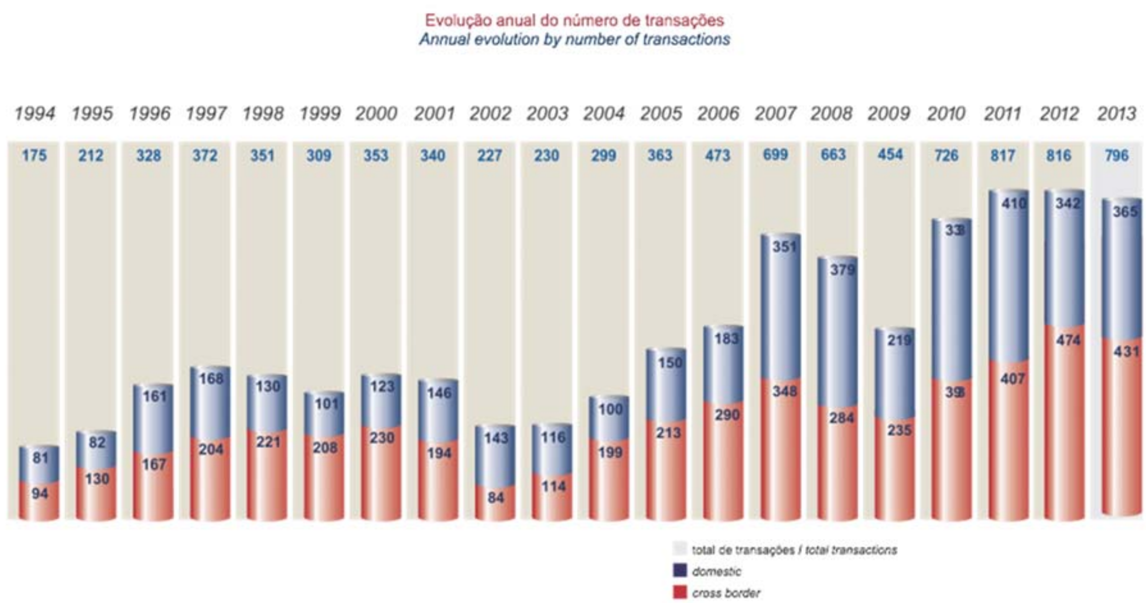


Figure 2 – Annual evolution by number of transactions
Source: KPMG, Pesquisa de Fusões e Aquisições 2013 – 4o Trimestre: Espelho das transações realizadas no Brasil, 2014

[13] KPMG, Pesquisa de Fusões e Aquisições 2013 – 4o Trimestre: Espelho das transações realizadas no Brasil, 2014

Historically, according to the KPMG M&A Surveys in Brazil, cross-border transactions represent around 40% to 50% of the total number of deals completed and announced, demonstrating that a significant part of the volume of foreign direct investment ("FDI") attracted to Brazil is directed toward mergers, acquisitions and joint ventures.

The importance of the foreign investor is corroborated by the current massive inflow of capital in Brazil. According to OECD statistics, in 2012 Brazil was ranked third globally for FDI inflows, only behind the U.S. and China. [14]

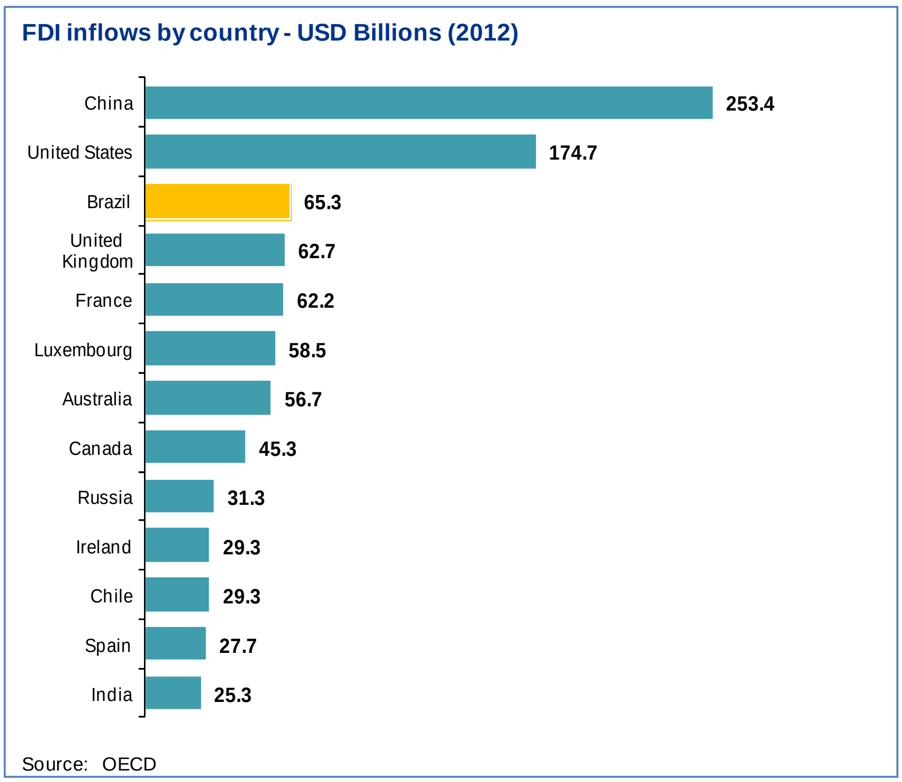
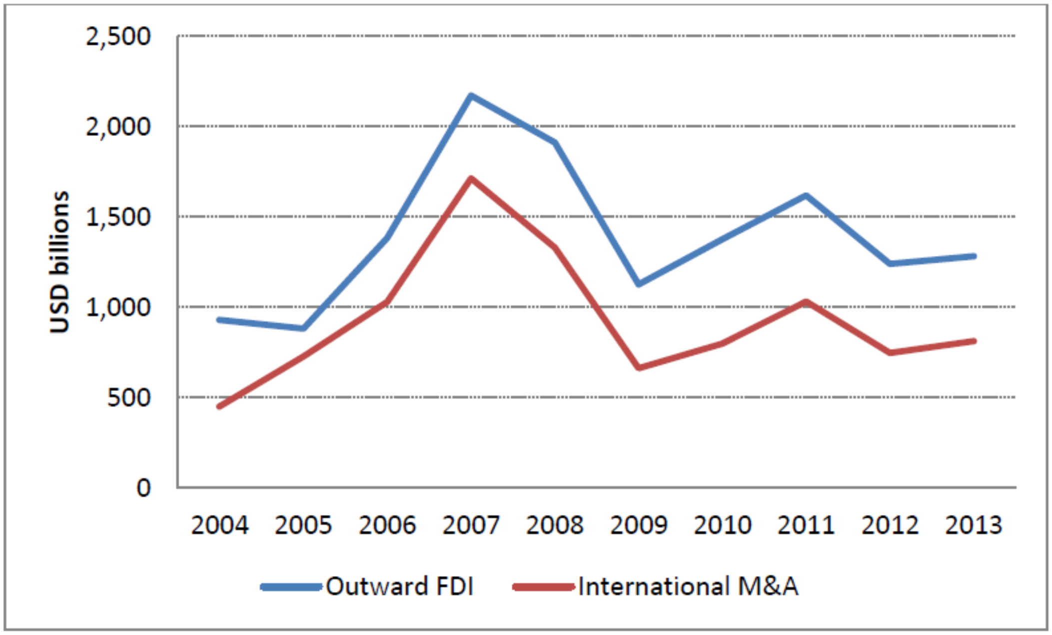


Figure 3 – FDI inflows by country

Source: OECD International Direct Investment Statistics 2013, OECD Publishing

[14] OECD International Direct Investment Statistics 2013, OECD Publishing

Global FDI outflow is directly correlated with cross-border M&A activity as demonstrated by crossing OECD and Dealogic statistics[15]:



Source: OECD International direct investment statistics database and Dealogic M&A Analytics database.

Figure 4 - Outward FDI x International M&A

3.2 THE M&A PROCESS

The M&A process can be summarized into three stages: pre-deal, during the deal and post-deal with seven clear work streams. An attempt to link the three transaction stages to the stages of the wedding metaphor are demonstrated below:

I. Pre-deal (the "flirting phase")

1) Strategy formulation

2) Target screening and approach

[15] FDI in Figures, April 2014, OECD Publishing, 2014

II. During the deal (the "engagement phase")

3) Due diligence

4) Valuation

5) Negotiation

6) Closing (or "Completion") – *the "wedding day"*

III. Post deal (the "marital" or the "day after phase")

7) Integration

8) Consolidation

Gole and Hilger (2009) present a slightly similar process that includes[16]:

I. Planning – the "flirting phase"

1) Establishment a growth strategy

2) Screening and selecting candidates

II. Investigation – the "engagement phase"

3) Establishment of diligence objectives

4) Validation of value

5) Development of actionable findings

[16] Gole, W. J, Hilger, P. J. Due diligence: an M&A value creation approach. John Wiley & Sons, Inc. 2009

III. Execution – the "marital phase"

6) Negotiation and completion – *the "wedding day"*

7) Integration

8) Post-deal assessment

Although the stages are logically sequential, the work streams, particularly the ones that are part of the "during the deal" activities, run almost concomitantly. A company negotiates, performs due diligence and evaluates the price to be paid for the transaction almost at the same time, alternating the degree of emphasis here and there before culminating with the completion of the deal, also referred to as "closing", which is the event when both parties, like in a formal wedding, agree on a set of terms and commitments and sign the official papers, in the presence of witnesses, who will formally declare the parties "married".

3.2.1 **Strategy formulation**

Gole and Hilger (2009) state that “it is a central tenet of M&A best practice that investment strategy, and acquisitions in particular, should be guided and driven by purposeful strategic planning”. During the strategic review process executives need to address the advantages and disadvantages of organic versus inorganic growth (“buy” or “build” analysis). A central question is whether the organization has the capability to develop the desired competence internally, at what cost and how much time and effort are required. After evaluating that, the executives assess how that would compare to the possibility of buying that competence in the marketplace.

	Internal development (build)	**Acquisition (buy)**
Potential advantages	Control over execution Focused development Control over cost	Speed of execution Cross-company synergies Complementary expertise Removal of a competitor Low market entry risk
Potential disadvantages	Lengthy execution period Inbred perspective Uncertain market acceptance Increased competition	High integration risk High entry cost Unwanted assets and unwelcome liabilities

Source: Gole, W. J, Hilger, P. J. Due diligence: an M&A value creation approach. John Wiley & Sons, Inc. 2009)

Table 1 - Build x Buy (Advantages x disadvantages)

This concept is reinforced by Cullinan and Holland (2002) who believe “the chances for transactional success dramatically improve when the target’s business is aligned with the buyer’s strategic goals”. [17] Hubbard (2013) agrees that pre-acquisition planning is a key factor in the acquisition process and he builds on the idea that without proper planning the acquirer puts himself at risk since it limits the information available for discussion with the target company and jeopardizes the evaluation of synergies and due diligence process. “Understanding the vision and plan going forward is also fundamental to employee retention and gaining ‘acceptance’ and, in some cases, enthusiasm from target employees”.

[17] Cullinan, G. and Holland, T. Strategic due diligence- Excerpted from Global deal making: definitive guide to cross-border mergers and acquisitions, joint ventures, financings and strategic alliances. Bloomberg Press, 2002

In real life, transactions can also happen in a reactive way. For example, a seller hires a financial advisor to search for a buyer and this advisor knocks on the door of a number of companies that are supposedly potential buyers. On a number of occasions, some of these buyers who were approached had not been considering an acquisition and therefore were not fully prepared for a deal. Consequently, the process skips two important steps: (1) strategic review and (2) target screening. Instead of a solid understanding of the company's strategic position and a proactive search for the right target company that fits that strategy, in a reactive approach, the buyer has very little time to plan before jumping into the due diligence process. This is confirmed by Gole and Hilger (2009), "If organizations are continually reacting to deals as they are brought to market, they run the risk of being enticed into randomly acquiring businesses unaligned to their organization goals and objectives"[18]

3.2.2 **Target screening and approach**

"Acquisitions are strategic tools"[19], suggests Howson (2003), and identifying and approaching an acquisition target is only sensible after a proper strategic review is exercised in which M&A has been identified as the logical means. As previously discussed, a target screening exercise should only begin with the establishment of goals and objectives. According to Jensen (1982), "many companies jump the gun and begin looking without first considering what kind of company would best further their strategic goals". [20]

Jensen (1982) enumerates four phases of the target screening and approach process:

1) **Defining objectives**: an acquisition-minded company should start the process by determining the three or four most important strategic benefits that an ideal acquisition would provide.

[18] Gole, W. J and Hilger, P. J. Due diligence: an M&A value creation approach. John Wiley & Sons, Inc. 2009
[19] Howson, P. Due diligence: the critical stage in acquisitions and mergers. Gower Publishing Limited, 2003, Reprinted 2008
[20] Jensen, A. E. Seeking a candidate for merger or acquisition. Business Horizons, May-June 1982. P80-84

2) **Establishing criteria**: the buyer should define measures and attributes, in line with strategic objectives, that are important to define the target company. These attributes could be size, geographic presence, technologies, talent or certain resources, for example. If the objective is to conquer a specific region, the target company needs to have a presence in that region. If the goal is to increase revenue by 40%, the target company needs to be large enough to enable revenue synergies to achieve the objective of 40% revenue growth.

3) **Identifying candidates**: the screening process is based on market research, public and private databases, industry and trade associations, consultants and subject matter experts.

4) **Finding information**: once potential candidates have been identified, the next task is to qualify those candidates by gathering information on them available to the public to determine which are most suitable. This is a process that requires time and organization. Sources of information include annual reports, credit reports, financial statements, newspaper articles, trade magazines, analysis reports and interviews with market participants, regulators, industry observers and analysts.

5) **Contacting prospects**: the final step is to contact top prospects, either directly or via the use of an intermediary. The purpose of the first contact is not to make a deal, but rather to arrange a meeting to make an introduction and if possible understand the so-called “willingness to transact”.

Jensen (1982) provides practical quantitative guidance for the screening effort by suggesting this exercise should identify “fifteen to twenty highly attractive companies that seem likely to be sold”. Howson (2003) complements this view by suggesting that “targets will then be ranked according to their abilities to meet strategic objectives and categorized according to whether they are strong contenders for purchase or merely fallback options”.

Approaching a target for a transaction somewhat resembles approaching a person for a date. Getting from the first approach to a deal can take a long time and according to Howson (2003), can produce extreme reactions: “some potential vendors will rejoice, thinking they are about to get rich, others may be deeply offended, others say ‘no’ when they mean ‘yes’ and yet others go away only to come back again”. These reactions are the result of not only a company’s corporate culture and transaction background, but also the personalities of those involved. Howson (2003) concludes that “if a deal is to happen at some point both parties will perceive a mutual interest and decide to take preliminary discussions further”.

Again, according to Howson (2003), “If an approach does lead to mutual interest, both parties will want to begin serious negotiations” and if “there is sufficient agreement between them to continue” the “due diligence can therefore begin”.

Note: in a sell-side situation, the process is quite similar and instead of screening to identify an acquisition target, the company is performing an investor search.

3.2.3 **Due diligence**

It is at the due diligence period where the two companies agree to get to know each other better and share critical and strategic information, particularly on financial, commercial, operational, people, legal and tax aspects. Due diligence is a detailed investigation of the target company and its results will support the negotiations, valuation, deal structuring and post-deal integration.

Due diligence is one of the most important procedures used to study, investigate and evaluate a transaction. As explained by Bing (1996), “it normally occurs after the parties involved in a deal have decided the deal is (…) feasible and after a preliminary understanding has been reached (or appears reachable), but before a binding contract is signed”.

According to Howson (2003), “successful due diligence leads to negotiations and, if it goes well, the deal is executed”. For didactic purposes, it makes sense to follow this logical order, however, in practice, negotiations begin when the two companies start talking during the target approach period, and certainly some level of negotiation is necessary to make the parties agree on some common ground in order to jointly pursue the merger talks.

Due diligence is a process tailored to the needs of the parties involved and usually entails looking at historical data, prospective information and to some extent the physical condition of the assets and/or talent to be acquired. In short, as defined by Bing (1996), it is the “verification that the investment complies with the investor’s criteria”, as defined during the target screening exercise.

Howson (2003) lists 14 types of possible areas to be covered during a due diligence exercise. He highlights the Financial, Legal and Commercial areas as the most common due diligence topics. As secondary topics, it is possible to see due diligence exercises covering Human Resources & Culture, Management, Pensions, Tax, Environmental, Information Technology (IT), Technical, Operational, Intellectual Property Rights (IPRs), Property, Antitrust, Insurance & Risk areas.

Table 2 - The main due diligence topics

Due diligence topic	Focus of inquiries	Results sought
Financial	Validation of historical information, review of management and systems	Confirm underlying profit. Provide basis for valuation
Legal	Contractual agreements, problem-spotting	Warranties and indemnities, validation of all existing contracts, sale and purchase agreement
Commercial	Market dynamics, target's competitive position, target's commercial prospects	Sustainability of future profits, formulation of strategy for the combined business, input to valuation

Source: Howson, P. Due diligence: the critical stage in acquisitions and mergers. Gower Publishing Limited, 2003, Reprinted 2008

Table 3 - The other due diligence disciplines

Due diligence topic	Focus of enquiries	Results sought
Human Resources and culture	Make-up of the workforce, terms and condition of employment, level of commitment and motivation, organizational culture	Uncovering any employment liabilities, assessing the potential Human Resources costs and risks of doing the deal, prioritizing the HR issues that need to be dealt with during integration, assessing cultural fit, costing and planning the post-deal HR changes
Management	Management quality, organizational structure	Identification of key integration issues, outline of new structure for the combined business
Pension	Various pension plans and plan valuations	Minimize the risks of underfunding
Tax	Existing tax levels, liabilities and arrangements	Avoid any unforeseen tax liabilities, opportunities to optimize position of combined business
Environmental	Liabilities arising from sites and processes, compliance with regulations	Potential liabilities, nature and cost of actions to limit them
IT	Performance, ownership and adequacy of current systems	Feasibility of integrating systems; associated costs. IT plans for the operational efficiency and competitive advantage
Technical	Performance, ownership and adequacy of current technology	Value and sustainability of product technology
Operational	Production techniques, validity of current technology	Technical threats; sustainability of current methods; opportunities for improvement; investment requirements
Intellectual Property Rights (IPRs)	Validity, duration and protection of patents and other IPRs	Expiration; impact and cost
Property	Deeds, land registry records and lease agreements	Confirmation of title. Valuation and costs/ potential of property assets
Antitrust	The various national filing requirements (some of which can be expensive if not complied with); degree of market/information sharing with competitors	Merger control filing and clearance; an assessment of any antitrust risks posed by the target's activities; an assessment of the enforceability of the target's contracts
Insurance/Risk	Present, future and, most importantly, past exposures of the business. The structure and cost of the existing program	The costs and benefits of retaining risk versus transferring it

Source: Howson, P. Due diligence: the critical stage in acquisitions and mergers. Gower Publishing Limited, 2003, Reprinted 2008

Bing (1996) lists topics to be covered by the due diligence exercise without defining the field it fits into. Topics include Capital structure and Ownership, Management, Products and Services, R&D and Technology, Real Estate and Facilities, Markets, Competition and Customers, Marketing, Pricing, Advertising and PR, Manufacturing, Purchasing, HR, Employee Compensation and Benefits, Corporate Culture, Legal, Information Systems, Budgeting and Planning, Insurance and Bonding, Environmental, Debt and Banking, Investments and Cash Management, Taxes, Accounting, Cash, Accounts Receivables, Inventory Fixed and Other Assets, Liabilities, Backlog and Income Recognition, Cost of Sales, Selling and Administrative Expenses, Intercompany Transactions, Investment Issues.

Drastic consequences can result from the failure to perform proper due diligence, overlooking critical areas, and particularly non-financial matters. According to Bing (1996), “financial statements provide thumbnail sketches of a business and its history, supplying few clues and insights into a company’s present, and (…) a reasonable guess of its near-term future”.[21]

Note: in a sell-side situation, the seller prepares for the due diligence to be performed by the acquirer. In a merger of equals, reciprocal due diligence is applicable.

3.2.4 **Valuation**

The gifted professor and respected valuation authority Aswath Damodaran uses Oscar Wilde’s definition of a cynic to make a distinction between value and price: he is the one who “knows the price of everything and the value of nothing[22]”. According to Damodaran “that characterization would fit many investors who regard investing as a game and define winning as staying ahead of the pack”[23].

Deal usually goes ahead when valuation portrays a win-win situation for both acquirer and seller (Gole and Hilger, 2009). For the acquirer, the combined value of the acquirer business to the buyer exceeds the purchase price and for the seller the amount received is higher than other alternatives, including continuing to own the stand-alone business.

[21] Bing, G. Due Diligence Techniques and Analysis: Critical Questions for Business Decisions. Quorum Books. Westport, Connecticut. 1996
[22] Wilde, O. The Picture of Dorian Gray. Enhanced Books, 2014 (First Published in Lippincott’s Magazine, June 1890)
[23] Damodaran, A. The Little Book of Valuation: How to Value a Company, Pick a Stock, and Profit. John Wiley & Sons, Inc, New Jersey, 2011

Valuation issues can derail a transaction arise when the acquirer realizes that the transaction is unlikely to destroy value (Gole and Hilger, 2009).

3.2.5 **Negotiation**

Naturally, negotiations start at the beginning of the process (e.g. when approaching the counterparty) and continues until the closing of the transaction.

The critical stage in negotiations is right after the due diligence when due diligence findings are aggregated and factored into the valuation model to determine the combined value of the acquisition (Gole and Hilger, 2009). If the value of the target company is lower than previously thought, a higher premium is required to be paid and it could lead to a renegotiation of the terms of the transaction.

3.2.6 **Closing, Integration and Consolidation**

Closing is the action of signing the Sales and Purchase Agreement ("SPA"). This is equivalent to a "yes" in a wedding. After the closing, there is no way back. The merger is completed.

Now it is time to celebrate and start the integration and consolidation process. Integration is the transition period where the merged entity is being designed and formed. A lot of effort and planning is usually invested to produce a smooth integration of people, assets, customers, suppliers, technologies, infrastructure and operations. Consolidation is the actual period after integration and when the new entity is already formed and working to achieve the plan which was the base for the merger rational.

4 **RESEARCH METHOD**

4.1 INTRODUCTION

As previously discussed, one basic question encouraged this study: After all the effort, expectations and money usually invested in *dealmaking*, why are so many transactions simply abandoned, even when the benefits are clear for the business, shareholders, customers and employees?

This study is characterized as an exploratory qualitative research approach. According to Chizzotti (1995), exploratory research generally “provokes the clarification of a situation to raise awareness of it”[24]. This research method was chosen to offer specialized techniques for obtaining information[25] (Bauer and Gaskell, 2003), which results in rich and substantive descriptions of the phenomenon being studied[26] (Vieira, 2004).

The qualitative approach was chosen, mainly, due to difficulty of collecting statistical data on potential factors contributing to deal failure. Merger talks collapse for a number of reasons, objective and subjective. This type of information is usually confidential, treated with a lot of discretion and motives behind failure are usually not disclosed. According to Neves (1996), “qualitative research (...) comprises a set of different interpretative techniques which aim to describe and decode the components of a complex system of meanings”[27].

Exploratory research is characterized by its flexibility and versatility with respect to methods and is more appropriate when there is little accumulated and systemized knowledge[28] (Vergara, 2000).

The qualitative research conducted aimed to extract impressions and experiences from executives directly involved in promising M&A talks that collapsed. The source of information

[24] Chizzotti, A. Pesquisa em Ciências Humanas e Sociais. São Paulo. Cortez, 1995
[25] Bauer, M. W. e Gaskel, G. [ed.] Pesquisa qualitativa com texto, imagem e som. Um manual prático. [Qualitative Researching with Text, Image and Sound: a Practical Handbook] (P. A. Guareschi, Trans.) Petrópolis: Editora Vozes, 2003
[26] Vieira, M.M.F. Por uma boa pesquisa qualitativa. In Vieira, M.M.F., Zouain, D.M. (Org). Pesquisa qualitativa em administração. Volume 2. Rio de Janeiro, FGV, 2004
[27] Neves, J.L., Pesquisa qualitativa: características, usos e possibilidades. Caderno de pesquisa em administração. FEA-USP. São Paulo, V.1 N.3 2º Semestre, 1996
[28] Vergara, S.C. Projetos e relatórios de pesquisa em administração. 3ª edição. São Paulo. Editora Atlas, 2000

was composed of a group of dealmakers with different backgrounds, including corporate professionals, private equity, advisors, and investment bankers.

In exploratory research studies, the concept of representation of the sample is not applicable. From the sample chosen for convenience, data collection was done through 16 in-depth interviews which aimed to extract the greatest possible amount of objective and subjective elements linked to the formation of a decision taken to abandon a transaction. The 16 interviewees were chosen based on their level of experience and roles played in the transaction processes. The objective was to cover the whole deal flow.

The proposal of this work, which has never been done before on this subject in the mainstream academic space, is to investigate the reasons that lead to 'transaction cold feet’ in order to reveal something that is usually omitted, not disclosed in press releases, underexplored in terms of depth by both the popular and specialized press, and rarely discussed in detail by the parties involved.

4.2 SCOPE AND APPROACH

The qualitative approach focuses on how people interpret and give meaning to their experiences and the world in which they live. The researcher uses a qualitative approach to explore the behavior, perspectives and experiences of the people involved in the object of study. It can be said that aspects of a qualitative investigation focus on how humans interpret and make sense of their reality.

The qualitative research method is interpretative rather than descriptive (Vergara, 2000). Therefore, one of the advantages of this method is that it allows you to change the direction of the investigation once ideas or data are discovered or continue until the possibilities are exhausted or another direction is discovered (Bauer and Gaskell, 2003).

According to Vieira (2004,) “Another important characteristic of qualitative research is that it generally offers rich and substantive descriptions, beyond explanations about processes in context and identifiable locations”.

In exploratory research studies, the concept of representation of the sample is not applicable. From the sample chosen for convenience, data collection was done through 16 in-depth interviews which aimed to extract the greatest possible amount of objective and subjective elements linked to the formation of a decision taken to abandon a transaction.

Therefore, the technique of sampling for qualitative research purposes is classified as non-probabilistic. According to Malhotra (2001), non-probabilistic sampling relies on the personal judgment of the researcher, and not on the possibility to select sample elements[29]. Consequently, the researcher can arbitrate or, consciously, decide which elements should be included in the sample. The non-probabilistic samples can provide good estimates of population characteristics, but do not allow an objective evaluation of the precision of the sample results. Since there is no way to determine the probability of choosing any particular element for inclusion in the sample, the estimates obtained are not statistically projectable to the population.

4.3 INTERVIEWS

The research was conducted in 2014, between March and June. In this period were made 16 individual interviews with open questions. After each interview, the data was analyzed to detect recurring ideas, links and to understand the correlation between the different dialogues as well as different points of view.

The body of data comes from executives, of both genders, who are actively working on M&A processes and witnessed at least one transaction that was not completed, in which at least one of the parties involved was a Brazilian company. The body of data, therefore, is non-probabilistic, selected for convenience.

[29] Malhotra, N. K. Pesquisa de Marketing – Uma orientação aplicada. 4th Edition. Editora Bookman, 2006

The sample of 16 active deal makers determined by convenience was designed to cover the whole deal flow:

- **Strategy and Business development ("BD")** professionals usually brought in before the deal takes shape and with direct contact with top management considering (or not) deal making. Strategy and Business development professionals usually participate before, during the deal, and sometimes after.

- **Deal management** professionals are individuals hired to coordinate the M&A process, negotiate, value e close the deal. The Deal Management professionals are usually responsible for target (or investor) approach; liaising with due diligence and valuation teams and attorneys responsible for drafting the SPA.

- **Due diligence professionals** run the transaction evaluation (e.g. due diligence) process

- **Legal advisors** are responsible for drafting the SPA and performing legal due diligence

- **Integration** professionals are consultants hired to perform Post Deal Integration work. These professionals not rarely are brought in during the due diligence phase.

Figure 5 - Coverage of the deal cycle

To unveil the underlying drivers of the non-deal phenomena, the choice was to perform face-to-face interviews with professionals with extensive experience in deal making. These specialists were selected for having experience in transactions that did go through but also participated in merger talks that were never completed.

We grouped the interviewees in two groups: (A) Advisor and (B) Buyer/Seller. For confidentiality reasons, names were omitted.

Table 4 - Advisor and Buyer/Seller

				Transaction experience		
#	**Identification**	**Role**	**Focus**	**Total**	**Non-deal**	**Level of involvement**
1	A1	Advisor	Strategy/BD	11+	11+	High
2	A2	Advisor	Strategy/BD	11+	11+	High
3	A3	Advisor	Deal Management	11+	11+	High
4	A4	Advisor	Deal Management	11+	11+	High
5	A5	Advisor	Due Diligence	11+	11+	High
6	A6	Advisor	Due Diligence	11+	11+	High
7	A7	Advisor	Due Diligence	11+	11+	High
8	A8	Advisor	Legal	11+	11+	High
9	A9	Advisor	Integration	11+	3-5	High
10	A10	Advisor	Integration	11+	11+	High
11	B1	Buyer/Seller	Strategy/BD	6-10	6-10	High
12	B2	Buyer/Seller	Deal Management	6-10	1-2	High
13	B3	Buyer/Seller	Deal Management	11+	11+	High
14	B4	Buyer/Seller	Due Diligence	3-5	3-5	High
15	B5	Buyer/Seller	Due Diligence	3-5	1-2	High
16	B6	Buyer/Seller	Due Diligence	3-5	11+	High

Source: Interview program. Prepared by the author

This study aims to investigate a subjective concept. The option to conduct in-depth interviews as a data collection technique can be justified as long as it promotes a greater understanding of the motivations, beliefs, attitudes, and feelings about a particular underlying subject (Malhotra, 2006).

In-depth interviews further explore the reasons that lead to a particular reaction as a result of the facts or situations presented (Bauer e Gaskell, 2003).

In general, the interviewer perceived a general willingness on the part of the respondents to cooperate, especially because of the reserved manner in which the interviews were conducted with them. It became apparent that the ideal interview, recommended by Lodi, was achieved: “the

interviewee brings favorable and unfavorable reasons to participate in the interview. Some favorable reasons include altruism, the pursuit of emotional satisfaction and intellectual satisfaction”[30] (Lodi, 1991).

The questions, which were relative open, were conducted according to the characteristics of the interviewee and flowed according to their personal experience and willingness to share. However, a malleable free script with relevant questions on the subject was used as a guide during these interviews in order to contextualize the topic under investigation and better understand the depth of the respondent's relationship with the M&A process, for example:

1) What is your role in the transaction?

2) How many transactions have you participated in?

3) How many have you seen abandoned?

4) How active was your participation in these processes?

5) In your opinion, based on your personal experience, what factors lead to the abandonment of a transaction? Think about an emblematic transaction that you have participated which was not completed. What contributing factors lead one or the two parties to walk away from the deal? Is there a price for walking away from a deal? Please comment.

7) Finally, have you witnessed transactions that were not supposed to be completed, which one or the two parties demonstrated ‘cold feet’ or hesitation but at the end decided to go ahead? What were the consequences? Please comment.

[30] Lodi, J.B. A entrevista: teoria e prática. São Paulo. Editora Pioneira, 1991

An analysis of the content was used to treat the information collected. It is an "extremely useful analysis technique, especially in qualitative research, which emphasizes the need for systemization of testimonials and relies on the study of language"[31] (Dellagnello e Silva, 2005). Still, according to Gill (2003) there is no single perspective on content analysis, but rather a number of different styles of analysis[32].

At the pre-analysis stage, transcription of testimonials was performed, which were then examined and organized by certain factors that culminated in the abandonment of the transaction. At the end, the data was interpreted with the objective of extracting, from the information gathered, the relationships between message elements and the simultaneous presence of two or more elements in a testimonial.

Interviewees are actively working professionals and based in the cities of São Paulo and Rio de Janeiro and selected by accessibility of the author via professional networks.

4.4 SCOPE LIMITATIONS

The reliability criteria for qualitative research should not relate to those of quantitative research, particularly with reference to the representation of the respondents when compared to the broader population.

A number of limitations could be considered when assessing the results of this study, including the fact that the sample consisted of 16 participants. It should be pointed out that the concept of a representative sample does not apply to this research study, making it impossible to generalize the results in relation to any definable population (Bauer and Gaskell, 2003).

Qualitative research is a discovery or exploratory process (Vieira, 1996) and the most appropriate method to understand phenomena for which there is not much knowledge available (Vergara, 2004), which is the case for deal making failure, hesitation or 'cold feet' in transactions.

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[31] Dellagnello, E. H. L. E Silva, R.C. Análise do conteúdo e sua aplicação em pesquisa de administração. In Pesquisa qualitativa: teoria e prática. Volume 2. Rio de Janeiro. FGV, 2004

[32] Gill R. Análise de Discurso. In Bauer M.W., Gaskell G. Pesquisa qualitativa com texto, imagem e som: um manual prático. Petrópolis. Editora Vozes, 2003

Furthermore, although the nature of exploratory probing does not allow the formulation of hypotheses a priori (Vergara, 2000), it is believed that through analysis of the testimonials collected it is possible to generate new assumptions which may be useful to further explore the topic and conduct future research studies, thus contributing to develop knowledge on business administration in general and, more specifically in the field of Mergers and Acquisitions.

The interviews seem to have achieved some reasonable level of empirical saturation[33] [34] (Glasser and Strauss, 1967; Strauss and Corbin, 1998) and indicated specific conclusions.

Finally, the information gathered consisted mostly of recollections and interpretations of the interviewees, a group of active seasoned professionals with valuable insights and vast experience and knowledge about deal making. It is important to mention that, as individuals, they could have introduced bias and subjective elements from their diverse personal involvement with the subject under study: the “No-deal” phenomena. Additionally, the diverse sample may mask important trends and findings if the study were made among a particular subset of participants.

[33] Strauss, A. L. and Corbin, J. M. Basics of qualitative research: techniques and procedures for developing grounded theory. Sage Publications Inc., 1998

[34] Glaser, B.G. and Strauss, A.L. The Discovery of grounded theory: strategies for qualitative research. Chicago. Aldine Publishing Company, 1967

5 **DATA ANALYSIS**

5.1 FINDINGS AND DISCUSSIONS

In this section of the study, it is presented the analysis of the interviews performed as well as the information gathered, key findings and interpretation. When interpreting the data, the focus was directed to the contributing factors to the collapse of merger talks. Interviewees were very collaborative and the rich data obtained from the interviews was filtered so it is presented only the information relevant to the study, instead of state them all, because it could disturb the reader.

The data is presented following the logic order of the conversations with the interviewees:

1) The typical roles in a transaction;
2) The usual deal flow;
3) When usually a merger talk collapse;
4) Common factors contributing to the collapse of merger talks;
5) The price for walking away from a deal; and
6) Other considerations.

5.1.1 **What are the typical roles in an M&A process?**

As confirmed by the interviews, the roles performed in transactions are directly related to which party the professional is representing (e.g. buyer, seller, advisor), combined with its contribution to the deal evaluation (e.g. strategy, due diligence, valuation) and the different stages of the transaction process (e.g. pre-deal, during the deal, post-deal).

The main actors in a deal are:

Buyer and seller

The “Buyer” or “Investor”: the one paying for the stake in a business, acquiring shares or assets of another company.

The “Seller” or “Target”: the party selling a stake in a business, divesting shares or assets to another company.

In a so-called merge of equals, the figure of buyer and seller might be not very clear or easy to identify; in certain cases not even present at all. If the new merged company maintain a 50/50 shareholding structure with no special powers or benefits to any of the parties.

Buyers and Sellers can be grouped by its nature: Corporate or Private Equity. Corporate includes public (listed companies) and private companies. Private Equity is usually composed by investment firms dedicated to investment in the private equity of operating companies and they make a living by acquiring, fixing and selling business.

Finally, based on the origin of capital, Buyers and Sellers can be classified between domestic (Brazilian) and foreign companies. Interviewees also groped companies based on the type of capital: family-owned, public (listed) companies, multinationals and state-controlled entities.

Note that governments and state-owned companies can go shopping and, according to interviewees, their motives and rational to engage in a deal involve a reasonable level of political interest.

Advisors

Advisors support buyers and sellers to source, evaluate and manage a deal. They usually work side by side with executives in blended teams or in supporting functions feeding decision makers. The number of advisors can be large depending on the size and complexity of the transaction.

The perimeter of the work of advisors can vary a lot but typical scope work can be grouped according to the deal stages.

- Stage 1: Pre-deal advisory

During the pre-deal phase, buyers and sellers are evaluating the opportunities to invest in a market or divest a business. In this phase is generally not uncommon for CEOs, CFOs and Boards to get an external view to develop or validate Strategy formulation process.

- Stage 2: Deal advisory

  Deal advisory starts with the identification of targets for acquisition or potential investors to invest in a company. Buyers and sellers can make use of advisors to manage the deal. The work involves negotiation and project management. The deal manager will coordinate other advisors and internal teams with view to close the best possible transaction. The remuneration is based on success fee and is role played by specialized financial advisory firms, M&A boutiques and investment bankers.

  During the deal is also performed due diligence, valuation and the drafting of key deal documents, including memorandum of understanding, offer letter and the SPA.

- Stage 3: Post deal advisory

  Post deal advisory is usually consultancy dedicated to plan and execute a smooth integration process, preparing the merging companies for the Day 1 and after. They also work on calculating and validating synergies. Aside from integration teams, in the post deal phase, a number of consulting work can be used to support the new merged entity.

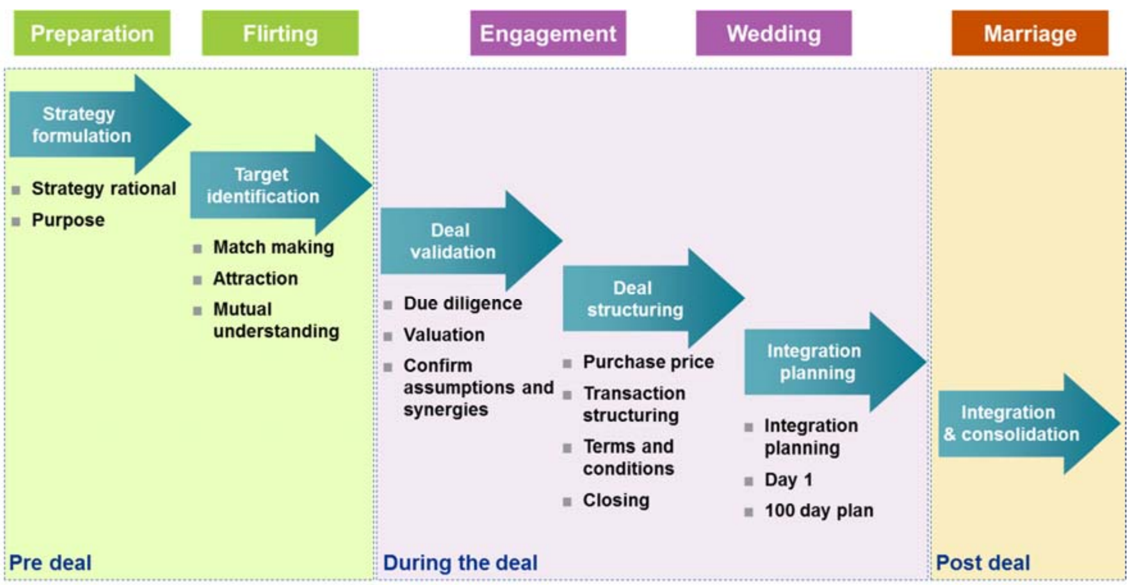
No significant differences were observed in the responses or observations between the group of advisors compared to the group of dealmakers on the buy or sell-side.

5.1.2 **What is the usual deal flow?**

Interviewees confirmed the deal flow previously discussed in the literature review, explaining that in practice some of the phases tend to run concomitantly, so there is some level of flexibility how things are done in practice. They also corroborated that merger talks tend to collapse as the companies start to get to know each other in more detail; relatively similar to what happens during the engagement phase of the 'flirting, engagement and wedding' analogy. The more you know more susceptible are you to see beyond the first impression.

With the contribution from literature and the interview program, we propose the following deal flow:

Figure 6 - Deal flow



Source: prepared by the author

5.1.3 **Is it possible to determine where does usually a merger talk collapse?**

As previously discussed, not all M&A processes reach a successful conclusion. As the parties become more and more familiar with one another, sometimes a negative perception emerges that the opportunity for potential value creation does not compensate for the cost of merging. In these cases, one or both parties decide to abort the negotiations and walk away from the deal. “Deal breaker” is the industry jargon for an issue that, if unresolved during negotiations, would cause one or more parties to walk away from a deal.

According to the interviews, merger talks usually collapse somewhere between deal validation and deal structuring, specifically during or right after the due diligence.

> “It’s at the due diligence when information is exchanged and skeletons in closet can be unveiled” (*Advisor, Deal management*)

> “All relevant issues discovered during the due diligence exercise will impact valuation [purchase price], terms and conditions of the deal to be closed as well as the structure of the deal. Sometimes, the risks are so high that surpasses the price to be paid by the target, destroying the deal”. (*Advisor, Deal management*)

> “It’s during the due diligence when deal breakers arise”. (*Buyer/Seller, Due diligence*)

> “A risk revealed during the due diligence phase may be manageable with proper deal structuring. Depending on the situation, certain measures can be adopted to try shielding the merged entity or ‘newco’. This is particularly valid for tax, labor and legal risks. Advisors bring their market experience to design mechanisms to mitigate the risks, without eliminating them, but bringing a better level comfort to the parties involved.” (*Advisor, Legal*)

> “In certain cases, the deal structure proposed by the sellers need to be negotiated. Sometime the transaction falls apart because of lack of flexibility between the parties. Obviously, it all involves cash to be paid or received and respective timing of cashing it.” (*Buyer/Seller, Deal management*)

5.1.4 **What are the common factors contributing to the collapse of merger talks?**

Analyzing the results of the interview program, it is possible to classify deal breakers into two categories: qualitative and quantitative.

Qualitative issues are difficult to be measured in numbers but can represent real thread to the deal, the acquirer or the new merged entity. Quantitative issues can be translated into numbers and factored in the purchase price, adjusting the valuation model and/or normalizing multiples.

Although a number of issues were reported, six main topics were recurrently attributable to having a great influence on deal collapse:

1) Window dressing;

2) Unrealistic expectations in relation to the valuation of the business;

3) Tax related risks, aggressive tax planning and over engineered schemes;

4) Lack of information during the due diligence exercise;

5) Disputes of interpretation and failure to reach an agreement in relation to due diligence proposed adjustments;

6) General lack of governance, informalities and questionable corporate practices;

Table 5 - Qualitative x Quantitative issues

Qualitative ("soft") issues	**Quantitative ("valuation") issues**
• **Lack of information** • **Informalities, lack of governance and questionable corporate practices** • **Window dressing, hidden issues brought to light during the due diligence process or non-disclosure of material items at the appropriate time** • Cultural differences and incompatibility of personalities • Deal fatigue due to the length of negotiations • Lose-ends untied and inconsistencies thorough the process • Lack of conviction to close the deal • Unexpected departure of key executives and personnel • Integration risks • Lack of professionalism	• **Unrealistic expectations about the future of the business and its value** • **Tax (and labor) related risks, aggressive tax planning and over engineered schemes** • **Failure to reach an agreement in relation to due diligence adjustments** • Quality of earnings and profitability • Overvalued assets • Other contingencies and hidden liabilities • Resistance to sharing transaction risks

Source: Interview program. Prepared by the author.

Note: six most recurring issues are highlighted

5.1.4.1 **Window dressing**

According to the interviewees, it is not uncommon that, in preparation for a sales process, many target companies make debatable adjustments to the financial statements and management reports to make the rosiest possible picture to potential buyers. This can jeopardize credibility and eventually lead to the merger talk collapse.

> "Numbers that have no proper support forecasts based on wishful thinking, hidden issues brought to light during the due diligence process or non-disclosure of material items at the appropriate time are typical manifestation of window dressing in transactions. This obviously impacts trust, which is fundamental for any type of negotiation, particularly in M&A" (*Advisor*, *Due diligence*)

5.1.4.2 **Unrealistic expectations in relation to the valuation of the business**

Different expectations in terms of value of the business being sold or merged was the second most common issue reported by the interviewees.

> "It is normal to see gaps in the expectations between sellers and buyers. The more sophisticated the seller is, less dissonance will be seen in the negotiation. For example, I have seen cases where the sellers do not have a clear idea of what a discount cash flow is and what they have in mind in a multiple thrown in the air by some amateur advisor. This creates a lot of confusion and at the end we have to try educating the seller on how to proper value a business. The problem is that when the seller has a number in the head is difficult to override it." (*Buyer/Seller*, *Strategy/BD*)

5.1.4.3 **Tax (and labor) related risks**

The tax environment in Brazil is complex, it changes with some frequency and the burden is one of the highest in world. According to interviewees, it is not uncommon to see Brazilian companies, particularly family-owned business and mid-size companies trying to reduce the burden.

> "Tax complexity is significant and it can be a deal-breaker. Different interpretations of complex rules and the fact that there is no tax clearance increases the level of uncertainty in negotiation. Challengeable tax incentives, aggressive tax planning and creative

> schemes to reduce tax burden can have a direct impact on the perception of risk and consequently the valuation of the company to be acquired" (*Buyer/Seller, Due diligence*)

> "Tax evasion is more difficult with the new tax electronic systems in place (e.g. SPED) but still out there" (*Advisor, Due diligence*)

5.1.4.4 **Lack of information (or preparation)**

> "There is nothing more frustrating for us than signing a non-binding offer, kick-off the due diligence period and realize the target company is not prepared for the deal. There was this particular transaction where the information was so scarce and we had to hire an accounting firm to reconstruct the target company accounting and build information for us so we could analyze and evaluate the business opportunity. Sellers were managing the business on a cash basis and had very little structured financial information to share. This transaction was a pain. We tried very hard because it was an interesting asset in a geography that was key for us to expand into… but after months digging the scarce information available we decided to walk away." (*Buyer/Seller, Strategy/BD*)

5.1.4.5 **Failure to reach an agreement in relation to due diligence proposed adjustments;**

At the end of the due diligence period, buyer and seller get together to discuss the key due diligence issues and respective impacts on the negotiation and valuation of the target company as well as mechanisms to mitigate risks identified during the process.

> "During the financial due diligence we tend to focus on assets that could be overstated or with risk of realization, unrecorded liabilities or hidden contingencies, working capital trends, CAPEX trends. On the income statements side, we investigate the quality of earnings, non-recurring items impacting EBTIDA, related party transactions, provisions, allocations, capitalization of expenses and cut-off issues. The due diligence report includes a summary of all adjustments identified with will feed the valuation model and price negotiations. Obviously, there are cases were the perception of risk of the sellers are very different than buyers and it creates an impasse, sometimes, difficult to reconcile… and the deal collapses. (*Advisor, Due diligence*).

> "Due diligence exercises in Brazil often identifies more issues and risks than investors in developed markets may be used to, particularly in tax and labor spaces." (*Advisor, Due diligence*)

5.1.4.6 **General lack of governance, informalities and questionable corporate practices**

Questionable practices, informalities and lack of governance were listed by interviewees as one of the main factors contributing to merger talks collapse.

A seasoned due diligence advisor summarized well the sentiment shared by most interviewees:

> "Talking about deal making in Brazil, I understand there cases that may lead to the abandonment of a transaction due to qualitative issues, particularly those involving reckless management, fraudulent acts, criminal and clearly contrary to the laws are those that can have weight in the decision. Still, this decision depends on the type of investor and objectives of the transaction. Institutional investors (PE's, Investment Funds and the like) are more reluctant to treat such issues as listed above. However, Brazilian strategic investors may have a more complacent view (in the sense of being able to resolve the situation in the 'post-acquisition') because of the necessity of acquisition of the asset (or entity, or technological knowledge, or withdraw a potential competitor) .The price drop is also related to the type of investor. Funds and PE's may resent the gains (short and medium term) that could be assessed given the potential of the target company was not acquired. Strategic buyers may face a future major competitor, or fail to acquire certain knowledge or technology that could lead to a jump in levels of revenue, EBITDA and market share. In general, the most visible consequences at first are issues involving litigation and contingencies (materialized and not materialized) arising from tax, tax and labor issues. But concerns about fraud, and acts and conduct contrary to the laws also imposed itself as probable future problems. Having said that, I perceive a clear distinction between Brazilians and foreign investors: local deal makers are more complacent and tolerant in relation to ethical issues. U.S., European and Japanese investors are very much concerned about reputational risk and FCPA type of issues." (*Advisor, Due diligence*)

Another interviewee confirmed:

> "I witnessed Brazilian strategic investors that, with the support of a large financial institution that financed entirely, did not care for the numerous indications of financial and accounting misconduct (some of those confessed written by sellers), acts contrary to the laws (including bribery of government officials), and the consequent exposure of the target company. The transaction was completed, the buyer has been working to adjust the internal practices of the

> acquired company and managing all contingencies and risks identified during the due diligence. During the closing, the sales price, form of payment and the terms of the acquisition were also adjusted so that the buyer could mitigate some risks and get some protections against probable future risks. That included getting the formal commitment of former owners to respond to any risks and exposures (including the payment of fines, debts, costs and court and attorney's fees when applicable). In some cases, the mechanism of 'escrow account 'was used." (…) "Based on my experience, this is the type of negotiation that only a buyer well versed in doing business in Brazil can achieve. Sophisticated buyers, particularly international firms, have difficulties to live with and manage that kind of risk, particularly if originated from questionable corporate practices" (*Advisor, Integration*)

Brazilian companies are increasingly becoming aware of recent anti-corruption and anti-bribery laws in Brazil. The new rules are similar to the US FCPA and UK Bribery act. A number of small and mid-size companies that still make use of non-orthodox practices to avoid bureaucracy and reduce tax burden soon will need to adapt. Today, these companies rarely engage top reputable accounting firms to audit their financial statements.

5.1.5 **Is that a price for walking away from a deal?**

The collapse of a merger talk can give the parties a feeling of frustration, particularly for those emotionally attached to the deal. However, if the due diligence unveils a high degree of uncertainty, risks beyond the acceptable levels or a purchase price that is difficult to realize in the future, the best decision to take is to walk away.

In line with the above, a Brazilian dealmaker noted:

> "Know your walk away number". (*Advisor, Deal Management*)

However, walking away from a deal is not that obvious. Gole and Hilger (2009) explain that "acquisition transactions take on a life of their own" and "individuals and organizations become invested in them" and this is manifested in the forms of dangerous enthusiastic support, optimistic expectations and broad-based company involvement. "Many of the forces at work would mitigate against 'pulling the plug' on the transaction" and any temptation to continue "justifying the transaction is usually a triumph of hope over good judgment and should be strongly resisted".

This contrary force pushing for deal completion is a behavior commonly referred to as “deal fever”, a mindset not uncommonly manifested in the M&A process. It is characterized by overconfidence and “high levels of testosterone”. Basically, as suggested by Bing (1996), the “investor’s enthusiasm for the business can be so great it clouds his views”. He goes further by making a distinction that “the longer the business has been coveted, or if it represents a key component in a strategic plan, the greater the irrational enthusiasm, creating a reluctance to be objective”.

This view is shared by a good number of interviewees:

> “You don’t want ‘deal fever’ blind your objectivity or hijack your reason. Consequences can be disastrous.” (*Buyer/Seller, Deal Management*)

The next case shows a foreign investor doing what was necessary to close the transaction, a typical case of ‘deal fever’ as described in the interview:

> “Again, family-owned business are complicated. I was working for this client [buyer] for two years trying to crack a deal with this promising business. The main driver was the potential of the Oil & Gas industry in Brazil. The target had a very optimistic view about the future of the business. This was in 2009-2010 and the potential of Pre-Salt discoveries were blinding everybody involved in the deal. Aside from the problems to validate the forecast assumptions, the sellers was not very sophisticated and it took almost one year to complete the due diligence. No proper financial reporting in place and despite the size, the company was managed on a cash basis. This was no deal for amateurs. There was all possible complications including ex-wife, broken relationships with sons of the first marriage, three advisors trying to manage the deal on behalf of the founder of the business and selling part (!)… The length of the negotiations almost killed the deal, but the buyers were in the ‘deal fever’ mode and there was a mandate from HQ to close the deal.” (*Advisor, Due diligence*)

It is interesting to observe different perceptions of risk from sellers and buyers. The following case illustrate the case of a seller who, in his view, believe there was an "excess of caution" from the buy-side. The potential acquirer here was a foreign investor:

> "The merger was clearly a win-win proposition for all parties involved. On the buy-side there was a foreign investor and we were the private equity fund working with the sellers, a Brazilian company. The buy-side due diligence advisors informed their client about potential tax risks. They took the opinion of the advisors in a very strict way and a lot differently of what we are used to see in Brazil. In practice the tax risk was very low or almost nonexistent. Particularly because the sellers offered the ability to adjust the "risk" through a deposit in a escrow account, an attitude totally "pro deal"! The advisers certainly had a decisive influence on the deal to be abandoned. In my view the attitude of advisers was the worst possible, clearly wanting to get rid of the problem. The adviser simply preferred to say that the risk was high and the buyer dropped the deal. What a shame for the investor because a few months after the negotiation the risk actually never materialized and a great opportunity was lost. The company has been delivering a result of the above the forecasted business plan." (*Buyer/Seller, Deal Management*)

5.1.6 **Other considerations**

Cultural aspects and other soft issues often underestimated

Except when cultural issues were manifested in questionable corporate practices, interviewees did not see cultural aspects as an important risk for deal making.

> "In developed markets, cultural aspects are taken more serious. For example, in those markets, we do integration planning as part of the due diligence process and one of the things we analyze is 'cultural fit'. I'm working in Brazil for two years now and I haven't seen cultural issues being taken into consideration for closing a deal. It is only analyzed after the transaction is closed and the companies have to integrate their operations. In Brazil, people are much more worried about numbers, synergies, operations and the infrastructure to support the business. I think it is part of the stage we are. As the M&A industry evolves, we will get there. (*Advisor, Integration*)

Haspeslagh and Jemison (1990) analyzed cultural aspects in deal making and stated that "managers may not always have information to judge how different cultures and subcultures of both organizations are before they experience those differences". Having said that, they suggest, "an early focus on which strategic capabilities need to be preserved, to what extent they depend on maintaining a cultural difference, and to what extent they can be contained in a sub-part of the organizational focus".

In other words, the value creation in its various forms (size, customers, markets, synergies, competences) may be directly linked to the cultural aspects and losing those skills might potentially have a reasonable impact on the ability to realize the potential value to be created by the merger, so it cultural issues should not be underestimated, but should be factored into the decision making process along with other quantitative or qualitative issues.

Investors trying to enter Brazil may accept to pay an extra price

Foreign investors trying to enter Brazil seem willing to pay a higher price when compared to domestic players, according to the interview program:

> “Every time a foreign investor is willing to pay more than what the valuation says it is justifiable by the word ‘strategic’. ‘It’s a strategic investment’, they say. As a valuation professional, I have to accept the fact that these buyers are seeing something more than just the numbers we present to them.” (Advisor, Deal management)
>
> “I have seen a number of transactions where foreign investors have a mandate to enter Brazil and they will pay as much as the target asks. Sometimes they accept a ridiculous price.” (Advisor, Due diligence)
>
> “Private Equity investors are very conscious about the price they are paying and they are just the opposite of some eccentric foreign investors. Price equity tend to try paying less than the fair price. They are clever investors and their focus is on the short term. Strategic investors tend to think in the long term. Their decision making process is based in the next ten to twenty years, not the next five years.” (Advisor, Strategy/BD)
>
> “For our HQ it was important to expand into Brazil and we believed it was possible to turnaround the business and bring synergies and new products to conquer the Brazilian market. The acquisition was just a platform for further consolidation” (Buyer/Seller, Strategy/BD)

Deal fever is a powerful force and may bring irrationality to deal making

Liu and Taffler (2008) studied the overconfidence of CEOs in M&A decision making by analyzing a sample of 1,900 transactions and data on more than 3,100 CEOs and concluded that CEO overconfidence has a significantly negative impact on both short-term and long-term post-M&A performance[35], confirming Bing's hypothesis.

McSweeney and Happonen (2012) confirm that commitment, secrecy and intense concentration, as well as pressure from outside advisors can create a situation where "the acquisition team may feel unable to stop the process or slow its tempo",[36] making the No-Deal phenomena unlikely to be manifested. According to the authors, this can lead to "escalading desires to complete the process quickly and 'close the deal' (…) [leading] to overvaluation and inadequate considerations of integration issues".

This view that the momentum of the transaction is hard to resist is also supported by Cullian, Le Roux and Weddigen (2004). They confirm this by exemplifying the case of Dominicks's acquisition by Safeway, a leading American grocery chain, in 1998. The deal was closed in a rush, just five weeks, which is about a third of the average closing period for large transactions. This swift transaction was based on the Safeway's CEO's confidence that he would be able to increase Dominick's 7.5% operating margin to 9.5%, even though Safeway was operating at only 8.4%. On the strategic side, the deal proved to be unfitting. According to Cullian, Le Roux and Weddigen (2004), "Dominick's focus on prepared foods, in-store cafes, and product variety did not fit Safeway's emphasis on store brands and cost discipline. Dominick's strong unions resisted Safeway's aggressive cost-cutting plans. And with its customers unwilling to accept Safeway's private label goods, Dominick's was soon losing share to its archrival, Jewel" (…) and not able to "sell [Domimick's] for even one fifth of the original purchase price".

Cullian, Le Roux and Weddigen (2004) believe that if a proper due diligence process were taken and its risks well studied by Safeway, the company would possibly be able to detect potential

[35] Liu, Y. and Taffler, R. Damned out of their own mouth: CEO overconfidence in M&A decision-making and its impact on firm performance. Working Paper. University of Edinburgh Business School. Edinburgh, 1998.
[36] McSweeney, B. and Happonen, E. in In Faulkner D, Teerikangas S, Joseph RJ, editors, The handbook of mergers and acquisitions. Oxford: Oxford University Press. 2012.

dangers and quantify some of the problems that were manifested after the close of the deal. In other words, proper due diligence would give elements for Safeway to walk away from the deal.

6 **CONCLUSION**

According to Gole and Hilger (2009), there are two circumstances leading to deal failure: when the transaction presents an unacceptable level of risk or when its value creation plan was based on seriously flawed assumptions; or both.

Horn, Lovallo and Viguerie (2005) affirm that “although canceling a project or exiting a business may often be regarded as a sign of failure, such moves are really a perfectly normal part of the creative-destruction process” and in fact the “unaccepted alternative is to gamble away the company’s resources on endeavors that are likely to fail in the long run no matter how much is invested in them”.[37]

Based on the exploratory interview program performed to support our qualitative research, it is believed that this study makes six contributions to the M&A literature, particularly in relation to the Brazilian transaction space:

i. Identifies six main issues contributing to the collapse of merger talks, as follows:

1. Window dressing;
2. Unrealistic expectations in relation to the valuation of the business;
3. Tax related risks;
4. Lack of information (or preparation);
5. Failure to reach an agreement in relation to due diligence proposed adjustments;
6. General lack of governance, informalities and questionable corporate practices

ii. Recognizes that in a merger talk, qualitative issues, such as informalities, lack of information, corporate governance and management style can be as destructive as valuation issues such as tax risks, contingencies, quality of earnings and other liabilities;

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[37] Cullinan, G. Le Roux, J. and Weddigen, R. When to walk away from a deal. Harvard Business Review, 82/4; 96-104
[37] Horn, J.T. Lovallo, D.P., Viguerie, S.P. Learning to let go: Making better exit decisions. The McKinsey Quarterly. 2, pp 65-75. 2006

iii. Captures the sentiment of active dealmakers in Brazil that foreign investors tend to be stricter in relation to qualitative issues. Domestic buyers tend to be more flexible and complacent;

iv. Recognizes the existence of a powerful contra force commonly referred by practitioners as ‘deal fever’, a form of overconfidence that can override rational decisions in merger and acquisitions;

v. Determines that usually merger talks collapse at (or right after) the due diligence phase

vi. Apparently, Brazilian bureaucracy, complexity and high tax burden may be an important driver for informality and the adoption of non-orthodox tax practices, particularly on the family-owned business space.

When it comes to our main research question, the interview data supporting the findings and conclusions also provide valuable insights to each factor driving merger talks collapse as well as open up new potential areas for future research.

A question emerged at the conclusion of the research:

Is there an underlying factor driving the six main issues contributing to deal making failure?

What is directly entrenched in issues such as 1) Window dressing; 4) Lack of information; and 6) Lack of governance, informalities and questionable practices; and that could be indirectly present in items like 2) Unrealistic expectations in relation to the valuation of the business; 3) Tax related risks; and 5) Failure to reach an agreement in relation to the due diligence proposed adjustments?

Critically analyzing the six main issues contributing to merger talks collapse, it is possible to conceive that “lack of professionalism” at one or both sides is potentially the single common factor driving risk to an unacceptable level at the same time that it is an important condition that

allows the use of flawed assumptions are used to create a false portrait of value creation. During the interviews, it was possible to hear that the so-called ‘jeitinho brasileiro’ (or the Brazilian way of finding a ‘solution’ to accomplish something by circumventing rules or social conventions), when applied to business, may also be interpreted as ‘lack of professionalism’.

It is important to stress that, based on the interview program conducted, deal makers actively working in Brazil today did not report issues such as macroeconomic conditions, political and social environment or market as determinant factors contributing to deal making failure. These are issues that can be treated with a relative objective approach and factored into the valuation model. Additionally, these factors are potentially evaluated upfront, at the strategy formulation phase or target identification phase, as they are mostly external to the deal.

M&A is a process that takes time and normally encompasses a recognized ritual between the parties. To some extent this ritual could be comparable to human relations. For example, for a man or woman that just met each other, it is difficult to ask for a background check, credit report, and psychological, behavioral or medical opinion when you are still in flirting stages.

Concluding, it is recommended that companies seeking to engage in merger talks, particularly those trying to attract investors, get prepared before entering in serious negotiations. Preparation here means improving corporate governance, resolving informalities, challengeable tax practices and evidences of questionable corporate acts and window dressing mechanisms. It clearly does not mean applying the ‘jeitinho brasileiro’ to accomplish strategic goals, meeting financial objectives or solving operational issues.

In that sense, the use of specialized external professional advice may the proper solution. Certain issues are not fixable from one day to another (for example, certain tax risks need at least five years to disappear), but companies contemplating M&A should not await for a due diligence exercise conducted by a counterpart that would expose their internals and let the deal to collapse to then start considering to get more professional.

On the other hand, investors should try all available mechanisms to identify certain issues that can potentially lead to deal making failure upfront, before engaging in serious negotiations. That could perhaps be done in a form of a phased approach or a pre-deal fast track due diligence exercise in agreement with counterpart, with a view to avoid spending a tremendous amount of money, time and resources in merger talks that are doomed to fail.

Finally, deal makers should have in mind Scott Neustadter's cynical advice in (500) Days of Summer: "some people are meant to fall in love with each other… but not meant to be together."[38]

[38] Neustadter, Scott. (500) Days of Summer: The Shooting Script. Newmarket Publishing & Communication Company. New York, 2009

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