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Main Deviations over Specialist's Usual Praxis Affecting Prices and Their Sources in Mergers and Acquisitions Deals. A Behavioural Add-On to Rationality. The Spanish Market Case in 2013

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Abstract

Rationality criteria in Mergers and Acquisitions (M&A) deals is Value Creation. Behavioural Corporate Finance evidences several ítems influencing the activity. M&A specialists Advisors are decision making contributors, witnesses and responsible for the evolving support of the related standards arising from their praxis. Research built for the first time with the involved specialists advisors platform by in depth interviews and surveys shows the main factors with capacity to produce deviations and the main deviations. The resulting knowledge allows capacities of analysis and negotiation and increases the value of planning, training and management at deals frames. Rationality might be enhanced by the advisors behavioural criteria.

Keywords: Mergers and Acquisitions, Behavioural Corporate Finance

JFL Classification: G34 – Mergers, Acquisitions; G02 – Behavioural Finance

Introduction

Behavioural disciplines have a trayectory of challenging and complementary coexistence with Rationality. Let us consider a brief summary of their history and of their outputsaffecting Mergers and Acquisitions to better understand the antecedents and reasons for the contribution of the research.

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The concept of rationality involves some difficulties from the perspective of the Philosophy. One of the main challenges is its relativism based on the need for the previous definition of the criteria to qualify its achievement as mentioned in Ferrater Mora (1994). Rational Choice Theory, reaching this target, became one of the key scientific devices in the Social Sciences with decision making as a central element working for rationality.

Several critical contributions, specifically Bounded Rationality from Simon (1955) and Prospect Theory and many others from Kahneman (1974, 1979,1984, 2011) challenged the mainstream in Economics enabling new developments. The interrelations among Economics and other Sciences, particularly Psychology, might explain the origin of Behavioural disciplines according to Camerer and Lowenstein (2004). Behavioural might be considered as subfields that work for the improvement of the economic and financial models as suggested by Camerer (2005). Behavioural áreas, including Behavioural Corporate Finance, are in continous development and have a significant academic and market acceptance and divulgation.

M&A rationality is linked to value creation throughout sinergies coming from economies of scale. Behavioural Corporate Finance adds studies and shows evidences of several ítems influencing the activity that are mainly regarding biases, heuristics, managerial traits and horizons, offers characteristics, market valuations and reactions, contracts design, and Integration and agency conflicts. Among many other sources authors like Sheffrin (2007), Ackert & Deaves (2010), Dong (2010) Weber (2010) and Ahern & Weston (2007) analyze and collect related theories and research outputs. Behavioural studies, particularly those on biases and heuristics are still to be further developed as mentioned by Schwartz (2010) and Dowling & Lucey (2010). And overall as stated by Haleblian et al (2009) M&A studies show absence of theoretical unification, Integration and consolidation and do require better planning and improvements in metrics and sampling. Further research is necessary while the up to date need requires to count with both rationality linked to value creation and with the current behavioural theories and evidences when considering M&A deals.

The incremental contribution of the research being introduced is the knowledge of the factors with capacity to produce distortions affecting prices in Mergers and Acquisitions deals and the main deviations created, as well as the availability of a simple behavioural method to apply in addition to rationality consisting in not to act out of the specialists standards.

These results have been achieved with the participation for the first time of the specialists advisors involved in the deals who have been able to identify the sources of deviations as well as those agreements done in M&A that are out of the standard praxis.

The context of the researh has been therefore immersed in the universe of the M&A specialists advisors. The hypothesis targeted and achieved by the research was the confirmation of the three main sources of deviations in M&A deals affecting prices represented by the Financial needs of the Acquirer, by the Needs to do the deal by the Seller and by the diferent deal Participants profiles or roles whether Financial, Industrial or Managerial. The importance of the research results is integrated by the knowledge of the sources and deviations and by the behavioural add-on found. The main ingredients of the research novelty might be found in the use of the specialist platform and in the potential use of the knowledge achieved for analysis, negotiation and training.

The purpose of the following approach is to show this additional perspective focused on advisors judgement of standard behaviour.

1. Approach

M&A deals vary according to a wide range of factors, making each deal to be unique. However, organized processes, leaving apart the deal's specifity, have become an international standard at the sectors of Private Equity, Venture Capital, Investment Banks, Institutional Investors and specialized Consulting, Legal, Tax and Investment Advisors. All these actors might be considered as the specialists advisors as far as, apart from other strategic reasons, a significant stake of their profits come from their temporary cooperation with or presence in the capital of the companies involving M&A deals. They have created specific language and frames that play in this international reference to contribute to certainty and confort among the parties to the deal.

M&A deals pricing result in a conditioned and evotionary magnitude that is subject to modifications in accordance to the circumstances agreed by the parties. Price ingredients affect to and are affected by company management, participants profile, deal financing and the propensity to do the deal. Processes and prices complexities may create non wished distortions affecting the deals planned value.

The idea of the present approach is to complement rationality based in value creation with the behavioural perspective based on the specialists judgement.

Advisors involvement, together with the deal's Information and agreements, is a key significant common factor in organized M&A processes, according to Tapies et al (2004) and to Enrique Quemada (2009). Advisors are decision making contributors, witnesses and custodians of the developed experience, becoming responsible for the evolving support of the related standards arising from their praxis.

By making the assumptions that expectations of rational behaviour in M&A deals processes equals to usual proffesional praxis on the agreements and that the advisors are qualified interpreters of the related decisions and its normality it is possible to achieve the knowledge of the distortions over normal praxis affecting deal price and their sources. This allows to know what is a deviation and its source under the specialists judgement. This knowledge enables to look not only for the essential value creation but to look also for avoiding behaviour out of advisors standards, inside the limits of normal behaving.

2. Research Data

The target was defined as the confirmation of the factors with capacity to provoke deviations and the main deviations observed over the usual proffesional practices in M&A Agreements affecting price elements.

The research was conducted in the Spanish market in 2013 under the frame of a Business Science PhD Thesis done by Novas (2013).

First step, in-depth interviews of the Elite's kind as stated by Vallés (2007), was done with the cooperation of four specialists M&A Advisors, having all of them more of 10 years of individual professional and academic experience on the field.

A Delphi survey based on the results of the interviews was prepared and fulfilled by twenty two specialists M&A Advisors from the fields of Investment Banking, Venture Capital, Private Equity, Consulting and Law Firms and M&A Teams inside companies. Two of them with 3 to 10 years of M&A experience and twenty with more than 10 years of related individual experience.

The surveyed advisors included the market leaders in number of deals and deal volumes and their firms, most of them multinationals, held the best positions on M&A rankings on number of deals, volumes, related Funds and Consulting activities.

The survey consisted of six chapters regarding Statistical data of the sample, Context confirmation, Sources of deviations confirmation, Deviations confirmation, Trends and Preferences. Quality of the results made unnecessary further survey rounds.

3. Finding

The research revealed and confirmed first the sources of deviations, or Biases producers, and their motivation according to the following details:

- Factor 1: Financial needs of the Acquirer. On different variants the financing entity or entities of the deal for the Acquirer increasingly intervene on the approval of the business plan of the target company, of the deal price and of the related debt payment plan because these are the elements that form the financial plan involved. Financing is ussualy issued with guarantees affecting target company and also the related shareholding of the Acquirer. The deviations generated by this factor have their origin in the propensity of the financial entities to maximize their capacity to, under certain circumstances, forcé the advanced payment of the debt and the execution of the guarantees given.
- Factor 2: The needs that due to different causes propel the Seller to sell the Company. Several reasons may drive the need to sell, including regulatory causes, absence of liquidity, debt agreements, internal pacts of Private Equity or Venture Capital firms and distressed positions among others. In these situations propelled by the Seller needs to do the deal it is less difficult to accept not only price reductions but also economic terms and conditions that would result unacceptable under other contexts.
- Factor 3: Deal participants profile. The participants profile impact deal negotiation, pricing, process and agreements. By one side simultaneous belonging to Shareholders and to the Management Team may mean a different price payment justified by its essential rol on the Projects viability and by the support to a future transaction. Industrial nature of a deal participant on the other hand confers an undetermined staying horizon as well as a bigger trust in the Project given the available knowledge.

Finally, on the other side, financial participants and in particular those specialusts oriented to a temporary presence involve specific demands of profitability and confort and a bigger support to the importance of the Management Team.

The main deviations found in agreements revealed and confirmed by the research are:

- Use of Investment vehicles residence. The legislation of vertain countries, as it is the case of Luxembourg for example, allows the almost inmediat execution of guarantees agreed.
- Sale Mandates and Purchase Options favouring the financial entities control of the acquired company capital in distressed circumstances or in advanced debt payment situations.
- Debt Payment schema based on Interest rates of the kind denominated Pay If You Can that are related to the available cash of the company in comparison with the planned one. Non payment of these interests in the planned dates do generate additional indemnification interests and its priority payment position.
- Variable rates of Interest according to covenants materialization. This deviation represents a price increase in direct relation with company management meaning a penalty to their results.
- Assumption of Market Break Up. Once the M&A Agreements are signed and in effect and the new company in full operations it may happen due to the market break up pact that one of the involved financial entities find difficulties at its own financing source because of financial market disruptions allowing them to the requirement of the whole debt advanced payment and the execution of the guarantees.
- Grouping several commercial short term loans for deal financing coming from commercial Banks in order to avoid the eventually unacceptable conditions from the traditional senior debt financing.
- Andorran's Pact and other special Shareholders Agreement's Vetos. These devaitions have their origin in those situations with absence of finance making the Seller to continue being a minority shareholder in the Investment vehicle of the Acquirer. Looking to avoid the unwished prolongation of the planned term some special deviations may be generated in the form of special shareholders vetos. One of these is known as the Andorran's pact and compels to the first one setting a share price, whether the Seller or the Acquirer, to purchase or sell to the other one all the shares at the price set.

- Guarantees of mínimum profitability of the deal. This deviation consists in the mínimum price granted of the share set in the agreements in favour of the shareholders represented by Private Equity or Venture Capital Firms for their shares to be sold in the future next deal of the company even if this is in detriment of the rest of the other shareholders profits of the deal.
- Minority shareholder option to decide the Management Team of the company. This deviation happens as a requirement from the Financial Investors, Private Equity or Venture Capital Firms, that are given the rights to take off the Management Team appointed by the majority shareholder and select a new one under agreed risk situations.
- Due Diligence absence and light processes. Under te frame of a successive plan of purchasing deals in the same sector an investor of industrial nature may produce the deviation of non doing the due diligence work given his available knowledge and a sufficient level of guarantees. Also in M&A deals where new competitors arise, eventually provoked by the advisors, the processes followed by the new attendants may produce deviations caused by lower verification, and by scarcity of representations and Warranties. These light processes sometimes are due to the need of taking advantage of previous work done by other competitors and sometimes are based in the target of expenses saving.

The research shows that there is a complete agreement among the specialists advisors, 100%, on the sources of distortions represented by the Financial needs of the Acquirer, the needs to do the deal by the Seller and the deals Participants Profile. Regarding the deviations, amínimum of eight experts confer the attribute of deviation in all the cases, what confirms for each of them its nature and its present.

Other additional findings on Context confirmation, Trends and preferences by the specialists are:

- On the context characteristics: reduced M&A market with lower valuations and scarcity of financing. Financial entities increasing their requirements on the agreements and financial Investors doing less disposals due to lower pricing although increasing their demands when acting as purchasers even in minority positions. Deal negotiations getting longer and with stronger due diligence processes. Increase of the number of frustrated deals and increase of the number of distress operations.

- On the Trends. The forecast for the mid term, 1 to 3 years horizon, considers an increasing number of deals while maintaining valuations and deals pricing. Increasing finance availability with similar to date conditions and granting. Financial Investors will keep and increase their current requirements. The impact of regulatory changes will remain weak.
- On the Advisors preferences. The four main determinant factors on M&A deals for the specialists are the strengths of the business, the quality of the Management Team, the absence of deal financing needs and the quality and speed of Information during the deal process. The experts signal a profile difference between Industrial and Financial participants when acting as majority purchasers in the deals. Price is the only common factor to both of them in that situation. The Industrial looks additionally for the Agreement and for the results of the target company until the signature while the Financial priorizes Management Team and Due Diligence process. Finally, regarding the envieonment factors influencing bigger levels of M&A activity the advisors remarked the positive influence of an economic expansive context with low official rates of Interest and the relevance of a stable regulatory frame.

Conclusions

M&A activity is developed under a frame of uncertainty. Rationality is the main ally to combat the involved risk. Rationality in Mergers and Acquisitions deals has its foundations in value creation. If rationality by means of the assumptions done in the research could equal also to normal praxis behaviour under the judgement of the experts then it would be possible to conclude in the importance of avoiding deviations when considering deals.

In any case, and with all the precautions driven by the need of considering the effects of potential changes due to different market places and periods of time, to avoid deviations might be considered a Behavioural Corporate Finance contribution to complement rationality in the complex and uncertain universe of M&A deals.

It might be concluded as well from this research that:

- The majority of the deviations are on the financial side whose presence in M&A deals based on the research results deserves special attention. The presence of any of these factors or of their sources might generate in the deal participants capacity of alert, capacity to orient negotiations and capacity of analysis.
- Two significant evolutions are in progress. The credit granting function is changing the limits as far as continuity of the debt and certainty on the amounts are being questionned by some deals distortions. On the other side another evolution is happening to the natural concept of equal rights for all shareholders as observed in some of the deviations.
- The presence of deviations increases the value of plans, of management and of training. Planning details usually evaluated on financial data as a translation device might not consider well some qualitative effects that deviations can produce affecting the results. Management as well may not be able to satisfy some of the requirements included in a demanding deviation. And above all training in the presence of distortions increases its value because of the new situation. As stated by Fendt (2011) training on M&A processes and ability to communicate are the most missed and demanded ítems from Managers involved in corporate deals. Planning, Management and Training are of essential value in M&A deals. Its review with precaution is a good recommendation in the case of a potential or effective presence of a distortion.

Finally, strengths of the business, quality of Management Team, absence of finance needs and quality and speed of Information are the preferences of the experts becoming in this sense recommendations. It is possible now to add a further advice: while looking for value listen to the advisors and behave normal following the usual proffesional praxis in M&A agreements. The simple behavioural method to apply looking to complement the creation of value is not to act out of the experts standards.

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