The M&A Dogma in the Oil and Gas Industry[1]

Why, as per several reports, are over 80% of M&As doomed to fail? Some experts have cited reasons such as: lack of expected sales increases (33%), execution gaps (32%), failure to achieve expected cost synergies (26%), failure to achieve revenue synergies (23%), and lack of cultural alignment (20%). These only reflect post-M&A scenarios, which the integration team is responsible for. However, the seeds of failure are sown much earlier, and integration teams can only mitigate the damage initiated by the real culprits: CEOs and board members.

CEOs and board members often define mergers narrowly, with terms such as "*synergies*", "*efficiencies*", and "*streamlining of processes*". Producing a well-oiled machine becomes the yardstick by which an M&A is evaluated. This makes failure inevitable, and leaves the CEOs and boards unprepared and vulnerable—financially, strategically, psychologically/culturally, procedurally—in addition to lacking customer focus.

M&A Failures in Oil and Gas

Halliburton's attempt to acquire Baker Hughes, followed by GE's acquisition of Baker Hughes are prime examples of a narrow problem-solving approach applied to M&As. In 2016, GE acquired Baker Hughes for $30 billion; by late 2018, GE announced a separation from Baker Hughes, valuing it for less than $15 billion!

In 2018, McDermott's merger with CB&I was billed as "*an exciting day for McDermott*," with CEO David Dickson stating, "*We are confident that the execution of our 'One McDermott Way' strategy will allow us to drive value for our stockholders and meet the continuously evolving needs of our customers*." By September 18, 2019, McDermott's stock had lost 90% of its value, compared to a 17.7% decline in the energy sector ETF.

When Keane Group purchased rival C&J Energy Services in June 2019, the companies expected the transaction "*to add to cash flow immediately and bring annualized run-rate cost savings of $100 million within 12 months after closing*." The jury is still out but the stagnating stock price does not portend the anticipated shareholder returns.

More recently, Occidental Petroleum, with the help of Warren Buffett's $10 billion cash infusion, won the battle with Chevron to acquire Anadarko. In a telling comment, Mr. Buffett rationalized the merger not as a testament to the acumen of Oxy's board or CEO Vicki Hollub but as "*a bet on the fact that the Permian Basin is what it is cracked up to be… oil prices will determine whether almost any oil stock is a good investment over time*."

None of these failures were due to inadequate integration resources.

Why Boards and CEOs of Oil and Gas Companies Are Failure Prone

Oil and gas companies have access to the smartest leadership talent. Many CEOs and board members start their careers in the front lines, often working in technical positions within engineering, law, accounting and finance, petrochemical, and geology, among other departments. The depth of their experience cultivates a thorough understanding of the industry, builds technical acumen, and strengthens their professional relationships within the industry. Unfortunately, these strengths turn into weaknesses when it comes to M&As.

When a CEO and board view a merge as an engineering problem rather than a dynamic strategic issue, they set out to: (1) clearly define the problem space with parameterized, controllable attribute values, and (2) generate and evaluate alternative options in measurable terms. This approach propagates a risk-mitigation mindset and limits the discussion to quantifiable, though often irrelevant, metrics. The problem-solving mindset has an unfortunate consequence—senior leaders focus on what can be controlled and measured, irrespective of its relevance and importance to the big picture. Since many factors that can be measured and controlled reside within the organization—e.g., processes, employees, departments, budgets—the CEO and board look inward when evaluating an M&A opportunity.

The downside of a problem-solving approach to M&As is exacerbated by the selection bias and confirmation bias it fosters. Once the solution to an M&A problem is defined in terms of outcomes such as cost savings, the company leadership becomes laser-focused on efficiencies and ignores other important aspects of the transaction. Anything related to cost savings or revenues receives disproportionately higher attention. Cost savings becomes the solution space for evaluating all options.

What's more, scores of CEOs present the same recipe for M&As even though we know well by now that the recipe is not right: deploying more technology for differentiation or cost reduction, implementing more initiatives to reduce cost, and chasing the unattainable goal of "pricing power." CEOs and board members who aim to simultaneously grow the top line and slice costs find themselves boxed in. The merger is justified with detailed plans about post-merger efficiencies though these savings, efficiencies, and synergies eventually fail to materialize. Mired in a problem-solving mindset, CEOs and boards remain unprepared, and lose customer focus.

A Financial Failure Waiting to Happen

Berkshire Hathaway has an enviable track record of acquiring and integrating companies that were hugely profitable before the merger and continue to be profitable after the merger—Dairy Queen, Geico, Burlington Northern Santa Fe, Clayton Homes, Duracell, Benjamin Moore & Co, Marmon Group, Shaw Industries, and Nebraska Furniture Mart, to name a few. Berkshire's financial preparedness goes beyond their $100 billion plus cash balance; it resides in the easy-to-understand methodology used to value a potential acquisition candidate, the avoidance of bidding wars, a principled approach that eschews debt as part of the transaction, and clear incentives for the leadership of the acquired company to continue in their roles.

In contract, CEOs and board members of oil and gas companies erode value for shareholders and customers when they go at M&As financially unprepared. Take the case of the Occidental-Anadarko deal. Rather than a clear, transparent, and principled approached to valuing Anadarko, Occidental went into a bidding war with Chevron with several prominent shareholders openly saying Occidental overpaid. Shortly after the merger, Occidental's CEO and board embarked on a cost-cutting spree to pay off the debt. This meant selling prime real estate that Occidental had acquired in the energy corridor only a few months earlier, taking a cash infusion of $10 billion from Warren Buffett, issuing an additional $38 billion in debt, and selling over $8.8 billion in assets to Total and other competitors.

To be sure, we are not suggesting debt or leverage is a bad idea. As Mr. Buffett explains, using leveraged buyouts and private equity can have advantages for those shops, but not their clients.

> *The name may have changed but that was all: Equity is dramatically reduced and debt is piled on in virtually all private-equity purchases. Indeed, the amount that a private-equity purchaser offers to the seller is in part determined by the buyer assessing the maximum amount of debt that can be placed on the acquired company.*
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> *Later, if things go well and equity begins to build, leveraged buy-out shops will often seek to re-leverage with new borrowings. They then typically use part of the proceeds to pay a huge dividend that*

drives equity sharply downward, sometimes even to a negative figure.

In truth, "equity" is a dirty word for many private-equity buyers; what they love is debt. And, because debt is currently so inexpensive, these buyers can frequently pay top dollar. Later, the business will be resold, often to another leveraged buyer. In effect, the business becomes a piece of merchandise.

When an M&A is approached as a problem to be solved, taking on debt with the idea of repaying through cutting costs seems like a great solution to a narrowly defined problem. However, it is a poor reflection on a firm's financial preparedness, which is a larger construct involving fiscal discipline, transparency, and forthrightness between all parties. Senior leaders at companies contemplating M&As often assume intensive budgeting is a financially strategic move. Using debt to acquire a company, then paying for the acquisition cost through fire-sale asset disposal and expense reduction (with a focus on efficiencies and synergies) is anything but strategic! In companies where cash-flow issues dominate conversations, management's focus shifts to short-term tactics for boosting cash in deleterious ways. One E&P company took on jobs that improved short-term cash flow but they snuffed out all hope of ever being profitable. Another company's management engaged in window dressing backlogs by counting framework sales agreements as actual sales!

Strategically Unprepared CEOs and Board Members

Berkshire Hathaway's diverse portfolio of acquired companies—furniture retailing, jewelry, metals, energy, restaurants, manufacturing, paint, carpets, and more–hides the common strategic themes underlying their success. None of the companies acquired needed to be turned around—they were stable, profitable businesses, with well-established brands that customers and suppliers trusted. They all had solid cash flows and virtually no debt. In almost all cases the owners sought continuity and Berkshire preferred these companies to continue to operate under their current management. As stated by Buffett, Berkshire Hathaway's CEO:

Berkshire offers a third choice to the business owner who wishes to sell: a permanent home in which the company's people and culture will be retained (though, occasionally, management changes will be needed). Beyond that, any business we acquire dramatically increases its financial strength and ability to grow. Its days of dealing with banks and Wall Street analysts are also forever ended.

Evidently, when acquiring Nebraska Furniture Mart, Mr. Buffett gave the owner a check and she in turn gave him her word that the business had no debt. The deal was sealed with a handshake. Strategically, during an acquisition, Berkshire starts with a clear understanding of a company's strengths and strives to preserve them. This is different from acquiring a company for its unique strengths and trying to mold it in the image of the parent company or destroying it piece by piece to extract efficiencies and synergies.

A few years ago, we advised one of the largest upstream oil and gas companies, ParentCO, as they sought to venture into unconventional fields by acquiring RiskCO, a very profitable company. A strategic analysis revealed a low fit between the stable, risk averse, and highly process-based culture of ParentCO and the "seat-of-the-pants" culture of RiskCO. Against our recommendation, RiskCO completed the acquisition, tried to mold the target company in its own image, destroyed the company, and ultimately sold it for 12% of what it had initially paid! Consider the strategic process used by ParentCO to evaluate RiskCO. They prepared umpteen pro forma budgets to identify potential savings predicated on merging support functions like human resources, legal, and procurement. They held numerous meetings to enumerate cost-saving methods, including consolidating physical space and reducing headcount. They discussed ways in which RiskCO could work more like ParentCO so that it could be "*culturally integrated*"!. Yet, they never contemplated, measured, or quantified the deleterious impact of all these activities on key stakeholders like employees, customers, and suppliers. With no clear strategic goal besides "*creating shareholder value*" RiskCO lurched from one initiative to the next till it was sold off. Neither the cost-savings nor the synergies materialized to the extent envisioned before the merger.

Psychological Unpreparedness of CEOs and Board Members

Like a marriage, an M&A involves a courtship period, a formal union, and then adjusting to the relationship. Financial health is a necessary but not sufficient condition for a happy marriage. More important is the relationship itself. When boards and CEOs are psychologically unprepared for a merger they are left with acrimony, conflict, and stress at all levels of the organization.

A shareholder in a private company once approached Warren Buffett. She wanted to sell her majority stake to Berkshire at a relatively low price simply to spite her sibling with whom she had an acrimonious relationship. Mr. Buffett asked if her goal was to be successful or to prevent her brother from being successful. He then refused the deal given the acrimony and psychological stress it could lead to. Taking into account the potential for conflict—which is quite unquantifiable—

Mr. Buffett did not fall into the trap of merger synergies, cost savings, and financial performance.

In contrast, take the case of Occidental buying Anadarko. Carl Icahn, one of Occidental's largest shareholders with 4.4% of the shares, is highly critical of how the CEO and board went about the deal. Rather than focusing on ensuring the merger's success, Occidental's board, which includes the CEO, appears to be consumed with preserving the current board structure! The genesis of this conflict, in large parts, rests on the psychological unpreparedness of Occidental's board and CEO. Suppliers, employees, and other stakeholders have come under psychological stress after unexpected announcements regarding sale of office space and assets, and at times when the company has been reconfigured as if it were a puzzle. Shareholders and other stakeholders will likely interpret this as a reflection of the board and senior leadership being strategically myopic.

In large parts, evaluating the psychological aspects of a potential M&A deal requires the CEO and board to complement a problem-solving, mechanistic approach with a more humanistic approach. A laser-sharp focus on manifold psychological issues could turn out to be more vital than plans for budgeting, financial cost savings, and synergies. Like a marriage, a merger or acquisition is not a mechanistic problem with a pre-planned solution. Rather, M&As must be thought through in terms of their psychological underpinnings and their potential for cognitive, emotional, and relational conflict.

Lack of Customer Focus in M&A Deals Among Boards and CEOs

A study[i] of 429 mergers sheds light on the relative benefits of adopting an efficiency-driven approach based on cost savings alone, compared with a customer-focused approach based on satisfying customers for sales growth. Each of the 429 mergers was measured on its focus on efficiency as well as its focus on customer satisfaction. Compared with mergers that focused only on efficiency, those that simultaneously focused on efficiency and satisfying customers created 140% more value for shareholders! Yet, to the best of our knowledge, CEOs and board members in the oil and gas industry rarely assess the impact a merger has on customers. Ironically, a simultaneous focus on customer satisfaction and efficiency requires a deep level of synergy between all the different factors that drive customer satisfaction.

Based on a study with over 6,200 customer evaluations of companies in the oil and gas sector we developed the Strategic Synergy Index (SSI) for correlating customers' views. The SSI is based on customer perceptions of a company on 30-plus items that encompass eight strategy pillars, loyalty behaviors, corporate reputation assessments, switching costs, and company leadership. The Strategic

Synergy Index between two companies can range from 0 to 100—a score of 0 indicates no synergy while a score of 100 indicates complete synergy.[2] A high Strategic Synergy Score indicates the two companies will face fewer setbacks developing a well-defined customer value proposition, retaining high-quality employees, and gaining management credibility and trust among stakeholders. To be sure, we are not advocating that M&A decisions should be solely based on the SSI score. Rather, the SSI score can provide useful guidance to management, and ensure the company is not biased on its internal focus.

Take the case of Anadarko, which was wooed by Chevron and ultimately acquired by Occidental. The Strategic Synergy Index for Chevron-Anadarko is 77, indicating above-average synergy. The Strategic Synergy Index for Occidental-Anadarko stands at 57, indicating only average synergy. Thus, the Chevron-Anadarko combination would have found it easier to achieve sales growth than the Occidental-Anadarko merger!

The Strategic Synergy Index between Keane and C&J Energy Services is only average, at 66. In contrast, C&J and Halliburton (SSI=76) and even C&J and Schlumberger (SSI=81) are highly compatible for sales growth. To the best of our knowledge, few if any CEOs and board members in the oil and gas industry utilize such information when contemplating M&As.

Procedural Unpreparedness Among Boards and CEOs For Transformative M&A Deals

Leadership often overlooks procedural hurdles that can beset M&As. Their playbook typically consists of creating a post-merger integration team that, with the help of consultants, attempts to measure cultural elements that can be harmonized. They review and streamline myriad policies and procedures—HR policies, compensation policies, expense reporting, among others. Such process integration exercises can last anywhere from a year to a few years. Worse, the procedural integration could provide a road map for cost cutting. The integration process is sometimes used to dangle a carrot or shake a stick at the management and employees of the acquired company, incentivizing and requiring them to become like the parent company. The very reason why a smaller company is acquired is snuffed out during procedural integration!

Many companies roll out an integration team comprising of process consultants specializing in process integration, brand integration, communication strategy,

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[2] Two companies with an SSI score between 0 and 20 indicates no synergy, 21-40 indicates below-average synergy, 41-60 indicates average synergy, 61-80 indicates above-average synergy, and 81-100 indicates very high to almost complete synergy.

and the like. Unfortunately, this is done quite reactively, almost like digging a well after the house catches fire. Consultants follow their playbook without understanding the nuances of the merging companies. Integration teams take months, quarters, and years to get around to developing processes, by which time the damage is done. Informal conversations with industry insiders reveal that Occidental is undergoing this process with no end in sight!

A Cautionary Note

Given the economics of the oil and gas industry, M&A activity is bound to persist. By changing their ossified approach to contemplating and completing M&As, CEOs and board members can improve their success rate. This will require discipline and change in thinking on many dimensions—financial, strategic, psychological, procedural– as well as adopting a customer focus. The primary yardstick for a merger's success cannot continue to be cost savings and efficiency. Else, the cycle will be hard to break and companies will continue to miss the forest for the trees.

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i Swaminathan, Vanitha, Christopher Groening, Vikas Mittal, and Felipe Thomaz. "How achieving the dual goal of customer satisfaction and efficiency in mergers affects a firm's long-term financial performance." *Journal of Service Research*, 17, no. 2 (2014): 182–194.