LLM International Business Law 2015-2016

Due Diligence Process in Mergers & Acquisitions and Integration Problems

Supervisor: prof.mr. Erik P.M. Vermeulen

Dogan Baran Mengus

954086

Tilburg 2016

Contents

1. Introduction and the Importance of Due Diligence

In mergers and acquisitions, due diligence is the process of investigating the prospective target. In an acquisition, the managers of the bidder are at a disadvantageous position by comparison with the seller's side, due to the lack of information regarding the target. And shareholders, management teams, stakeholders of both seller and buyer may have different interests, one of the aims of due diligence is to create an equal environment for the negotiation period and thus support the parties to reach an alignment of interests.

In this context, it is important to understand the motives behind the mergers and acquisitions. The motives behind M&A transactions can be a company's desire to enhance its reputation in the market or among its stakeholders, access to new product lines or new technology, reduce the operational expenses, diminish the numbers of rivals, increase the market share, increase the manufacturing capacity, access to new suppliers, diversification and so on. However, most of the transactions cannot accomplish their deal objective; within this context, the due diligence and integration process play a fundamental role.

Through the due diligence, an acquirer can determine the appropriate price for the target and the method of the payment, predict possible risks and liabilities, specify the important provisions to negotiate with the other party, analyze the competition issues, and clarify that the target is as it seems, thus with the help of due diligence an acquirer can corroborate the merger decision or decide to walk away. Also, the information gained during due diligence will assist the bidder in the negotiation period, while drafting the agreements and allocating the risks regarding representations and warranties. In addition, this information will be beneficial to determine regulatory and governmental requirements, and stockholder approvals. Therefore, after an appropriate due diligence, the bidder can determine a better road map for the transaction. After all, due diligence creates fiduciary relationships between the bidder and the target due to the disclosure of all the material facts and this relationships require confidence and trust.

A well-conducted due diligence process enables a bidder to obtain information regarding the capital structure, composition of board of directors, level of indebtedness, middle management and employees, legal status, government style, corporate culture, financial status, intellectual properties and other intangibles, assets, liabilities, cash flows, potential risks, litigations, relations with customers and stakeholders of a target corporation. In order to conduct a successful due diligence; the bidder should insure that its team has the capability of the review the documentation, which will be provided by the seller, due to the probability of mismatch between the complexity of the documents and lack of skills of the M&A team. Also, the poor communication among the bidders team or between them and the seller's representatives can be caused of failure.

The due diligence process starts with the bidder's legal questionnaire and request for the disclosure documents of the seller. Especially in friendly mergers parties does not meet with difficulties in course of obtaining information regarding each other; but parties must be watchful during the examination of such legal, financial, cultural and any other sort of information. In some instances, a seller may provide misleading data regarding its corporation. Also, the bidder should search and store various public records of the seller before starting to the due diligence process. The bidder can reach some information regarding the seller through some government, civil or industry organizations, and even through media. Also, the seller may give warranties to the bidder in order to provide confidence regarding its declarations. That warranties are usually subject to a certain period of time, and limited by amount. Regarding the individual claims, there is often de minimis limitation. Besides, in order to success their claims, parties should conduct their claims in accordance with the requirements for the conduct of the claims and if the claims are contradictive, the process will be expensive.

Although the advantages of due diligence, due diligence is an expensive and time consuming event. During the due diligence process management team of the bidder focuses on the deal, therefore they might default on their daily business. Due to the time pressure and the expenses, managers can be willing to close the deal without an appropriate due diligence. Business professionals often make this mistake and the consequences are generally unsuccessful or unintegrated merged companies. Under any circumstances, parties must bear in mind that without an appropriate due diligence they cannot achieve their deal objectives.

2. Legal Due Diligence

The purpose of the legal due diligence is to analyze the vendor's legal documents and other records, thus evaluate the target company from legal point of view. Buyer's legal counsel should have two main objectives; determining the current status of the target company and possible legal-financial consequences of the completed transaction. During the legal due diligence process, the buyer's legal team assesses the target company's liabilities and obligations which may have an impact on the value of the target company. For instance, the target company may have liabilities for unpaid tax or pension fund deficits, redundancy payments, pending litigation and obligation imposed by environmental protection laws or practices[1], or pending law suits may create future obligations. Legal due diligence enables the bidder to ensure that the assets of the seller have the value as stated, the seller has ultimate right on these assets without any restrictions, and there are no risks that may decrease the value of the assets.

In such transaction, the buyer requires to ensure that the target is a duly organized company, all the transactions and documents are arranged properly, in the instance of the required approvals for the prospective transaction is present and they are received from the shareholders of the company to be acquired. Also, the bidder should be aware of whether there are any defensive mechanism which has been adopted by the seller in order to avoid hostile takeovers, for instance additional share purchase rights for the shareholders, and the buyer can fulfil these requirements through a well-conducted legal due diligence.

The bidder also needs to check all the contractual obligations of the seller because some of these obligations may pass to the buyer. In this regard the buyer should check whether there are change in control provisions that may affect the future of the merged company. Exclusive dealing arrangements should be examined

[1] Sudarsanam, S, Creating Value From Mergers and Acquisitions, Second Edition, Prentice Hall, FT, p.620

carefully in order to clarify whether there will be conflicts with the bidder's current agreements. All of the loans of the seller should be considered and entered in to any calculation during due diligence.

In order to keep the key employees of the seller, the buyer should review the employment contracts and union contracts, and determine whether the contractual obligations (e.g. salary, bonuses, benefit) are suitable.

If either the bidder or the seller has a significant market share or a little number of rivals, there can be antitrust law obstacles. Also, all the intellectual properties owned by the seller should be identified and distinguished. The value of intangible assets are varies according to their significance for the buyer. If the buyer is going to acquire the target for its specific intangible assets in order to gain competitive advantage or enhance its product diversity, then the rights which is given to that intellectual properties will become more important.

A. Sample Legal Due Diligence Check-List[2]

Legal due diligence check-lists include legal matters as well as financial-commercial matters, human resources matters, operational matters and environmental matters. Legal, financial, and cultural due diligence are examined separately in this work. However, there are strong links between different types of due diligences. In some cases different areas are interlocked and often legal matters includes financial, human recourses, operational, and environmental issues.

I. Corporate Issues

First of all, the bidder should understand the legal structure of the target corporation. The buyer's team should examine corporate records of the seller, such as certificate of incorporation (with the all amendments), bylaws, minute books, annual reports which provided for shareholders, a list of current shareholders, stock transfer books, a list of direct or indirect subsidiaries of the seller.[3] Another issue related to corporate matters is that the buyer's team should check all the

[2]Sherman, AJ, 2010, Mergers & Aqusitions From A to Z, Third Edition, AMACOM p74-82
[3]Sherman, ibid p.74

agreements among the seller's shareholders or members of the company. The last issue is examining all the contracts which may have restrictive effect on the sale or transfer of the shares; such as buy/sell agreements, subscription agreements, offeree questionnaires, or contractual rights of first refusal; all agreements for the right to purchase shares, such as stock options or warrants; and any pledge agreements by an individual shareholder involving the seller's shares.[4]

II. Financial

Financial matters are mentioned and examined in chapter three (Financial Due Diligence).

III. Management and Employment

The buyer should examine a great number of contracts, agreements, plans, and records regarding the management and employment matters including all the employment agreements, copies of all union contracts and collective bargaining agreements, employee benefit plans, profit sharing plans, stock option plans, insurance plans and policies, severance pay plans, personal information (name, personal file, address, etc.) of any officer or key talent who has quitted his/her job within two or three years.[5]

If the USA law is applicable to the transaction, the buyer also should check Equal Employment Opportunity Commission (EEOC) and any state equivalent compliance files; Occupational Safety and Health Administration (OSHA) files. (Equal Employment Opportunity Commission enforces civil rights laws against workplace discrimination in the United States of America. Occupational Safety and Health Administration aims to "assure safe and healthful working conditions for working men and women by setting and enforcing standards and by providing training, outreach, education and assistance" in the USA. Many other countries have similar governmental entities for similar purposes, therefore the buyer should investigate all related documents and records with the governmental

[4] Sherman, ibid p.74
[5] Sherman, ibid, p.77

entities. Workplace discrimination includes any kind of discrimination which can be based on race, nationality, gender, religion, age; and action for damages against workplace discrimination may create risks for the buyer. If the sellers company does not fulfil the obligations of assuring safe and healthful working conditions for employees, the buyer may face liabilities.)

IV. Tangible and Intangible Asset

A seller should provide to the buyer a list of all tangible assets which are owned by the seller; such as real properties and chattel goods, also rented or leased properties including all the relevant information. The bidder should review real estate tax bills, mortgages and other loans, all the relevant contracts regarding the assets, all the documentation regarding intangible assets; for instance patents, trademarks, copyrights, trade names, franchises, licenses, and other intangibles.

V. Litigation and Claims

The bidder's legal team should get an opinion letter from each attorney who defends or prosecutes significant litigation in which the seller is a party, and a list of material litigation or claims for more than a certain threshold (i.e. 10.000$) against the seller "asserted or threatened" regarding the quality of products or services, warranty claims, tort claims. Also the bidder should get and examine a list of arbitration awards, description of labor relations history, documents of governmental proceedings.[6]

VI. Contracts and Obligation of the Seller

In this context, the legal team should review and examine lots of contracts in order to understand the obligations and the rights of the seller, which will pass to the combined corporation. These contracts consist of the material purchase and sale agreements; consignment agreements; research agreements; joint venture agreements; franchise, licensing, and distribution agreements; agreements which may restrict the seller's right to compete in any sort of business; agreements for purchase services; integrated reports; letters of credit; agreements with

[6]Sherman, ibid, p.81

transportation companies; licenses, permits, and any sort of government approvals, operating permits, health or safety certificates; contracts for the purchase, sale, or removal of natural resources; all unperformed sales contracts; and documents related to all property, liability, and casualty insurance policies (which should include coverage, premium, policy number, policy type, expiration date, deductible, claims, and information regarding the insurer, carrier or broker).[7]

VII. Miscellaneous

Finally, the buyer should review the press releases, curriculum vitae' of managers and key employees, industry and market surveys, copies of speeches of the management team, letters of credit, and press clippings.

3. Financial Due Diligence

Financial due diligence is the process of determining whether the transaction creates value from financial point of view for the buyer or not. Some academicians tend to separate accounting due diligence from financial due diligence and study on these fields as separate but interrelated topics, however, my perspective on this matter is that financial due diligence contains accounting matters, and should be examined as a whole.

The financial due diligence process tries to determine the possible return and the risks of the transaction and enables the buyer to determine the value of the target company (which includes understanding the target's assets and liabilities), and evaluate the current financial situation as well as past profitability and cash flow of the target company. At this stage, a buyer tries understand the current and past financial situations of the target, in fact forecasting the future financial situation of the combined company is one of the most important aims of financial due diligence. Also, the bidder's team should verify whether all financial records and documents are

[7] Sherman, ibid, p.79-80

up to date and have been accurately maintained.[8] Another usage of financial due diligence is to predict and evaluate financial or tax risks. As mentioned above, the value of the company may be inflated by the seller, meaning the company looks as if it is valued more than its actual value. And also the seller's senior management may be tempted to put undue pressure on middle management to make budgets, to meet revenue goals, or to achieve certain expectations.[9] To avoid such risks, well organized due diligence is the key tool. In order to be successful, the bidder's team should have as much contact as possible with the seller's managers and employees.

During the financial due diligence process, the buyer's team evaluates financial statements of the seller which summarize accounting results of the target company for a specified period of time, such as fiscal or calendar year. Generally, well organized financial statements create transparency and reliance for the assessment of a company.

In this chapter; main valuation methods, intangible assets, and tax issues are respectively examined.

A. Sample Financial Due Diligence Check-List

The bidder should review all the financial records of the seller which should be prepared in accordance with GAAP, including; annual and periodic balance sheets, profit and loss accounts, annual statements of shareholders' equity, management reports regarding the material aspects of the operations, products and services, the responses for the auditors' requests and reports of independent accountants, term loan agreements, all the documents regarding tax issues, revolving credit agreements, projected budgets, all documents related to shareholder loans, account receivable reports, private placement memorandums which prepared and used by the seller.[10] If the seller has overseas operations; the bidder should check the status of the local legislations and regulatory restrictions, exchange controls, the market situation of that foreign country, import/export issues etc. If the seller has been

[8] Sherman, ibid, p.77
[9] Rosenbloom, AH, Due Diligence for Global Making, Bloomberg Press, NY, p.103
[10] Sherman, ibid, p. 77

obliged as a guarantor for the third party, the agreements between the third parties and the seller should be considered by the bidder.

The bidder should also require personal guarantees of the seller's indebtedness from its shareholders or other related parties.[11]

B. Main Valuation Methods

Valuation of the target company in mergers and acquisitions might be the most important stage of the financial due diligence. In this stage, the buyer determines the value of the target company which sets the maximum or "walk away" price, and this price guides the buyer during the negotiations.

Company valuations methods can be classified as follows[12];

- Balance Sheet Based Methods (Book value, Adjusted book value, Liquidation value, Substantial Value)
- Income Statement Based Methods (Value of earnings, Value of the dividends, EBIT, EBITDA)
- Goodwill Based Methods
- Discounted Cash Flow Model

I. Balance Sheet Based Methods

Balance sheet based methods tries to assess and determine the target company's value according to its assets. These methods based on an idea which considers that a company's value is inside of its balance sheets. However, these type of estimations of the target company's value do not consider the expected financial performance of the combined company, also they do not take into account the organizational structure, employees' performances, and current market situation etc. and these considerations may have an impact on the value of the target. Thus, these imperfections have brought criticisms towards the balance sheet based valuation

[11] Sherman, ibid, p. 75

12 Fernandez, P, February 2007, Company Valuation Methods. The Most Common Errors in Valuations, IESE Business School – University of Navarra p.4

methods. Balance sheet based methods can be demonstrated as follows; book value, adjusted book value, liquidation value and substantial value.[13]

Book Value: Basically, a company's book value is equivalent to the difference between its assets and liabilities.

$$Book\ value = Assets - Liabilities\ or\ Equity + Reserves$$

Adjusted Book Value: This is a measure of a company's valuation after liabilities, including off-balance sheet liabilities, and assets are adjusted to reflect true fair market value. This method seeks to overcome the shortcomings that appear when purely accounting criteria are applied in the valuation. When the values of assets and liabilities match their market value, the adjusted net worth is obtained.[14]

$$Adjusted\ book\ value = Real\ Value\ of\ Assets - Real\ Value\ of\ Debts$$

Liquidation Value: This method shows a company's value if the event of a liquidation happens. As a balance sheet valuation method, liquidation value is determined by the company's assets. Liquidation value is calculated by deducting the liquidation expenses from the adjusted net worth.[15] However, the usage of this method is limited to a very specific occurrence: when the buyer intends to acquire a company in order to liquidate it after the transaction has been closed.

Substantial Value: This method enables the bidder to calculate the amount of investment should be made in order to have a similar valued company as the target. Substantial value does not include those assets that do not contribute the operation of the target. There are three types of substantial value: Gross substantial value represents the asset's market value, net substantial value can be found through subtracting liabilities from the gross substantial value and recused gross substantial value can be found through reducing the value of the cost-free debt from the gross substantial value.

[13] Fernandez, ibid, p.6
[14] Fernandez, ibid, p.7
[15] Fernandez, ibid, p.8

II. Income Statement Based Methods

These methods enables to calculate a company's value through its income statements.

Value of Earnings[16]: This method calculates a company' equity's value by multiplying the annual net income by *price earnings ratio (PER)*. Price earnings ratio is determined by the market value of a stock according to its earnings through making a comparison between the market price per share and the earnings per share. PER provides what the market is willing to pay per share, and this determination is based on current earnings of the share. For instance, if a share's price is €21 and the earnings in the last year was €3 per share, its price earnings ratio would be 7.

$$Price\ Earnings\ Ratio = \frac{\text{Market Value Price per Share}}{\text{Earnings per Share}}$$

$$Equity\ Value = PER\ \times Earnings$$

Value of the Dividends[17]: Dividends are payments from a company to its shareholders; in most of cases a dividend is result of distribution of profits. A share's value is indicated by its dividends according to this method. This method calculates the equity's value through dividing a per share dividend distributed by the company (DPS) by required return to equity (Ke).

$$Equity\ value = \frac{DPS}{Ke}$$

'*If the dividend is expected to grow indefinitely at a constant annual rate g, the equity value can be found through the following formula*'[18]:

$$Equity\ value = DPS1\ \ / \ (Ke - g)$$

*DPS1 is the expected dividends per share for the following year.

Earnings before Interest and Taxes (EBIT): EBIT provides a company's profit that consists of all expenses but interests and tax expenses. The main aim of this method is to find out a company's earning capacity in the course of its operations which does not affected by interests and taxes.

[16] Fernandez, ibid, p.9
[17] Fernandez, ibid, p.9
[18] Fernandez, ibid, p.9

$$EBIT = Revenue - Operating\ Expenses + Non\ Operating\ Income$$

Earnings Before Inderests, Taxes, Depreciation and Amortization (EBITDA): EBITDA calculates a company's profitability which does not include interests, taxes, depreciation and amortization. The main aim of this method is to provide how much revenue can the company make with its current operations which does not affected by inderests, taxes, depreciation and amortization.

$$EBITDA = Revenue - Expenses + interests, taxes, depreciation, amortization$$

III. Goodwill Based Methods[19]

First of all, Goodwill based methods are not common methods as they were before, however they still in use time to time. Goodwill based methods tend to evaluate a company's value above its book value or adjusted book value since they considers that intangible assets create some advantages, and these assets cannot be found in balance sheets or income statements.

According to International Accounting Standards Board standard 38 (IAS 38) an intangible asset is "an identifiable non-monetary asset without physical substance." Intellectual properties can be demonstrated as Intangible assets. As a matter of fact, these assets promote and increase the value of a company; especially we can reach this consequence from strategic point of view.

The "Classic" Method: The classic method calculates a company's value by addition its goodwill to its net assets. The formula of the classic method is ;

$$V = A + (n * B)$$
$$or$$
$$V = A + (z * F)$$

A: $value\ of\ the\ net\ assets$

n: $coefficient\ between$ 1.5 and 3

B: $net\ revenue$

z: $percentage\ of\ sales\ revenue$

F: $turnover$

[19] Fernandez, ibid, p.10

Usually, the first formula is used for industrial companies and the second one is used for the retail trade.[20]

Abbreviated Goodwill Income: This method calculates a company's value through following formula;

$$V = A + an(B - iA)$$

A: net assets

an: present value, at a rate t, of n annuities, with n between 5 and 8 years

B: net revenue from the previous year

i: ''interest rate obtained by an alternative placement, which could be debentures, the return on equities, or the return on real estate investments (after tax)''[21]

Union of European Accounting Experts' Method: According to this method a company's value is equavalent to the goodwill plus the substantial value. The formula of this method is as follows:

$$V = A + an(B - iV)\ giving\colon V = [A + (an\ x\ B)]/(1 + ian)$$

Using the factor -an- helps us capitalizing on the compound interest. By this method, a profit less than the flow which is obtained by investing at a risk free rate i a capital equals to the V value of the company.

This method and the abbreviated goodwill income method has differences such as, the goodwill is calculated from the value, however the abbreviated goodwill income method calculates from the net assets.

Indirect Method: The formula of this method is ;

$$V = \frac{A + \frac{B}{i}}{2}$$

$i\colon interest\ rate\ paid\ on\ long\ term\ treasury\ bonds$

For instance, the X company's net assets *A* is 140, net revenue from last year *B* is 20, interest rate paid on long term treasury bonds *i* is 10%, thus the equity's value is 170.

[20] Fernandez, ibid, p.13
[21] Fernandez, ibid, p.13

Direct Method: This method calculates a company's value through the following formula;

$$V = A + (B - iA)/tm$$

$tm: interest\ rate\ earned\ on\ fixed\ income\ securities\ multiplied\ by\ a\ coefficient\ between\ 1.25\ to\ 1.5\ to\ adjust\ for\ the\ risk$[22]

This method tries to calculate the value of the goodwill by restarting for an indefinite duration the value of superprofit obtained by the company.[23]

Annual Revenue Based Method:

According to this method, the value of the goodwill can be found by multiplying a certain number of years with superprofits. In other words, this method shows the value of a company which is the value of net assets plus *m* years of profits. The formula of this method is :

$$V = A + m(B - iA)$$

i: interest rate for long term loans

$m: number\ of\ years, usually\ 3 - 5\ years$

IV. Discounted Cash Flow(DCF) Model

DCF model tries to determine the value of a company through forecasting its future cash flows and discounting them at a discount rate which is appropriate for the risk. The discounted cash flow model can be applied to various situations by the buyer. For instance, DCF model can be used for forecasting the future cash flow of the target, estimating the appropriate cost of capital for the target, discounting the estimated cash flows to give a value of the target, estimating the terminal value of the target, and adding some cash inflows from asset disposals or business divestments.[24] DCF model also serves to provide the added value from the transaction by comparing the equity value and pre acquisition stand-alone value of the target, thus the buyer can determine the amount of the control premium which will be given to the seller's shareholders from this added value.

There are some value drivers which are related to the buyer's future cash flow estimations and, as a matter of fact, these estimations are based on the assumptions for the post-acquisition operation of the seller's company by the buyer. According to Sudi Sudarsanam, there are six main value drivers; forecast sales growth in volume

---

[22] Fernandez, ibid, p.13

[23] Fernandez, ibid, p.13

[24] Sudarsanam, ibid p. 437

and revenue terms, operating profil margin, new fixed capital investment, new working capital investment, the competitive advantage period (CAP) and the cost of capital.[25] In this context, providing more information regarding these value drivers might be necessary. First of all, Competitive Advantage Period(CAP) is a time period in which a company expects to generate some returns, and according to expectations these returns will exceed its cost of capital. The theory claims that the returns will be decreased under the cost of capital after some time by the competitive athmosphere. CAP is affected by both internal and external elemets such as the market position of the company among its rivals, intellectual properties of the company, competitive privileges of the buyer, regulations, qualifications and range of the resources and capabilities etc. The formula of CAP is[26] :

$$CAP = (Value * WACC - NOPAT)(1 + WACC)/I(R - WACC)$$

$NOPAT$: *net operating profit after tax*

$WACC$: *weighted average cost of capital*

I: *annualized new investment in working and fixed capital*

R: *rate of return on invested capital*

Cost of capital is estimated from the seller's cost of equity and debt before the transaction is completed and the weighted average cost of capital(WACC) is used for determine the targets cost of capital. However, the cost of equity and debt can be changed after the transaction has been completed due to the product and market diversification of the seller. If the post-acquisition capital structure of the target differs from its pre-acquisition structure, the WACC has to be adjusted for the difference.[27] The formula of WACC is:

$$WACC = \frac{Ke * E}{V} + (1 - Tc) * \frac{Kd * D}{V} + \frac{Kp * P}{V * P}$$

Ke: cost of equity Kd: cost of debt Kp: cost of preference shares

E: market value of equity Tc: corporation tax rate

D: market value of debt   V: E+P+D, the value of the firm

P: market value of preference shares

[25]Sudarsanam, ibid, p.438

[26] Fernandez, ibid, p.18

[27]Sudarsanam, ibid, P.440

Finally, the formula of the seller's company's value after the transactions[28]:

$$\sum_{r:t}^{T} \frac{FCFt}{(1+WACC)^{\ t}} + \frac{TVt}{(1+WACC)^{\ T}}$$

FCFt: free cash flow of target in period t

TVt: terminal value of the target at t

T: terminal period for forecast, and t:1…., T[29]

The post transaction value of the company may include pension fund deficits and also selling of assets and divestments proceeds which must be calculated on after tax basis.[30]

After this point, adding some information regarding basis terms might be helpful. First of all, free cash flow comes from operations of the company; the company genarates this flow by its operations, thus financial debts are not considered. Therefore if a company does not have debts, it means that the free cash flow is equal to equity cash flow which is remaining cash flow after the working capital requirements, covering fixed asset investments, paying the financial charges, and repaying the corresponding part of the debt's principal.[31] The formula of the equity cash flow is :

$$ECF = FCF - \{interest\ payments\ x\ (1-T)\} - principal\ payments + new\ debt$$

In addition, a company's value can be calculated by discounting the equity cash flow at the rate of required return to equity for the company(Ke).[32] Thus, the target company's total value is equal to the value of the debt plus the market value of the company.

$$Ke = \left[\frac{Div1}{Po}\right] + g$$

$Div1: dividents\ for\ the\ next\ period$

$Po: share\ price$

$g: divident\ growth\ rate$

---

[28] Fernandez, ibid, p.18

[29] Sudarsanam, ibid, p.443

[30] Sudarsanam, ibid, p.443

[31] Fernandez, ibid , p.18

[32] Fernandez, ibid, p.19

Furthermore, it is possible to calculate a company's value by discounting the capital cash flow. A company's value is equal to the value of the capital cash flows discounted at the WACC before tax.

C. The Hidden Gem That Cannot Be Found in Financial Reports: Intangible Assets

Intangible assets are assets that do not have physical existence, but add value on the company, and generally it is hard to assess them. Patents, copyrights, licenses, trademarks, tradenames, goodwill, loyal customer lists, and some tech based assets (i.e. software) can be demonstrated as intangible assets. Intangible assets can be divided into three groups: first group includes copyrights and trademarks which generate cash flows through produce a specific production in which the manufacturing rights are belong the copyright or trademark owner, second one provides cash flows to the company rather than to a product (i.e. brand name), and the last one consists of some intangible assets that do not generate cash flow currently but there are possibilities for generating cash flows in the future. Due to the basic valuation methods have been explained previously, in this section the strategic role of intangible assets and providing a guidance to how to investigate a company according to its intangible assets will be the main issue.

The goodwill based methods, which are mentioned previously, are used for determining a company's value and they acknowledged that intangible assets create value. Also, the value of some intangible assets can be calculated by the cash flows. Trademarks, copyrights and licenses give to the owner the exclusive right to produce a specific production, consequently their value comes from the cash flows which can be generated from the exclusive right.[33] However, copyrights and trademarks enable its owner to benefit from the exclusive right for a finite period of time, thus the estimation of cash flows will be only valid for that indefinite period. Another important example of intangible assets is franchise, which gives its title holder the right sell a product of a brand-name company. In this occasion, the franchisee gets the power of the reputation of the brand name and in return gives a fee to

[33] Damodaran, A, January 2006 Dealing with Intangibles: Valuing Brand Names, Flexibility and Patents Aswath Damodaran Stern School of Business, p.5

franchisor. One of the benefits of franchising is that the franchisor usually advertise its product, therefore brand name has a significant value. Another one is that the franchise often enables franchisee to reach important equipment and knowledge regarding its specific business. Consequently, the bidder should investigate the reputation of the franchise, service expertise, substructure of the business, current and possible rivals, market conditions of the product or service, and consumption habits of consumers for various locations. However, the franchisor may have some problems regarding its business and this problems can directly affect the franchisee, therefore the history, legal and financial situation, and the future predictions of the franchisor should be considered by the buyer.

In the following chapter of this study, human resources due diligence is examined, however since human capital is an intangible asset, some information regarding this issue should be given. In short, well-educated and experted employees can contribute, bring innovation, maintain the business, and educate some other employees, thus add value on the company. Finally, unlike some other intangible assets, human capital is not for sale but rent. Therefore, the bidder should consider that the keeping key employees may be difficult under some circumstances, i.e. a strong competitor may provide better conditions and salaries for a key employee.

One of the strategic importance of intangible assets shows itself in a competitive environment, because intangible assets create competitive advantage. As a matter of fact, intangible assets provides sustainable competitive advantage due to firm-specificity, social complexity and causal ambiguity make them hard to imitate by rivals.[34] Intangible assets can provide competitive advantage by enabling to entering into a large or growing market, gaining technological expertise and brand name.

On the other hand, the significant presence of intangible assets may augment the information asymmetry between the shareholders and the managers since in an acquisition the buyer determines its bid according to its investigations regarding the target which include intangible assets, and some shareholders may not have ability to possess the required insight of intangible assets, thus they may tend to judge the

[34] Capasso, A, October 2004, Stakeholder Theory and Corporate Governance: The Role of Intangible Assets, University of Sannio- Department of Economic and Social Systems Analysis; ECGIS, p.6

managers for overestimation of the target. In order to avoid this situation, management team shall provide the specifications of its intangible assets and/or clarify the usage of them, however this actions may diminish the value of intangibles due to the confidential nature of intangible assets. Under this circumstances, the management team of the buyer should carefully determine its behavior to the shareholders; creating confidence with shareholders, meanwhile keeping confidential information inside are vital for the future of the transaction.

D. Tax Issues

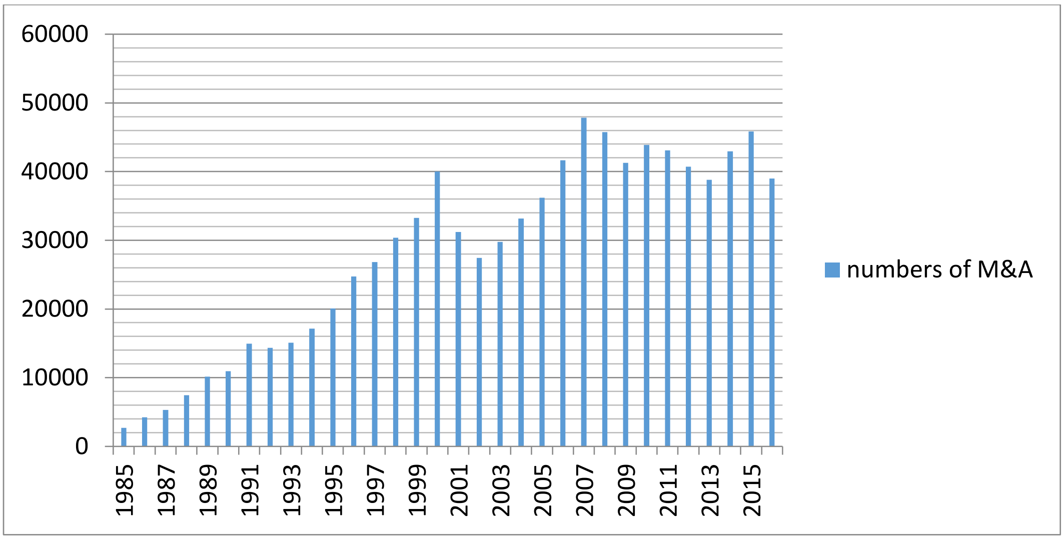
Tax is a very important issue for financial due diligence process. Tax implications are various depending on the country in which the transaction result in, and the merged company will operate, therefore the bidder's team should study the applicable tax law of the related legal system. The tax due diligence should consist of various taxes; the bidder's team should not only consider income taxes, but employment taxes, R&D tax incentives, stamp duties, fuel taxes, and often target companies have unresolved tax exposures in generation-skipping transfer tax etc.[35] The bidder's team should also consider the legal status/type of the target due to different types of companies may have different tax liabilities.

To be able to understand whether the tax exposure goes to the deal value or to the warranties, we need to understand the tax profile of the target, and the definite price adjustments should be used along with the tax issues and not rely on the warranties. Also, understanding the target's tax profile contributes the completion of the transaction. The bidder's team should investigate the historical tax computations of the seller's company, and possible impacts of the transaction on tax issues should be considered. This investigation enables the bidder's team to decide the structure of the transaction (asset or stock purchase, financing through debt or equity etc.) in order to create tax efficiencies. For instance, if the transaction will be completed through stock purchase, the target company will not be effected by corporate level gains due to the stock purchase takes place between the bidder and the shareholders of the seller. Consequently, this situation is beneficial for the seller and its shareholders because there will be no corporate-level taxes but shareholder level taxation.

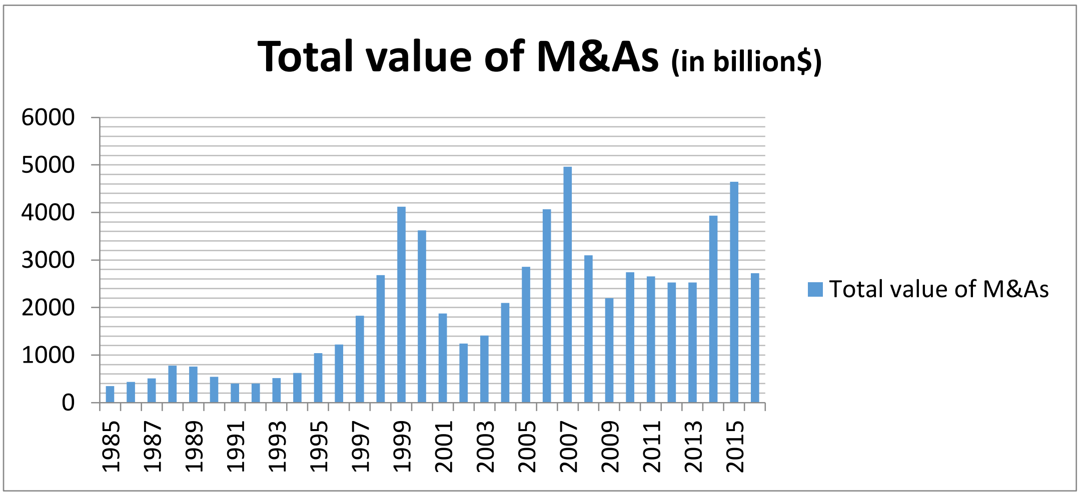
[35] see Scott, I, Misic, D, April 2014, Creating Deal Value With Tax Due Diligence, EY Advisory Services

4. Mergers and Acquisitions Activities, Successes - Failures and Reasons

Mergers and acquisitions have been used for long time in order to achieve economic growth objectives. Although, the general opinion regarding to mergers is that mergers fail and the main argument is that two out of three of the mergers fail in accordance with their deal objectives; mergers and acquisitions are still popular and used for economic growth, competitive advantage, R&D, diversification, consolidation and so on. The following chart demonstrates the numbers of M&As from all over the world between 1985-2016. (Total transaction number was 45823 in 2015.)



The following chart shows the transaction values of M&As from all over the world between 1985-2016. (Total value was $ 4346 billion in 2015.)



In order to achieve a successful merger, parties should have a clear acquisition purpose and plan, have a skillful and professional management team, resolve cultural issues, conduct an appropriate and detailed due diligence process, identify and examine the cultural issues and create integration strategies, and evaluate the initial synergy properly. Also well-established and transparent communications are important. If the parties cannot fulfill these requirements, they most probably will face failures with regards to their transaction objectives. Besides, the behaviors and negative opinions of the target's management team, lack of knowledge regarding the target or the market conditions, poor management of the target, lack of experience regarding M&As, and do not having an appropriate post-merger integration plans can be caused of merger failures.

In the following parts of this chapter, some successful and failed mergers and acquisitions are examined.

A. Case Studies

The first example is the biggest failure in the mergers and acquisitions history: ***American Online and Time Warner***. In 2001, American Online, which is a global mass media corporation, merged with Time Warner which is a multinational media and entertainment conglomerate. The deal was one of the biggest in American business history with $165 billion. The motivations behind the deal was that the merged corporation would create synergy and benefit from the combination of technological infrastructure and operations, and increased customer diversification. However, the merger caused $ 9 billion loss and the companies separated after 7 years. The main reason of the failure was lack of due diligence regarding the evaluation of operational compatibility, and also the deficiency of executing growth plans. The differences between corporate cultures and inharmoniousness of both party's managers prevented an accomplished integration. Therefore, the merged company had an unstable management structure, and consequently failed. In spite of the expected benefits of the transaction, AOL and Time Warner could not materialize the expected synergy and the unconformity between both managers and employees resulted in putting up resistance to the growth plans. Besides the lack of due diligence and integration of corporate cultures, the merger created a negative financial situation. In 1990, Dot-Com's internet bubble caused overvaluation of AOL's stock price, and between 1996-2001 their stock price increased 1,426%. With the help of this rising, AOL provided an inflated market capitalization of $ 226 billion at the time of the transaction. However the transaction was a stock-for-stock merger and Time Warner was a small company by market capitalization and was only provided with AOL's shares, consequently these reasons made the merger in practice, a takeover. Before the transaction has been closed, Time Warner had seen decline in its profits and share price, and after the merger has been closed, the Dot-Com's internet bubble was ended, thus AOL had a significant decrease in its value and losses of $99 billion. After the de-merger in 2009, AOL's value was one-seventh as its pre-merger value. This failure showed again the importance of conducting an appropriate due diligence. The strategy of merging two companies can be seemingly brilliant, however without a proper strategic planning and executing, every merger might fail.

The next example is the merger of ***Hewlett-Packard Company (HP) and Compaq Computer Corporation (Compaq)***. The merger was through stock purchase and HP paid $24 billion for the transaction, and the deal was the biggest in the computer industry. Motivations for the transaction was that the combined company would value more than $ 87 billion, expand the operations in 160 country with more than 160.000 employee, and increase the product and service capability. Both parties had been suffered by price wars in computer production industry and the merger seemed as an excellent chance to compete the rivals. The CEO of HP believed that the merger would enhance HP's market share, and create a full-service tech company. The HP side of the deal was eager about the merger due to they wanted a better position in the market, and for them consolidation was more important than diversification. However, the computer market was declining and both parties were not in a good position at the time of the merger, following this the stock price of both HP and Compaq decreased within two days after the announcement of the transaction and this caused $ 13 billion of losses in terms of market capitalization. One particular issue was that the corporate cultures of the parties was incompatible; HP's culture was driven by engineers and it was based on consensus, on the other side, Compaq's cultures was based on rapid decision making, and these different decision making mechanisms beclouded the integration process. The parties had different roots, employee attitudes and management styles, and they did not analyze and evaluate the compatibility of their corporate cultures sufficiently. Herewith, parties had communication problems and could not execute the decisions rapidly and effectively.

Another interesting story is about BMW and The Rover. In 1994, the German car, engine and motorcycle manufacturer BMW acquired The Rover Company, which was a car manufacturing company from England, for £800mn. The motivations behind the deal were that BMW wanted to grow and increase its market share, attain The Rover's 4 x 4 and front-wheel driving technologies, Rover had subsidiaries; MINI and MG Rover, and during those days English manufacturing sector had lower level of costs than German sector (%60 lesser), therefore BMW would reduce the costs. The strategic plans and expected synergies seemed sufficient to conduct the transaction, however due to the lack of communication and coordination between the top managements of both parties, the strategies could not be executed and consequently the merger was failed in accordance with its objectives. Another problem was that the top managers of BMW were able to do business in English; but engineers, middle manager and intermediate staffs were not, thus these facts caused lack of communications and delayed integration process. Also, the management styles and corporate cultures of both parties were considerably different, Germans had a direct approach and British had more relaxed approach. For the following two years after the transaction has been completed, BMW only provided financial supports to The Rover Company without any integration program. BMW relied on the cost differences between acquiring The Rover (thus its technology) and developing that technology in house, and believed in the expected synergy. However they did not achieve the synergies and BMW sold The Rover to Phoenix Consortium in 2000.

The next example is the merger of ***Sprint and Nextel.*** Sprint, which is an American telecommunications holding company, merged with Nextel, which was a wireless service operator, in 2005. The transaction was trough stock purchase and Sprint paid $35 billion for it. The motivations behind the deal were that the combined company would be the third biggest wireless provider in the U.S, parties would grow through gaining access to each other's customers (especially for Nextel, this was one of the biggest motive), Sprint wanted to expand its operations regarding consumer wireless services, and transferring and combining technologies would create value. However, the transaction caused huge expenses and ended up with integration problems. The difference between corporate cultures showed itself in every level of hierarchy within the merged company, especially in the management level. Sprint had a bureaucratic and formal corporate culture; on the other side, Nextel's corporate culture was more entrepreneurial and flexible. Lack of trust, communication and adaptation caused blockage of operations and executions. Due to their entrepreneurial culture, Nextel's employee tended to make decisions and solve problems quickly, but their colleagues from Sprint often required approvals from their superiors. Due to the cultural incompatibility, many mid-level executives of Nextel left the merged company, consequently the loss of key employees reduced the quality of operations. And one vital mistake was that after the merger, parties maintained to have two different headquarters and this made the coordination and integration more challenging. Moreover, the market conditions were not in favor of Sprint Nextel, the company faced strong rivals, and the macroeconomic conditions were weakening. In 2007, the stock price of Sprint Nextel was %30 lower than it was back in 2004.

Unlike the previous examples of failed mergers, the next one will demonstrate how a successfully planned integration process can form a valuable combined company as an outcome. ***AkzoNobel – ICI:*** In 2007, AkzoNobel sold Organon, which was a pharmaceutical company, and started more focusing on the coatings sector. According to the CEO of the group, Hans Wijers, ICI was an attractive target from both financial and strategic point of views. The transaction would create one of the biggest coatings and chemistry company of the world. AkzoNobel was in a leading position in coatings sector and ICI had a strong market share in the decorative painting market, and the products of both companies had common solvents and chemicals, therefore the transaction provided a suitable environment for both parties to bring synergy. Also, the combined company expanded its customer volume. According to the results of the financial due diligence of the transaction, the deal would enhance the shareholder earnings, and provide sufficient internal rate of return, and it did. The transaction also strengthened AkzoNobel's position among its rivals; the company was % 60 bigger that its nearest rival after the transaction has been completed, geographical spread and enhanced product diversity enabled the combined company to take the leading position among its competitors. Apart from those appropriate financial and strategic environment, the success of the deal underlies a well-planned integration process and robust implementation of it. AknoNobel accomplishedly analyzed the corporate culture of ICI and determined a road map. During the integration process, the managers of ICI fully participated in the process and played key roles, parties carefully focused on the linguistic and cultural differences in order to avoid communications problems, the headquarters of ICI rapidly closed and the employee moved to the headquarters of AkzoNobel, ????????? And after three years, the companies were completely integrated.

The merger between ***Omnicom and Publicis*** is a current example of failed mergers. In 2013, 'equal' companies Omnicom and Publicis decided to merge and create the world's biggest advertising company with more than $ 35 billion market capitalization, 130.00 employee and $22 billion of pro-forma revenue. The shareholders of both companies would have equal ownership on the merged company. From financial point of view, the transaction made sense; in 2012, Publicis had $ 7 billion revenues and a market capitalization of $ 14 billion, and Omnicom had $ 8.8 million revenues and a market capitalization of $ 17 billion. In addition, the combined company would become the biggest company regarding a pro forma basis. The expected competitive advantage in the advertising market of the combined company was another motive for the parties. However, after a while later the merger failed to materialize. The main reason for the failure was the differences between corporate cultures and management styles. The CEO of Omnicom, John Wren, stated that they knew there would be cultural differences and they underestimated the depth of the differences, and consequently the major decisions could not be made easily. The both CEOs of Omnicom and Publicis decided to serve as co-CEOs for the next 30 months after the transaction has been closed, however they failed to coordinate and collaborate, and they had a conflict regarding who would be the next chief financial officer of the combined company. Due to the conflicts and differences, parties could not close the transaction within a reasonable time frame, therefore the expenses of the transaction increased. In addition, Both CEO's did not allocate enough time for their routine operations under the time pressure. Consequently, the merger failed in terms of its deal objectives.

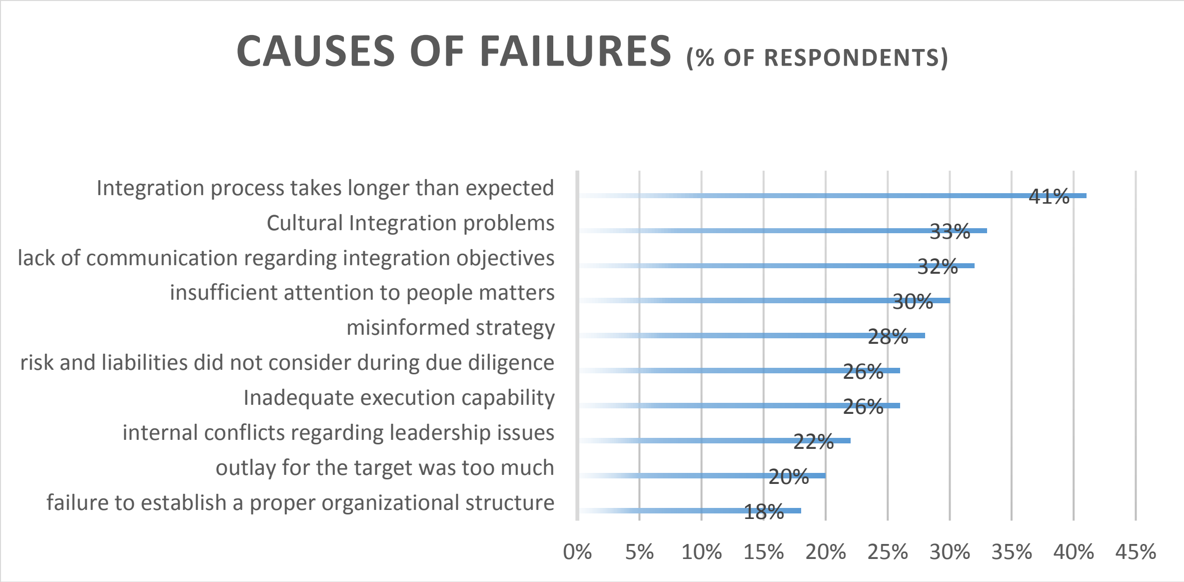
The next example is the acquisition of ***Skype by eBay***. In 2005, eBay (an American e-commerce company) acquired Skype, which is a telecommunication company, also computer software and internet telephony services provider, for $ 2.6 billion. The motivations behind the deal were that Skype had 480 million users from all over the world, meanwhile the membership growth of eBay was decreasing and eBay wanted to access Skype's membership base. Although Skype has vast amount of users, the company's revenue history was not adequate for giving hope when it comes to covering the expenses of the transaction. Another strategic plan was that Skype would have an active role in the communications between the buyers and sellers on eBay, therefore the virtual commerce place would become more real, consequently eBay would improve its service and increase the number of customers. The revenue of e-commerce is based on the transaction frequency, thus eBay's plans made sense from strategical point of view. Also, Skype would open up new business segments for eBay and expand the geographical business area. However, the merger failed and eBay could not achieve its goals. The technological integration did not work out due to the buyers and sellers on eBay did not consider this modernity as a necessity for their deals; communication through e-mails was good enough for them. Finally, the corporate cultures of both corporations were incompatible, hence the integration process were not successful. eBay had a conservative and bureaucratic corporate culture, and Skype had more democratic and receptiveness environment. Eventually, eBay sold Skype to Microsoft in 2011.

WhatsApp's acquisition by Facebook took place in 2013, and was a successful acquisition. Facebook acquired WhatsApp in stock and cash for $ 19 billion and kept it as a separate service provider. Facebook wanted to access to a new market and add a new part of business, thus it had chance to provide new services through this acquisition. WhatsApp had 450 million active users (at the end of 2013 WhatsApp had 600 million users) during those days and Facebook's messenger only used by 53 million people, therefore this transaction would enable Facebook to access more users. Also, the acquisition of WhatsApp enabled Facebook to get in to the Chinese Market (using Facebook was not allowed). And in some countries (such as South Africa) WhatsApp was more commonly used than Facebook, therefore the transaction enabled Facebook to increase its market share in those countries. Getting access to diverse user information from WhatsApp enabled Facebook to improve its services. In addition, WhatsApp was generating an income from charging its users $ 1 for its services, and it was able to monetize $ 20 million of annual revenue. However, some analysts argued that the WhatsApp was overvalued by Facebook, also the deal was the biggest since Time Warner's merger with AOL for $ 124 billion, and it was the biggest in the technology industry. Corporations often do M&A in order to increase customer or user numbers and many of them fail as examined above. However Facebook's acquisition of WhatsApp has become successful, because both of the parties had innovative and entrepreneurial corporate cultures, and both companies were governed by founder-CEOs, therefore Facebook did not have to strive with complicated managerial issues and complicated internal organization, consequently the integration process was easy and successful. As it made sense from financial and strategic point of views, the transaction also made sense regarding corporate culture issues. The founder of WhatsApp Jan Kaum and the founder of Facebook Mark Zuckerberg have become partners and friends, and Zuckerberg gave opportunity to Kaum to fully participate in the operations, and those factors contribute the success of the transaction.

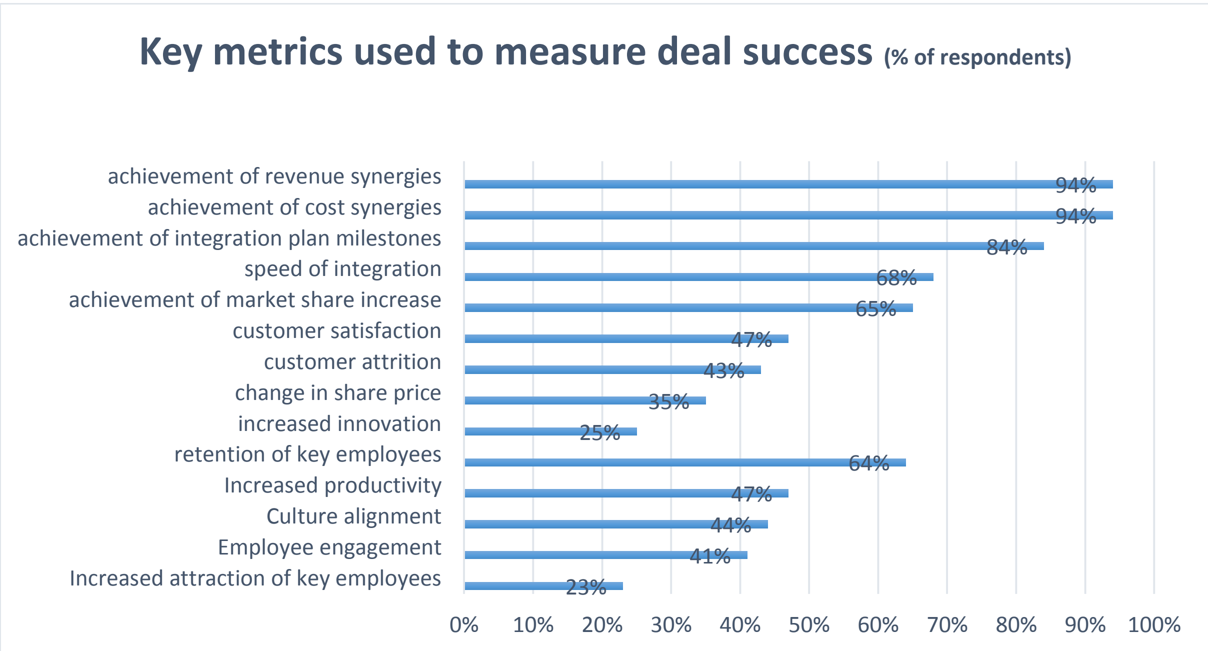
The final sample transaction is the acquisition of ***MyFitnessPal by Under Armour.*** MyFitnessPal is a free smartphone application and a website in which users can set training, losing or gaining weight goals, calculate calories, and track their diet. According to consumerreports.org, MyFitnessPal was chosen as the best free smartphone application in the diet rating and MyFitnessPal had more than 80 million registered users when the acquisition took place. On February 4, 2015 MyFitnessPal acquired by Under Armour for $ 475 million. Under Armour is an American sportswear manufacturing company, which was founded by Kevin Plank in 1996, and he is still the CEO of the company. In appearance, the transaction does not make sense from financial point of view, due to MyFitnessPal is a free application and is not going to generate cash flows in the future. However, Under Armour's strategic plans were well-structured, Under Armour also bought Endomondo (a fitness application and website) in February 2015 for $ 85 million and with MyFitnessPal the company created its own social platform with more than 120 million users, and Under Armour's digital health and fitness community became the biggest. (The biggest company in the sportswear business, Nike, had only 18 million registered users on its fitness application.) The company aimed to get access to the personal data of the users; these people are obviously interested in fitness and sports, therefore they are a customer group for Under Armour. Kevin Plank stated that "One thing we emphatically know is that the more they work out, the more apparel and footwear they're going to ultimately buy". Afterwards, Under Armour reported that they saw % 37 rise in their profit by comparison with a year previous, revenues increased % 31 to $985 million, sportswear sales increased % 30, and footwear revenue rose % 55. Evidently, Under Armour were in a state of financial status in which the company was no under any major financial risk of underperforming their benchmarks, therefore the strategic acquisition of MyFitnessPal did not caused any additional burden for Under Armour. Finally, the acquisition was successful due to the financial conditions, increasing number of new users, strategic plans have started to create a value and so on, however the cultural issues should not be underestimated; both parties had entrepreneurial founder-CEO dominated corporate culture, consequently the buyer did not have to face with managerial complexities, and the transactions took a short time due to the decision making mechanism was belong to the founder-CEO of the target. As a matter of fact, the CEO of MyFitnessPal considered that it was an occasion to sell his business due to its probable competitors (google-health, Apple-health) were very strong, and the price of the deal was more than sufficient for them. Therefore, he and his team executed the decisions and fulfilled the requirements rapidly. According to the deal, MyFitnessPal would keep its headquarters separately. Due to the parties did not have to put extra effort into integrating the headquarters, employees, cultures and businesses, the integration process was smooth, simple and successful.

B. Integration Problems in Numbers

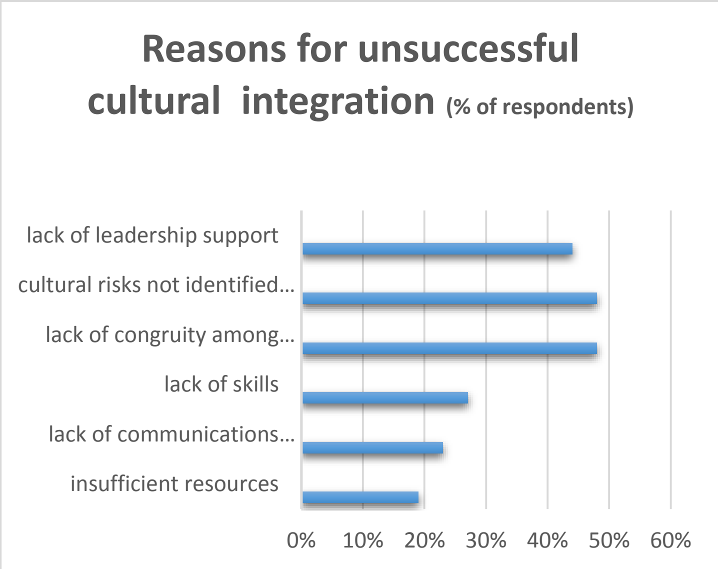
There are various studies regarding the impact of cultural integration process on M&A objectives. Aon Hewitt, which is a multinational consulting firm, surveyed 123 companies from all over the world regarding integration problems and provided data related to this subject. The source and data for the following charts is obtained from Aon Hewitt's survey. The percentage of the companies which reported for not possessing an approach towards assessing and integrating the cultural aspects in the deal was reported to be fifty eight. None of these firms which had a particular approach towards cultural issues said their approach was effective while 68 percent of them had no strategy regarding the cultural issues what so ever.



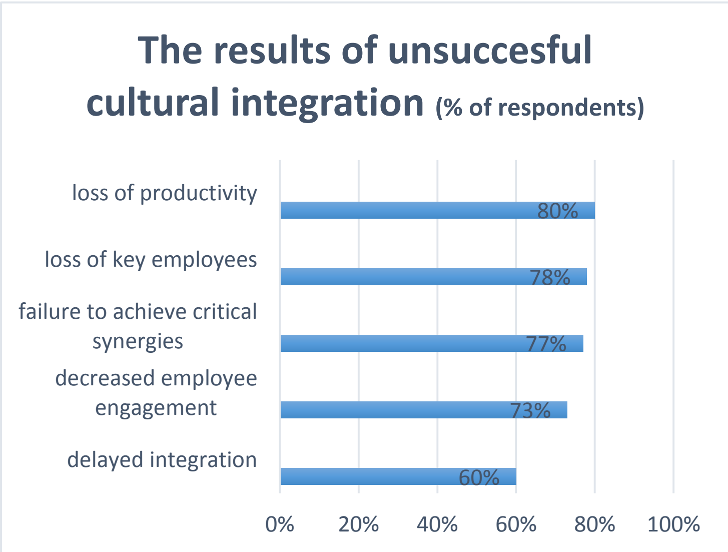
The survey demonstrates that the cultural integration problems are the second most common causes for deal failure. However, cultural integration problems are related to other factors directly or indirectly, such as longer time period for integration process (41%), post-merger leadership conflicts (22%). Consequently, this study once again revealed that cultural integration problems are vital. The following chart shows the key metrics used to measure deal success and cultural issues have direct or indirect impact on deal success. Especially, retention of key employees, increased productivity, culture alignment, employee engagement and increased attraction of key employees are related to human side of business.[36]



[36] See Aon Hewitt, 2011,Culture Integration in M&A Survey Findings



- Adjoining chart reveals that lack of leadership support and disagreements between leaders regarding preferred culture caused unsuccessful integration, therefore both sides of the transaction should focus on leadership problems. As mentioned above several times, the importance of cultural due diligence is often underestimated. 48% of the respondents of the survey stated that they did not identify and consider culture risks during their due diligence.



- Adjoining chart shows that most of the cultural integration results are related to deal failure. The five results in the chart clearly demonstrate that an unsuccessful integration process detract the merged company from its objectives.

According to the survey, firms that achieved their deal objectives (some or all of the goals) spend more time on cultural issues during due diligence, spend less time for assessing the culture but more time for managing culture, more focused on establishing a new culture, and attached great importance to communication during integration process in comparison with other participant companies which could not achieve their deal objectives. Consequently, legal or financial conditions can be perfectly suited to the transaction, however underestimation of cultural due diligence and unsuccessful integration process will negatively alter the future of the transaction.

5. Cultural Due Diligence and Integration Problems

Every company wants to manage and develop their corporate culture appropriately, due to the corporate culture being the key element for profitability and success. Especially, in mergers and acquisitions, corporate culture and cultural integration problems are main considerations about the merged company. There are two components which made the corporate culture due diligence important: the effect of corporate culture on organizational performance and the real danger of culture clash on mergers and acquisitions transactions.[37] After the transaction has been completed, the merged company may face culture clash which is sort of conflict caused from different belief or decisions regarding operation of the company.

In mergers and acquisitions, the impact of corporate culture is always underestimated, but various studies show that between 3/5 and 4/5 of the transactions fail. According to the management survey which is made by The British Institute of Management, one of the most important reasons for the failures is “the underestimation of difficulties of merging two cultures.” Another study which is made by Coopers&Lybrand indicates that %85 of the executives from 100 companies with failed or troubled mergers, said that the major problem was the management style and practices.[38]

Edgar Schein has defined the corporate culture as follows; “A pattern of basic assumptions---invented, discovered or developed by a given group as it learns to cope with its problems of external adaptation and internal integration--- that has worked well enough to be considered valid, and therefore to be taught to new members as the correct way to perceive, think and feel in relation to those problems.” A general misunderstanding is about how the corporate culture is formed, however there are organizational cultures in every operating companies, whether planned or unplanned.[39] The impact of the corporate culture shows itself in the behaviors of employees, managers and in the business environment. Consequently, the corporate culture have impacts on the human side of the operations.

[37] Carleton, JR, 2009, Cultural Due Diligence, Vendor Group p.1
[38] Carleton, ibid, p.3
[39] Carleton, ibid, p.3

Some academicians, i.e. Jonathan Konstan-Pines, argue that corporate culture is only important during M&A integration. They also state that the future strategy will lead the employees of the merged company, therefore the strategy should be the first thing to focus on. According to this opinion; a parent company can easily dominate and reorganize the target company and get faster results, and he states that “companies had stock prices higher when they acquired companies with different strategy and different culture.” My opinion regarding this issue is that this result is true when a large company acquires a small one and of course when different values get combined the result will be positive, however in cross-border M&A’s, or in mergers between equal companies, corporate cultures are still vital. Corporate culture is important to establish a future strategy for the merged company, and it shall be examined and considered before the future strategy has been made. Under appropriate legal and financial environment, the aim of cultural due diligence should be finding a way to integrate both companies. The differences between the parties regarding the corporate culture, technology or strategy can be used for creating value from the transaction. Competitive but meanwhile cooperative corporate culture can be created by an appropriate cultural due diligence and integration process.

A. Some Problems Regarding Cultural Differences

- Different decision making ways: In order to have an effective integration, decisions should be made rapidly. However, different decision making styles may cause failure to make decisions or practice the decisions, or decelerate the decision making process. For instance, one party may decide through consensus, and other one through top-down decision making.
- Different leadership manners: The alteration of the leadership manner may cause the loss of some employees who object to this alteration and generally these employees are top talents, and also the other employees may have adaptation problems. For instance, one side can use dictatorial leadership manner, and other one can be consultative.
- Working style of employees: Employees of merged companies can have different styles and functions, and the aim of integration process is to combine these differences and create a ‘new’ style for the merged company.

However, when the assumptions and expectations of the corporate culture for the each party are inconsistent, then employees of the merged company may have communication problems, fail to understand their responsibilities and so on.

- Personal achievement or teamwork: If one party focuses on individual performances or employees of the party set personal goals, then there will be problems with other people who believe that they can achieve certain objectives through teamwork, and integration of these two groups of employees and set common goals will be compeller.
- Convenience for change: While one party may willing to risk new issues, set new goals or change the objectives; the other one may want to maintain current situation or focus on current goals. These differences can cause failures in practicing or planning new strategies.

B. How can we solve cultural problems?

There are various approaches in order to solve cultural integration problems and one common approach is to set expectable cultural principles, and impose employees to adopt these principles. These principles are usually general principles such as, innovation, focus on customers, team-work, entrepreneurship, respect to others etc. However, this approach does not solve many problems and there are no such evidence to show that these general principles lead employees effectively. It is hard to carry into effect these principles due to perceptions of these values are not effective. In a professional business environment every employee should be respectful to each other, and when a company sets a principle like 'be respectful to others' , it does not solve cultural integration problems. In this context, companies should determine more specific and efficient principles, and then they can impose these principles and train their employees in accordance with their core principles. Mergers and acquisitions integration problems are various and should be identified as occasions requires. In this regard, every transaction must be considered as unique. However, some basic integration problems can be identified, and these essentials can lead the bidder.

Deloitte, which is a multinational consulting-service firm, made a research regarding cultural issues in mergers and acquisitions and they provided seven steps for integration process. These steps are:

- "Make culture a major component of the change management work stream
- Identify who owns corporate culture and have them report to senior management
- Insist that the cultural work focuses on the tangible and the measurable
- Consider the strength of both existing cultures, not just the weaknesses
- Implement a decision making process that is not hampered by cultural differences
- Build the employee brand with a view toward how it will be understood by employees
- Put people with culture change knowledge and experience on the teams that define the key interfaces in the new organizational model."[40]

- With the help of well-established cultural due diligence, parties can be able to predict and take precaution against potential culture clash problems, and they can create a cultural integration plan which will lead the parties during the integration of both cultures. It must be taken into consideration that the cultural due diligence is as important as financial and legal due diligence; in fact, the cultural due diligence can be the most important component of the due diligence process in some cases. Cultural due diligence provides data-based predictions of culture clash problems, and recommendations on how to annihilate or minimize the impact of them.[41] In this context, the cultural due diligence process should start with a cultural audit in order to understand the each company's corporate culture and make comparison between them. Parties should make a survey regarding core values and philosophies, visions and missions, leadership and decision making styles, strategies, communication styles, organizational values and norms, expectations and opinions of employees relating to the transaction and so on. After such a survey, parties can better interpret each other's corporate culture, but on paper. In order to conduct a better cultural due diligence, the

[40] Deliotte Merger&Acqusition Services, 2009, Cultural Issues in Mergers and Acquisitions, 2009, p.4-5
[41] Spedding, LS, 2009, The Due Diligence Handbook: Corporate Governance, Risk Management and Business Planning, CIMA, p.296

bidder shall send its M&A experts to the target's headquarter or other main workplace, and then those experts should observe the internal environment of the target and communicate with the prospective employees. This team of experts shall include various people from different areas of professions; such as lawyers, business professionals, a psychologist, a sociologist etc. and the team should be only focused on the observation and comprehension of corporate culture. The diversity of experts and the large size of the 'cultural' due diligence team can be seen expensive; however when we consider the amount of losses caused by failed mergers, adding a couple of professional experts on the M&A team will not cause a huge burden. Contrary to what is believed, having a better team will mitigate the likelihood of having a problematic integration process. The combination of a cultural survey (in which the respondents are target's employees, managers etc.) and an observation from the outside (by the bidder's M&A team) can provide more detailed and prospering cultural framework.

Together with the cultural survey and the external observation, both parties should request operational and behavioral data from each other, regarding on the relevant domains in both organizations.[42] The evaluation of such data enables the parties to contrast and comprehend each other's corporate culture. There are 12 domains which the parties shall disclose to each other:

1. **Intended purpose and the way**: It is important to understand what the company aims to achieve from its organizations, therefore the following questions should be answered; what is the business plan and the purpose of the organization? What results can be expected from the business organization? What is the intend of the organization? How are the decisions regarding these issues discussed, made, and executed.
2. **Key business drivers**: This shows how the company defines itself with regards to its market and the position of its organizations in the market. Differences regarding the key business drivers can create disagreements. For instance, one party may define success with regards to total market share, while the other one may identify as net profit margin.[43]The questions regarding the key business

[42] Spedding, The Due Diligence Handbook: Corporate Governance, Risk Management and Business Planning p.296
[43] Spedding, ibid, p.297

drivers also try to find whether there is any competitive edge or not and if so, how is it defined.[44] (The competitive edge can be defined by quality of services and products, market share, stability, sustainability, price differentiation and so on.)

3. **Leadership and management issues**: This domain is mainly related to the middle management level, also has strong relations with low and high levels. The differences in management and leadership styles can cause some problems in terms of decision making and execution of decisions. The main concern is about which style will be predominant in the operation of the company. In this context, it is important to understand what is the balance between management and leadership approaches with the personnel.[45]
4. **Infrastructure**: In this regard, each party should understand how the other company is organized, how do the personnel systems interface with the line systems, how is the relationship between different units and groups organized, and how are the reporting relationships organized.[46]
5. **Organizational policies**: In this respect, understanding the daily course of business, level of flexibility and its practices, formal and informal systems are the main concerns.
6. **Key measures**: This domain states the motivation behind the company measures and the consequences. When the key measures are assessed, it is understood that the outcome of the measures were a great motivation for both the employees and executives. Comparing the key measures between both companies is a vital cultural indicator.[47]
7. **Work practices**: There can be differences in work practices between two party, therefore conflicts may rise; especially in cross-border mergers and acquisitions, work practices should be examined carefully. Both parties should understand how the other party performs. For instance, some companies attach importance to individual success and responsibility, while others prefer group work.

[44] Spedding, ibid, p.297
[45] Spedding, ibid, p.298
[46] Spedding, ibid, p.297
[47] Spedding, ibid, p.297

8. **Physical Environment**: This matter has an effect upon how employees feel about their work and the organization. Alteration of physical environment may diminish the eagerness to work of employees. For instance, one party may have an open work environment, while the other one may have private offices; or one can have open access to facilities and the other one may have high security.[48] These differences can create compliance problems, therefore parties should carefully examine and compare their physical environment and its impact on employees.
9. **Expectations**: This domain especially has an impact on the governance of the business. Understanding the expectations of both employees and managers regarding the organization will provide a framework in terms of governance.
10. **Cultural indicators**: Cultural indicators can simply give clue regarding the corporate culture of a corporation. For instance, employees' way of dressing (i.e. formal or informal) and addressing each other and their managers (reverential or more friendly) can provide an impression in relation to corporate culture. Also, the formal work hours and overwork hours should be considered and compared in this regard.
11. **Technology**: In this regard, the parties should disclose the information regarding their technological infrastructure (if it is not highly confidential) and how do they utilize their technology. Technology utilization is important for internal operation, services and products.
12. **Supervisory roles**: The supervisory interaction between employees and their managers is one of the determinatives for corporate culture. In this context, the degree of entitlement, level of trust and responsibility between employees and managers are the main issues.[49]

C. Human Resources Due Diligence

Human resources due diligence can be considered as one of the sub-categories of cultural due diligence, and once again, this concept is often underestimated or overlooked. The importance of understanding the corporate culture of the target is examined above; similarly, the bidder should assess the role, capability and behaviors of employees in the light of the corporate culture of the

[48] Spedding, ibid, p.299
[49] Spedding, ibid, p.298

target. As mentioned above, incompatible corporate cultures in an acquisition can cause loss of key employees; also without conducting an appropriate human resources due diligence, keeping the key employees inside will be compeller. A research[50] which is made by Jeffrey Krug, demonstrates that the corporations lose a large number of executives years after the deal has been closed.[51] However, human resources due diligence exists in order to resolve those problems. Human due diligence will be focusing on choosing the structure of the company to be acquired, and how it will be connected with the prospective company, and it will be determined who amongst the managerial level will be kept in the merged company and the feedback of the rank and file. Human resources due diligence enables acquirers to have knowledge about employees, determine the structure of the organization, fill the top positions of the merged company rapidly, set the tone for the combined culture, resolve conflicts in decision making process.[52]

During the human resources due diligence, the M&A team should first identify whether the target has a compatible and functioning organizational structure that enables it to make effective decisions and execute them.[53] In this context, the team should evaluate and understand how the reporting structure and the business units of the target are structured, how many executive levels exist, and how is the authority distributed between different executive levels. These issues can be identified as the "hardware" of the organization.[54]

Secondly, the team should evaluate the internal dynamics of the target such as, process of making strategic and operational decisions of the target's executives; effectiveness of checks and balances on the executives, and these issues can be identified as the "software" of the organization.[55]

Finally, the team should take stock of the target's assets and capabilities, and determine which departments are vested with these capabilities.[56] Especially, where

[50] Krugg ,J, February 2003Why do they keep leaving?, HBR
[51] Harding, D, Rouse, T, April 2007, Human Due Diligence, Harvard Business Review, p.126
[52] Harding, Rouse, ibid, p.129
[53] Harding, Rouse, ibid, p.127
[54] Harding, Rouse, ibid, p.127
[55] Harding, Rouse, ibid, p.127
[56] Harding, Rouse, ibid, p.127

the aim of the transaction is to acquire capabilities, the importance of this investigation grows. The M&A team should investigate the scope of the unit's responsibilities; quality of the outputs; the roles, goals, and job descriptions of key areas.[57]

D. Another Perspective: The Impact of the Society on the Corporate Culture

Hypothesis: In cross-border M&As having a sociologist in the bidder's team may enhance the effectiveness of the cultural due diligence.

A society is a group of people which have strong social interaction, live under same authority and dominate by the cultural traditions, and sociology works on the interaction between a person and society in an enormous working field, from the relationships between two people on a street to global social processes. Every society has a collective consciousness level just as every human being has, and in this level there are value judgements, beliefs, cults, ideas, orders and boundaries which have an impact on every person's consciousness, as a matter of fact, every person in a society shall be in accord with the collective consciousness of the society. Therefore, understanding the society enables managers of the bidder to comprehend behaviors, way of doing business, and expectations of the managers and employees of the target. In the current economic system there are no borders; commercial terms and their meanings for local economies, and the principles of business are the same for different companies from different countries. However, the interpretation of the way of doing business is different. In order to achieve certain goals, the bidder should identify the expectations, beliefs and viewpoints of the target's employees.

Merging two companies from different countries increases the difficulty level of the integration process, therefore in cross-border M&As, the bidder's team should consider the social structure of the target company's home country. After understanding the society, the bidder can better interpret the corporate culture of the target, and this awareness will expedite the integration process. As mentioned above, having a sociologist in the M&A team will not cause huge burden; especially in cross-border mergers and acquisition, having various professions in the M&A team will increase the likelihood of achieving the deal objectives. In this context, the buyer should send its

[57] Harding, Rouse, ibid, p.127

extended M&A team to the target's home country and its main offices. The team should focus on understanding the society and the local business environment with the main lines and then examine the corporate culture of the target in the light of financial, legal and sociological structure of the target's home country.

6. Conclusion

According to various authors, academicians, and executives; the Due Diligence process has huge impact on post-acquisition performance of the combined company. Taking into consideration that two out of three of the mergers and acquisitions fail in terms of their deal objective, the importance that should be given to the due diligence process is increasing.

Due diligence teams usually conduct well-established legal and financial due diligence processes; as a matter of fact if an acquirer has a professional and skillful M&A team, which should use situation specific legal and financial due diligence check-lists and successfully evaluate the target company from legal and financial points of view, the combined company can anticipate to achieve its deal objectives. However, the importance of corporate culture and integration process are always underestimated, and this study argues that cultural due diligence and integration process is as important as financial and legal due diligence for M&A transactions. Incompatible management styles or ego wars between CEO's caused many failed transactions in the M&A history.

The surveys and case studies, which are examined in this study, demonstrates that the M&A world should attach more importance to the corporate culture and integration process in order to avoid M&A failures.

Bibliography

Aon Hewitt, 2011, Culture Integration in M&A, Survey Findings

Barth, ME, Kasznik, R, McNichols, MF, March 2000, Analyst Coverage and Intangible Assets, Forthcoming, Journal of Accounting Research(2001)

Bruner, RF, 2004, Applied Mergers and Acquisitions, New York: John Wiley & Sons

Capasso, A, October 2014, Stakeholder Theory and Corporate Governance: The Role of Intangible Assets, University of Sannio - Department of Economic and Social Systems Analysis; European Corporate Governance Institute (ECGI)

Carleton, JR, 2009, Cultural Due Diligence, Vendor Group

Ceil, C, July 2013, Role of Due Diligence in Mergers and Acquisitions, University of Tampa, John H. Sykes College of Business

Conway Jr, A.C, Rouse W.R, January/February 2002, Protecting Yourself: Due Diligence in Mergers and Acquisitions, John Wiley & Sons Inc. Publications

Damodaran, A, January 2006, Dealing with Intangibles: Valuing Brand Names, Flexibility and Patents, Stern School of Business

Deloitte, 2009, Cultural Issues in Mergers and Acquisitions, Deloitte Development LLC

Fernandez, P, February 2007, Company Valuation Methods. The Most Common Errors in Valuations, IESE Business School – University of Navarra

Fernandez, P, November 2015, Three Residual Income Valuation Methods and Discounted Cash Flow Valuation, IESE Business School, University of Navarra

Fernandez, P, November 2015, Valuing Companies by Cash Flow Discounting: 10 Methods and 9 Theories, IESE Business School, University of Navarra

Harding, D, Rouse, T, April 2007, Human Due Diligence, Harvard Business Review, p.124-133

Harper, P, 2002, Merging Cultures, EBSCO Publishing, p.7

IACONO, M.P, 2011, Cultural Due Diligence as a Proactive Strategy of Organizational Change: An Empirical Analysis, Working paper series, n. 12

Kohlbeck, MJ, Cohen, JR, Holder-Webb, LL, February 2009, Auditing Intangible Assets and Evaluating Fair Market Value: The Case of Reacquired Franchise Rights, Issues in Accounting Education, pp. 45–61,Vol. 24, No. 1

KPMG, 2016, U.S Executives on M&A: Full Speed Ahead in 2016, Survey Findings, Fortune Knowledge Group

Lev, B, September 2003, Remarks on the Measurement, Valuation, and Reporting of Intangible Assets, FRBNY Economic Policy Review

Rosenbloom, AH, Due Diligence for Global Making, Bloomberg Press, NY

Schnapf, L, Fall 2000, Cost-Effective Environmental Due Diligence in Corporate Mergers and Acquisitions, NR&E, p.80-83

Scott, I, Misic, D, April 2014, Creating Deal Value With Tax Due Diligence, EY Advisory Services Publications

Sudarsanam, S, Creating Value From Mergers and Acquisitions, Second Edition, Prentice Hall, FT

Sherman, A, 2011, Mergers & Acquisitions From A to Z, 3 rd Edition, AMACOM

Spedding, LS, 2009, The Due Diligence Handbook: Corporate Governance, Risk Management and Business Planning, CIMA Publishing

Panda, A, April-June 2013, Do You Know Who You Are Dealing With? CulturalDue Diligence: What, Why and How, Vikalpa, Volume 38, No.2

Penman, S.H, Sougiannis, T, January 1995, A Comparison of Dividend, Cash Flow, And Earnings Approaches to Equity Valuation

Wangerin, D.D, April 2015, Do Fools Rush In? The Importance of Due Diligence in M&A Transactions, Michigan State University Publications