Gillum Strategy Partners

VIEWPOINT

The Best Practices of Mergers

Best Practices of Mergers:

Adhering to a set of eight principles does not guarantee merger success, but if followed, the odds of success will dramatically increase.

Introduction

"The Best Practices of Mergers" is a collection of recurring merger success factors Gillum Strategy Partners (GSP) assembled based on an aggregate of 70+ years of experience and visibility into mergers and acquisitions by our firm's managing partners. These experiences include recent projects ranging from the world's largest technology merger (HP/COMPAQ), to the creation of the fastest growing systems integration company (Knightsbridge/Base Consulting), and the profitable merger of Böwe Systec and Bell+ Howell. Additionally, we have developed our operational experience, consulting expertise and visibility into M&A activity at companies ranging from Apple, Booz Allen & Hamilton, Cummins Engines, Deluxe Entertainment, General Dynamics, Gulfstream, Hard Rock International, Honeywell, i2 Technologies, Johnson Controls, K2 Ski Corporation, Microsoft, Rank Group, SAIC, Siebel, Quaker Oats, Yahoo!/Broadcast.com and numerous others.

After formulating our own list of practices, we tested our viewpoint against established principles depicted in academic literature and the popular business press. The result is eight fairly straight-forward best practices focused on mergers of relative equals. While some of the principles seem intuitive, there are often strong disagreements on intuition. For example, there are two schools of intuition regarding the speed of change of the merger – one school believes that companies should not rapidly change and should preserve elements of both companies; others believe that full scale integration cannot be done quickly enough. In this paper we take a position supporting the latter.

This list of principles is by no means exhaustive in addressing the issues and opinions that come up in the course of mergers, as there seem to be almost as many opinions on the best approaches to mergers as there are mergers themselves. Business combinations are very complicated with many more than eight key interactions. While this collection of principles is not a recipe for guaranteed merger success, if it is followed, the odds of success will dramatically increase.

Eight Key Principles for Merger Success

1. Buy for the Right Reasons.

Managers who become caught up in the excitement of dealmaking often lose sight of the financial and strategic reasons behind the merger. Managers must focus on several key factors to ensure that financial and strategic synergies remain top of mind throughout the merger process.

2. Plan, Decide and Act Quickly.

Merger planning and decision-making is

critical and must be done quickly and methodically throughout the merger process to ensure employee and other stakeholder confidence.

3. Build One Team.

A single integration team is crucial to successfully lead companies through the details of the merger. Additionally, field research points to evidence that teams that work together quickly are generally the ones that integrate more strongly than those that suspend project work in order to build their merged culture.

4. Pay Close Attention to Customers.

During the merger, firms often unintentionally neglect their customers. Several methods prove extremely valuable for maintaining current customer satisfaction and evaluating customers gained through the merger.

5. Maintain Focus on Metrics.

Mergers bring a great deal of excitement and enthusiasm that lead some executives and integrators to lose sight of the key metrics that drove the deal in the first place. It is critical in the merger process to demonstrate the merged company's health by meeting or exceeding key metrics set at the announcement.

6. Take a Structured Approach to Human Capital.

Culture is perhaps the most difficult aspect of mergers. How do you determine the key human capital assets of each firm? How can you motivate and retain key players? The answer to these questions can be the determining factor in the success of the merger.

7. Merge to Foster Change and a New Vision.

Strategy is tightly correlated with culture. Managers who have a vision can use a merger to infuse much needed new life.

8. Over-communicate.

Communication can be an asset or a liability that can make or break a merger. Simple, clear and frequent communications provide the opportunity to catalyze the merging companies toward success, while their absence nearly assures failure. Several key communications practices will ensure its success.

Buy for the Right Reasons

This might sound intuitive, but managers who become caught up in the excitement of dealmaking often lose focus of the deal's real goal: achieving financial and strategic synergies. Once a deal has progressed past a certain point, managers become emotionally invested and potentially blinded by its glamour. They may implement a merger even though due diligence suggests that it is happening for some wrong reasons.

Negotiation Strategy

A detailed negotiation strategy is critical from the start, as excitement may overcome rationality as early as the actual purchase price negotiation. The foremost aspect of this strategy must be a ceiling to the offer.[1] Knowing the best alternative to a negotiated agreement is important so that managers can walk away if the negotiating opponent is not offering something better. Powerful negotiation strategies use game theory – beyond clearly defining your side's boundaries it is advantageous to play with the entire set of possible reactions. A balanced team of connected parties and unconnected parties (that might include a dispassionate executive) should review the deal and establish the walk-away price.[2] Remember, there are many non-price issues that arise in negotiations that ultimately impact price and the success of integration. Employee benefits practices, environmental and employment practices, sourcing and lease agreements can all get in the way of realizing the benefits of the merger.

Knowing the tradeoffs and the implications for value are important in building agreement and achieving the desired benefits.

What follows is a guideline for developing a custom set of company and industry-specific factors on which to focus throughout the merger process. Managers must have the discipline to walk away if these factors become faulty.

- Focus on synergies created by combining firms to justify the premiums paid for acquisition. Base synergy value calculations on:

  1. cost savings
  2. revenue enhancements
  3. process improvements
  4. financial engineering
  5. tax benefits.

  An acquisition is clearly unattractive if the purchase price exceeds the value of these synergies.

Analyze the target thoroughly. There is no such thing as too much due diligence. Due diligence should always include a full analysis of all financial statements. Some common accounting tricks which make a target seem superficially attractive will appear with a deep look at the statements. In addition, a thorough analysis of the customer-facing side should be performed with a special focus on the fit and style of product and service offerings. Companies should also consider exogenous factors such as market uncertainty and competition.[3] A good due diligence strategy might include a classic strategy framework like Porter's Five Forces or the 4Cs of Competition (company, customer, costs and capabilities).

- Anticipate competition to acquire target. If your firm believes a target is a good deal, chances are that other firms have noticed it as well. Industry rivals are likely contenders, but unexpected competition may come from firms in different industries for whom the target

fits in a different, yet valuable fashion. By learning as much as possible about the competitive landscape vying for the target, a firm can prepare a rational strategy to compete.

- Make sure there are alternatives to the deal. A sound strategy has a clearly defined plan for use if the merger is shot down by the target, regulators or shareholders, or if it begins to fail. An alliance or licensing agreement is a good alternative. Doing nothing is also a viable alternative. Ultimately, simply having such a strategy in place can make the difference between future success and failure. Moreover, a known alternative is a powerful tool during purchase price negotiation.

Plan, Decide and Act Quickly

The importance of deep merger planning cannotbe underestimated. Minute details such as hanging the updated company sign or answering phones the new way on the first day of merger closure can have enormous impact. Now imagine the impact of details such as which competing product lines will survive. That same impact strikes for a breadth of aspects, including cultural, leadership, strategic, marketing and firm identity issues.

The Clean Room

A concept called the "clean room" handles this massive amount of decisions. A clean room is an isolated merger safe-haven in which an integration team focuses intensely on marching through the merger's most important decisions. The integration team often includes functional or competing counterparts with a major task of deciding which of the two firms' products will make it to the final product portfolio. Certain rules keep the clean room sacrosanct. Clean room decisions are irreversible. This lends an important power and consideration to the decisions made there.

Adopt-and-Go

Another interesting concept prevalent in the famous Hewlett Packard-Compaq clean room was "Adopt-and-Go." This method determines where there is product overlap, identifies the best of competing solutions and quickly integrates them into the new product portfolio, avoiding long drawn-out internal product-line battles. Once all decisions have been made, the definitive planning step is to test. A simulation should be created which mimics the operations of the merged company before the merger closes. For instance, one could attempt to place an order from the new company and measure the success of the order fulfillment.

Quick Decision-Making

Making decisions quickly is as important as making them firmly. The tempo at which two firms come together to look and feel like a newcompany is used by many as an indicator of the merger's success. While nervous shareholders watch closely to see whether it was wise to hold the stock, employees may become less productive due

to the emotional stress of the length of uncertainty. Although anxious to adopt the new culture, they may be naturally disposed to fall back into the patterns of the old company. Quick, tangible merger results help counteract these phenomena and may also give management and integration teams the necessary encouragement to keep moving.

Timing

Intense planning should start during the due diligence stage. While scoping out the acquisition target, managers should already be planning how to integrate the company. The time in between the announcement of the merger and the close of the merger (which should be kept to 100 days or less) are the most critical. As many issues as possible should be addressed during that time, especially any career affecting aspects (e.g., new management team, organization chart, layoffs). The second most critical time is the next 100 days after the merger close. These periods will appear effective if managers achieve tangible successes that were not possible before the two companies came together. This can powerfully assuage stakeholders anticipating whether or not the merger was a wise choice.

Build One Team

Broad melding of companies comes from the early development of one smaller, yet crucial team: the integration team. Mergers are often treacherous periods for companies due to the double duty of merging firms and making quarterly financials. The integration team is a dedicated group of managers tasked with sculpting the merger's details.

Several facets enhance the efficacy of the dedicated M&A team:

- They must appear independent and unbiased toward any specific division, executive, or firm.
- Power must come along with the independence.The M&A team must be authorized to make wide-reaching decisions that affect multiple divisions of multiple firms.
- Although not tied to any executive, the team should have executive level decision-making capabilities. The managers of the integration team should therefore possess executive level insight, vision, and skills.
- The team must have a deep knowledge of the merging firms to handle gray-area situations that arise.

With a powerful integration team in place, a merger will have a higher success rate when it comes to building one company. Besides the overwhelming amount of details it must work through, the integration team can make the merger flow smoothly with a few key principles:

- Allow project teams to own changes that happen during integration.
- Encourage new teams to work together quickly.

Some believe that if project teams suspend project work and spend time building their merged culture they will work better together in subsequent projects. Field research, however, shows the opposite[4]: teams that are given the hardest deadlines for projects in progress during the integration generally are the ones that integrate most robustly. Perhaps they do not have time to think about how to work together; they just learn by doing. Uniting under a common pressure and goal does much to build relationships and teams.

Pay Close Attention to Customers

Firms often become so focused on the merger that they unintentionally neglect their customers. During this critical time, there are two ways to maintain focus on customers:

- Launch aggressive customer-focused initiatives alongside the merger.
- Critically evaluate customers likely to be gained through the merger.

Stay Focused on Current Customers

Launching aggressive customer-focused initiatives alongside the merger counteracts the natural tendency to neglect customers as firms concentrate their energies on the merger. While changes are happening within the company some external changes that positively affect customers' experiences with the newly merged firm will do much to keep them on board. Outward changes also give transparency to the merger, making customers feel more engaged and more understanding of future difficult situations.

Evaluate New and Current Customer Base

Customers who are newly acquired through the merger should be meticulously evaluated. These could be customers who are new to the acquiring company, but loyal to the acquired company. Also new customers might be attracted by new synergies created by the merger. Since these customers will impact revenue, two techniques prove valuable in ensuring that the merged firm reaches revenue targets:

- Develop a process that closely evaluates the profitability of acquired customers. Assess profitability of all products and services the acquired company offers, determine which customers buy which product or service, and then consider extra costs like tying up account executives associated with each customer.
- Identify less profitable or unprofitable customers and form an exit strategy or method to turn those customers profitable. For example, educating customers about how to use online tools instead of call centers can reduce

associated customer costs.

Maintain Focus on Metrics

Many numbers are involved in mergers and acquisitions, from deal value and stock prices to headcounts and cost reduction. Still, some executives and integrators get so caught up in the emotional excitement and the drive to close the deal that they lose sight of action plans to measure up against key metrics once the transaction is completed. This is extremely dangerous because a merger's relative success is based on how closely the metrics match predictions made at the merger announcement.

Meeting and Exceeding Metrics

Once the transaction is negotiated, the next focus is on the metrics that will drive the merged company to health. If it is important to set goals for such figures (e.g., cost reduction, revenue, and channel performance) during the merger announcement, then it is even more important to reach or exceed those goals during integration. Doing so will have an enormous impact on increasing shareholder confidence. Meeting goals can also create an energizing environment which yields positive sentiment around the merger, creating an atmosphere that drives future successes and confirms that the merger was a good move.

Each merger provides unique benefits. The following is a sample of reasons for a merger to take place and respective examples of how to measure actual results.

- *Driver:* Cross-selling opportunities *Check:* How many customers were retained? Which customers purchased more products?
- *Driver:* Enhanced margins *Check:* Which SG&A costs were saved? Smaller headcount? Greater purchasing power from suppliers?
- *Driver:* Leadership position *Check:* New awards and press mentions? Unaided brand awareness?
- *Driver:* Management talent *Check:* How successful at keeping management?

Take a Structured Approach to Human Capital

Culture remains the most difficult aspect to manage in M&A. Many deals are made or broken on culture. While leaders must decide on the best recipe for fusing cultures, there are two important actions that management should consider when addressing this issue:

- Create a balance sheet of human capital.[5] To some that may sound outrageous. However, culture in mergers is often as important as financial implications and therefore should be handled with the same care by critically assessing the human capital assets of your firm, their firm, and how they would work together.

Develop a plan to retain and motivate key players. High-end talent is often a key acquired asset. However, many mergers are followed by a mass exodus of key talent – in fact, headhunters often prey on the most talented employees of an acquired company during a merger. As losing these key contributors can make a merger fail, it is essential to develop a strategy to retain and motivate them. It is imperative to identify a pre-merger firm's key contributors and demonstrate how much they are demanded by the new merged company. A common method is to provide financial incentives in the form of a retention package which could include performance bonuses, stock options, raises and/or promotions. Also, be ready to deal with the "stars" who try to use the merger to disproportionately improve their position. Decide in advance how to deal with them and what the back-up strategy is. Be ready for adversity; successfully dealing with such inevitable roadblocks is predicated on having a plan before the encounter.

Merge to Foster Change and a New Vision

Strategy is tightly correlated with culture. When faced with a changing industry, a company that was once a "darling" may become old and tired. Managers who have a vision of their industry ideal strategy can use a merger to infuse much needed new life. They should consider the cultures of each potential target and which one will inject the right DNA to move the combined firm toward the ideal strategic vision.

To help unify the two firms post-merger, the culture that emerges from a merger should not represent the legacy of either individual company.[5] If the new culture is reminiscent of one of the pre-merger firms, the merger may be viewed as more of a "take-over" which connotes hostility. Such a situation might create an "us" versus "them" sentiment which is damaging to business and extremely detrimental to moving the new entity towards its ideal strategy. If a new and different culture develops after the combination, then it becomes evident that a true merger has occurred.

This means changing time-honored processes and procedures for both entities in a way that is noticeable to employees and customers. Managers must define the new company culture, develop processes and procedures that reflect that culture, and disregard how either of the parties used to do it. If automation of routine tasks will be part of the culture, employees must have the tools and clear decision processes available to them on such projects. If new product development is the emphasis of the merger, managers should establish the process for attracting the resources that enable the development team to do the job. This is the time to use the opportunity to improve on the cultural weaknesses of the old organizations and establish new, goal-oriented behaviors.

Over-Communicate

Communication during a merger is both an asset and a liability. The liability aspect is

the easiest to understand – during a merger there are penalties for under-communicating.

- People experience deep concerns. For example, team members devoting 10% of their day to worrying, gossip and/or securing their "parachute" has a tremendous negative impact on organizational productivity. The net sum of 10% of the company's time being redirected toward "concern and worry" is the same as if you asked every tenth employee to sit at the beach rather than coming to work. Would an executive voluntarily shut-off machines 10% of the time on a production line? Nonetheless, companies involved in mergers consistently do not spend the extra time and effort to over-communicate and consistently address people's concerns.

- People become disengaged. People who do not know what is going on consistently just disengage – after all, if they are not important enough to be communicated with, how important can their job be? Without clear and constant communication to all team members, a great divide can build – those who understand the merger and are running rapidly to seize its benefits are on one side and the clueless and disengaged are on the other. Careful communication is one of the few ways you maintain a similar l'esprit des corps among the teams locked up in rooms working on the merger as well as among employees throughout the organization.

Alternatively, communication plans are a tremendous asset when they are seen as an opportunity to 'light a fire' instead of seen as an obligation to 'send a memo'. When leadership shares information about a merger, team members are acutely attuned to what is being said – they are listening. Managers must carefully map out who will hear what when. Effective communication during a merger can provide a company the catalyst for: (1) creating a sense of urgency; (2) changing the pace of play on the issues that matter most; (3) demonstrating priority and commitment; (4) outlining clear accountability and organizational "ownership" for change.

Establishing a Sense of Urgency

Every second counts. Meaningful change will only occur when employees are motivated to come out of their comfort zones and understand that "business as usual" is no longer acceptable. They must be aware of the dangers in being complacent and recognize potential threats such as new competition. It must be clear that if action is not taken immediately, there will be significant financial losses.

Prioritizing Issues that Matter Most

Set the agenda and keep the messages simple. Managers must keep employees focused on issues that have the greatest potential for creating value. A transformation

effort will not succeed unless its members understand, appreciate and commit to making the effort happen. After creating the structure for change, managers must keep the process flowing by ensuring that the most crucial issues are kept at
the forefront.

Demonstrating Priority and Commitment

Managers must be seen "walking the talk" for people to believe the effort is important. Actions are arguably the most powerful communicators to prove that change is happening.

Demonstrating Priority and Commitment

Everyone in the organization must share in the responsibility to institute great change. Roles and responsibilities should be defined. Additionally, two-way communication between the manager and employee to establish realistic short-term goals helps keep the urgency level intact and forces reflection on the way to the ultimate goal. Achieving these intermediate goals provides proof to members that their individual efforts are working and adds motivation to keep going.

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Gillum Strategy Partners (GSP) is a boutique strategic consulting firm providing services to top tier clients in a broad base of industries, including technology, manufacturing and services. GSP's areas of expertise include go-to-market strategies, marketing effectiveness, channel and alliance management, growth strategies, sales productivity and operational improvement. We emphasize pragmatic solutions with measurable results and often work with our clients through implementation.

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