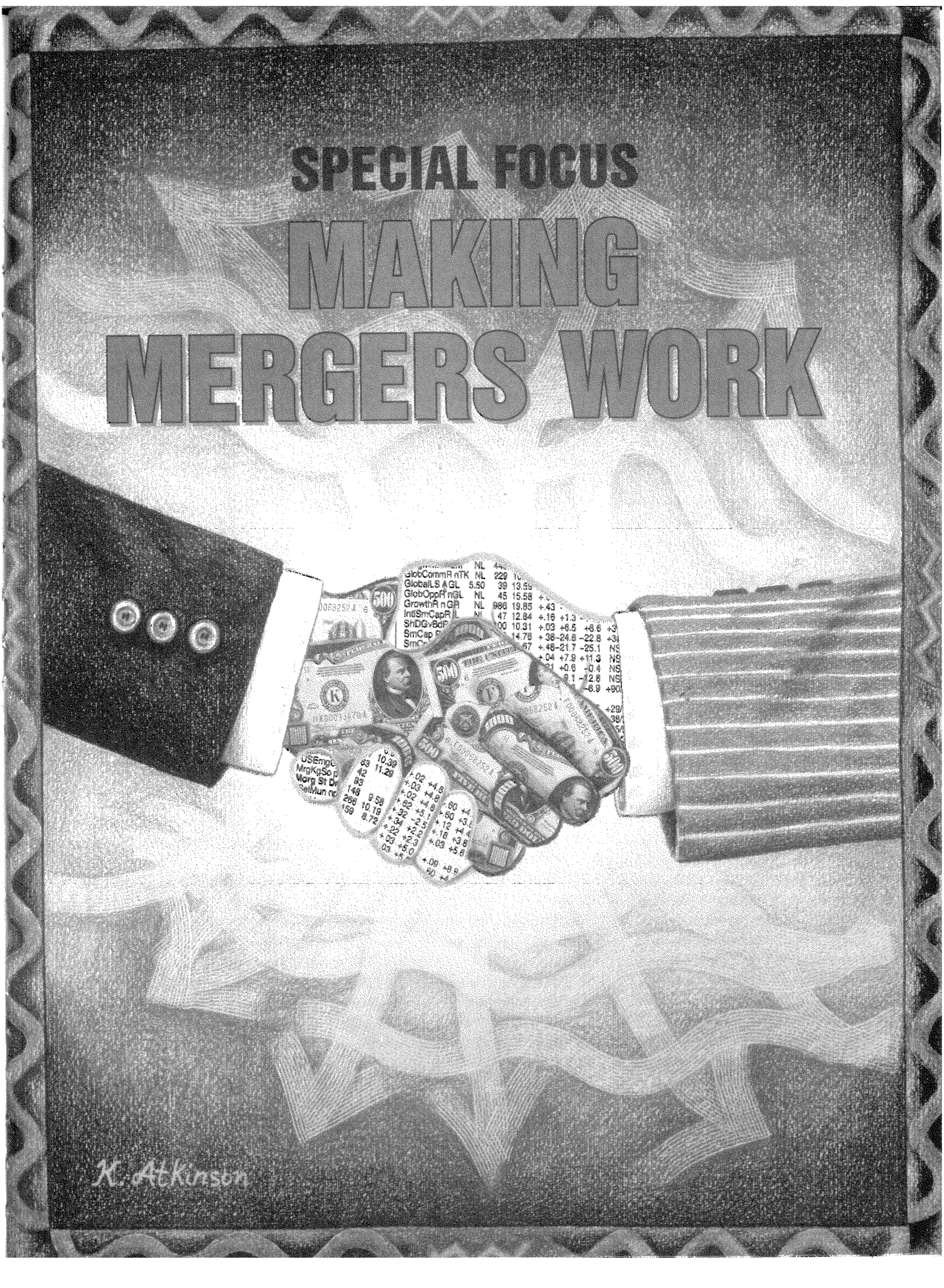
SPECIAL FOCUS
MAKING
MERGERS WORK
K. Atkinson

NOTES FROM THE M&A TRENCHES

Dick Massimilian

Deciding to join with another company is easy. The hard part is making the marriage work.

As we reflect on nearly four years of unrelenting merger mania, the business press still reports on an almost daily basis news of the latest merger or acquisition mega-deal across virtually all industries. Spending tens of billions of dollars to grow in size and scope barely raises a corporate eyebrow. But hidden beneath this merger frenzy lies an increasingly indisputable truth, as we see more and more deals thrust into the limelight with each passing quarter: The clear majority of these combinations (65 to 80%, depending upon which study you read) still do not yield their anticipated value.

Curiously, a slowly emerging recognition of these odds has done absolutely nothing to slow acquisition activity; instead, senior executives, denying formidable challenges and fearful of being left behind, seek comfort in combinations that produce mediocre results and disenchanted partners.

The odds against successful corporate marriages, and the overwhelming number that fail, make the few highly effective approaches a compelling basis for discussion. Indeed, the companies we've seen begin to crack the M&A code offer valuable instruction to their corporate counterparts. For those seeking a roadmap with which to embark upon a merger or acquisition, the path begins with four absolutes.

The Four Principles of Successful Integration

Mergers and acquisitions that deliver superior returns and justify their acquisition premiums are those that have been designed and implemented with four imperatives in mind:

1. *Designed Integration.* A clearly defined business case must drive the integration process. In other words, *how* you combine is tied directly to and driven by *why* you are combining.

2. *Differentiated Leadership.* Leadership roles and governance structure must be clearly articulated early on, despite certain inevitable missing links.

3. *An Integrative Perspective.* Careful consideration must be given to the human aspects of the deal, not simply the financial and strategic elements.

4. *Expanded "Due Diligence."* Organizational issues must be addressed before the deal is done, and, after the close, appropriate levels of resources must be devoted to combining management processes and organizational infrastructures.

Far too many combinations are derailed by differing interpretations of what the putative deal rationale means in practice.

Designed Integration: Does 1 + 1 = 3? For any combination, there are sources of strategic leverage that produce a whole greater than the sum of its parts. The first and most important step to a successful merger or acquisition is to specify and clarify these sources by asking why 1 + 1 = 3. Far too many combinations are derailed by differing interpretations of what the putative deal rationale means in practice.

The trick is to articulate why 1 + 1 = 3 with sufficient degrees of both clarity and alignment. It's here that many deals go off track. By clarity, we mean a brief statement, usually one to three sentences, that a lay person can understand, such as:

"Combining Company A's manufacturing and R&D expertise and optical product portfolio with Company B's cable market access will enable the new entity to become a leading player in communications markets in Europe and Asia."

The statement must be sophisticated enough to be relevant, but specific enough to avoid meaningless generalities. It is the job of the senior executive in charge of the merger or acquisition to articulate this statement. Typically, this means the executive prepares the initial statement draft, then shares the statement in an open forum with the key players (including direct reports), in a process that results in a final statement. The process of alignment in an open forum is essential; without it, vague rationales, such as "creating a financial services supermarket" or "moving up/down the value chain," are invitations to disaster.

Moreover, the statement of why 1 + 1 = 3 is of paramount importance

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because the sources of strategic leverage determine the critical success factors (CSFs) for the combination, i.e., what must go right during the first 180 days after the close if the deal is to realize its intended value. Post-close, there are virtually limitless demands for attention and resources. The reasons why 1 + 1 = 3, and the resultant CSFs, enable combination leaders to differentiate the crucial from the merely important. They in effect dictate not what must be done, but what must be done first.

Differentiated Leadership: Who's on First? It is also crucial to determine, before the closing, the governance structure for the merged or acquired entity, asking *who* will be responsible for *what*? Governance issues can be messy and, in the heat of deal fever, they are all too often relegated to the list of post-close priorities. This is particularly true when there is a perceived need to retain key people. The unfortunate consequence is that promises are often made before the deal is final that later inhibit freedom of choice in designing a governance structure.

What refers to the nature of the new organization—the organizational structure, including roles and responsibilities and who enjoys decision-making power. Once these roles have been defined, it's important to assign people to positions. While it is ideal to define structure and roles before choosing incumbents, it rarely, if ever, happens that way. But for those intent on effecting a seamless transition, the two key imperatives are these:

- It is tempting but extremely risky to announce a merger or acquisition without having at least a preliminary idea of the governance and reporting structure. You may or may not be able to share it widely, but you should have an idea of what you think the structure will look like (subject, of course, to additional information obtained after the deal closes). A general picture of the structure does not necessarily imply an understanding of who fills each specific position.
- At close, do everything possible to tell people to whom they will report, or at least when you will tell them. Finalize the governance structure quickly (though sometimes anti-trust considerations make it problematic to burrow deep into organizations). While announcing a governance structure may reveal decisions about consolidating operations—or "winners and losers"—more quickly than is ideal, it is nonetheless critical to move fast. Time is very much of the essence.

Until people know "who's on first"—who is in charge, to whom they report, and where they fit in the general scheme—the lion's share of their attention will be devoted to speculation of that question, instead of how to make 1 + 1 = 3. When that happens, business stalls. Many an executive who has been through this process will tell you that, in retrospect, he or she moved too slowly in stating "who's on first." Few, if any, regret having moved too quickly.

An Integrative Perspective: It's More Than Just the Numbers. Talk to anyone close to a specific merger or acquisition, and most often that individual will describe it as "the deal." That term connotes a narrow, transaction-oriented perspective, and usually a financial one. In other words, the unspoken assumption is that if the numbers work, the combination will work. Those individuals compensated upon consummation of the deal are especially prone to this point of view, but even when the combination is viewed by some through the human resources lens—with the focus on the implications for individuals and groups—the financial perspective still prevails.

The higher the deal fever, the more likely it is that fundamental organizational concerns will return to haunt the dealmakers after the close.

Organizations are complex systems. They exist in particular economic, social, and political environments. They have unique strategies. Employees perform particular tasks within both a formal organizational structure and an informal operating environment or culture. Combine two organizations and, at a minimum, you are combining two strategies, sets of people, organizational structures, policies, and practices. Perhaps most important, you are combining two distinct cultures. An exclusively financial or a human resource perspective alone ignores most of these elements.

An integrative perspective requires that combination leaders address several fundamental issues in considering the probable success of the combination. These questions include, but are not limited to:

- What is the optimal strategy for the combined enterprises? Why are these two entities better off together versus apart? In what way will this new combination add new or greater value?
- What is the appropriate architecture for the new entity? This is much more than what the organization chart looks like and who fits into which box. The issue of architecture deals with everything from the actual name of the new entity to the type of culture that will best fulfill the organizational strategy.
- What is the process for managing the transition from two organizations to one?

The point is this: Don't think of a merger or acquisition as simply a "deal." Rather, think of it as a process—in fact, a complex process. Never assume that because the numbers work, the deal will. The higher

Table 1: Expanded Due Diligence—Sample Questions

Strategy	What is the strategy of Company A/Company B? What is the fundamental value proposition of each company? To date, how successful has each strategy been?
Formal Organization	What have been the core tasks/work activities of the organization? How is each company currently organized? What is the current organizational structure (organization chart)? What is the fundamental organizing principle (e.g., products, markets, geography, and matrix) for each company? What is the degree of centralization/decentralization in each organization? What are key elements of each company's core work processes along the value chain? What are key elements of the design, development, manufacturing, marketing, sales, distribution and support processes for each company? How are management processes conducted (e.g., strategic and operational planning, performance management)? What are the existing management information systems at each organization? What are key elements of human resource policies and systems of each organization (e.g., compensation, benefits, training and development, HRIS)?
People/Leadership	Who are the senior leaders of each organization? What are the leadership styles and capabilities of incumbent management? What critical people skills and competencies give the business a competitive advantage?
Informal Organization	What are the underlying norms and values of Company A/Company B? What behaviors are rewarded formally and informally? What are the informal structures, processes, and relationships that have emerged within each company? What is the nature of relationships and communication among units, functions, or groups within each company? What are characteristic leadership behaviors and how do they affect each organization?
Strengths and Weaknesses	What is the glaring strength of Company A/and Company B? What are weaknesses of each company?

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Expanded Due Diligence: You Can't Start Too Early. We've established the critical importance of addressing organizational issues, which always include each company's management process, talent pool, and culture. But all too often, the tacit assumption of those executives charged with the success of a merger or acquisition is that resolving these issues can wait until after the deal is struck. That point of view can have disastrous consequences.

To be sure, there are some good arguments for withholding information. It is true that legal constraints sometimes prevent an open exchange. There may also be a healthy reluctance to open the kimono lest the deal never come to fruition. But there is a significant difference between refraining from answering questions in full and simply refusing to raise them. The latter usually translates into a bad deal for shareholders.

Table 1 lists some of the questions that should emerge during expanded due diligence. The executives charged with the success of the combination should begin asking them as soon as a deal is seriously considered. This list is by no means exhaustive; it simply highlights areas for exploration and potential "showstoppers"—issues requiring so many resources that they render the cost of the combination greater than the realized value. The sooner these issues are identified, the sooner the cost of those resources can be calculated into the acquisition analysis.

The key issue here is one of timing. It is easy to address complex questions once the deal has closed; in fact, it is impossible to avoid those questions at that point. Real leverage occurs, however, when those questions are asked before the deal is done. The organization committed to the success of a combination expands its notion of due diligence beyond the financial and human resources perspectives, and does so early on.

Theory vs. Reality

The key question in contemplating a merger or acquisition is not whether a particular combination can realize the shareholder value for which the deal was done. Any two corporate entities can, in theory, be combined. The real issue is the amount of resources required for the resultant entity to deliver its intended value. No one wants to effect a merger or acquisition that will cost more than it will produce. The four principles of successful integration applied in practice will help today's combining companies beat the odds and maximize their chances of achieving true value. ◆

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ASSIMILATE, INTEGRATE, OR LEAVE ALONE?

Nancy Kaplan

What you do with the company you just acquired depends on why you bought it in the first place.

Although the dollars involved in mergers across all industries leapt upward over 120% between 1990 and 1999, M&A dollars in that industry rocketed up a breathtaking 760%. In 1999, the communications industry accounted for over 20% of the total value of M&A activity—more than 460 mergers and acquisitions costing approximately $305 million. Reported activity in 2000 promises to continue the trend.

But if the performance of past mergers predicts the future, the majority of the most recent marriages will likely fail to increase the shareholder value of the acquiring company within one year. In fact, over 50% of mergers and acquisitions will result in destruction of shareholder value for the acquiring company in that period of time.

Even good deals fail. Bringing together two cultures, integrating systems and processes and methodologies, rationalizing disparate compensation and benefit and incentive plans, all while realizing the usually much-touted cost-cutting and revenue-enhancing benefits of the deal within one year can be an overwhelming task. And one year is all Wall Street allows.

Because acquisition is now integral to many corporate strategies, the ability to make deals work—over and over again—is critical. Ensuring repetitive success depends on three factors: (1) defining the reasons for the merger, (2) adopting a merger strategy that is consistent with those reasons (the drivers of the integration), and (3) maintaining the external focus on customers. The hyperactive communications industry provides excellent examples of both successes and failures with these factors.

What Works for Cisco May Not Do for Pancho

Cisco Systems provides one of the most positive examples of a company that keeps its eyes on the three essential elements of merger success. With 18 acquisitions in 1999 alone, and an even higher rate of acquisition in 2000, Cisco obviously has a lot of experience. And with each of its acquisitions, it has clearly articulated its objectives, and its strategy and tactics have supported those objectives.

Growth at the forefront of technology drives much of Cisco's M&A activity. Two prongs of Cisco's merger strategy derive directly from this objective: (1) diligent pre-acquisition screening on the softer issues, such as cultural fit, and (2) a willingness to allow the newly acquired companies to maintain their unique characteristics.

Cisco acquires successful companies, those with an expertise or market niche that Cisco has not developed internally, and the company is careful not to destroy the many intangibles that created the success in the first place. The minimal required integration is swift and respectful, and each unit is allowed—and expected—to continue to focus on the customer rather than on the new parent.

Unfortunately, Cisco's model has become synonymous with "best practice" for all integrations. Today's "accepted wisdom" touts the need for companies to remain respectfully distant from their newly acquired units. Don't tinker with corporate culture; don't burden the new unit with a lot of requests for information; don't demand that the new member adopt the parent's processes and procedures.

Good advice—if the driver of the acquisition is the desire to expand into a new business, and if the acquired company is profitable, efficiently run, and growing. In such cir-