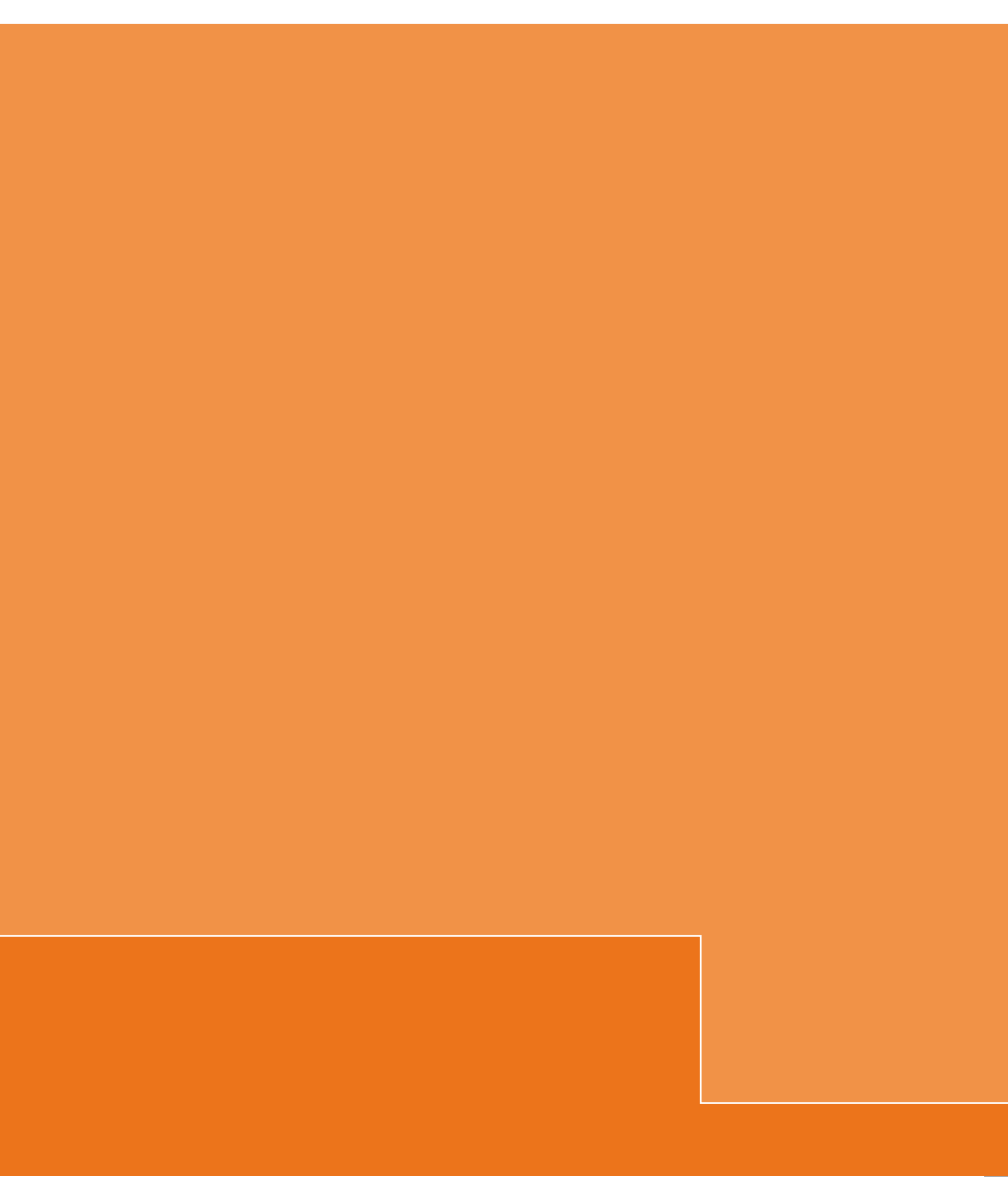


Dangerous liaisons

Mergers and acquisitions: the integration game



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A dangerous game

The dominant feature of the global business agenda in 2007 has been the unprecedented level of corporate mergers and acquisitions. But mergers can be a dangerous game and, with access to credit likely to be more difficult in 2008, companies will need to ensure that any merger activity delivers real value to stakeholders.

Hay Group and La Sorbonne asked European business leaders to share the real story behind the complex world of mergers and acquisitions. Our research revealed that only nine per cent of business leaders considered their deal to have achieved its original objectives. Some 45 per cent of the executives we polled had opposed the mergers that they experienced – 30 per cent actively.

We all know that appearances can deceive. An attractive balance sheet may not necessarily point to the perfect corporate partner. How can suitors be certain that behind the seductive figures lies their ideal acquisition, before they go down the M&A aisle?

Our research

Hay Group's Dangerous Liaisons report combines the results of a three-phase research program, conducted jointly with La Sorbonne and believed to be the most detailed study of European M&As ever conducted.

Hay Group conducted interviews with 200 senior European business leaders who have experienced a major merger or acquisition during the past three years.

It then carried out desk research into the 100 largest M&As to take place in Europe over the same period.

Finally, La Sorbonne conducted qualitative and quantitative research amongst 300 global employees of merging organizations on behalf of Hay Group.

Critical factors for M&A success

We have identified two key factors which provide a firm foundation for a smooth integration process and that companies should adopt to be part of the successful few.

Striking the right balance

- **Get the balance right:** carefully consider how to align and integrate both the tangible and intangible assets of the companies to be merged.
- **Raise the due diligence game:** use the time between announcement and completion to audit fully both tangible and intangible assets.

The impact of leadership

- **Prioritize a leadership capability review:** acknowledge that the roles required in a M&A context are often one or two levels higher than senior managers' current capacity.
- **Do not delay:** top team selection needs to be carried out quickly. The sooner key roles are defined and allocated, the better. The rest will follow.
- **Live the vision:** the top team must demonstrate the new company values to the workforce as a whole in everything they do.

“ Only nine per cent of business leaders surveyed considered their deal to have achieved all its original objectives. ”

What are intangible assets?

These are a new class of assets that include the following:

- organizational capital of each company and includes culture and market convergence, governance, agility, communication and team working ethos
- relational capital includes brand, client loyalty and a company’s external and internal networks
- human capital refers to factors such as leadership capability, workforce skills, and employee engagement and productivity.

It is vital to assess the intangible assets as well as the tangible assets in order to fully understand the differences between the organizations and evaluate the risks involved in any merger or acquisition.

Hay Group’s intangible assets model		
Organizational capital	Relational capital	Human capital
Culture and market convergence	Brand	Leadership
Governance	Client intimacy	Employees
Agility	Client loyalty	Development and management
Communication and teaming	External networks	Engagement
Energy and clarity	Internal networks	Productivity
Organizational structure		
Tacit ‘know-how’ and innovation		

Hay Group’s intangible asset model can be broken down into three key areas.

Part I – getting merger strategy right

Of all the survey respondents, only one third saw a significant increase in shareholder value or a notable upturn in sales and market share and/or achieved significant cost efficiencies.

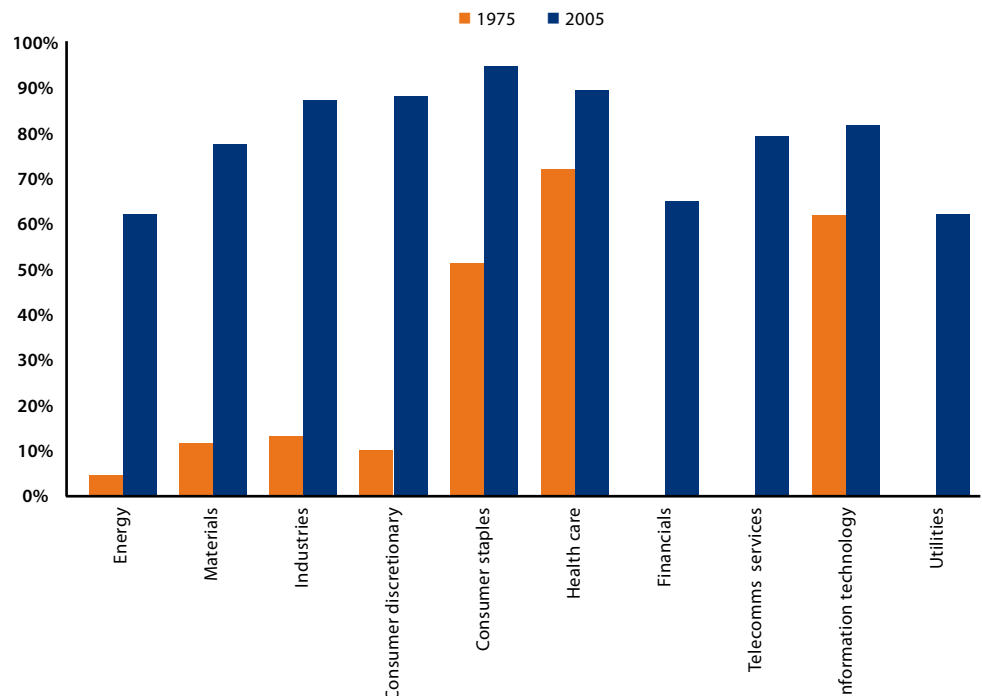
There is more to getting merger strategy right than adding up the numbers. Companies too frequently focus on this as they struggle to combine merging organizations and deliver better returns to shareholders.

This whitepaper looks at the critical omissions in due diligence and post-merger integration strategies that are among the primary causes of M&A failure. Two areas that are often neglected are the management of intangible assets and the role of leadership.

We found that firms still emphasize 'traditional' financial and systems due diligence and integration, at the expense of the vital, intangible assets which may not be visible on balance sheets.

These factors are equally critical to the merger process and include frontline ability to deliver brand promise, client relationship management, corporate governance, organizational structure and human capital.

Intangible value as a percentage of total market capitalization by sector in 1975 vs 2005



The rise and rise of intangible value: intangible assets made up on average 23 per cent of companies' market capitalisation in 1975, compared with 73 per cent in 2005. Source: Standard & Poors 'Power of Intangible Assets' 2006.

Part II – striking the balance

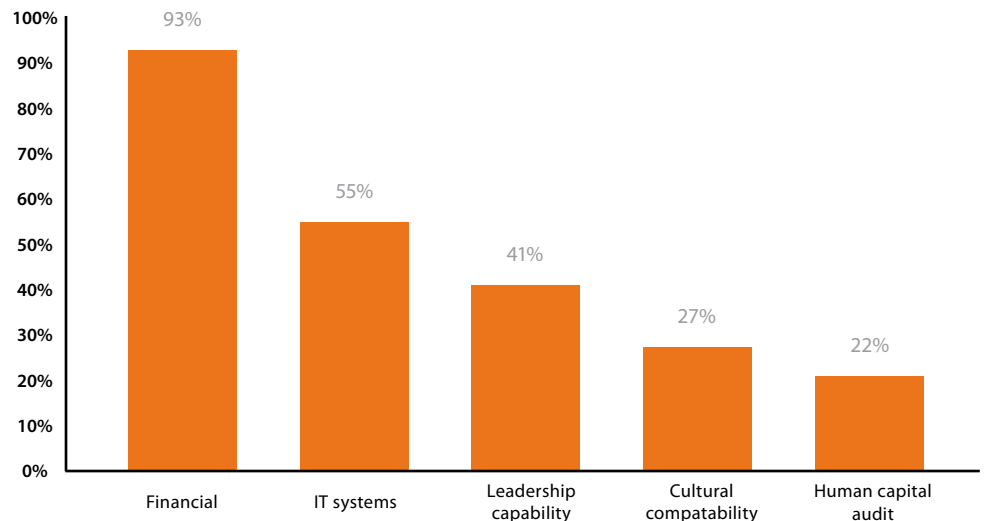
The value a successful merger can create is undisputed but there is also a risk in an increasingly volatile market. M&A deals are not for the fainthearted. Despite the recent impact of sub-prime lending on the average availability of credit overall, M&A remains a trusted weapon in the growth strategies of organizations today.

Yet a mere nine per cent of business leaders told Hay Group that their M&A experience had been fully successful – which means that more than nine in every 10 corporate

mergers ultimately fail to deliver on all the criteria which initially drove the deals in the first place.

Our research reveals that most executives today focus on integrating their tangible assets such as P&L accounting, IT and procurement systems and functions such as HR, marketing and finance. Far fewer made any attempt to identify or mitigate the risks to intangible assets – which our research proves is one of the two key determinants of M&A success.

Due diligence priorities



Old habits die hard: our survey respondents are still focusing on auditing tangible assets during due diligence.

70 per cent of business leaders claim it is too difficult to conduct due diligence on intangible assets.

Risky business

Indeed, business leaders seem only too aware of the risks inherent in failing to pay due attention to these intangible aspects of the merger process. More than half of business leaders believe that this strategic imbalance intensifies the risk of failure: 54 per cent state that neglecting to audit non-financial assets such as business culture increases the danger of making the wrong acquisition.

What is clear is that for executives, old habits die hard. Though there is a keen awareness of the need to deal with intangible assets, the focus remains on traditional due diligence: nearly three quarters of buyers – 70 per cent – failed to audit the intangible assets of the target company altogether.

“Tackling integration by way of systems and finance integration is a common approach – but one which ultimately risks failure if the balance is not struck between the tangible assets and the more complex elements such as business culture, human capital and corporate structure: the intangible assets” comments David Derain,

director within Hay Group who leads its M&A work in EMEA.

Another consequence of neglecting intangible assets is the lack of support for mergers at all levels in the acquired company – even among the most senior ranks. Almost half of the acquired leadership teams opposed the mergers they experienced. A worrying 30 per cent reported they were active in their opposition. Among frontline staff, some 78 per cent are opposed to such deals with over half actively.

Business leaders’ lack of strategic focus on intangible assets may be in part due to inherent difficulties in obtaining the necessary data on these aspects to make informed decisions. It is for this reason that many are demanding a robust form of reporting on business culture, human capital and organization structures as part of the due diligence process.

The post-merger integration strategy should begin during the pre-closing phase. Its focus should be on both the intangible as well as the tangible assets, with a related risk analysis plan.

Almost two thirds of executives surveyed – 63 per cent – believe that, after integration, there remains a notable difference in culture and levels of commitment between the two organizations.

Culture shock

Our study has highlighted the potentially disastrous consequences of neglecting intangible assets. One is the impact of failing to integrate business cultures. Almost two thirds of executives surveyed – 63 per cent – believe that, after integration, there remains a notable difference in culture and levels of commitment between the two organizations.

Business culture represents the unwritten rules of how organizations work – the unique organizational ‘glue’ which every company develops and which may not prove compatible when two or more organizations are to be fused. In a cross-border transaction, it may be exacerbated by national differences in values, beliefs, expectations and attitudes towards work, management styles and a host of other cultural factors.

Ignoring culture when firms merge is likely to ensure old behaviors persist. This will ultimately destroy integration. Distinct – and often opposed – ‘camps’ emerge as people strive to protect their habitual ways of working and their emotional equilibrium. Companies which do not take steps to address differences in corporate culture are planning to fail.

It is perhaps no surprise then that executives who have been through the M&A process expressed marked dissatisfaction with the post-merger culture, with over one fifth – 22 per cent – describing the early months as ‘culture shock’ and an additional 16 per cent even going so far as to label it ‘trench warfare’.

With this in mind, integration strategies must engage and enable the workforce in the post-merger process. Our research found that only one in 10 companies gave priority to engaging the workforce as part of their integration strategy.

When a workforce feels excluded from the integration process, resistance is likely to emerge. Empowering the workforce as agents of the change process will engender more positive attitudes and actions towards the merger.

In any organization, employees look to their direct line managers and senior leaders for clues about acceptable parameters of behavior. In a merger situation, this tendency will be all the more marked once the deal has been announced. The alignment of the leadership of both sides of the deal is therefore critical to success. If leaders on either side are seen not to support the change, the result will be problematic levels of active opposition from employees at every level.

Getting the balance right

The outcomes of mergers and acquisitions are difficult to predict. Human and cultural aspects in particular make each organization unique. When setting out to combine the DNA of two companies, it is impossible to know precisely what the end outcome will look like.

With this in mind, there are steps business leaders can put in place to create the right balance for a smooth and successful integration process.

Getting the balance right between the intangible and tangible assets requires clear strategic thinking from the very beginning of any deal. The finances may look attractive, but serious thought needs to be given to how well the organizational, relational and human capital can be integrated.

Integration of tangible assets such as policies, functional processes and cost economies is often what is tackled first. It is more straightforward to work out a plan to deal with these visible elements of the merger. While this is key to delivering cost reduction, focusing on integration synergies alone will not deliver growth or increase shareholder value.

In order to get to the 'value creation zone' more quickly, merging organizations must align intangible assets. These elements would include brand promise, governance, employee engagement and client relationship management, as they start to integrate their processes and systems. The two aspects of integration strategy should be addressed in parallel. As our research has revealed – it is too late to think about this six months after the deal has gone live.

“ 49 per cent of business leaders demand robust mandatory reporting structures for business culture and human capital. ”

Part III – the impact of leadership

Business leaders who prioritized a leadership capability review were four times as successful in achieving their merger objectives.

Where opposition to a deal occurred it became more pronounced as one moves down the organization. Resistance was more marked at middle management level, where almost half of managers opposed mergers, a fifth actively so.

Mergers and acquisitions are, by their nature, disruptive. Any transaction, no matter how large or small, initiates a period of fundamental change, for both the organizations themselves and for the workforce living through the integration process.

Hay Group examined a variety of factors that impact upon the success of a merger or acquisition. It is clear that two factors really make the difference between the average performers and those that excel: the balance between the intangible and tangible assets and leadership. We studied, in particular, the impact of leadership on the success of M&A, the speed and ease of integration of merging companies and the level of disruption caused by the integration process.

Worryingly, we found that effective leadership is the vital missing link in most M&A activity. “The capacity to align merging organizations – in particular the intangible assets – rests primarily with the top team,” argues David Derain. “Business leaders must take an objective view when selecting the top team, in order to select the best team possible – one capable of rising to the challenges of post-merger integration.”

Executives who conducted a formal leadership capability review during the due diligence stage were ultimately four times more successful in delivering the objectives which drove the merger. One fifth of them reported that their merger was completely successful – almost twice the average. This compares with a mere five per cent of those who did not review leadership ability in a formal way.

Business leaders who carried out leadership due diligence were also more likely to garner support for the merger at every level of the acquired organization. Nearly half (47 per cent) of these executives described the first 100 days after integration as a ‘brave new world of opportunity’, with a further one fifth calling their smooth transition ‘business as usual’.

In contrast, almost half of business leaders who failed to conduct a leadership capability review said their organization developed a destructive post-merger climate.

Business leaders also reported that failure to focus on leadership during due diligence also had a negative effect on levels of employee productivity and motivation.

A quarter of top executives who neglected to audit leadership experienced a dip in productivity and engagement levels among frontline workers once integration was completed.

Only 13 per cent of business leaders stated that engaging and integrating senior management and the workforce was given high priority as part of their company's integration strategy.

However, those who did conduct a leadership capability review reported an improvement in motivation levels of more than 10 per cent.

During merger and integration effective leaders will demonstrate their belief in and commitment to the deal. That in turn will help sustain employee engagement and productivity. An in-depth understanding of employees' skills and motivations at leadership level will provide valuable insight when taking vital steps to engage the workforce and convince them that a deal makes sense.

“Executives always underestimate the impact of M&As on the informal and social networks that make a formal organization work,” argues Claude Dion, who works extensively on M&A post-merger deals at Hay Group. This is why leaders need to be clear about their strengths and weaknesses

and have a realistic plan of action supporting the integration strategy. Yet, despite the critical role leadership plays in M&A success, more than half of companies failed to review leadership capability as part of the due diligence process.

Leadership is the vital missing ingredient in most M&As. The impact the leadership team has on the success of integration and the performance of merged companies is clear.

Business leaders who are prospecting for acquisitions must audit leadership capability at the earliest opportunity when considering a merger, and act decisively to put the right team in place if they are to ensure a smooth transition – one which maintains employee productivity and can position the new company for profitable growth.

The impact of new leadership on value		
Has the merger or acquisition genuinely unlocked new value?	New leadership team	Old leadership team
Yes a significant amount	50%	19%
Yes a small amount	35%	31%
No	8%	4%
Not yet	7%	46%

All change?

A new management team is nearly three times more likely to deliver success.

Given the critical impact of leadership on successful post-M&A integration and on the future performance of the new company, one crucial decision buyers face is whether or not to replace the top management team.

There can be no hard and fast rule in answer to this. Making the right decision depends on the strategic drivers behind the M&A, merger objectives, transaction type, relative performance of the merging companies and the leadership capabilities already in place. All of this emphasizes the importance of carrying out leadership due diligence.

However, our research suggests that there are clear advantages to bringing in a new senior management team. Buyers who elected to replace the management team fare better than those who keep the existing team in place. Appointing a new management team is nearly three times more likely to deliver success.

A new leadership team is also more likely to deliver increased shareholder value – with 29 per cent of buyers who appointed new leadership claiming that the merger had increased share price a great deal, compared to just five per cent of those who retained the acquired firms' management teams.

So why does replacing the leadership team have such a critical impact on success? The key lies in the attitude of the management team to the

merger, and the impact this has on the culture and operations of the merging organization.

“The senior management team must live the vision for a newly merged organization, demonstrating the right behaviours and setting the tone right from the outset, in order to reassure employees of the validity and future success of the new company”, explains Gaurav Lahiri, M&A director at Hay Group.

A new management team should be put in place as early as possible during the merger or acquisition, not only to enhance the integration process, but equally to bolster the likelihood of success when it comes to achieving business objectives. Replacing the top tier may appear to be high risk, but as our research demonstrates, the pay-off in terms of results more than justifies it.

“The message for merging companies is clear,” argues Deborah Allday, M&A director, Hay Group. “For those companies acquiring star performers or making portfolio acquisitions in unfamiliar territory, retaining the existing management team will deliver business as usual.

“However, for buyers aiming to drive significant new value, or achieve economies of scale by integrating companies, a new management team is three times more likely to deliver results.”

The need for speed

The average time to appoint a new management team was 74 days. The impact of this on firms' performance is disastrous.

Merging organizations entails the bringing together of two or more sets of strategies, operations, processes, people and cultures, in a way that still enables the new company to operate efficiently and to grow profitably.

Such a complex undertaking is bound to have a disruptive effect on customer care so the need for speed is clear. The faster a leadership team is in place and able to dedicate its resources to ensuring a smooth transition, the less disruptive to effective operations and customer service a merger is likely to prove.

Yet merging companies are falling short in this regard. The average time to appoint a new management team for the transactions studied by Hay Group was 74 days – which amounts to two and a half months of leaderless operations.

The impact of this on firms' performance is disastrous. Business leaders estimated the average period of disruption to frontline operations of acquired companies to be a staggering two and a half years. A quarter of mergers studied had still to reach complete integration as much as three years after the deal. Of those which had already achieved complete integration, the average time taken was 19 months.

Yet significantly, companies appointing a new management team as early as the due diligence stage are more than twice as likely to reach full integration within a year, significantly reducing disruption time. Close to half – 46 per cent – of firms under new management from an early stage managed this, compared to less than a quarter of those failing to put in place a new management team during due diligence.

Conclusion – the perfect match?

The value a successful merger can create is undisputed. Despite the impact of recent sub-prime lending on the average availability of credit overall, M&A remains a trusted weapon in the growth strategies of organizations. Private equity firms remain hungry for investment opportunities, at least in the medium-term.

Yet buyers must pay due attention to a company's real value: that which is found in its boardroom, human capital and business culture. A keen strategic focus on these intangible assets is vital not just during courtship, but throughout the merger process, if acquirer and acquired are to enjoy a long and prosperous future together.

When the balance is achieved between tangible and intangible assets it provides a solid foundation for strategic growth and ensures return on investment. It also allows senior executives to embrace the leadership challenge in a realistic way. This approach is reassuring for financial partners and shareholders. The degree to which those responsible for merger strategy prioritize getting the intangibles right can make the difference between an engaged, productive workforce and acrimonious opposition; between a brave new world of value and all-out warfare.

Achieving a marriage of business cultures will make the difference between lucrative return and expensive failure. After all, divorce is a costly business.

About Hay Group



Hay Group is the only management consultancy that helps merging organizations manage both the intangible as well as tangible assets involved in a merger or acquisition. We help businesses ensure that the value of the newly formed organization is realized right from the start.

Hay Group's global M&A practitioners have extensive experience of working with senior leaders to bring an objective perspective to the M&A process, helping to keep the focus of the new organization on what matters externally: customers.

An expert view of the assets and interests of the companies involved in a merger or acquisition and of the issues and challenges faced throughout the transaction can greatly enhance the speed of integration and the sustained success of the new company.

Hay Group is a global consulting firm that works with leaders to turn strategies into reality. With 89 offices in 47 countries, we work with over 7,000 clients across the world. We develop talent, organize people to be more effective and motivate them to perform at their best.

Hay Group helps merging organizations by:

- clarifying merger or acquisition strategy and aligning top teams around new strategic intent
- creating new governance processes, defining new operating models and executive management structures
- identifying and managing the risks to tangible and intangible assets
- establishing transitional management, leadership and synergy teams to speed up integration
- developing communication strategies and processes that help to engage employees and build workforce commitment

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Dangerous Liaisons

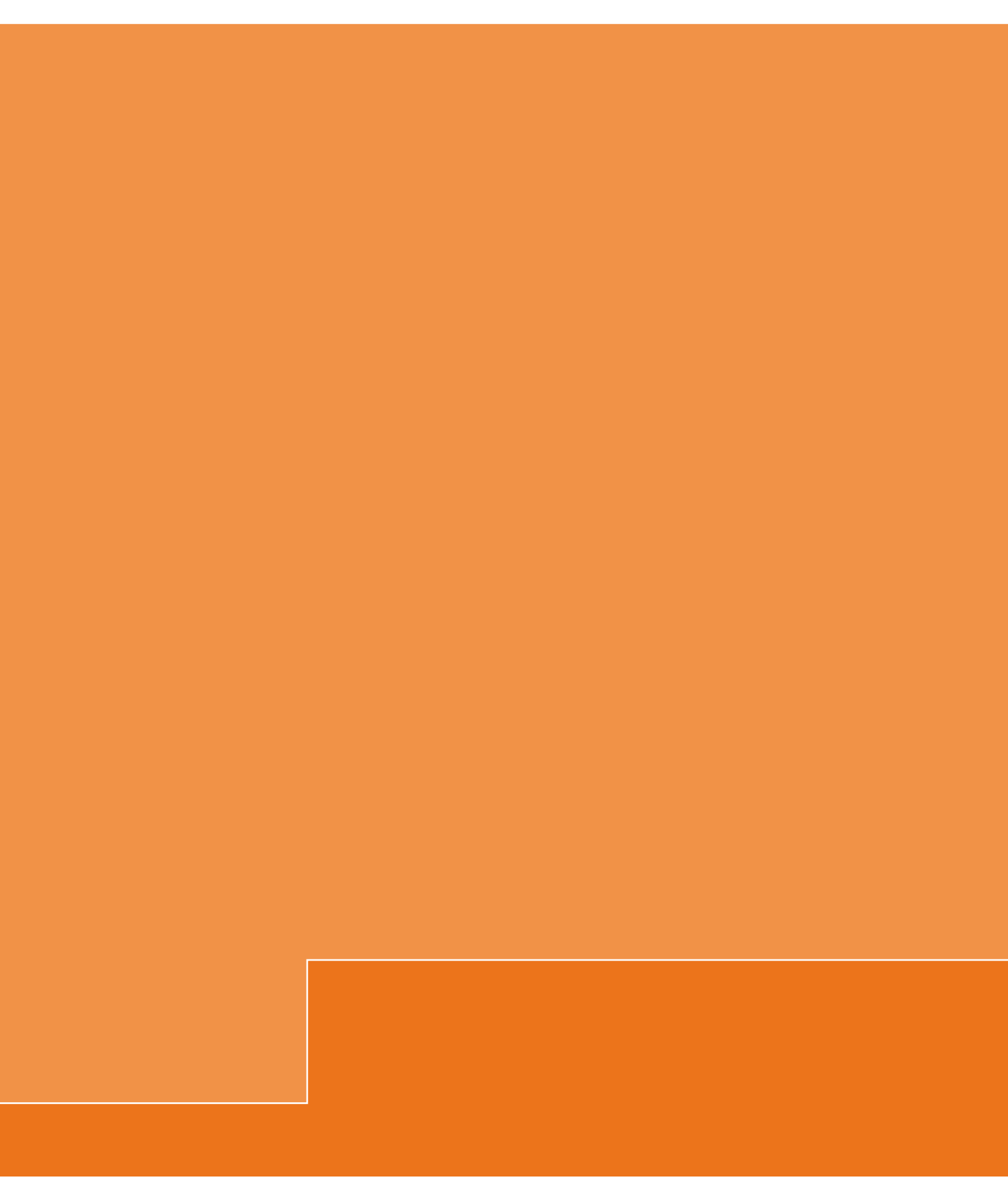
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