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Getting Fit for Mergers and Acquisitions

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Leading Ideas

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by Deniz Caglar and Michael Connolly

The company had a history of growing through acquisition. But using rollups to become a leading player in a fast-growing niche of services and technology had saddled the company with a complex organizational structure and significant inefficiencies.

Now, as it prepared for its biggest acquisition ever — that of a global company that would increase its size by a third — the company decided to take a comprehensive look at its costs, operating model, and organization. Over the course of a year, the company analyzed all of its major selling, general, and administrative functions and processes and set about reinventing them. The result: By the time the acquisition was complete, the company was much better organized and had an operating model that would allow it to efficiently absorb the new acquisition — and help the whole enterprise run better.

In preparing for this transformative acquisition, the company used an approach we call *Fit for Growth.** This powerful discipline, which is described in detail in the book *Fit for Growth: Strategic Cost Cutting, Restructuring, and Renewal* (by Vinay Couto, John Plansky, and Deniz Caglar; Wiley, 2017), rests on three pillars. First, companies that are fit for growth focus on a few differentiating capabilities that lie at the heart of their competitive advantage. Second, they align their cost structures with those capabilities. Recognizing that not all costs are bad, fit-for-growth companies manage their costs tightly and thoughtfully, freeing up funds to further invest in the "good" costs that strengthen a company's differentiating edge. Third, they organize for growth. Based on their differentiating capabilities, fit-for-growth companies design an operating model that enables and sustains cost reductions and then create the right conditions for managers to drive growth.

Typically, the *Fit for Growth* approach is used to realign existing resources at established companies with long operating histories. But it can also prove to be a powerful lever when companies are reorganizing and changing shape because of a significant merger, acquisition, divestiture, or spin-off.

A *Fit for Growth* mind-set can be pivotal in helping a company transfer newly acquired capabilities to other parts of its enterprise.

To understand why the *Fit for Growth* approach is so valuable in combinations or separations, remember that success in deal making — a high-stakes, expensive undertaking — is never assured. Our research shows that successful deals tend to fit with or enhance acquirers' core capabilities systems. Deals that don't have such a capabilities fit usually fail to create shareholder value. At the same time, it is clear that companies are putting more at stake when they undertake transactions. There has been a resurgence in the number of transformational deals, as companies set out to expand their market reach, broaden their product portfolios, and add significantly to their technical resources and management talent. In a 2017 PwC survey, 54 percent of respondents said that their company's biggest deal in the last three years had been "transformational," up sharply from 29 percent in 2010.

Amid the pressure to eliminate redundancies and find synergies, deal-making teams can easily lose sight of what's important and of what needs to be preserved. That's why *Fit for Growth* has special relevance in deals. It provides a set of guidelines that ensure the deal is being sought for the right reasons, that the right synergies are being pursued in the right ways, and that the new businesses are being stood up the right way — across all phases of M&A or separation.

Adding Value at Every Step

The *Fit for Growth* approach can help with every phase of a deal, from due diligence to postmerger integration planning to actual integration.

Due diligence. After a global food manufacturer decided to buy some smaller brands — a departure from its history of focusing on high-volume brands and large-scale operations — it had to decide whether to manufacture the new food products at its own plants or maintain the plants of the acquired company. A company steeped in the advantages of scale will revert to what it knows, which in this case would have meant bringing the acquired products into one of its existing plants with excess capacity. But as executives discussed what made the acquired company unique (i.e., its differentiating capabilities), the conversation kept returning to packaging. It turned out the acquired company's distinctive packaging could not be easily replicated by the acquirer in its own plants, at least not right away. As a result, the acquirer decided not to consolidate production at its facilities.

In this case, the *Fit for Growth* lens applied to due diligence prevented an operating model change that could easily have confused customers and destroyed the deal's value. A *Fit for Growth* mind-set can also be pivotal in helping a company transfer newly acquired capabilities to other parts of its enterprise — sometimes with striking results. Although *diligence* is typically used to describe the financial and market analysis that precedes an offer, we

Illustration by David Suter

employ a broader definition. In our parlance, *diligence* describes an attitude of curiosity and an openness to outside ideas that the best acquirers always maintain when an acquisition is in some sense transformational. That sort of diligence can and should go beyond the point where the deal has been signed; indeed, it should continue after the acquired company has been fully integrated.

Integration planning. Before it completed its acquisition of the company that would increase its revenues by a third, the services and technology company referenced above had a problem to fix: its method of turning orders into cash. The company's model was primarily geared toward making the sale, and only secondarily toward collecting the cash that was supposed to flow from the sale. As a result, the accounts receivable department was not allowed to approach customers about late payments; that was the sales force's responsibility. Yet the sales force, whose compensation was tied to making sales, had no incentive to chase down slow-paying or nonpaying customers. What's more, the sales team often consented to nonstandard contract terms — a practice that complicated billing.

The cost-restructuring component of the *Fit for Growth* framework has two broad categories that proved helpful as the company, seeking to re-create its cash collection system, prepared to absorb the new entity. The first was its operating model, which has to do with where companies perform specific activities. The second was its level of operational excellence, which has to do with how companies carry out those activities.

These two filters helped the company rethink its process for collecting cash, resulting in changes to decision rights, performance metrics, and ultimately the contracting guidelines themselves. In hindsight, it may seem that the need to address these issues before bringing an additional business into the fold should have been obvious. But if the company had taken a different approach to M&A, leaders might have focused on preserving the existing model instead of rethinking how the core work should be done.

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Separation planning. Divestitures of units or assets offer companies a rare chance to move away from operating models that have long since ceased to make sense, and to build a new company (or new companies) with only the needed assets and tailored organizational models.

In many instances, *Fit for Growth* thinking has made a crucial contribution to a separation effort. A financial-services company had two categories of products, one that was subject to intense regulation and one that wasn't. A *Fit for Growth* program was put in place to remove the inefficiencies so that what had been a single large company with too much cost could become two companies, each with just the right amount of resources to deal with the relative level of regulation. A *Fit for Growth* cost reduction lever called "zero basing" — which assumes that every cost can be eliminated until someone demonstrates otherwise — was instrumental in streamlining the support functions of both new companies. It worked because the cost-cutting decisions were tied to a detailed capabilities assessment.

Portfolio reviews. Another area of M&A in which the *Fit for Growth* approach can be useful is in helping companies see the business and product lines they should or should not be in. Asking a company where its core strengths are, and why customers keep coming back, helps leaders understand the investments that were essential to the company's success. This is true on a micro level, for example when deciding which product or service attributes make a difference, which parts of the staff are needed, and which customer service policies work. But it's also true on a macro level. After we embarked on this line of inquiry with another global food company, it rapidly became clear that its private-label business, which was consuming a large quantity of resources without producing a commensurate profit, required different capabilities from the core business. That prompted the company to sell the private-label business and invest the proceeds in a few innovative brands that executives felt would work better in the company's own system of capabilities.

Constructing postmerger models. The term *discovery* is often used narrowly in M&A, to refer to the preliminary analysis a prospective buyer does to figure out if it really makes sense to buy an asset. In a *Fit for Growth* context, however, the idea of discovery carries a larger operational meaning. It suggests that companies should look for the right model for what they are trying to put together — or take apart. This is very different from the default approach, in which the acquirer assumes its model is best and everything is expected, after the close, to conform with that model.

The *Fit for Growth* methodology itself forces companies to consider models that may suit the post-deal environment better. Companies that make acquisitions and merger decisions through a capabilities lens and adopt a *Fit for Growth* approach through the process will have a higher chance of success. ✚

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