strategy+business

Six Rules for the New CFO

by Irmgard Heinz, Jens Niebuhr, and Justin Pettit

from **strategy+business** issue 53, Winter 2008

reprint number 08404

booz&co.

Reprint

Six Rules for the New CFO

As central figures in mergers and acquisitions, today's chief financial officers are redefining the practices of their profession.

by Irmgard Heinz, Jens Niebuhr, and Justin Pettit

Illustration by Lars Leetaru

The most unique advice on mergers and acquisitions (M&A) that Aditya Mittal has ever heard came from a Roman Orthodox bishop. The CFO of Mittal Steel was considering how to turn around a newly acquired and struggling steelmaker in Romania when the local bishop told him to build a church at the entrance to the facility. "I'm telling you that will work wonders," the bishop said. Mittal was taken aback, but decided to follow the advice. "We built a beautiful Roman Orthodox church; all the workers got involved in it part-time. And that changed everything," says Mittal, remembering how the integration barriers dropped away and the plant's workers embraced a new beginning. Thus a church played a key part in the success that the company, now ArcelorMittal, the world's largest steelmaker, has had in Romania.

The story makes an important point: Not every deal is done by the same rules, and no one strategy fits every company. There are many ways to succeed at M&A, a fact made clear in 15 interviews with CFOs of leading companies recently published in the strategy+business Reader *The CFO as Deal Maker: Thought Leaders on M&A Success*. There's Johnson & Johnson, which lets most of its acquired properties operate independently in a decentralized model, and Henkel AG, which prefers to integrate them to the extent economically sensible. There's Deutsche Telekom AG, which says M&A success is about capturing synergies, and Merck & Company Inc., which says M&A is about obtaining a stake in promising new discoveries.

Strategy, Synergy, Integration

And yet, for all the differences in how companies approach M&A, our work with financial executives over the years and our interactions with them in the course of conducting these interviews have led us to conclude that all CFOs play three basic and essential roles in the merger process.

The first role is as one of the company's *key merger strategists* — the executive who, along with the CEO, ensures that the merger plan meets larger corporate objectives.

This means the CFO's role isn't limited to ensuring that the deal is financially sound; it extends to posing more qualitative questions to those championing the deal: Is the target appropriate? Why? What could go wrong? CFOs ask these questions not just to understand the potential problems, but also to get a clear sense of the upside, so that when deals go forward, they can articulate the vision and help turn the company's various stakeholders into believers.

Indeed, one of the strategic decisions in which CFOs need to participate is what sort of deals their companies should pursue. Traditional deal making is only one tool in most companies' growth kits — and "not necessarily the one that gets the most use," says Peter Kellogg, the CFO of Merck. Nowadays, many companies pursue partnerships that involve licensing and joint development, manufacturing, and marketing initiatives. "We seek to find a win-win approach that is financially logical," Kellogg says.

The CFO's second role is as the deal's *synergy manager*. Synergies can take several forms, including cost savings achieved by consolidating operations and increased sales through new capabilities. Regardless of the type of synergy, the CFO plays a key role in creating the post-merger integration plan and identifying the people who can execute it. Good synergy managers know the value of financial incentives, but they don't leave anything to chance; they also institute monitoring systems that tell them if things are going awry.

This role is increasingly essential, because the window for capturing synergies closes quickly. Thus, to capture synergies in a timely manner, Deutsche Telekom plans the integration before the deal closes and makes a board member responsible for its execution. In the first year, too much is at stake to let an integration effort go off in the wrong direction, according to CFO Karl-Gerhard Eick.

The CFO's third M&A role is as *business integrator* — identifying the changes related to personnel, processes, and organizational structure that will best bring out a deal's value. CFOs certainly play a hands-on role in bringing together the finance organizations of two previously separate entities, but there is also a role for CFOs in integrating departments outside finance.

CFOs should define the metrics and establish the goals that must be achieved to justify a deal's purchase price.

CFOs and their teams should define the performance metrics and establish the goals that must be achieved to justify the deal's purchase price. These goals may be tied to the company's compensation systems, putting the CFO at the heart of incentive design.

CFOs also must ensure the monitoring of progress against targets, a measurement and tracking function that is critical to successful

Irmgard Heinz
(irmgard.heinz@booz.com) is a partner with Booz & Company in Munich. She focuses on organization, change, and leadership and is head of the firm's European performance management practice.

Jens Niebuhr
(jens.niebuhr@booz.com) is a partner with Booz & Company in Düsseldorf. He specializes in IT strategy and organization, finance, and performance management, primarily for the telecommunications industry.

Justin Pettit
(justin.pettit@booz.com) is a partner with Booz & Company in New York. He specializes in shareholder value and corporate finance and is the author of *Strategic Corporate Finance: Applications in Valuation and Capital Structure* (Wiley, 2007).

This article is adapted from Robert Hertzberg and Ilona Steffen, eds., *The CFO as Deal Maker: Thought Leaders on M&A Success* (strategy+business Books, 2008).

postmerger integration. Finally, in order to reach these targets, CFOs who act as business integrators often sponsor synergy-oriented education and training programs or business literacy workshops that teach employees how to identify the key value drivers within their control and how to attain performance goals.

In fulfilling these time-tested roles and succeeding at M&A, leading CFOs become critical enablers of corporate growth. Here we present the six rules that CFOs should follow to ensure that when it comes to M&A, one plus one will equal more than two.

Shape the Strategic Intent

The CFOs repeatedly told us that all deals must support their companies' long-term value-creation strategies. To do a deal for a short-term reason, such as meeting a forecasted number, is usually a mistake. "It's dangerous to target levels of growth because then you may overpay," warns Johnson & Johnson CFO Dominic Caruso.

Deals can be done to add scale, to position a company in a promising geographic market, to expand a product line, or to gain better control of the supply chain. Sometimes, deals are done simply to add new capabilities. This is true of both Johnson & Johnson, which has completed more than 70 deals in the last decade, and of UnitedHealth Group Inc., which has done almost 100 deals, many of them small. "A lot of them were done to piece together capabilities," says CFO of UnitedHealth G. Mike Mikan. (See "How to Win by Changing the Game," by Cesare Mainardi, Paul Leinwand, and Steffen Lauster, *s+b*, Winter 2008.)

Whatever the strategic intent of a deal, the CFO needs to help shape and communicate it. In particular, the CFO must have the resolve not to be swayed by the market's initial response. In a bull market, investors sometimes throw up their hats to celebrate an acquisition that, in the long run, will damage or even bankrupt the acquirer. This was common during the dot-com boom. The opposite also sometimes happens; during bear markets, fundamentally sound deals can get an unwarranted thumbs-down from wary investors.

Time pressure heightens M&A risks, such as paying too much and giving short shrift to essential internal processes.

As one of the deal's key strategists and its clear-eyed analyst, the CFO has the responsibility not to be dissuaded by either unrealistic optimism or groundless pessimism, but to stay the course.

Anticipate Your Opportunities

We have all heard it before: "Company X acted opportunistically in an M&A setting." The implication is that a profitable deal emerged unexpectedly and that the buyer or seller pounced on it. Our experience, however, is that out-of-the-blue opportunities are quite rare, and to the extent that they require quick action, there is often not enough time for a rigorous pre-deal assessment. Extreme time pressure heightens M&A risks, especially those of paying too much and of giving short shrift to essential internal processes. The company that boasts of having made an acquisition "opportunistically" is often revealed later to have simply acted in haste.

This is not to say that speed isn't important; it is vital in M&A. But it's an advantage enabled by advance preparation. Such preparation increases the likelihood a company will get in early on an attractive deal and wrest momentum from rival bidders. This is what Bayer AG accomplished a few years ago, after a bid from a rival drug company put Schering AG in play. Bayer ultimately prevailed, completing a deal that extended its holdings from chemicals into pharmaceuticals and that gave it a promising franchise in oncology. But the deal never would have happened if Bayer, which is committed to preparation, hadn't been working off an existing list of potential acquisitions that included Schering. "We had already done our homework" when Schering became a candidate for acquisition, Bayer CFO Klaus Kühn says. Merck, another drug company, prepares in a different way. It employs dozens of regional scouts whose job is to stay abreast of molecular discoveries at universities and startup biotechnology companies. This increases the likelihood that Merck will be one of the first to know when an interesting partnership opportunity arises.

Advance preparation can also help in the financing of a deal. In 2002, after being appointed CFO at Spanish telecommunications company Telefónica SA, Santiago Fernández Valbuena spent long hours courting commercial banks to establish open pipelines to capital. That groundwork paid off in 2005, when Fernández Valbuena secured financing for the company's US$32 billion bid for the mobile and broadband service provider O_2 over the course of a weekend.

Never Overpay

Among the many mistakes that companies can make in M&A, the truly irreversible one is paying too much. There is no recovering from an acquisition that doesn't earn its cost of capital and that ends up diminishing the company's profitability or burdening it with a debt load that it cannot service. "If you can't build the case for how you're going to make money, you shouldn't go after a certain target," says Kurt Bock, the CFO of chemical company BASF SE.

Leading financial chiefs determine the value of potential targets in several ways. They triangulate value through multiple analytic methods, and they subject critical assumptions and other risk factors to a comprehensive sensitivity analysis. But even the most detailed numerical forecast isn't always sufficient. The problem is that the model's output is only as good as what goes into it — and synergy assumptions are a big part of that input. Aware of this, CFOs do not rely solely on the synergy estimates of the business managers who propose the deal and are pushing for it; they also call on centralized M&A departments, whose job is to view the economics more dispassionately.

A centralized M&A staff, with its breadth of experience, can also play an important role in spotting some less-obvious risks of M&A. The departure of essential employees and the possibility of regulatory change and culture clashes, especially when the parties merging are from different nations, can hurt revenue and profits, and can turn what may look like a sure bet on paper into a losing proposition.

Winning CFOs use creative deal structures to lower the risk of paying too much. Merck CFO Kellogg, for instance, recommends structuring riskier deals so that a portion of the payout is contingent on the target's achieving key milestones. Where feasible, these "earnout" mechanisms can be very effective in mitigating the risk of overpayment, aligning interests, and bridging the gap between the future expectations of buyers and those of sellers. The deal structure is also often designed to incorporate other elements of risk management, such as the form of consideration or the use of collars on stock deals.

Cash In Your Synergies

Once a deal is done, investors judge CFOs on their ability to deliver on promises and achieve synergies. There is generally little question about what is expected; CFOs have created these expectations themselves, by talking to the equity markets, often in considerable detail, about the deal's economic rationale. In today's demanding business environment, there is no time for blurry plans, timid decision making, or ambiguous communication.

Woe betide the CFO who has not already created a detailed implementation plan and convinced the business units of its urgency.

"When the deal closes, it's already 70 percent predetermined to be a success or a failure," says Deutsche Telekom's Eick. "If you aren't able to flip the switch and get started at that moment, it's too late." To meet the demands of planning implementation, CFOs need a dedicated financial control capability that enables them to keep track of critical events, measure the size and robustness of identified synergies, and create an unbiased and comprehensive picture of a deal's results. Integration plans should include a clear time line of milestones and hold specific managers accountable for achieving them. When the deal is closed, financial synergies that were once theoretical discussions should be embedded in budgets, and nonfinancial synergies should be tracked as integral parts of synergy scorecards.

CFOs should also ensure that every manager involved in capturing synergies has skin in the game. Four-fifths of the CFOs we interviewed said they create such incentives. ArcelorMittal CFO Mittal, for instance, instituted a "very simple" yet effective compensation plan that tied bonuses to achievement of some of the synergies expected in the merger that transformed Mittal Steel into ArcelorMittal. Those who didn't achieve 85 percent of the budget, which captured the synergy and value plan, got no bonus.

Some CFOs ask managers of acquired companies to participate in discussions about the available synergies as a way of getting their buy-in. This can be a smart way to mitigate the risk, present in all acquisitions, that key people will leave and morale will suffer, hurting financial results and causing customers to defect. The Italian energy giant Enel SpA did this when it bought Endesa SA, a Spanish counterpart, in 2007. Instead of unilaterally imposing a set of cost-control goals on Endesa, Enel assigned one Enel manager and one Endesa manager to collaborate on individual synergy targets. "You can't just walk in and say, 'You need to achieve €600 million [US$930 million] in synergies,'" says Enel CFO Luigi Ferraris. "You have to involve [the acquired company] in the process of making the analysis and coming to the same conclusion."

Finally, if a deal's synergies are not achieved, it often falls to the CFO to explain why. This is another task that should not be put off, if credibility with the capital markets is to be maintained. In these cases, the CFO should communicate as quickly and clearly as possible the root causes of the problem, the corrective action being taken, and revised estimates for the deal's economics.

If a deal's synergies are not achieved, it often falls to the chief financial officer to explain why.

Build Trust in Future Success

Much of the acquired value of a deal hinges on existing employees. People maintain operations, own trusted client relationships, and develop market insight. And yet in almost every acquisition, key staff members and managers react with concern to news of the transaction, wondering what it will mean for their future. Many workers lose focus; some consider leaving, and others do leave.

CFOs can mitigate this risk in a number of ways. For example, they can resolve staff uncertainty as expeditiously as possible. This means making fast-track decisions about organizational structure and staffing, as well as about governance and decision rights. With certain acquisitions, it may mean dealing forthrightly with labor issues. But the aim is always the same: to cut short internal speculation and re-engage people in the business as quickly as possible.

Making postmerger management appointments on the basis of merit can be a powerful retention tool. Key staff members usually take stock of the acquiring company's discipline and objectivity before deciding whether to stay. Mittal remembers that after the mammoth acquisition that brought Arcelor to Mittal, the onetime Arcelor people were standoffish, expecting "to be second-class citizens." They were in for a pleasant surprise. "We operate as a meritocracy, on an honest, transparent, and fair basis," Mittal says.

Don't Compromise on Control

For all their far-reaching responsibilities during an acquisition, CFOs ultimately must lead and reshape the finance function itself. This can be a huge challenge, because the reporting processes, information systems, and control tools of the acquired company often differ sharply from those of the buyer. And time is short — the new company generally has to meet deadlines for its upcoming quarterly statements, and the control and compliance requirements must not be compromised.

We find that leading CFOs break the finance integration challenge into three phases: a first phase focused exclusively on fulfilling external reporting requirements; a second phase intended to establish a set of common financial practices; and a third phase aimed at transforming the entire finance function into a world-class operation, while consolidating operations.

In the first phase, which typically takes place during the first 100 days after the transaction, the lack of structure can be somewhat daunting. The treasury and corporate finance functions in the new merged structure must be immediately operational, even though organizational decisions that will form the basis for the new external reporting structure are often still pending. It usually requires a powerful project management effort, based on the most likely hypotheses and scenarios, and aligning stakeholders with essential tasks, to ensure on-time data exchange and input from a variety of sources and to guarantee the quality of the final audit report.

During the second phase, which often starts in parallel with the first phase, best-in-class CFOs do several things. They identify the control capabilities the finance department will need; shift their attention to planning and performance management; and determine the financial processes, systems, and tools the business units will use. From a practical standpoint, it is often best to follow a dominant-model approach in this phase, which typically means adopting the acquirer's model, to ensure financial control and compliance. The emphasis is on getting a robust solution in place quickly — not on holding out for super-sophisticated structures for the merged enterprise.

It is after the basic finance operations are established that CFOs can work on the long-term changes that will make their finance departments more effective and efficient. This is the third phase, and it entails instituting global standards for structures, processes, and practices to simplify financial control and compliance issues. The best CFOs seize this opportunity to take a fresh look at their established systems, processes, and practices with an eye toward upgrading them.

Throughout this transformation process, CFOs ensure that overarching quality and compliance standards are met. This is what Ferraris, the CFO of Enel, did after his Rome-based company made acquisitions in eastern Europe in 2006 and was assigning business unit CFOs to oversee those operations. "I have always sent in an Enel executive to implement the financial control function and a reporting system to ensure that we are speaking the same language," Ferraris says.

The three roles of CFOs in mergers and acquisitions (strategy, synergy, and integration) and the six rules of M&A provide a sound foundation for success, but ultimately, the opportunity for corporate growth and profit through M&A is constrained by only one thing: the willingness of companies to enhance their capacity as deal makers by taking well-calculated risks and using innovative strategies and tools to achieve success. +

Reprint No. 08404

strategy+business magazine
is published by Booz & Company Inc.
To subscribe, visit www.strategy-business.com
or call 1-877-829-9108.

For more information about Booz & Company,
visit www.booz.com