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Making the Most of M&A

by Gerald Adolph and Justin Pettit

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Mergers and acquisitions are becoming more critical — and more perilous — than ever. You can build your capabilities, even in the midst of turmoil.

Making the Most of M&A

by Gerald Adolph and Justin Pettit

The credit collapse and economic crisis of 2008–09 may have reduced the number of merger and acquisition deals in the short run, but it has increased the importance of M&A capabilities going forward. Industries are consolidating and restructuring with increasing speed — sometimes by choice, and sometimes by government fiat. Companies with available cash are pursuing an increasing array of acquisition opportunities presented to them as the crisis unfolds. Just in the pharmaceutical industry, in the first three months of 2009 alone, Roche bid US$40 billion for Genentech, Pfizer agreed to buy Wyeth for $68 billion, and Merck said it would acquire Schering-Plough for $41 billion.

At the same time, the pressure to avoid failure, in deal making and execution, has never been so high. Years ago, a company might have had more time to fine-tune the details, or a chance to recover if its M&A initiatives went sour. Today, the margin for error is much reduced. Capital is more expensive, the time granted by investors to produce results is shorter, and there is less slack in the balance sheet to recover from missteps. If the postmerger integration falters, then analysts grow skeptical, shareholders look for the exits, employees become restless, regulators and prosecutors get curious, and competitors pounce.

The Greek historian Herodotus could have been talking about M&A when he said, "Great deeds are usually wrought at great risks." But too many companies are unprepared for dealing with the complexities of M&A risk. World-class capabilities are not built overnight; they are developed and refined over several years and multiple transactions.

Illustration by James Steinberg

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Moreover, many companies diminish their effectiveness by managing M&A as a linear process. They treat each stage of a deal as if they were handing off the baton in a relay race, switching from the boardroom team, to the negotiating team, to the integration planning program leaders, to line management. This approach lengthens the time line of the acquisition, exposes the newly merged company to the impatience of the markets, and makes it harder to resolve issues early — so they surface later, causing additional delays and difficulties. The alternative is to pursue the stages of M&A in parallel (with substantial overlap and continuous referencing back and forth), managed by a single large team whose members communicate easily and regularly with one another and with the rest of the organization. This type of process places great demands on resources, time, and staff. But the results are worth the added effort. To understand this approach, consider how the process works for more experienced M&A leaders during the four basic stages of any merger or acquisition.

Stage 1: An Enhanced Pre-deal Business Case

An effective M&A process begins before any deal is considered — with senior management setting out a road map for future growth. This road map is not only a traditional long-term strategic plan, but rather a detailed set of proposed milestones toward the strategic goals of the company integrating mergers and acquisitions, organic growth investments, and alliances. The road map provides a foundation for understanding the kinds of deals that a company should pursue, and establishes a "sanity check" to make sure there is a compelling business case for all proposed deals.

With that road map in hand, the chief financial officer and M&A team can make an objective assessment of a deal's prospects. In today's environment of skeptical stakeholders, the traditional narrow business case — a financial snapshot of a deal's attractiveness, including a broad description of long-term benefits and little discussion of potential execution problems — is no longer acceptable. Instead, a thorough analysis must show whether the combined company can realize the full value of the transaction. This might mean answering questions such as:

• How accurate is our perception of the business environment? What are we assuming about regulators, customers, and competitors?

• How might those assumptions, often developed from our first impressions, differ from reality? (For instance, will the merger invite new competitors?)

• What makes us believe that the combined company can succeed any better than the parts would on their own? Is an acquisition the only way to capture these synergies?

• What capabilities does the acquired company bring, and where are there gaps that could threaten the new company's success?

• Can we successfully integrate the operations? What will the talent attrition rate be? Do we have the financial resources that the combined company will need?

If a transaction aligns with the broader growth road map, it may be worth more than its stand-alone value. If it doesn't fit, or if the warning signals are too daunting, an experienced acquisitions team should be prepared to pull out of the deal.

Johnson & Johnson (J&J) has proven itself adept at this process over the course of roughly 70 acquisitions since the late 1990s. In describing two deals — one a

$23 billion offer for Guidant, which J&J decided to abandon when the bidding rose too high, and the other a $16.6 billion deal for Pfizer's consumer health-care business, which was successfully concluded — CFO Dominic Caruso makes clear that the business cases for the two were different, but equally well thought out.

"We always begin with our strategy," explains Caruso. The Guidant transaction, he says, offered an "opportunity to add a microelectronics capability that was primarily implemented in our market approach to cardiac rhythm management. But the real underlying capability that existed there was the microelectronics. We went after it as an opportunity to add that new base of technology to the business.

"Pfizer represented a different kind of opportunity; they were strong in certain geographic markets where we weren't [and vice versa]," Caruso continues. "For instance, we had a much stronger presence in China than Pfizer did. That was good because it meant we could sell more of their products there. Whereas in a market like Mexico, Pfizer had stronger ties than we did. So that turned out to be a nice set of complementary growth enablers."

Stage 2: Strategic Due Diligence

A traditional due diligence exercise, defined narrowly, is intended to validate, verify, and "stress test" the financial and legal aspects of the business case. But as business cases become more robust, due diligence should become more comprehensive. *Strategic* due diligence seeks to answer two questions: First, is it reasonable to conclude that the deal will produce an enduring, attractive economic return? Second, can we validate that the participating companies have the skills necessary to deliver on that promise?

To answer those questions, the team must assess such issues as the combined leadership talent, the likely responses of potential competitors, and the risk of technological or cultural incompatibilities between the two companies. Chief Financial Officer Marcus Schenck of the German energy service provider E.ON AG described the company's strategic due diligence process this way: "Once our people have developed a business plan for a possible takeover target, we ask tough questions to see whether they really have thought everything through. 'Is there really a market? Are market price assumptions realistic? What do we know about the costs? Will there be regulatory hurdles? How easy will it be to implement this? What will the competitive reaction be?'…Of course you have to have a good grip on the financials, but you also have to have a gut feeling for the things that could go wrong and where to find them."

Stage 3: Plotting the Postmerger Integration

It is easy to recognize poorly crafted integration plans. They often set lofty goals but leave line managers to figure out the details. The worst plans are simply paper exercises that no one really intends to follow after the close. By contrast, in a well-designed planning process, the integration team articulates what each function, business, and geography should look like after the merger, and what each team should do to bring the plan to life:

• **Translating the strategic intent into integration guidance.** In the new, postmerger company, the important functions, geographies, and lines of business will have questions. They may ask if the merger is part of a push toward consolidation or an entry into an adjacent market. Some will want to know if the acquiring company intends to transform the entire organization, absorb the merger partner, or simply attach it and allow it to function independently.

• **Building external stakeholder enthusiasm.** In the wake of a merger, it's easy to become consumed by internal tumult, but often the ability to succeed in the long term is shaped by the response from outside. Important constituents include customers, franchisees, supply chain partners, regulators, schools and other talent markets, local communities, municipal governments, and alliance partners. For communications with each of them, the integration plan needs to spell out what to say, when to say it, and what specific action plans need to be in place to deal with their concerns.

Focus first on those stakeholders who are critical to the deal's success and whose support the company is most at risk of losing. Learn about their concerns and the reasons the merger has triggered resistance; then,

Seizing Opportunities in the Financial Sector

by Alan Gemes, Ivan de Souza, and Roberto Marchi

Upheaval in the capital markets is producing the most significant structural changes in the global financial-services industry in decades. Governments and regulators around the world are encouraging and leading this restructuring to a much greater extent than ever before. Besides assuming significant stakes in the industry themselves, they are offering financing alternatives to those willing to take over ailing institutions, create stronger balance sheets, and participate in market restructuring.

The most capable financial institutions are seizing this opportunity to acquire competitors, increasing their scale and seeking to benefit from the market discontinuity. This pattern was established at the beginning of the crisis, when JPMorgan Chase acquired Bear Stearns and Washington Mutual, Barclays acquired assets from Lehman Brothers, and Bank of America bought Merrill Lynch. Similar M&A activity continues in retail banking, mortgage banking, investment banking, and other sectors.

But just as in the past, when mergers and acquisitions often failed to meet the lofty expectations for value generation that were held by those who initiated them, too many financial institutions today are not prepared. They lack the proper tools and processes to fully understand the inherent worth of firms they are contemplating acquiring. And it often becomes clear, after the event, that the acquirers have not sufficiently thought out their integration game plans. They have focused on retaining talented professionals by addressing the cultural differences between the combined firms, devising large-scale internal communication programs, implementing large training programs, integrating operational and technological platforms, and eliminating overlaps and redundancies.

All of those familiar practices remain important and worthwhile. But in these troubled times, they are insufficient alone. Three additional integration success factors are particularly important.

First, executives of acquiring institutions need to quickly assess and manage the risks facing the new enterprise. Integration teams must quickly determine the status of the book of business (the accounts and commitments held by the company being acquired), looking for fragilities associated with the current environment (for example, derivatives and mortgage-backed securities). This is all the more relevant today because due diligence teams have very limited time to conduct an in-depth appraisal of a target's financial statements. At the same time, those statements have become significantly more complex because of the use of new leveraged instruments. Management should also resist the temptation to immediately lay off staff involved with poor credit decisions, because these individuals may possess important knowledge of relevant transactions and internal procedures.

Second, in a market fraught with fear, management needs to recognize that even minor operational mishaps affecting customers could cause them to take their business elsewhere. This is not a time to place operational efficiency above customer loyalty. So acquirers need to pay special attention to reliability during the transition period, even at the expense of running platforms in parallel for a while.

Finally, remember that the staff of the institutions being acquired may feel distressed. This makes it even more important to boost the morale of the integrated staff and to win the loyalty of the employees of the acquired institution. The starting point for this is a transparent and fair performance appraisal process, which will encourage competent staff to remain in the merged organization.

As challenging as today's climate may be, it clearly represents historic opportunities for the survivors and the consolidators. Financial institutions that can take advantage of M&A opportunities and also integrate the acquired firms in a thoughtful and value-preserving manner will emerge as strong players.

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One newly merged company had to delay its launch schedule to arrange a helicopter capable of hoisting the letters of its new name to the top of its headquarters building.

armed with this knowledge, explain the purpose of the merger and its benefits for them.

• **Designing "one company."** Creating a single enterprise from two formerly independent, and often competing, organizations is a daunting task. It requires lofty thinking, but it also entails sweating the smallest details, such as identifying which contracts contain change notification clauses and which signs must be changed on which buildings. One newly merged company had to delay its launch schedule to arrange a helicopter capable of hoisting the letters of its new name to the top of its headquarters building.

A good plan for a positive "one company" outcome describes the necessary changes in organizational structures, systems, and processes. It specifies the staffing levels needed by the merged company, which physical locations will be eliminated, which business partners will be kept, and which incentive structures and business systems can be combined. It sets forth specific milestones and identifies who will be responsible for each element of the plan. This detailed sequencing of all the transition steps allows management to approve the timing of captured synergy and implementation costs. It also helps functional teams plan how to fill resource needs in critical areas such as IT, training, and finance.

• **Capturing near-term value and positioning for upsides.** There is enormous pressure to demonstrate clear progress during the first year or two of a merger. The key to managing that pressure is to enable a balanced pace of short-term synergy: fast and fierce enough to keep the faith of stakeholders by demonstrating tangible results, but not so aggressive as to sap the new organization of morale, talent, and energy. Typically, a company has six to 12 months to start delivering results in the most obvious areas, such as savings from eliminating redundancies and capturing cross-selling opportunities. But to fully deliver on a merger's promise and unlock the new company's potential, the transition teams must improve the way business is done — not just folding together the combined companies, but rethinking the new company's infrastructure and processes.

• **Energizing the teams.** Get the right employees and managers into the right jobs and enable them to be enthusiastic about their new roles and the combined company. Most companies use top-down culture surveys to support vision and values integration, and to flag systemic conditions that may cause problems. The best M&A practitioners go a step further and build detailed programs for organizational and cultural change that are tied to specific integration initiatives. They also recognize the power of the daily hallway chatter among employees. These back-channel communications provide an important avenue for building enthusiasm and excitement; they are also effective at defusing the kind of rumor and gossip that can paralyze a workforce.

• **Stabilizing operations.** Amid merger-related pressures, distractions, and conflicts, it's easy for integration team members to lose sight of their primary responsibility: keeping both companies going until they become one, and ensuring the combined entity can operate. Especially during the first crucial weeks of a merger, planners need to detect problems before they grow intractable. (Are products getting placed on the shelves? Is the sales force covering all the stores?) In addition, each major transition — every product rationalization and accounting procedure change — needs its own stability plan and problem-resolution mechanisms. Issues such as delegation of authority, payroll, workload

The Coming Shakeout in Airlines

by Jürgen Ringbeck and Daniel Röska

The demand for air travel dropped significantly at the start of the financial crisis, and few airlines were prepared. Since the last severe shakeout, in 2001–02, almost all carriers have been focused on short-term results. Many are entering this new crisis with fundamental and capital-intensive legacy problems, including aged fleets, the wrong mix of leased versus owned equipment, and misaligned systems and processes that constrain operational and service performance.

And many airlines are in serious financial jeopardy. In January 2009, Booz & Company conducted a study of the profitability of 37 publicly traded airlines. Only five were in robust financial health: Ryanair, Singapore Airlines, easyJet, AirAsia, and Southwest Airlines. These are mainly low-cost carriers that focus on short-haul traffic and have the lowest operating costs in the industry. Many of the others — more than 40 percent of all airlines — were in poor financial health. They have little room to maneuver; it is doubtful that even substantial efforts to improve performance will put them on solid footing in the current environment. Some already face bankruptcy or government intervention.

Exacerbating the current outlook is an additional set of medium-term challenges. Most forecasters expect oil prices to again climb as high as $70 per barrel. Environmental taxation is on the rise. And persistent capacity bottlenecks at critical airports create delays, missed connections, and scheduling inefficiencies in aircraft rotations that result in rising costs.

In the face of these conditions, only three outcomes are possible. The first is a return to an era of state-owned carriers (in parts of Europe and Asia) and highly regulated markets everywhere. For travelers and the industry as a whole, this would be a very unattractive prospect; experience suggests that costs would rise and service would decline. The second outcome would be "muddling through," in which most airlines cut back service and exit unprofitable markets. However, such situations often lead to a downward price spiral that further endangers profitability and increases competitive pressures. And when airlines reduce capacity, they lose the economies of scale associated with efficient scheduling of planes, crew rotations, and fuel cost distribution. The third possible outcome would be a consolidated industry in which the strongest airlines — those that are either the most profitable or the most favored strategically — pursue mergers, acquisitions, and alliances to improve their market positions.

This latter outcome is the only one that would lead to a healthier industry. Increased economies of scale would enable the remaining competitors in each market to better serve their customers and invest in new opportunities. The added customers on consolidated routes would also allow

conflicts, and pricing must be resolved immediately, if only temporarily, for the organization to function. There might be a merger going on, but everybody still needs to know who his or her boss is.

Quest Diagnostics Inc. faced these challenges as it integrated a series of acquisitions from the late 1990s to the mid-2000s. Each deal involved assimilating a complex network of laboratories, physicians, and time-sensitive couriers in a business where customers would switch to competitors if the operation did not continue to function smoothly through all phases of the integration. The leaders of the company recognized the imperative and spent a great deal of time on the integration plan, conducting what-if scenarios, simulations, and trials before the final implementation.

• **Closing the deal.** The last mile of the merger-negotiation marathon is exhausting and fraught with minutiae, legalities, and tough and sometimes emotional decisions. A long, drawn-out process can sap the strength of employees, disrupt current operations, and, of course, delay management's ability to deliver on its promise. For one U.S.-based merger, the integration team had to modify its layoff plans in one state because the seller's CEO was being considered for a high-level political appointment. He worried that layoffs would jeopardize the appointment, because it had to be approved by a government committee headed by the affected state's congressional representative.

• **Identifying and managing "moments of truth."** Some big decisions that involve emotional or symbolic issues, such as choosing the location of a new headquarters, which factories to close, or a new corporate name, represent obvious "moments of truth": events that visibly evoke the future direction of the new enterprise. Other events can be far more subtle but just as influential, in ways that only integration teams who understand airlines to use planes that are larger and thus more cost-efficient and to bundle more traffic from more destinations through large hubs, increasing utilization and yield. This is exactly what occurred in Europe's long-haul flight market, which today is essentially directed through three major airline gateways by British Airways, Lufthansa, and Air France. History proves that consolidation can also provide airlines with a variety of functional synergies. In 2005, Lufthansa merged with Swiss International Air Lines; two years later, in 2007, the market capitalization of the combined airline had risen 70 percent, and it outperformed the industry benchmark index by 10 percentage points.

Consolidation will probably take place first among national and regional airlines, following the examples of Delta and Northwest in the U.S., and Kingfisher Airlines and Air Deccan in India. Across intercontinental boundaries, where economies of scale in airline mergers are more difficult to achieve, we will probably see the global alliance model extended into transcontinental joint ventures that share critical assets like brand, seat capacity, sales and distribution channels, and operations.

Historically, the promise of airline consolidation has remained unrealized because of regulatory restrictions. Governments naturally seek to remain in control of their airlines for reasons of strategic value and aviation safety and security, and because so-called flag carriers (whose planes are often literally painted with the country's flag) are a tangible symbol of a nation's reputation and strength. The recession will strengthen that resolve as governments try to safeguard local employment. Nevertheless, further consolidation in the liberalized regional markets would be the most beneficial outcome for the survival of this industry, as well as the best way to preserve jobs. And it is likely to happen soon. Those airlines that do not move to secure their futures quickly as this consolidation takes place may be left out in the cold.

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the companies' cultures can appreciate. In one merger, two companies with strong plant safety heritages came together. The smaller company had a policy banning mobile phone use while driving company vehicles (even when it was legal). The new firm adopted that policy, after an astute integration team alerted the acquiring company's senior management to the signals their decision would send about the new company's seriousness about safety, and the extent to which the deal was a merger versus an absorption.

• **Creating a post-close transition plan.** Transition plans prepare a company for action as a merged whole. They specify, for example, when day-to-day line management will take over operations from the dedicated integration teams. A premature return to "normal" operations can undermine success — but if the handoff is delayed too long, the line managers might not buy into the new plan.

Stage 4: Executing Successful Integrations

By the time a company reaches this point, it has considered a wide range of scenarios and has created alternative plans to manage them. However, for the promises of the deal to bear fruit, the company must convert plans into reality. This is the work of the final stage: staying the course after the excitement of the deal has subsided.

The most significant risk to a well-designed implementation plan is drift. In a business world that increasingly values decentralization and the empowerment of line managers, keeping a complex, interdependent implementation on course can be a challenge. It requires adherence to the outline of the plan, yet also requires that managers be granted the flexibility needed to adapt to changing circumstances.

Postmerger governance demands a team with the authority to manage and enforce plan execution and to oversee plan variations. That team may be the executive

Health Care: Continued Consolidation

by David G. Knott, Charles Beever, and Danielle Rollmann

Despite a challenging economic climate, merger and acquisition activity in the health-care sector remains relatively buoyant. Based on our conversations with industry leaders, we perceive a growing momentum to reevaluate corporate portfolios and to exploit today's stock prices to build capabilities quickly. It is still uncertain, however, whether M&A activity will change the underlying dynamics of the industry.

We expect consolidation to continue in every health-care sector. Already, pharmaceutical companies have undertaken some significant M&A actions: the Roche/Genentech, Pfizer/Wyeth, and Merck/Schering-Plough deals, as well as a series of smaller biotechnology acquisitions. In the United States, we expect health-care providers, most notably hospitals, to increasingly consolidate in some form over the coming years, given their significant capital needs at higher costs, their eroding financials, and their need for additional clout with, or bargaining power relative to, dominant local payers. U.S. health insurance plans are looking for greater scale as well as new capabilities in areas such as utilization management, health information technology, and patient education and management.

An open question is what model of cross-sector industry engagement we will see going forward after M&A. Will bare-knuckled competition continue, but with larger players? Or will the titans of this industry focus on the programs and collaboration across the industry that will drive true improvements in health-care delivery, outcomes, and cost?

Much has been said about the burden of health-care costs on the U.S. economy. Press coverage continues to focus on the high cost of pharmaceuticals, but more than 80 percent of national expenditures for personal health care consist of costs associated with the delivery of care via hospitals, physicians, clinical services, nursing homes, and home health agencies.

To date, we have seen a variety of experiments intended to reduce costs and improve quality. These involve technologies such as remote monitoring tools, along with new low-cost delivery channels such as retail clinics, medical malls, and concierge services. Potentially transformative approaches such as evidence-based medicine and electronic health records hold promise for improving quality and reducing demand and costs.

However, scaling these experiments up to establish a new operating model for the industry will require fundamental changes in delivery and financing, new alliances and collaborations among stakeholders, and greater levels of investment. We are beginning to see the emergence of such a new operating model, one

or management committee, or it may be a separate, dedicated integration oversight team. In either case, the team needs to have had some continuity through all four stages, so that it now has an innate sense of the newly merged company's needs. Avoid the common error of handing off governance responsibility to managers who were not substantively involved in planning — or if you must make them responsible, then at least provide an oversight safety net.

Clarity in strategic intent, especially in the beginning, provides a touchstone that carries all the way into this final stage. Henkel KGaA, the global household products company based in Germany, offers a good example. When Henkel undertook its $2.9 billion acquisition of the Dial Corporation in 2003 (the deal was concluded in April 2004), the management teams of the two companies had to resolve very different visions of the integration, which could easily have derailed the execution.

Henkel Chief Financial Officer Lothar Steinebach explains, "Dial's management knew that they would become part of the bigger Henkel organization, but they were hoping to be left to operate the business as they had in the past. However, at Henkel, the businesses Dial is in — home care and personal care — are managed in different divisions. To avoid adding complexity to Henkel globally, we decided to align Dial with these existing divisions. There was a lot of friction. In the end, we had to make clear that the integration plan was not up for negotiation."

Unfortunately, the necessary measures are often painful for stakeholders. But not heeding them, and not making the purposeful decisions needed to resolve them, is dangerous. An on-course implementation requires "knowing thyself." Just as a smoker trying to quit needs to recognize and avoid the situations that produce cravings, a newly merged company needs to understand its own cultural tendencies (for example, focused on creating value by collaborating to improve clinical and cost outcomes. Realizing this potential will require stakeholders to build new capabilities. For example, health plans will need to improve customer service for their more engaged consumers, enhance their utilization management, develop better wellness and disease management programs, and make use of informatics and patient-centered technologies. Pharmaceutical companies will need to enhance their ability to work with payers and other stakeholders to demonstrate the value of their products.

Much of this capability-building will occur through M&A. A recent Booz & Company research study analyzed health-care M&A deals since 1995, identifying the strategies that distinguished the biggest winners from the biggest losers in terms of stock performance one year after an acquisition. Strategies were classified according to whether the companies were in the same sector (a consolidation strategy), adjacent sectors (capability building), or unrelated sectors (diversification). The largest group of deals was made up of consolidations, and the numbers of winners and losers with this strategy were even. By contrast, those companies aiming to build capabilities had 38 percent more winners than losers, despite paying the highest multiples for targets.

In the future, therefore, we believe the winners in health care will be companies that systematically integrate an understanding of the capabilities required to win in the market with a well-structured, well-executed acquisition and alliance strategy.

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"we always come back to cost cutting" or "we always defer to local management") and how those tendencies can lead a company away from its declared design and time line, or from carrying out the difficult decisions made earlier.

Capabilities and Momentum

The companies that master the capabilities of successful M&A and build their teams accordingly are the most likely to succeed in the uncertain, hyperactive M&A environment of the coming years. When an M&A team is skilled and capable, a certain momentum takes hold. The systems and processes, management, and lines of business start acting in alignment. Physical locations shut down as planned; some people are reassigned, others are promoted; business partners are chosen; IT systems are linked or eliminated; incentive structures are combined; and cultures are harmonized.

In the end, the two companies become one. The process of the acquisition is completed, and the new company turns its attention, once again, to the prospects of growth. +

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Resources

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