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Deals That Transform Companies

How to shift your business model with M&A integration.

BY GREGG NAHASS

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Leading Ideas

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How to shift your business model with M&A integration.

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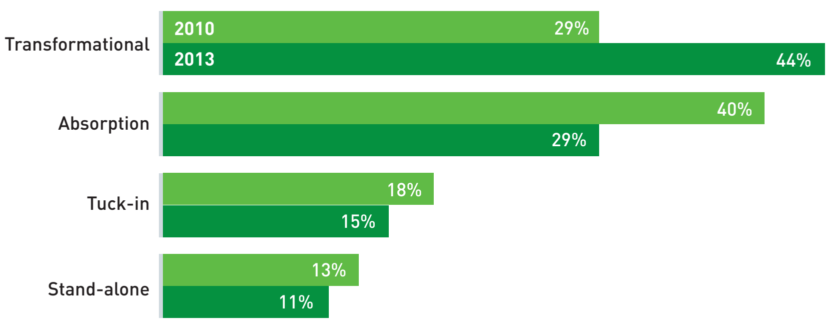
As capital remains cheap and competition increases, more and more corporate finance strategists are willing to take on transformational deals. Unlike absorption deals, in which companies acquire businesses that complement their existing operations, transformational deals involve acquiring new markets, channels, products, or processes in a way that requires significant operational integration. In fact, successful integration is key to realizing the potential value of these deals.

Between 2010 and 2013, the percentage of transformational deals increased from 29 percent to 44 percent, according to PwC's annual survey of senior management of Fortune 1000 companies that had completed mergers or acquisitions in the previous three years (*see Exhibit*). During the same time period that transformational deals grew, respondents reported that absorption deals declined from 40 percent to 29 percent. Although transformational and absorption deals accounted for most of the M&A activity, respondents also reported a small number of tuck-in deals, which involve integrating small companies, and stand-alone deals, which keep the acquired entity operationally separate from the rest of the organization (see "M&A Integration: Looking Beyond the Here and Now," PwC's 2014 M&A Integration Survey Report).

What's driving this shift? Our analysis suggests that more companies are seeking to fundamentally change their business model or the scale of their enterprise. In many industries, the obvious absorption targets were snapped up during the years following the 2007–09 recession. Now, companies are seeking growth outside their core competencies in an environment that's being reshaped by disruptive technologies, evolving regulation, and changing customer expectations.

Transformational deals need not be big; their hallmark is that they fundamentally reinvent opera-

Exhibit: **The Largest Acquisition Types, 2010–13**



Note: Percentages may not total 100 due to rounding.
Source: "M&A Integration: Looking Beyond the Here and Now," PwC's 2014 M&A Integration Survey Report, pwc.com/US/M&A-Integration-2014

tions and maybe even change the dynamics of the industry. In healthcare, for example, payors are buying providers and creating new shared risk–bearing health networks. In telecommunications, mergers between major Internet and cable television companies could create new, innovative models of content creation and distribution. In retail, companies are pursuing deals to transform their operations, including supply chains, as they try to get products to consumers more cheaply and quickly than their competitors do. Amazon is busy building physical warehouses throughout the country, while also seeking greater automation and higher productivity through its $775 million acquisition of Kiva Systems, a robotics startup that services warehouses. Meanwhile, Walmart is turning its formidable network of bricks-and-mortar retail outlets into e-commerce assets from which it can quickly fulfill online orders. The company has been on a buying spree to acquire tech startups in social software, mobile apps, and cloud infrastructure, with the goal of reaching consumers in an omnichannel environment: stores, online, and mobile.

Illustration by Adam McCauley

The Integration Challenge

Transformational deals have become desirable, but business leaders agree that they are the most difficult transactions in M&A today. Half of the respondents to PwC's 2014 M&A survey said that their company had the core competency to integrate absorption deals, but fewer than a quarter said the same thing about transformational deals. Respondents also noted how difficult it is to make these deals work. Whereas 65 percent characterized their recent deals, many of which were transformational, as a significant strategic success (i.e., the deal was concluded and the businesses began working together as planned), fewer than half reported success in achieving financial goals, and only 35 percent said they had realized their operational objectives.

The success rate of financial goals tends to be higher than that of operational goals because most companies focus on financial synergies right away to achieve quick wins. Operational goals—such as supply chain integration, business process and systems integration, and the meshing of two different innovation capabilities—are tougher to realize because they require a sustained commitment to integration completion over the long term.

Take R&D, for instance. The search for game-changing technologies may be fueling many transformational deals, but their integration can be extremely challenging. In PwC's 2014 M&A survey, only 30 percent of respondents reported either favorable or very favorable results in integrating R&D. That's partly because R&D tends to be driven by culture and is prone to talent leaking away if employees are dissatisfied in the new environment.

Transformational deals are much more likely to succeed if the new enterprise is distinctive in a coherent way, applying the same capabilities in all the sectors in which it does business (see "The Capabilities Premium in M&A," by Gerald Adolph, Cesare Mainardi, and J. Neely, *s+b,* Spring 2012). For this reason, they require significant operational integration.

In our work, we have discovered seven fundamental tenets to follow for capturing sustained economic value during integration. Although these are important regardless of deal size, complexity, or geographic reach, they are absolutely critical when it comes to transformational deals. If you don't achieve operational excellence soon after the deal is closed, you will not capture the tremendous value promised by a transformational merger or acquisition.

1. Accelerate the transition. Focus on obtaining bottom-line results as quickly as possible to maximize shareholder value.

2. Define the strategy. Clearly state how the new enterprise creates value and how the deal affects its most strategic capabilities.

3. Focus on priority initiatives. Allocate resources to the activities with the greatest potential for financial rewards.

4. Prepare for Day One. Identify and execute critical Day One tasks early, before longer-term, more detailed planning commences.

5. Communicate with all stakeholders. Reach out early and often, describing the deal's rationale and progress to customers, employees, investors, and everyone else in the value chain.

6. Establish leadership at all levels. Assign accountability, define functional authority, and establish clear roles.

7. Manage the integration as a business process. Follow a defined approach to focus resources and capital on the right activities at the right times.

Integrating the Unfamiliar

The root of the transformational challenge is the need to integrate a company—usually a big company—whose operations are unfamiliar. In an absorption deal, the integration team members understand the business. It's not unlike their own. They can make basic assumptions and undertake some planning with a reasonable degree of confidence, even before the close. For a transformational deal, however, waiting until Day One to begin the deep due diligence necessary is potentially much more damaging because it extends uncertainties and delays critical decisions.

These delays and uncertainties can create several integration blind spots that risk undermining the deal. For example, transformational deals are more prone to blind spots involving synergy assumptions, particularly those related to revenue growth. When modeling potential synergies, buyers of transformational deals usually have to consider a greater number of variables than they would for other deals. This often leads them to make subjective assessments as they consider questions such as *What will the market environment be? How will the demand for the product evolve? Can we cross-sell into a new customer base or channel? Can we enter a new market? Will this reduce competition?*

Transformational deals can also be more challenging for cost-based synergies, especially for business process and systems integration. That's because transformational deals require greater collaboration and alignment between the companies to determine the optimal approach—compared to absorption deals, where it's common to simply migrate to the acquirer's procedures and processes.

Agility and Leadership

One way to mitigate delays and uncertainties is to learn in depth about the incoming company's capabilities as early as possible. A characteristic of the highest-performing deals reported in the survey—those with relatively high performance in all three areas: strategic, financial, and operational—is the early involvement of integration teams. In 92 percent of these deals, integration teams started work either before or during due diligence.

This approach requires agility on the part of the integration team. Agility in this context is the ability to act rapidly and creatively in real time: identifying, gathering, and evaluating as much information as possible to make integration decisions and maintain momentum. The team should recognize that transformational integration involves more than pulling IT systems together and realizing synergies. It also means engaging effectively with staff at the acquiring company. Some target company staff members may be reluctant to share what they know. Others may be genuinely inexperienced at explaining what they do. Someone has to pick up the phone to set up meetings and start asking questions.

Integration is successful when senior leadership also preaches and practices agility, staying actively involved, making critical decisions, and managing the pace of integration so that the changes to the combined company happen in a planned and reasonable way. The integration could easily involve hundreds of people in dozens of functional departments or business units. If the top team doesn't set priorities, maybe no one will. That would be devastating to the pace of integration, and, ultimately, to deal success.

Together, agility and leadership can speed the integration. And although speed is necessary, so is long-term commitment. Companies often lose integration momentum between six months and one year after the close. Realizing operational goals takes perseverance, and that's particularly important if companies are to overcome the uncertainty—and capitalize on the opportunity—of the transformational deal. +

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