

More than two thirds of acquisitions fail to create meaningful shareholder value. When mergers between similar companies seem an obvious way of gaining opportunities of scale and scope, why do so many lead to disaster?

**Richard Carr, Graham Elton, Sam Rovit and Till Vestring** emphasise the importance of having an investment thesis and of getting the planning right from long before the merger announcement – so that the new team can hit the ground running from the first day of the new company's existence.

# Merging on the Miraculous Mastering Merger Integration

**S**hanghai Automotive Industry Corporation's sudden exit from acquisition talks with MG Rover earlier this year highlighted the risks involved with the acquisition process. Despite intervention from the UK government to reconsider, the Chinese company refused to take on the failing UK car giant.

The Chinese car firm had reason to be cautious, and not just because Rover was ailing: acquisitions are a notoriously treacherous way to grow. And Bain and Company's 30 years of experience of mergers and takeovers indicates that the most dangerous time of all occurs after the contract ink is dry and integration efforts begin.

Why is this? Part of the reason is that too many corporate mergers take place in the strategic stratosphere, without an investment thesis that sets the deal on bedrock and shows how the new entity will look, operate and act to make more money. In effect, the problem is a simple one – companies are

not planning ahead, despite what they might say.

The best integrations start with a stringent blueprint for owning the business and making it a better one. Having a proper investment thesis not only gives the acquisition a leg up, it also tells acquirers right at the outset where they should focus their integration efforts to gain the most value from the deal.

To prove the worth of this concept, we interviewed a score of the most successful acquirers, we surveyed 250 global executives involved in M&A, and we conducted several studies correlating acquirers' deal integration practices with their deal success. Four significant rules for success emerged:

Identify during due diligence the areas that need to be integrated urgently. Then prioritise these areas at takeover.

Integrate quickly where the takeover affects the financial opportunities that informed the deal's investment thesis.

→ Put cultural integration high on your agenda.

As the flip side of integration focus, keep most of your employees' efforts trained diligently on the base business.

Integration is difficult, but when executed thoughtfully it greatly increases a deal's chances of success. Handled poorly, it is the leading cause of deal failure. In Bain's survey of 250 global executives, two out of the three top reasons given for disappointment with acquisitions were related to integration. These included ignoring integration challenges, and having problems integrating management teams and/or retaining key managers.

## Plan for ownership

The advice to "plan ahead" is a verbal redundancy, but it can't be emphasised enough – especially when one considers that the vast majority of integration planning is observed in the breach. Every deal your company proposes – large or small, tactical or strategic – should therefore start with a clear statement of how that particular deal would create value for your company. This is the investment thesis referred to earlier. In essence, it is simply a definitive statement that spells out how adding a particular business to your portfolio will make your company more valuable. And it will only work if it is based on a clear understanding of how money is made in your business. A credible investment thesis should describe a concrete benefit, rather than a vaguely stated strategic aim.

At this point many companies roll their eyes and think, "Well of course our company uses an investment thesis!" But unless you're in the private equity business, which in our experience is more disciplined in crafting investment theses than are corporate buyers, the odds aren't with you. Bain's survey revealed that only 29 per cent of acquiring executives had an investment thesis that stood the test of time, and more than 40 per cent had no thesis at all. Of those who did, half discovered that their thesis was wrong within three years of closing the deal.

Another way to avoid falling into the trap of planning after the event is to make integration feasibility part of your due diligence. A moment's thought shows that it's impossible to perform a thorough due diligence and develop a fair price without taking the feasibility of the integration into account along with cost.

Yet companies frequently fail to think seriously about integration until well after a deal is announced or even closed. Almost half the executives interviewed in Bain's survey admitted that they did not create a clear road map outlining the necessary integration steps during due diligence. More than 60 per cent felt they should have spent up to a third more time planning integration.

By translating the goals they hope to reach from the deal into a series of simple integration instructions, the best acquirers force themselves to bridge the gap between the theory and the reality of making companies come together.

## People planning

There's a long list of tough decisions that CEOs should make early on – everything from naming the new company to creating an organisational structure. But picking leaders is paramount.

In 2002, Johnson Wax Professional (JWP) merged with Unilever's commercial-cleaning products unit to create JohnsonDiversey. JWP was a floor-care and housekeeping products and services company with revenues of \$1.1 billion, and the directors of JWP planned effectively in order to get the merger right. Greg Lawton of JWP spent more than 100 hours with Diversey executives before the merger was announced – so that on the day the news broke, he was able to name the new management team. Lawton's selections showed a balanced representation from both companies and were based on culture and values as well as talent.

In the months before the announcement, Lawton also created a joint integration team. By the time the deal closed, the team had chosen middle managers for key jobs, articulated clear lines of authority and established formal working procedures. Being able to hit the ground running like this – instead of arranging the deal and then asking, How are we going to manage it? – is key to success.

While the JohnsonDiversey deal illustrates good people planning, the merger of Jefferson Smurfit and Stone Container, two box-making giants, in 1998 is an exemplar of planning around process.

Because their merger was predicated on obtaining economies of scale, they focused on cutting overlapping operations. Joint Smurfit and Stone teams began mapping out which plants could be combined. That allowed them to announce the shutdown of 17 per cent of their US containerboard capacity, as well as 33 per cent of market pulp capacity, within a week of merging. By reducing high-cost capacity and refocusing production on the needs of higher-margin customers, Smurfit-Stone increased its average price for containerboard within 90 days, quickly boosting profitability at a vulnerable time.

## Integrate quickly where it counts

As the Smurfit-Stone story shows, skilled acquirers focus on the largest paybacks. In Bain's survey of 250 global executives, 80 per cent of respondents agreed that integration must be "highly focused on where the value is in the merger."

This sounds obvious, but all too often companies try to integrate in too many directions. And as we've

seen, the best guide to discovering where the priorities lie is the underlying investment thesis.

Generally a deal creates one of two benefits: it enhances the core business, or it represents a completely new platform for active investing.

If a deal enhances the core, its goal is either to grow the *scale* of a company's operations (by adding similar products or customers) or to expand a company's *scope* of operations (by combining companies that offer each other new products, customer segments, channels or markets).

These three types of investment theses – active investing, expanding scope or growing scale – form a range for integration efforts. As one moves along the spectrum, the required extent of integration increases.

If an acquired company is the first plank of a new platform, it will probably require minimal integration – perhaps simply inserting some management talent from the acquirer. At the other end of the spectrum, scale deals require extensive integration of all activities to capture the value that inspired the deal in the first place. That value may come from reloading plants, consolidating vendors to lower purchasing costs or lowering administrative costs.

In the vast number of deals that fall somewhere between these two extremes, the deals that enhance scope need to be integrated only in discrete areas. So getting the focus right is critical. An acquisition that expands a company's product scope may require extensive integration in overhead functions, distribution and customer service, for instance. But it probably won't require integration in manufacturing and R&D.

### Selective integration

To find out the success or otherwise of scope mergers, we went back to the companies we examined a year after the merger announcement was made, to see how their stock was performing. When we studied the scope acquirers whose stock had outperformed their industry peers, we found that all the high performers had blended organisations partially or minimally. But when we looked at the scope acquirers whose stock had underperformed, we found that most of them had integrated fully or significantly – only a third of them had integrated partially or minimally. So for deals based on scope, the data supports the case for selective integration.

Illinois Tool Works Inc. is a past master at selective integration in scope deals. ITW's aim is to squeeze value out of complementary assets, rather than blend operations. W. James Farrell, who became CEO of ITW in 1995, spent \$6 billion over a period of six years to buy more than 200 companies – most of them small and most of them private.

The company focuses on the 80-20 principle;

the idea that companies obtain 80 per cent of their revenue from the top 20 per cent of the products they sell to key customers. Accordingly, local managers have broad authority to manage their units – provided, of course, that they live by the 80-20 rule, focusing primarily on top customers and products.

ITW integrates control functions, rather than operations. Headquarters handles taxes, auditing, investor relations, R&D support and some HR functions. After W. James Farrell took the helm in 1995, his deals more than doubled ITW's revenues to \$9.5 billion in 2002, while the stock price has increased five-fold. Again, this is proof that selective integration works for scope-based deals.

### Comprehensive integration

However, attempting to grow market share through a scale merger requires a more extensive integration effort. So as well as considering the scope mergers, where minimal or partial integration works best, we also looked at the scale acquirers a year after the announcement was made. Of the scale acquirers whose stock had outperformed that of their peers, all the high performers had integrated fully. Less than half of the scale acquirers whose stock had underperformed had integrated comprehensively; and the remaining underperforming acquirers had blended companies only partially or not at all.

Even so, prioritising where to blend operations still gives acquirers an edge.

Philips Medical Systems makes imaging products such as ultrasound equipment and MRIs. Between 1998 and 2001 Philips Medical acquired four companies to broaden its product line and to stay competitive with its heavyweight rivals, Siemens Medical and GE Medical Systems. The acquisitions lifted Philips from a distant third place to a position comparable with Siemens, the number two player.

This required a major integration effort. In October 2001, with the last deal complete, Philips deployed 17 “synergy search-and-rescue” teams to identify the greatest potential for cost savings and revenue increases.

From a list of 500 initiatives the teams first pursued the highest payback tasks, such as integrating individual product lines. Throughout the process, William Curran, former CEO of Philips Electronics North America, which oversaw the Philips Medical Systems programme, targeted the biggest prizes. In under six months the teams had identified synergies three times the amount originally quantified. As a consequence Philips Medical announced €342 million in synergies in February 2004 – vastly surpassing its goal of €230 million.

### The culture show

Philips Medical and ITW excel at extracting deal →

## Note to acquirers: mergers should start before the merger

Our advice to companies eyeing acquisitions is, do your integration homework long before taking the big test. Making good on the value that shareholders expect from deals can be an uphill battle – and it's a battle most frequently lost when merger integration is an afterthought.

Best-practice acquirers have a motto for integration success: start early and study hard. In our experience with thousands of deals over 30 years – and in interviews with a score of acquirers that overcame the dismal odds of success associated with large deals – we've found the best deal teams consistently design a “merger before the merger.”

From the initial due diligence through to final signing, regular interaction becomes a required element of the deal. The goal is a structured plan allowing a company to take on the marketplace

as soon as the ink is dry. Success generally involves a “clean team” that, working under strict confidentiality with both companies, analyses critical data that can't legally be shared or that the companies wish to protect. Companies can staff a clean team with employees from both firms, as long as those workers don't return to jobs in which they could use the data to competitive advantage if the deal falls through. Or if the company is unhappy with this arrangement, another option for facilitating the clean team is for outside lawyers, accountants or business analysts to be brought in.

Without revealing sensitive information to either party, clean teams create a road map for joint strategy, operations and market efforts. This allows acquirers to jump start the integration process once the deal closes.

→ value. But that ability hinges on their skill in mobilising key employees. This brings us to the third of our principles: putting cultural issues high on the leadership agenda.

Former General Electric chairman Jack Welch frequently tells the story of one of GE's worst deals: the 1986 acquisition of brokerage firm Kidder Peabody. Rigorously disciplined GE failed to mould the freewheeling Kidder into a typical GE unit. GE nitpicked expenses and imposed GE-style strategic planning on Kidderites, which was completely counter to their independent ways of operating. The result was that Kidder's top managers departed in droves. GE's \$600 million investment produced only \$250 million in earnings, before GE sold Kidder to PaineWebber in 1994.

After the Kidder debacle, GE Capital developed a merger approach called Pathfinder. This approach reflects GE's somewhat belated realisation that in integration, as much attention must be paid to scaling culture as to scaling businesses. Companies that go through the Pathfinder process come out indelibly stamped with the GE logo. As Welch put it: “At GE, we said one thing when we got a company: ‘You're acquired. Welcome. Here's the finance system; here are the rules.’”

Needless to say, this straight-ahead assimilation will not work for every acquisition. Our research indicates that cultural integration strategies should be tailored to the original investment thesis.

To better understand cultural integration issues, we studied 125 deals that cost more than \$1 billion

between 1996 and 2000. Surprisingly, we found little difference between deals marked by important cultural issues and those where the culture was less of an issue. But the deals in which management proactively addressed cultural integration issues showed significantly better results – regardless of the complexity of those issues.

Having a proactive approach netted acquirers a 5.1 per cent higher shareholder return relative to their peer index in the 12 months after deal announcement. Meanwhile, acquirers that ignored cultural hurdles underperformed by an average of 2.4 per cent. When we broke out scale deals – where integration mattered most – we found that the ones that ignored cultural issues performed some 8 per cent below peer indices.

### Building bridges

The best dealmakers base cultural decisions on the needs of their customers. In the case of JohnsonDiversey, where the combined companies needed to serve each other's customers, CEO Greg Lawton took pains to create a “bridging culture.”

Shortly after the deal was announced, Lawton held a meeting of his integration team. The cultural gulf was obvious. Johnson's entrepreneurial employees tended to arrive at the meetings with a relatively open, problem-solving mindset. DiverseyLever executives showed up with formal written proposals, which quickly dominated the discussions.

At Lawton's urging, the team members talked

about their differences. Next, they developed a way to make decisions that harnessed their combined strengths. Finally, they promoted that new approach throughout both companies, with the top team leading the way.

### Forging teams

JohnsonDiversey's nuanced approach worked well for its scope-enhancing deal. But subtlety and gradualism are rarely the right solutions for scale mergers. BP is a good example of a successful scale merger, and it was successful because it didn't pull any punches. Industry consolidation in the oil business was rife through the 1990s, and BP's CEO John Browne understandably feared that BP would get left behind. So between 1998 and 2000, the company closed a series of transactions totalling \$120 billion that brought BP, Amoco, Arco and Castrol into a single company with a market capitalisation of about \$200 billion – an amazing result to achieve within two years.

With a belief that “you have to create a single organisation, with common processes and standards, common values and a way of working that everyone can recognise,” Browne moved swiftly and on a large scale. Within 100 days of closing the Amoco deal he had filled the top management jobs and completed most of the staff reductions, including 10,000 redundancies.

BP's assimilation of Amoco was so thorough that some Amoco senior executives resigned, frustrated with the speed and scale of the changes. But BP achieved its projected \$2 billion in cost savings in just the first year. Its stock outperformed the oil-and-gas index by 17 per cent one year after the deal was announced.

### Fighting for the cores

Mergers exert a gravitational pull on employees. Almost inevitably, they take their eye off the ball. But consistently, our survey respondents underscore the importance of preventing employees from being distracted by the merger, and keeping them concentrated on the base business.

The good news is that this fourth principle is the easiest one to implement. It requires an everyday

competitive toolkit – setting priorities, checking in regularly and asking tough questions. Great acquirers mind the store with three basic tactics:

- Walking the talk
- Using the 90-10 rule
- Letting the line steer.

*Walking the talk.* Senior managers at successful acquirers set an example by paying increased attention to their customers between announcing the acquisition and closing the deal. When the department store giant Sears, Roebuck acquired catalogue retailer Lands' End in the spring of 2002, Lands' End's executive team spent extra time listening to its customers to make sure they continued to be happy with their service. To make sure there would be no disruptions to service in the run-up to the Christmas season, Lands' End CEO David Dyer put some integration efforts on hold.

*The 90-10 rule.* Only a small and respected team – 10 per cent or fewer of employees in any function – should drive the integration. That leaves at least 90 per cent of employees to focus on running the business. This is especially important for customer-facing functions.

*Let the line steer.* This last principle may sound counterproductive, but it's actually a wise investment in store-minding. Good acquirers often designate their line executives as members of a steering committee for the duration of the integration. The direct benefit is a line team with a clear and early view of any major changes that are in the offing. And the indirect benefit is keeping the hands of those executives on their respective tillers.

### The acquisition of riches

JohnsonDiversey, BP, Philips Medical and Smurfit-Stone have discovered that integration can make or break a deal. They've learned that by throwing a few switches at the right moment they can vastly improve their chances. And they've found that planning ahead is a vital component, not something you drop if the deadlines mount up. In mergers, as in life, experience is the great teacher. ■

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