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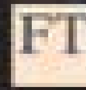
FINANCIAL TIMES

# HANDBOOK OF MANAGEMENT

THIRD EDITION



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*Edited by*
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# When two companies become one

ANDREAS HINTERHUBER

[ Mergers and acquisitions are an accepted part of corporate strategy. Yet despite their enduring popularity, their success rate is surprisingly low. This article shows how M&As can be made to work. ]

As frenetic as merger and acquisition (M&A) activity in recent years, so heated are debates questioning and defending its potential to add value. On the one hand, CEOs are usually enthusiastic and quick to affirm that broader reach, increased efficiency, and a more comprehensive product portfolio will allow to significantly enhance shareholder value. Stock markets, on the other hand, are more cautious. Within our own research on Best Practices in M&A, we compared the stock-market performance of the largest mergers and acquisitions completed in 1999 with the development of the S&P 500 index. The results were surprisingly disappointing. Merged companies, including Vodafone, Exxon, Astra Zeneca, Honeywell, and SBC, not only significantly underperformed the S&P 500 index but have to date failed to create any significant value at all.

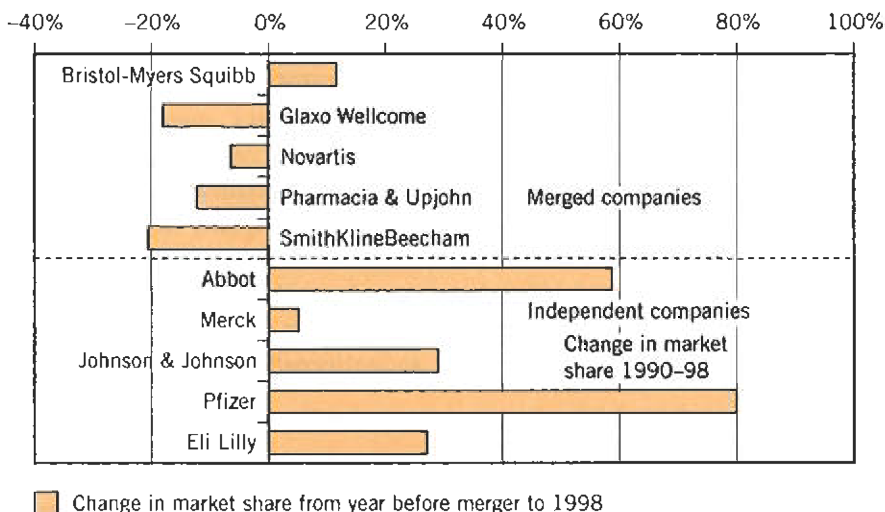


**Figure 3.3:** *Market share of merged companies: the case of the pharmaceutical industry*

Broader research (summarized in Table 3.1) also suggests that the average merger is doomed to fail.

The stock market is not the only place where mergers are won or lost. Equally important is the marketplace. An analysis of the market share development of pharmaceutical companies reveals that the market share of merged companies usually declines strongly in the period following a merger. On the other hand, significant growth in market share is usually realized by independent companies (see Figure 3.3).

Finally, as job losses accompany most mergers, employees are usually the least enthusiastic constituency – recent empirical research shows that employee productivity can decline up to 80 percent in a merger phase. In this context it is clear that

**Table 3.1:** *Merger research*

| Source | Scope of study | Period studied | Main findings |
|---|---|---|---|
| A.T. Kearney | 115 mergers and acquisitions | 1993–1996 | 58 percent do not create positive shareholder returns |
| Mercer Management Consulting | All mergers from 1990–1996 | 1990–1996 | 48 percent destroy shareholder value |
| Pricewaterhouse Coopers | 97 mergers and acquisitions | 1994–1997 | Over 40 percent fail to create shareholder value |
| Booz-Allen & Hamilton | 117 mergers and acquisitions | 1994–1996 | Over 50 percent underperform relative to industry peers |
| KPMG | 700 mergers and acquisitions | 1996–1998 | 53 percent of deals reduce shareholder value; 82 percent of CEOs view transaction as succesful |
| Boston Consulting Group | 277 mergers and acquisitions | 1985–2000 | 56 percent of mergers destroy shareholder value |
| McKinsey & Company | 193 mergers and acquisitions | 1990–1997 | 89 percent of companies fail to increase revenues after merger |

companies planning to merge face a steep uphill battle, despite all promises of future growth, reduced costs, and rising profits.

Our research into M&As produced two main findings. First, most mergers fail because managers apply a set of apparently common-sense rules. Second, outstanding "integrators" are able to create extraordinary growth in shareholder value, and employee and customer satisfaction by applying a set of apparently counterintuitive measures in M&A integration.

## Common assumptions in M&A integration

Most executives implicitly follow a set of commonly held assumptions when merging or integrating two companies. The most widely spread assumptions are:

### In depth planning as key requirement for success

The prevailing opinion is that an over-investment in planning pays off in the integration and long-term performance of the two companies. Therefore, the average deal is "closed" 8–12 months after announcement, in order to allow for enough time to hammer out the details of the deal. A VP of Siemens summed up the prevailing wisdom in the following way: "Speed is not enough, planning is more important than speed."

**Synergy realization as primary goal once deal is closed**

There is no doubt that the ultimate goal of mergers is an increase in profit beyond what each company individually would have been able to do. Thus, in the first year after a merger, synergy realization is generally seen as the single most important task of management in relation to ensuring merger success.

**"Early wins" in integration – pick low hanging fruit first**

It is common wisdom, that early wins in the integration stage build the necessary trust and commitment to attack more complex issues at a later stage. As Nelson and Lagges, two principals with management consultancy A.T. Kearney, say: "During the first year, it is important to combine two cultures and organizations, but it is fatal to get bogged down in heave operations integration. Start out by picking the low-hanging fruit" (Nelson and Lagges 1993).

**Integration managers are appointed for monitoring and implementation of synergies**

In nearly all of the companies we studied, integration managers at various levels of the organization were specifically nominated to monitor the implementation of synergies. The globally identified synergies are broken down by year, business line, and region, with integration managers monitoring progress in synergy realization. Objective is to ensure that reported synergies are also auditable by external or internal auditors.

**Financial yardsticks are best instrument to monitor progress of integration activities**

Finally, most companies studied have strong controlling instruments in place to benchmark the progress realized in the integration process. Consultant companies have developed a broad array of tools, such as the ERI (Ensuring Rapid Implementation) tool by BCG in this area, aimed at ensuring that the targetted synergies are also reflected in the P&L statement of the merged company.

These practices appear commonsensical. Yet our research indicates that they lead many companies dangerously astray. Though apparently focussed on the integration process, they ultimately distract companies from the grounds where the real battle for integration success is fought – the *marketplace*. This is the main reason why most mergers fail.



## Outstanding M&A integrators

When we started to study the integration practices of some companies with immense acquisition experience such as GE, Thermo Electron, Citigroup, and others, a set of counterintuitive patterns began to emerge. Similar patterns surfaced when we studied the rare cases of successful mergers, such as Aventis. The implicit assumptions of managers responsible for integration within these companies were radically different in critical ways.

First, the focus of all integration activities was the creation of an immensely competitive organization, rather than beating analysts' estimates of expected synergy levels. Second, managers in these companies realized that the creation of a common mindset was the most important prerequisite for achieving this objective.

The key lessons from outstanding integrators can be summarized in the following way:

## The window of opportunity is small – if after 3–6 months integration is not complete, it will never occur

The best integrators recognize the need for urgency, rather than planning, in integration. Less focussed on producing detailed business plans with the next three-year sales and earning developments, they know that the window of opportunity in integration is open for only a very limited period of time. A distinctive feature of outstanding integrators is speed. They start very early in pre-merger assessment and move very quickly in integration.

## Success is determined largely by how quickly a common mindset is created

The creation of a common mindset calls for the perpetuation of strong values and a performance-oriented corporate culture attentive to signaling effects.

Strong values and a strong corporate culture are necessary to give the employees joining the new organization a powerful sense of what the organization will stand for. These values are a combination of external market requirements, the unique strengths of both organizations, and the envisioned future of the new organization. They should also carry the organization toward a point in the future that is never quite reached yet is powerful enough to guide day-to-day decisions.

While most organizations pay at least some attention to values and corporate culture, only outstanding organizations realize the strong signaling effects that all actions implicitly have on the enforcement of corporate culture. In a merger, these effects are particularly important in two instances: commitment to start at the top with synergies, and commitment to let top performers go if needed.

The outstanding integrators in our sample realize that synergies implemented at the executive floor send a strong signal to the rest of the organization about top management commitment to synergies. By contrast, weak integrators, in their reluctance to let senior executives go, frequently move these people to staff positions deliberately created, thereby implicitly communicating to the organization that complacency is more important than performance, that history matters more than the future. With this, middle managers are tacitly encouraged to be softer than the requirements of the external marketplace, making it impossible for the company to realize any significant cost savings beyond what each organization would have been able to do individually.

Signaling effects are also important in decisions regarding top performers violating company values. In weak organizations, high performance confers the license to do everything not prohibited by law. Outstanding integrators know that top management commitment to company values is credible only when adherence to values is put above performance, which means to let high-performing individuals go on occasion. These considerations apply especially during the integration phase, where

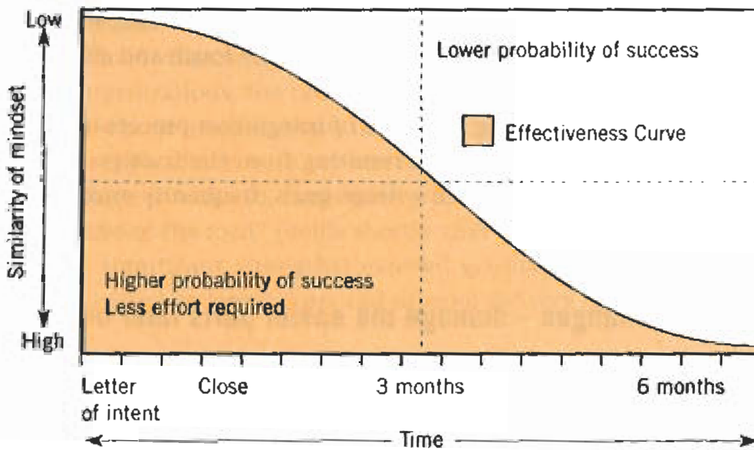


**Figure 3.4:** *Performance measurement in integration – success is dependent on how quickly a common mindset is realized*

middle and senior management not only need to adhere to specific values but also have to facilitate the creation of a unified body of new values (Figure 3.4).

## The vision of creating an immensely competitive organization drives all integration activities

Outstanding integrators realize that the only vision worth pursuing in the disruptive phase following a merger is the vision of creating an organization focussed on being extremely competitive in the marketplace. Several steps are involved.

3

First, an audit of the competitive profile of the two companies is conducted by an independent party to assess strengths and weaknesses of the two companies *in the eyes of key customers*. This view is then confronted with the perception of executives about strengths and weaknesses of their own and of the merged or acquired company. Second, an *ideal competitive profile* is drafted, taking into account the requirements of a competitive marketplace, company aspirations, and existing strengths and weaknesses.

Third, in light of usually considerable gaps between current customer perceptions of the company's strengths, management perception of actual strengths, and the competitive profile required in the future, action plans – frequently requiring drastic changes in operating logic, staffing, and strategy – are laid out, discussed, and implemented.

Finally, the company has to be energized toward achieving the desired goal of competitiveness from the very beginning of the integration process. Training, lectures, and so on are usually helpful but, in the end,. frequently only drastic changes in the way people perceive themselves, the company, and competition are able to

produce the required changes. In addition to sometimes demanding implementation skills, outstanding integrators have the skills to deeply touch and affect people's minds and hearts.

The energy level generated during this kind of integration process is in no way comparable to the lackluster atmosphere resulting from the fruitless attempt to motivate employees to achieve abstract synergy goals, frequently encountered in mediocre integrators.

## Start with radical changes – manage the easier parts later on in the process

In contrast to cautious changes and multiple rounds of reorganization typical of inexperienced integrators, we found outstanding integrators reorganize aggressively from the start. The desired competitive profile, discussed above, is the blueprint for reorganization at this stage. In the experience of outstanding integrators, which we amply support, it is far preferable to reorganize heavily and drastically at the beginning of the integration process – but only then. Afterwards, the organization is given the time and the psychological reassurance to establish its own identity and internal cohesion.

Compare this to the erratic rounds of reorganization observed in the vast majority of mergers. At the beginning, fearful of provoking conflict with the other party, only minor adjustments are made to company structure; later, in a second round of reorganization, the resulting inefficiencies are eliminated until, in a further round of restructuring, changes in the marketplace can be addressed. During this process, employee morale goes from bad to worse while the executive management is unable, even if it were willing, to provide any direction to the company.

## Integration managers focus on the competitive profiling of the new organization

It follows naturally that integration managers will not be held responsible for synergy planning and implementation. Experienced integrators, although aware that synergies are followed by financial analysts on Wall Street, know that synergy realization can never be the ultimate aim of a merger or acquisition; they also know that a highly competitive organization will produce earnings and cash flow consistently above expectations.

This, in turn, defines the role of the integration managers. Concurrently with business line, functional, or country heads, they ensure that the competitive profile of the merged company is consistent with the overall aspirations. The strategic impact resulting from this task usually far exceeds the rather mundane surveillance of headcount reductions. Here, external critical success factors, customer requirements, and the position of leading competitors are monitored periodically – at least

twice per year. The vision of a strongly competitive company is then translated into action-items following current customer perceptions and market demands.

In some organizations, the observed impact of this periodic feedback loop with the market are huge: organizations, happy with delivering products in the past, integrated their supply chains with key customers and redesigned key attributes of some of their products in order to consistently exceed customer specifications. In another case, a "middle-of-the-road" profile shortly after the merger (no specific weaknesses but also no significant strengths) evolved gradually into a competitive profile extremely focussed on lowest costs and superior delivery reliability.

## Performance along *external* critical success factors is the primary instrument for assessing integration progress

Outstanding integrators recognize that integration success means that a common mindset creates an immensely competitive company. For this to occur, this common mindset – shared values and cultural identity – is established quickly. Second, the integration progress is measured by comparing the performance along external, customer-defined, critical success factors against the targetted competitive profile outlined in the previous section (see Figure 3.5).

Alongside, indicators for internal efficiency are spread throughout the organization – some of the outstanding integrators created a "library of best practices" on working capital efficiency and other internal benchmarks that was then cascaded through the organization. Again, this permanent focus on the requirements of the competitive marketplace provides a much clearer orientation for employees at all levels than less inspiring calls for quicker implementation of synergies.

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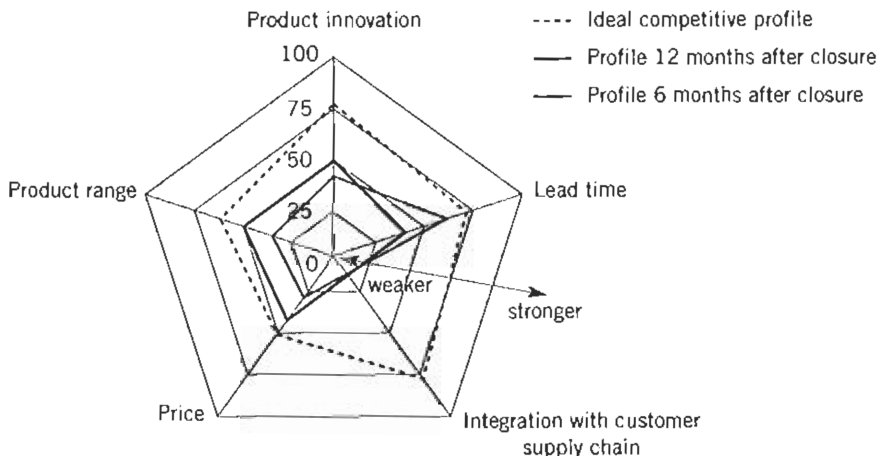


**Figure 3.5:** *Performance measurement in integration – actual competitive profile is periodically monitored against ideal*

## The rules of outstanding integrators

1. The window of opportunity is small – if after 3–6 months integration is not complete, it will never occur.
2. Success is determined largely by how quickly a common mindset is created.
3. The vision of creating an immensely competitive organization drives all integration activities.
4. Start with radical changes – manage the easier parts later on in the process.
5. Integration managers focus on the competitive profiling of the new organization.
6. Performance along external critical success factors is the primary instrument for assessing integration progress.

## Integration distilled

In the end, the unconventional wisdom of the world's best integrators boils down to a few essential rules. Whereas most companies get caught up in internal struggles and start to concentrate far too much upon themselves, outstanding integrators focus on the vision of competitiveness during the whole merger process – the demands of the external market take precedence over self-contemplation.

By the same token, soft issues are treated as the real hard issues. The creation of a common mindset, linking people's values with company culture, is seen as the single most important requirement for a successful merger by successful integrators. For this to be achieved, the organization is energized with a set of values derived from the demands of the marketplace, future aspirations, and current strengths of the merging companies.

Finally, speed takes clear precedence over accuracy. Today's mediocre integrators fail to see that the competition eagerly and happily waits for any slowdown accompanying the typical search for a detailed pre-merger plan. By contrast, the world's best integrators are *fast*: internally, in creating a common mindset, and externally, in becoming very competitive very quickly.

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