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THE OVERCONFIDENCE TRAP

GETTING IT HALF-RIGHT WON'T WORK IN THE HIGH-STAKES GAME OF M&A INTEGRATION

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GETTING IT HALF-RIGHT WON'T WORK IN THE HIGH-STAKES GAME OF M&A INTEGRATION

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Mergers and acquisitions are high-risk propositions under the best of conditions. The challenge is even tougher when the business climate is turbulent and uncertain. It would be comforting to believe that M&A best practices have become so well-documented and widely understood that hard-pressed executives can find the guidance they need by turning to repositories of prevailing wisdom on the subject.

It is true that the body of literature on M&A transactions has expanded in recent years, and there is a good deal of agreement on what works and what doesn't. Best-selling books such as *Deals from Hell*[1] and *Mastering the Merger*[2] boil down the secrets of M&A success into a few lessons. Others, such as *The Art of Merger Integration,*[3] offer more detailed prescriptions on how to develop and sustain a record of consistent M&A wins. It is tempting to conclude that companies can

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heed this advice and learn to manage their way through the M&A experience even in unsettled times.

Despite a sagging bookshelf, however, it would be unwise to conclude that M&A management has become a well-developed science. The field remains a work in progress, with best practices not yet defined precisely. Although books and papers on M&A agree on certain precepts, closer examination reveals significant variations and disparities. It isn't clear that everyone is applying the same theories, or that the numbers exist to make solid judgments about outcomes. And there are plenty of differences in the way executives understand and implement particular M&A approaches. We should be humble rather than haughty when it comes to the management of M&A.

With respect to the imprecision in defining M&A best practices, we want to highlight the extent to which maxims about effective deal management can be misconstrued or twisted in ways that miss important points. Truisms espoused by academics and advisors, or shared among executives, can be less complete than they seem on the surface. When the margin for error is narrow, that can lead to trouble. The following examples are drawn from the M&A literature and from our experience both in conducting and researching M&A integration.

HALF TRUTH 1:

TO GAIN GROWTH, BUY A COMPANY THAT'S A PROVEN WINNER.

Whole truth: If there's upside left, a proven winner may be the right target, but the better bet could be an ugly duckling with disruptive potential.

Big companies with a mature core business often try to excite investors by going after a target with a strong record that portends further growth. The question often asked in such cases is whether the target is as promising as other potential matches and whether its bona fides hold up under careful scrutiny.

But sometimes the M&A targets with the greatest growth potential are ugly ducklings that fit none of the conventional criteria for an attractive purchase. These are companies working on new technologies and business models that could revolutionize markets and destroy incumbents. That's where truly exceptional growth comes from.

Yet a disruptive innovation doesn't start off looking like a world-beater. To the contrary, in its early days a disruptor is typically a small firm with a fragile business model serving a low-end market, offering products that are no match for those available from industry leaders. McDonald's, Sony, Toyota, and Wal-Mart began this way and they didn't look very formidable in their younger days. While the apparent best target may be a company that has hit its stride (assuming it still has energy left for the next lap), there are times when management needs to think further ahead and invest in a less obvious choice that nevertheless represents more potential for value creation.

HALF TRUTH 2:

ACQUISITIONS ARE BETTER THAN LESSER FORMS OF OWNERSHIP.

Whole truth: Depending on the strategic objective, outright acquisition may be overshooting.

An outright acquisition is typically cleaner and simpler than establishing a joint venture or buying a partial equity stake. But making an acquisition may entail more of a commitment than a company wants or needs. In *The Strategy Paradox,*[4] Michael Raynor describes how Johnson & Johnson Development Company (JJDC) invested in a small life sciences company to give its parent company, Johnson & Johnson, access to a new sedation technology. A J&J division saw this technology as intriguing but not something it or any other J&J division could pursue, given their existing mandates.

By buying 20 percent of the company, taking a seat on the board, and obtaining a right of first refusal on commercialization rights to the new technology, JJDC created an option it could exercise if the technology did well in clinical trials. Alternately, it could abandon the technology at limited cost if it failed to pan out. Buying the small company would have tied J&J more tightly to the success of the technology than was warranted, and would have committed capital JJDC could use to take positions in other companies to create similar options in other areas.

"Disruptive innovation doesn't start off looking like a world-beater."

HALF TRUTH 3:

TO SATISFY INVESTORS, AN M&A TRANSACTION MUST UNLOCK BIG VALUE GAINS QUICKLY.

Whole truth: The way to impress investors is to deliver on your promises, so resist the impulse to promise more than you can deliver in a short time.

Over-reaching can be a problem when it comes to defining strategic objectives. Achieving success on a wish list that ranges from services growth to better R&D is very ambitious and may require additional acquisitions. A long list looks great on paper, but it can be murder to execute. Opening a complicated initiative spanning several fronts not only jeopardizes the fulfillment of promises about synergies, it can interfere with getting systems and processes ready to support the newly combined organization. That can have an adverse impact on customers, revenues, margins, business momentum and regulatory compliance.

HALF TRUTH 4:

MAKING THE RIGHT ACQUISITION IS CRUCIAL TO INCREASING SHARE-HOLDER VALUE.

Whole truth: It's not only what you add that creates shareholder value, but what you discard. Divesting businesses that can do better elsewhere is important, too.

Sometimes shedding businesses or assets can enhance your company's value creation potential. The fact that one or two of an acquired company's products are a great fit with yours doesn't mean they all are. Keeping misaligned segments of the acquired company can introduce a damaging drag. And even if there's great synergy today, that won't necessarily continue indefinitely; changes in market and economic cycles can alter the

PHOTO: PETE STONE

calculation rapidly. Companies should examine their portfolio of businesses on a regular basis and question whether any would be worth more if owned by someone else. In describing how Koch Industries has achieved an 18 percent compounded annual return over several decades, Charles Koch notes that his firm bought 37 businesses - but it also exited from 42.[5] Emotions may get in the way of objective analysis, of course. The "fiefdom phenomenon" often causes executives to resist selling pieces of the company for which they're responsible. And the person who championed an acquisition will quiver when someone suggests it ought to be sold. Nevertheless, it's wise to question whether there really is value to be extracted or whether the business would be worth more under different management.

HALF TRUTH 5:

FOCUSING ON THE DEAL'S STRATEGIC PURPOSE DURING INTEGRATION ENSURES THAT THE VISION WILL COME TRUE.

Whole truth: You should translate the vision into an "end-state" definition that includes the new company's products, platforms, resources, locations and other attributes.

Top management needs to translate the acquisition strategy into a definition of how the combined company should look and function to realize its vision. This means thinking through the new entity's products, platforms, resources, locations, suppliers, management structure and organization. That in turn requires addressing issues such as the right balance between revenue growth and cost reduction and what degree of integration will occur. Revenue growth is an attractive story to tell, but cost reduction is easier to plan and track. How much integration is needed may vary by business unit or function and by time frame. Defining the desired end state supplies the people running the integration process with a more specific picture of the destination they're supposed to be driving toward.

How does this look in practice? When two life sciences companies merged, the integration was guided by a detailed description of what senior management wanted the deal to achieve. The new company's structure and functioning were defined through a process that included attention to the perspectives and expectations of customers, shareholders, employees and other key constituencies. The merger resulted in substantial cost savings but the care in defining the desired end-state ensured that initiatives designed to save money didn't interfere with other strategic objectives.

HALF TRUTH 6:

A DETAILED MASTER PLAN IS ESSENTIAL FOR A SUCCESSFUL INTEGRATION.

Whole truth: You need an overall plan, but don't overestimate what you're likely to achieve by creating one or underestimate the need to augment and revise it as you go along.

A great plan won't spare you from having to deal with questions that need to get settled before the organization can function effectively, such as sensitive management appointments or disagreements over fundamental values. If you don't get those out of the way, they may derail the new enterprise. Avoiding trouble early on doesn't necessarily mean you're in the clear - it may burst out a while later. For example, the merger of two high-tech companies was nearly undone when differences among senior leaders festered and flared until the organization was rocked by confrontations, firings and litigation. Many aspects of the integration were going fine, but that didn't affect the acrimony at the top.

Assuming you're quick to resolve such issues, be certain you exert the requisite degree of control as the process goes forward. A single one-year master plan may be too high-level to achieve this and may incorporate invalid assumptions. Demand iterative one-month plans that each lead to some important and measurable outcomes. Keep re-prioritizing as you learn more. And don't overlook the importance of effective project management. Install the mechanisms to comprehensively and ruthlessly manage execution. Otherwise your plans may not be properly carried out, no matter how well-crafted they are.

"The level of intensity will fluctuate, and the nature of the contribution will vary, but every major group should be fully engaged from start to finish."

HALF TRUTH 7:

RESPONSIBILITY SHIFTS AS THE MERGER CYCLE PROCEEDS.

Whole truth: There will be some role changes over the cycle, but the whole team should be on the field from start to finish.

The level of intensity will fluctuate, and the nature of the contribution will vary, but every major group should be fully engaged from start to finish. Unlike a relay race, getting a merger across the finish line requires continued effort by the whole team. The odds of winning a blue ribbon decrease when people from certain business units or functions contribute at the start of the deal but then let others grapple with the complexities that arise in the later stages. Clearly, it's dysfunctional if too many different players participate with little coordination. Making a merger work requires the continuous application of multiple disciplines and perspectives. And everybody needs skin in the game to ensure the ultimate success of the transaction; not only operating divisions but corporate development, accounting, tax, and legal divisions should stay on board for the duration of the merger.

HALF TRUTH 8:

DURING INTEGRATION, YOU SHOULD STRIVE TO RETAIN KEY MANAGERS AND EMPLOYEES.

Whole truth: You should re-enroll not only people inside the organization, but also other key constituencies, including customers, suppliers and business partners.

It's not just your executives and employees who need attention. The early days of a merger present an enormous challenge with respect to retaining your most valuable

PHOTO: PETE STONE

cohorts - your customers, suppliers and business partners. You're going to have to spend a lot of time re-enrolling them by talking with or visiting them; by making absolutely certain that previous commitments to them are met; by communicating your plans over and over; and by being acutely sensitive and responsive to their concerns.

Sometimes simple things can get in the way. You may not have a good inventory of all your important constituencies; some companies have never documented all of their alliance partners, for example. What about the alliance partners of the company you're combining with? Given the likelihood of changes that come with any merger, it's vital to maintain the flow of communications with customers, suppliers and business partners. Even telling them you have no news to share at a given juncture is better than letting too much time pass with no update at all.

HALF TRUTH 9:

CONSTANT COMMUNICATION KEEPS EMPLOYEES INFORMED AND PREVENTS UNWANTED DEPARTURES.

Whole truth: Beyond words pouring forth from the front office, you also need leaders who model the desired values and behaviors of the merged organization, as well as mechanisms that permit communication from the organization to the leaders.

Communication is vital, but not just communication in the form of words from management. In addition to issuing announcements, taping speeches and sending e-mail updates, senior people should model values and behaviors consistent with the desired post-merger organization. Those values and behaviors should be reflected in employee goals and evaluations. Provision should be made for communication from employees to management as well and there should be mechanisms for soliciting feedback and measuring opinion. What if the retention plan doesn't seem fair to employees or rumors are drowning out the official pronouncements? Will top executives get the message in time?

HALF TRUTH 10:

TO ACHIEVE PLANNED REVENUE SYNERGIES, START IMPLEMENTATION EARLY AND PUSH HARD.

Whole truth: In the early stages, the challenge is to keep sales and customer service from getting hurt by the turmoil. Focus on avoiding harm rather than achieving big gains.

Early on, your aim should be to achieve cost synergies while avoiding actions that reduce existing revenues. This is not to say attention to revenue synergies should be deferred for a long time, particularly since they may be important to certain deals. But in the early stages of an M&A integration, there are many ways to impede revenue growth. Simply keeping revenues on their original track is no small feat. With everything from leadership to processes to systems in flux, it isn't surprising that companies in the throes of integration frequently implement new practices that jostle customer relationships and tangle sales operations. The guiding principle should be the one articulated in the physician's Hippocratic Oath: "first, do no harm."

HALF TRUTH 11:

PRECISE TARGETS FOR REDUCTION ARE VITAL FOR CAPTURING SYNERGY.

Whole truth: Being specific about reductions is important, but reductions from what? The starting point from which the cost reductions will be measured should be clear as well.

Without a well-defined baseline for reference, confusion and credibility problems may obscure good news when earlier headcount and costs can't be clearly linked to synergy claims. Keep in mind that synergy targets are frequently harder to hit than originally thought. There should be formal, non-negotiable agreements between the CEO and senior integration leaders as to what will be achieved by when, with all parties understanding what the targets mean in relation to the status quo ante.

HALF TRUTH 12:

DAY ONE SHOULD BE ISSUE-FREE.

Whole truth: Issue-free doesn't mean perfection. Focus on essentials and go with solutions that are 70 percent perfect but 100 percent achievable.

Day One should be issue-free. But that doesn't mean going flat out to have everything just so. First, it's important to focus on things that absolutely have to be in place on Day One and leave the rest for later. Just getting the essentials done will usually be challenge enough. Second, there is such a thing as aiming too high and hitting Day One with an unfinished masterpiece. Operate by the 70/100 rule: go with solutions that are 70 percent perfect but can be 100 percent implemented in the time available. Third, before committing to have something ready by Day One, evaluate the trade-offs between speed and risk. If rushing is unavoidable, how much is Day One readiness worth in terms of danger of malfunction? Finally, accept that opening day may be much less smooth than it appears to customers. Working around things that remain under construction will have to suffice for Day One. Not ideal, but don't let the perfect be the enemy of the good.

HALF TRUTH 13:

DAY ONE MARKS THE END OF THE BEGINNING.

Whole truth: Day One is a crucial milestone but hardly the end of the line. Much will remain to be done and integration efforts will need to be redoubled as Day One fades into history.

Day One should be the focus of intensive effort, but when it arrives, the new company won't have delivered on the vision that motivated the deal, nor will it be downhill from here.

In the merger of two chemical companies, success depended upon the development of new safety procedures which entailed a rigorous and extensive process extending well beyond the inauguration of the new company. By maintaining discipline, management avoided trouble with watchful regulators and, more importantly, saw to it that proper safety standards were upheld.

After Day One there's a temptation to heave a sigh of relief and return to daily business, or shift to the next transaction. But Day One will find many elements of the combination still unfinished (by design or otherwise), with significant effort yet to go. It may well be time to energize the process by bringing in fresh people, but Day One should be just a way-station on the integration timeline. The destination will still be months off, and the energy level needs to stay up as Day One comes and goes.

A LOT TO LEARN

As the above examples show, an M&A transaction involves multiple stages, many facets and much complexity. The principles and practices for managing such an initiative effectively are only partly codified and imperfectly understood. Even with respect to proven techniques, it's possible to lose something in translation and jeopardize a deal through misapplication. Executives should resist the temptation to assume that their organizations possess the whole truth about M&A management and approach each deal with the wary conviction that we all have much to learn. DR

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Endnotes

1 Bruner, Robert, *Deals from Hell: M&A Lessons That Rise Above the Ashes*. John Wiley & Sons, Inc., 2005.
2 Harding, David and Rovit, Sam, *Mastering the Merger: Four Critical Decisions That Make or Break the Deal*. Harvard Business School Press, 2004.
3 Lajoux, Alexandra Reed, *The Art of Merger Integration: A Guide to Merging Resources, Processes, and Responsibilities*. McGraw Hill, 1998.
4 Raynor, Michael, *The Strategy Paradox: Why Committing to Success Leads to Failure (and What to Do About It)*, Currency, 2007.
5 Koch, Charles, *The Science of Success*, Wiley, 2007.

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