Successful Integration

Richard S. Parenteau

J. Fred Weston*

January 17, 2003

* Richard S. Parenteau is Managing Partner of the M&A consulting firm, Quick-Cycle Consulting in Sunnyvale, CA, (rparenteau@quickcycle.com). J. Fred Weston is Director of the Research Program on Mergers, Restructuring, and Corporate Governance at the Anderson School, UCLA, (jweston@anderson.ucla.edu).

Successful Integration

Richard S. Parenteau and J. Fred Weston

It is important to identify in an Operations and Integration planning checklist the key decision areas. This provides an overview of the tasks to be accomplished in each of the four typical phases of the M&A process: strategy, screening, acquisition execution, and integration. In performing due diligence, representatives from all important areas of activities, as well as outside expert consultants, should work together to think through what is required for successful operations and integration performance. By considering the total process at the due diligence stage, the critical requirements for success can be identified. Then in addition to the legal aspects, the operating and integration relationships between the combining companies can be evaluated to determine whether the hoped for synergies can actually be achieved. This orientation can change the entire planning and execution activities involved. It represents a focused approach that is more informative and efficient.

Mergers and Acquisitions are complex activities that increase or destroy business value. The ability to execute M&A strategy successfully is critically important to most businesses at some point in their lifecycle. The common measure of success is increased business valuation from the realization of identified M&A synergies through successful integration of the acquired organization.

In this paper we focus on how integration results can be improved by preparing for issues ***during M&A activity phases PRIOR*** to the M&A transaction decision. We discuss Operations & Integration steps for each of the four typical phases of M&A activity: I. Strategy Planning, II. Candidate Screening, III. Transaction Execution, and IV. Integration.

Key Activities for Successful Integration

Based on our experience we recommend that companies place an earlier emphasis on integration activities, initiating them concurrently with the M&A strategy planning.

The M&A team should address the key integration activities needed for successful Operations & Integration (O&I) in each phase of the typical M&A Lifecycle. Proper implementations of these activities will deliver the value of the synergies motivating acquisition decisions. A phased approach to the key activities facilitates successful planning and oversight by both the O&I team and the individuals responsible for coordinating the implementation.

To accomplish both the Selection and Acquisition (S&A) activities and the integration of the acquired company, the acquisition team should be comprised of members focused on both the business strategy and on the O&I planning process. This concurrent activity is the key to a successful M&A project.

Equally important is designation of a single individual to lead O&I who has full-time integration planning and implementation responsibility throughout all phases of M&A. We advise selecting an experienced senior level person with these characteristics:

- Broad operating and general management experience in the acquiring company
- Self-assured and able to place combined business and workforce needs ahead of his/her personal ego
- Experience driving fast-paced projects, able to mold business processes and build relationships
- Comfortable driving decisions in highly dynamic situations
- Able to relinquish the assignment once major integration milestones are completed.

In Table 1 below we provide a general O&I checklist. We have designated the activities that should receive the greatest emphasis during each of the four M&A phases. We recognize that M&A Strategy varies significantly in scale and purpose. Also market situations vary by industry and the relative organization size and characteristics are unique to each merger. The O&I team should tailor the checklist to reflect the specific transaction.

Table 1
O&I Planning Checklist

	M&A Phase			
	I Strategy	**II Screen**	**III Execute**	**IV Integrate**
Asset Acquisition	P		R	I
Asset Divestiture	P		R	I
Organizational Restructuring	P		R	I
Outsourcing and In-Sourcing Opportunities	P		R	I
Capacity Changes	P		R	I
Cultural Changes		P		I
Personnel Changes		P		I
Best Practices		P	R	I
Employee Education		P	R	I
Incentive Bonus Plan		P	R	I
Executive Management Participation	P			I
Special Short-Term Help	P			I
Special Synergies		P	R	I
Short-Term versus Longer-Term Integration		P	R	I
Continuous Communications and Training		P		I
Acquisition Announcement		P	I	

P = plan, R = review, I = implement

Phase One: M&A Strategy

Initially, the Strategy and Acquisition (S&A) members of the M&A group compare company objectives, market trends, and customer input with company resources and product programs to identify ways to build business value. Some of these will be accomplished via internal programs and others will be via M&A synergy opportunities. In the latter case the S&A team will develop an M&A strategy plan for selecting candidates that provide identifiable synergies. The O&I team uses these synergies to identify specific key integration activities in four areas: 1) Asset Acquisition, 2) Asset Divestiture, 3) Organizational Restructuring and 4) Capacity Changes.

Early creation of a draft O&I plan before the acquisition provides two benefits new to most M&A teams, benefits that greatly strengthen the candidate selection and support rapid executive approval of the project and candidate. First, the draft integration plan helps candidate screening by identifying integration-enabling characteristics required of the candidate. It allows an anticipatory approach for creating draft integration plans. Depending on the project synergies, examples of O&I requirements for a good candidate are:

- Acquired product technology compatible with acquirer's manufacturing system
- Volume product production without numerous customer-unique variations
- Buyer's sales approach will not jeopardize retention of acquired customers
- Compatibility of acquired product with acquirer's sales model and skill set

Secondly, the plan identifies obstacles early enough that either a "showstopper" issue is discovered or effective adjustment processes can be achieved before the crunch of executing the integration plan in Phase Four.

Early O&I planning for difficult issues or long-lead adjustments make a critical difference to integration success, and can change the nature of the M&A decision or the "deal" structure. Examples of "showstopper" issues might be:

- Acquired technology outdated, cannot be manufactured efficiently without major redesign of complex products
- Acquired products have unique features for each customer that prevent volume production without major redesign and resetting customer expectations
- Customers rely extensively on a long term relationship with channel Sales Rep and are likely to go to competitor if the restructuring changes channel partnership relations
- Acquiring company's sales force does not have skills to sell the new products

Too often these problems have only been identified during integration after the acquisition was completed. In these cases the acquisitions failed to deliver the projected value.

Examples of adjustment requirements for other O&I issues include:

- How and where to increase manufacturing capacity
- Actions needed to add new sales channel to business processes
- Approach to combination and reorganization of customer support centers
- Personnel planning to retain (or not) people for roles in the combined company
- Plans for divesting portion of acquiring company no longer needed

There are clear benefits to identifying and working on these central O&I issues from the beginning of the M&A initiative. This analysis is critical for evaluating candidates. Identification of "showstopper" issues leads to early rejection of some candidates. Other

candidates will survive the second round of screening only if adjustment requirements are justified by strong long-term potentials of a combination.

Additional work to be done by the O&I team in the M&A strategy Phase One includes:

1) Identifying the approach for keeping Executive Management updated about the O&I plan, anticipated issues and progress. – This allows management to remain confident about the plan and prepare to handle anticipated issues, especially important for situations arising later during integration. During executive discussions of the acquisition with employees and others, executive support for the O&I team and its leadership empowers the team to make the difficult and rapid changes required to integrate the acquisition.
2) Special Short-Term Help – The M&A planning should recognize the need for a substantial amount of extra time and special skills in various stages. In particular, the effort needed for the due diligence work and the rapid pace of this work are a major surprise for those experiencing it for the first time. Seven day weeks with twelve hour days are often the norm. The peak effort and specialist skills are usually needed in the legal, accounting, and operations area. Extra consulting help is a requirement for successful completion of these efforts with avoidance of burnout and employee retention. The use of consulting M&A and O&I specialists familiar with the checklists and priorities will help complete both the due diligence and integration work on schedule. The planning for the O&I team's active participation in the diligence process affecting all operational issues should identify the extra resources needed to cover areas including: HR, Sales,

Customers, Support, Product (development and manufacturing), Contracts, Contingencies, Regulatory requirements, Partnerships, Revenue policies, Business structure and processes, Communications and Culture.

An example of successful early O&I planning and excellent execution of all four M&A phases occurred at a company where the M&A strategy identified an opportunity to replace Systems Network Architecture (SNA) (75% worldwide networking market share) with Transmission Control Protocol/Internet Protocol (TCP/IP) for corporate enterprise networks. Careful strategic analysis had suggested that by connecting the TCP/IP network equipment to mainframe computers using the same interface hardware currently used by the SNA network equipment, an orderly market transition from proprietary SNA to open-standard TCP/IP was possible. The company created an O&I plan for acquiring the interface technology from the owner, implementing it and validating the new solution internally, by compatibility testing and at customer sites such as the Federal Reserve System's Federal Funds Clearing Network. The detailed O&I plan prepared in advance allowed a rapid and successful implementation. Within two years of product launch incorporating the new technology, the company's SNA-replacement product line was achieving an annual revenue stream of over one billion dollars.

An example of a failure occurred at a company where weak Phase One O&I planning allowed major acquisition investments using capital stock valued at several billion dollars. However, the new technology products that were acquired were unexpectedly difficult to sell and the projected synergy value from selling the new

product line through the acquirer's worldwide sales force was not realized. This occurred because the O&I plan was not developed in either Phase One or Two and the company did not identify the inherent conflict between the existing well entrenched sales plan and the new product line. A key problem with the sales plan was the strong incentive bias for sale of small quantities of large dollar-value products. This conflicted with the new product line's requirement for selling larger quantities of smaller dollar-value products. Early O&I planning would have highlighted the challenging integration activity for the sales force incentive plan and would have identified an early "showstopper".

Phase Two: Candidate Screening

In the screening phase, the S&A team uses the strategic plan describing the synergies and the required integration-enabling characteristics from the O&I team to identify candidates for acquisition. As leading candidates are identified, special synergies unique to a particular candidate are identified. The O&I team continues its work matching these special synergies to the key activities of the combined firm. Particular attention should be paid to gaps between a particular candidate and the new configuration in the combined firm. The O&I team needs to immediately address situations where the candidate lacks the ability to support a synergy or when the planned approach for an integration activity is not feasible. The team will develop a mitigation scheme with related costs, or recommend abandoning the particular candidate as an unacceptable fit. It is essential that the O&I team have the power to influence the S&A team's acquisition decision when a poor O&I situation exists.

While the screening and initial discussions are proceeding, the O&I team is completing its draft O&I plan by covering the following areas:

Best Practices. Develop documentation of best practices for areas critical to combining the two companies. Business processes are vital to efficient operation and the combination of the two companies will affect key processes. By identifying these in advance and planning for changes, employee confusion can be minimized.

Synergy Discovery. Special synergies represent business value for the company from acquiring a particular candidate. These are generally non-obvious to the public and usually unknown to the candidate. They allow the acquirer to be comfortable that the probability for success is high and perhaps to choose to pay somewhat more for the acquisition if necessary.

Motivation by Incentives. Incentive bonus plans are formulated for all of the employees affected by the acquisition (handle "quota" employees separately). We are particularly sensitive to the need for motivating the employees of the combined company to complete a successful integration. The success of O&I depends on these contributors and we believe the incentive should start with a present value of approximately three thousand dollars per person and increase according to the individual's contribution to the success of the integration. The payout of incentives should be tied typically to three specific milestones that the individual can directly influence, with the last being measured in about 6 months or less from the beginning of integration. For commissioned employees their incentive program should complement their commission quota goals and

compensation. When combined with effective communication, incentives motivate employees to see the acquisition activity as a personal opportunity and to accept the dislocations of organizational change together with the increased work of the acquisition. Therefore, it is critical to include the cost of the incentive package in the O&I cost analysis section of the M&A project, and to secure executive approval of the incentive bonus plans.

Staged Integration. Short-term versus longer-term integration activities represent an important distinction in developing time phased schedules. Between the O&I plan and the issues raised during diligence, the O&I team will need to manage a large list of activities. By separating them into short-term projects for rapid delivery of the business value and everything else as longer-term, a reasonable integration plan over the first 100 days can be accomplished.

Communications. Continuous communications are the lifeline of a successful integration. The O&I team needs to plan for an ongoing effort using a variety of communication mechanisms. Information will need to be distributed internally and other versions of that information will be distributed to customers, vendors, partners, and market analysts. For the internal audience the topics will cover all of the areas outlined in the O&I planning checklist and will need to be updated and re-communicated numerous times. Print, video, audio, and web-based mechanisms are essential together with live interactive discussions and presentations.

Training. Employees and outside parties will all need training about the effects of the acquisition, new products, pricing strategy, ordering, support, etc. Substantial amounts of

the supporting business collateral will need updating over time. Items likely to require early attention will include product brochures and catalogs, marketing material and demonstrations, website and advertising information, pricing and ordering documents, sales "pitches", support documentation, analyst and investor communications, business and employee contact lists, internal business process documentation and product certifications.

Acquisition Announcements. Preparation of the acquisition announcement is a combined effort between the S&A team and the O&I team, sometimes in consultation with outside specialists. The acquisition announcement, usually from the CEO, will need to convince the audience that the acquisition is a major positive step for the company and demonstrate why the company wins. At the same time the presentation must include a candid assessment of the integration challenges and organizational restructuring that will occur. It is critical to maintain ongoing operations and avoid debilitating distraction from "fear of the unknown". People need to know the status of their jobs and also that the impact of the acquisition on their work load is being considered in the integration. And finally, the employees need to know that there will be recognition (the bonus incentives) for successful integration (although the details would be developed and communicated later).

An example illustrates the pitfalls of an inadequate O&I plan. We observed a company where there was no O&I team assisting the S&A team with candidate screening and where integration was routinely done "ad hoc" after the acquisition. We observed that the company made an acquisition with a segment that duplicated an existing product. In this case a division of the acquiring company was within two weeks of delivering

products competing with those of the acquired company. The internal products were already integrated into the company's product pipeline. This problem with the acquisition created unnecessary conflict and reduction of morale in both the acquiring and acquired companies that could have been avoided.

The benefits that would have been derived from having an O&I group working with the S&A group were clear. We have observed several situations where the risk of the M&A strategy is increased by a S&A team that is primarily market strategy focused and that lacks current information about product activities within one or more parts of the acquiring company. We believe that a key value provided by including an active O&I team is knowledge of the acquiring company's functional units and the ability to fill gaps in the operating knowledge of the S&A team.

Phase Three: Due Diligence and Transaction Execution

Thorough due diligence followed by rapid transaction execution must be accomplished for potential synergies to be achieved. This is an intense period of activity with constraints on who talks to whom and on what schedule. There are legal ramifications if information leaks occur. Proper time phasing is essential as integration proceeds.

Generally, members of the O&I team supported by outside specialists are best prepared to accomplish the O&I diligence work or in some areas to review the findings of other specialists. Properly coordinated diligence work is performed in a specific sequence designed to identify "showstopper" issues as early as practical and yet limit interaction between acquirer and acquired personnel to minimize legal risk in case the

transaction is not completed. During due diligence, outside specialists in law, accounting and operations integration are commonly used to provide both additional resources and the required legal shielding for certain trade secret disclosure risks.

The O&I team should prioritize key integration activities of the O&I plan dealing with relationship issues near the top of the diligence activity list. While an examination of the O&I plan may identify additional items, we consider the following five to be among the most important key activities because they contribute significantly to the core synergies of most acquisitions.

Identify Key Personnel. Identify the acquired company's key personnel required for successful O&I and determine how to address all issues that will affect their excitement for contributing to the combined company and commitment to helping O&I be successful. This requires a detailed examination of each person's prior work and new role in the combined company and whether these match their interests. This analysis includes: prior commitments, compensation plans, performance, skills, geographic logistics, etc. together with how this individual will integrate into the new organization business practices and culture.

Commitment. Identify the purchasing company's key personnel required for successful O&I and determine how to resolve issues that will affect their commitment to making O&I successful. The purchaser's employees take on additional O&I tasks and also guide and train employees from the acquired firm. It is critical that the purchasing company's personnel understand the value of the combined company and the relevant portions of the O&I plan so they will consistently reinforce a positive teamwork and good culture message to the acquired employees.

Customer Relationships. Closely examine and clearly understand key customer relationships and mutual commitments required for successful O&I. Assure that O&I supports these relationships and honors outstanding mutual commitments.

Identify Key Alliances. Key alliances and business partners may be impacted by acquisitions. The O&I plan needs to examine these relationships in detail and provide appropriate transition to the combined company's business model for partner relationships.

Financial Analysts Relationships. Frequently industry analysts stop covering the acquired company's products after an acquisition. Loss of market visibility can be deadly to market related synergies, and therefore the O&I plan needs to maintain or replace analyst relationships.

The five areas above deal with key O&I activities that will likely touch all major functional areas of the company and require a multi-disciplined approach to perform the required diligence. The O&I team's key contribution is its ability to assemble the results of this diligence and guide specialists toward solutions that contribute to the success of the O&I plan. For example, the HR representative will be looking at compensation and benefit issues from the perspective of how to fit the acquired company employees into the existing framework of the acquiring company. However the O&I team working with HR can direct different approaches for special situations in order to assure success of the O&I activity.

Another benefit of including O&I in the diligence activity is the ability to complete the O&I plan and include the associated costs and incentive plans. To

accomplish this, the O&I team also reviews the earlier work and updates information where needed to reflect new developments. This is reflected in the earlier table in the Phase Three column where items are marked with the symbol "**R**". The completed O&I plan will now permit the acquiring company's executive management to expect that synergy values identified in an M&A project include realistic projections supported by O&I analysis. Management's M&A transaction approval can now reflect expected increases in business value from the acquisition synergies net of Operations and Integration costs and incentive bonuses required.

We have observed examples where an acquisition resulted in the acquiring company having an engineering group at an inconveniently remote location. One key O&I activity of the acquisition was to secure the Intellectual Property represented by those engineers and to complete their current project. In the cases observed, the acquiring companies determined that upon completion of an existing project, the remote team would be relocated to the main engineering location. During the diligence phase the O&I team working with HR arranged to pay a project completion incentive (in one case equal to the engineer's base pay during project completion, effectively double time for 8 months). The projects were completed on schedule without significant personnel losses. Without an O&I focused approach supported by HR, we believe the impending relocation in these cases would have caused the engineering groups to dissipate before completing their work.

We have observed another example where the O&I plan for an acquisition was to allow the acquired company to continue operating as an independent subsidiary of the parent. In our opinion, this is a risky approach to most M&A activities. The problems of

TYCO illustrate the hazards of a business model of unrelated subsidiaries. In this situation the acquirer's M&A activity failed to develop an O&I plan that properly tied the acquisition synergies to key integration activities. We identified two major problems with this O&I approach which should have been resolved during the diligence phase and would likely have aborted the transaction: 1) No O&I activity was planned for the subsidiary to develop products or technology that specifically contributed to increasing sales of the parent's products, and 2) No O&I market analyst activity was planned to maintain the market presence of the subsidiary's products. As a result, the parent did not achieve increased value in the combined business, either via increased parent product revenue or from the subsidiary's product sales which declined. This acquisition was regarded as a failure and the subsidiary was subsequently sold. Later the parent was put "in play" and was sold as well.

Phase Four: Transaction Integration

In the first three phases O&I was in a supporting (but still critical) role. Now O&I is primary and responsible for the successful integration of the acquisition. The O&I team that developed the plan should have significant responsibility for the program management of the plan which includes communication, schedule management, issue resolution, plan adjustment and performance measurement. Note that it now becomes of paramount importance to have the continued leadership of the O&I integration by the single individual, discussed earlier, who has the full-time integration planning and implementation responsibility. This person is critical to the success of the O&I effort.

Communication

By this time in Phase Four, all disclosure issues will have been addressed and the communication portion of the O&I plan must now become fully operational. It is important to recall that to this point the rationale for the acquisition, its synergies and the integration plan are well understood only by the executives and the small group of people involved in the M&A group. Throughout both the acquiring and acquired companies bits of information, rumors, and fears regarding organizational change and job security will be circulating rapidly. Ongoing communication is critical to maintain credibility and focus energy on successful execution of the O&I plan and to change the plan when needed. The critical early job of the communication plan is to clarify purpose, confirm planned organization changes and how/when they will occur. It is key in the case of reductions that everyone understand that affected employees will be fairly treated. Organization changes planned to occur later will need special handling for affected groups. Immediately after addressing the organizational issues, it is important to communicate the specific assignments in the O&I plan and the incentives for success. A successful communication plan will inform and engage employees so that they support the effort and see personal opportunity.

Schedule and Change Management

A major part of O&I program management is timely task delegation to support the integration schedule. One of the most difficult parts of integration is to manage organizational change, which entails change in reporting structure, task assignments and business processes. Program management pays close attention to these tasks and assists

with adjustments as the details are worked out across functional units. Change creates confusion and turf issues, common problems that require quick resolution by the O&I team with clarification of plans or tuning the organizational changes. Managing the schedule needs to include celebrating milestones as they are achieved to maintain momentum and organizational morale.

This example builds upon the successful O&I example we discussed in Phase One. Recall that the acquiring company was successful using acquired technology together with its TCP/IP based products to open the competing company's proprietary SNA market. Subsequently, the competing company's SNA networking division (that dominated the worldwide market with a 75% market share in our earlier example) remained committed to their proprietary approach and didn't concede that a fundamental change was underway in the networking market. As a result of competition from the TCP/IP product introduction, the SNA division's revenue and market share declined reducing their value to their parent company. Now, the acquiring company from our earlier example approached the parent company and proposed: 1) to acquire the ailing SNA division in exchange for two billion dollars; and 2) to become the parent's new networking partner. The parent company agreed because there was a greater synergy value in the increase in their global network integration business than the value lost by selling the SNA division. However, the SNA division posed a particularly difficult integration challenge due to the prior competition. Using its O&I plan, the acquiring company was able to show the acquired employees that the legacy SNA product would still command a significant legitimate market. It was also able to show that the combination of the technology of the acquired SNA division together with their own

produced an exciting new opportunity. The combined company would dominate three markets, the new world SNA-to-IP market (without significant competitors) and the separate SNA and TCP/IP markets. The O&I of employees and technology for product development, customer support and manufacturing for the acquired SNA division was successful. The partnership alliance with the selling company for product sales and systems integration was also successful. Both companies increased revenue by billions of dollars.

Review, Evaluation, and Renewal

An effective post-audit of the acquisition process requires a review and an evaluation of a completed acquisition. The purpose is both for task accountability and to learn how to improve the M&A process for the next successful acquisition. Key areas for analysis include the following:

1) Preparation and utilization of the key O&I activity list for candidate screening and selection. Was this done and how was it used?
2) Comparison of the list of Phase One O&I activities and the actual Phase Four O&I activities. Excluding special synergies, the Phase Four list should be a major subset of the Phase One list. This suggests how successful the early planning was in predicting the O&I work that was performed in Phase Four. How can this be improved?
3) Comparison of projected costs associated with the final O&I plan used in Phase Three to support the Transaction justification from the S&A group, with actual costs from the Phase Four actual integration as documented in the "cost of

acquisition" accounting records. Were major costs overlooked or overestimated and why?

4) O&I contribution to executive diligence summary with go/no-go issues, resolution (if any) and management recommendations regarding transaction execution. How did the O&I group influence executive management's transaction decision? How could this be improved?
5) Hold post integration meetings with major groups participating in the O&I activity. Identify major successes during integration. How or why did these happen and how can this be done again. Identify major problems during integration. How or why did these happen and how can this be avoided next time.
6) As milestones are achieved O&I management should direct HR to make appropriate disbursement of incentive payments according to the approach approved by executive management. Were these incentives useful? How could they be improved?
7) Report a final results summary to executive management including significant lessons learned and recommendations. Executive management should review and reward results appropriately.

Summary

We have documented the many activities required for planning and executing an M&A transaction. Table 1 presented an operations and integration (O&I) checklist for the relative importance of planning review and implementation during the four key phases of an acquisition: strategy planning, candidate screening, transaction execution,

and integration processes. The paper puts flesh on the checklist describing the multiple requirements for implementing a successful merger transaction.

A central emphasis of the paper is the need to relate due diligence analysis to operation and integration issues. Active participation by the O&I group in the due diligence activities of the M&A organization executive group and its advisors is critical. O&I participation in coordinating the sequence of the diligence work with particular attention to the key integration activities identified in the draft O&I plan is necessary. Items which should affect the acquisition decision are frequently left to be dealt with later in Phase Four Integration. Failure to adequately consider O&I issues during initial M&A phases and due diligence ***prior to the transaction decision*** is the ***key reason*** why acquisitions may fail to deliver their potential values.

Another emphasis is the importance of recognizing the shocks involved in combining organizations. The employees of both companies are impacted by stress and requirements for taking on new and increased responsibilities. Employees of the combined companies need to be motivated by incentives to complete successful integrations. The financial rewards should be related to individual responsibilities as well as contributions to the organization changes required. Incentives can motivate employees to accept the disruption of organization changes and the increased work involved. The incentives should help employees view the acquisition activity as an opportunity for personal growth and development in a stronger organization.