Integration in the Post-acquisition Phase

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How to Make the Deal Work
Although most organizations today have a well-oiled corporate transactions process that includes a proven methodology, tools and access to skilled resources, many of them privately admit to mixed feelings when they compare, on the one hand, the business case immaculately presented and, on the other hand, the mixed outcomes of previous corporate transactions.

Often, the business synergies have been highlighted, the cost savings, infrastructure efficiencies or revenue enhancement opportunities clearly identified, the project management and the change management infrastructure addressed, and the CEO and board questions anticipated – an excellent piece of work in fact. However, in my firm’s most recent research, three-quarters of survey respondents indicated that they had not managed to meet or exceed “all” their objectives in their transactions. As frequently reported in the business press, the majority of M&A transactions do not add shareholder value. With the recent market collapses and the rise in the cost of capital for funding acquisitions, this trend is set to continue.

WHAT HAS GONE WRONG?
When one considers the CEO’s agenda, it quickly becomes apparent that many of the most important issues – from enhancement of revenue, to the timely achievement of the cost savings to the operational effectiveness objectives – are directly influenced by the company’s ability to successfully manage its human capital. However, in practice, what is found is that the management time required often well exceeds the predictions, with repercussions for business-as-usual activities. Even if they have not actually left the company, certain key employees have been known to operate at below par for some time. My firm’s experience also shows that the attrition rate of key employees significantly increases in the earlier post-acquisition stages.

In the case of a purchase, the buyer may find that what it has bought was not fully captured by the due-diligence process, especially in terms of the business and employment culture, while, in the case of a sale, due-diligence requests may have caught the company on the hop, with additional resources required to address them.

Above all, employees on both sides of the transaction seem to have an infuriating ability to become totally distracted, leading to the classic ‘J curve’ of productivity whereby, far from improving results, there is a noticeable fall in effectiveness in the first instance. The result is often that the confidently predicted synergies never arise or take much longer to be achieved than the pricing model anticipated, thus wiping out the anticipated increase in shareholder value.

How much value is lost will always remain a vivid debate as so many factors are to be considered. Several models can be used to quantify the linkage between the people issues and the corporation’s economic value. It will not be a surprise to learn that the impact of the people factor can prove to be significant. The corollary is that the Value at Risk involves numbers that become rapidly frightening.

Impact of Cost Overruns and Delayed Savings
The following example illustrates the potential magnitude of the problem. Let us assume a hypothetical transaction where the value of the contemplated acquisition amounts to US$3 billion. The price offered considers a 20% premium. The value of the premium (US$600 million) is based on expected cost and revenue synergies arising from the acquisition. Experience suggests that the integration of the business operations usually takes longer than expected because of the underestimated challenge of bringing together organizations with different employment cultures – my firm’s 2003 research highlighted that many integration processes are completed, on average, one year later than expected. The employee attrition rate tends to increase in the midst of a transaction.

Assuming that the rate of employee attrition increased by 10% following the transaction announcement and that the integration of the businesses would take one year longer than expected, the result would have been an impact on cash flow due to the delay and to the loss of talent of US$75 million and US$48 million respectively. Assuming that the target is valued at eight times the expected cash flows (a conservative assumption), the value destroyed would have amounted to US$984 million, or 64% more than the expected synergies.

Now if one really wanted to scare the CEO and the board, consider that typical cash flow multiples contemplated in recent transactions amounted to 20! It is apparent that one of today’s most significant challenges for organizations is to recognize the more significant human capital* issues and incorporate these into their business model from the earliest stage of the corporate development process through to the execution of the plan and the attainment of the business objectives. Only with this planning and effective execution can corporations achieve the cost savings and revenue growth predicated on the bid price and thus create...

* Human capital is referred to in the broadest sense and would include: compensation, benefits, performance management, talent issues, corporate culture, employee morale, governance, organizational effectiveness, operational productivity, management capability, organization design, leadership, human resources structure and delivery model, employee relations and industrial relations.
value. To extract the added value, the objectives must be properly defined in consideration of the corporate strategy; the issues must be identified and addressed in time; the integration must be executed as planned; and a willing workforce must embrace the new paradigm.

Human resource leaders clearly have a major and increasing role to play in the achievement of a transaction’s objectives – one would hardly expect an HR consultant to say otherwise but it is evident from the above.

**What are the Successful Companies Doing?**
A willingness to involve HR at an early stage is certainly a common factor in what successful companies are doing that the majority are not. So many transaction teams are driven by financial, tax, legal and operational considerations, with the ‘people stuff’ seen as an afterthought. My firm’s regular research shows that, year after year, companies spend no more than 10% of their due-diligence time on HR-related matters compared with close to 50% on financial and legal matters.

While experience suggests that a large proportion of human resource professionals have the tactical issues (for example, the terms and conditions of employment and broader employee policies, and the human resources management systems) well under control, it remains the case that the less tangible, more complex human capital issues like culture, management capability, leadership and workforce engagement are much more poorly managed. Ironically, these are the very areas where the ‘opportunity’ to destroy value is the highest!

Frequent acquirers have learned the lesson that an understanding of the people risks starts at, or even before, the identification of a potential target. Compare this with the majority of companies that view HR due diligence as nothing more than a financial risk assessment of pension and incentive plan liabilities.

Most companies are good at recognizing the role of HR in post-acquisition integration but only a small number are treating people issues as a strategic concern. The integration of human capital synergies into the deal price requires proactive management of the integration and a holistic human capital risk management approach is a must.

**Understanding the Problem**
Involving HR early on is not in itself a guarantee of success. To use a philosophical turn of phrase, it is a necessary but not sufficient condition. The real key is to understand the nature of the problem. In my experience, transactions can come unstuck for a variety of reasons, which can be categorized as:

- neglecting the departing or arriving employees,
- neglecting your own employees, and
- failing to anticipate cultural diversity.

I will now look at each of these in turn.

**Neglect of Departing or Arriving Employees**
Let’s look at the situation from the point of view of an acquirer. Acquirers need stability first and foremost. They need to lock in key staff, maintain business as usual through the transfer and engender genuine enthusiasm for the change in the acquired employees. However, the employees usually have different concerns. Certainly they too need stability, but they need to be persuaded that the deal is a good one for them, that they have a role to play in the new organization and that they can be successful.

Sometimes the employees are easily persuadable. If the business has not been financially successful, many employees might see the sale as being a way of providing them with greater job security. No doubt most Lehman Brothers employees welcomed the recent takeover by Barclays and Nomura of parts of the business, when the alternative might well have been insolvency. In a similar manner, the acquisition may well be seen as providing opportunities for employees that were not present previously – perhaps because the acquirer is a larger or more diversified organization that can offer greater career choice.

What about the employees of a recent spin-out from one of the world’s major companies, where the acquirer was establishing a start-up business from the spun-out entity? Employees in this case were faced with transferring from a large organization with rich employee benefits and a well-established career development process to a new venture which – while backed by substantial capital – was a real unknown for the employees and, in some countries, very small. Certainly, the financial rewards for success would be great – and for those of an entrepreneurial bent the opportunity to shape a start-up was very attractive. For other employees, however, the buyer had to recognize the need to provide reassurance – not merely in terms of preservation of terms and conditions (important as that was) but more in terms of future plans and potential.

Employees of the sold business frequently experience a sense of loss – indeed, one might characterize it as grieving for what they had. The sense of loss is rarely about tangibles, such as salary or bonus, but instead may be about comradeship and self-esteem; the sense of importance of working for a household brand, the social outings, and the choice of food for lunch, the Christmas party, the charity fun-run or the water cooler gossip. This is no ‘touchy-feely’ issue either. Employees may have to be consulted on the new arrangements and have the power to seriously disrupt the transaction if the buyer is seen to be running roughshod over their concerns.

A farsighted buyer will put itself in the shoes of the arriving employees. What are their hopes and fears? How can what they are losing be acknowledged even where the new company is unable or unwilling to replicate this? What pictures can be painted of the new future together? Indeed, using the word ‘together’ to emphasize that the future is not predetermined – that there is something to be created that all can be proud of – and, in short, giving the arriving employees a real sense of a fresh start is what it’s all about.

The price that both buyer and seller can pay if the needs of the transferring employee group are neglected can be high. In deals involving European companies, it is very likely that meaningful consultation with representatives of the transferring employees will be needed before the transfer can take place. Typically, such consultation is on the basis of an agreement by the
seller – enforced on the buyer – that employees will continue to enjoy ‘broadly equivalent’ terms and conditions. The problem arises when the parties attempt to interpret this phrase.

A recent client situation rested on the expectation by employees that enhanced early retirement terms would be on offer, whereas the buyer was only intending to match pension benefits at normal retirement age. As in many similar cases, the issue was not so much one of technical interpretation of the obligation, but of the tone set by the buyer and seller as a consequence. On closer examination, it was found that, while there were financial considerations, the underlying cause for concern among the departing employees was the realization that on early retirement they would be unable to join the seller’s alumni organization, with the resulting sense of loss. Once that was acknowledged and rectified, it became much easier (and cheaper) to deal with the early retirement issue.

Neglect of Existing Employees

The seller may have another batch of issues. There are often fuzzy edges for the group of employees who are being sold, and great uncertainty can be raised especially among those employees who provide services to the sold business. Is it just the sales team or will sales support be joining them? What about the payroll clerk in corporate HR, half of whose sole responsibility is for the departing employees or the management accountant who spends three months a year working with the maintenance team? Furthermore, there are the work colleagues who get left behind. A recent financial services spin-out meant that employees sharing a desk found themselves on opposite sides of the divide while new premises were sought. Whereas one employee continued to have free access to the company gym, his former squash partner did not. Both experienced a sense of dislocation.

However, the most common examples of neglecting existing employees arise when the company is an acquirer. Too often, the effort made to communicate with the incoming employees is not matched by consideration of the impact that the newcomers may have on existing employees. There are concerns about competing for jobs with the new arrivals, about the dilution of a unique culture, about the perceived need to cut costs to justify the purchase price, or about the extra burden that the newcomers may place on already-overstretched HR and IS support. Strategic HR due diligence may have identified opportunities for synergies but these may affect existing employees as much as, if not more than, new ones, especially if the acquired company has a more market-aligned (for which read lower) set of benefits and compensation programmes.

So what should be done to mitigate these problems? For a seller, it is vital to plan for the separation in terms of what it will mean – work practices and less tangible issues – for those employees who might be directly or indirectly affected by the sale. This means those staying as well as those going. For a buyer, the key consideration is the scale of the acquisition and the degree of intended integration. The impact on existing employees of acquiring a small stand-alone entity that will operate autonomously is clearly going to be much less than a ‘merger of equals’ where the distinction between new and old employees is almost invisible. Whatever the scale of the deal, post-merger or post-separation planning needs to start at, or even before, the due diligence, and the due diligence itself should seek to identify potential problem areas on both sides of the deal.

Failure to Anticipate Cultural Diversity

When a US ‘bricks and mortar’ company bought one of the last successful internet start-ups in the UK in 2005, it was faced with integrating a team of employees who could hardly have been more different from its own. There were differences in formality of working style, compensation strategy, organization and reporting, even in attitudes to working from home. In this case, the issue was obvious from the nature of the two organizations. Good planning enabled the acquired company to retain what made it function while introducing sufficient structure to allow the leveraging and economies arising from a large parent company. In other cases, this critical dimension is overlooked until after the deal, when productivity starts running into the sand and staff turnover goes through the roof. A common mistake is to assume that, if companies are in the same industry, then they are going to have the same culture.

Culture is an amalgam of many things – leaders, heroes, programmes, history and management style – and these are never the same; culture is ‘the way we do things around here.’ The understanding of norms, values and behaviour and how they support – or go against – the pursued objectives is what matters. Organization culture is not good or bad, it is the consequences for the objectives it has which are important.

Although many change levers exist in an organization from the governance and the organization’s structure to the employee policies and programmes, it is the role of leadership that tends to be critical. The leadership’s behaviour, actions and approach to communication are crucial in culture change environments.

Forging a common culture can take several years and therefore requires a deep understanding of what is valued and valuable in the two parent cultures. How close the cultures need to come is also influenced by the business integration needs... even if eventually there is a need to operate with a consistent array of values. Due diligence often fails to pick up on the critical cultural concerns because it relies on data provided by, and access to, senior leaders only. Talking to former employees, customers and suppliers, reviewing the way the company portrays itself in the media, looking at the words it uses to describe success – these are the pointers to the underlying culture. Once access is granted – often not until after a deal has been struck – every opportunity should be used to test the cultural climate, perhaps through a suitable survey.

Successful acquirers pay specific attention to the implications of cultural diversity and focus on addressing the identified main challenges and on building the appropriate change management infrastructure to support the necessary behavioural shifts.
MAKING A MATERIAL DIFFERENCE
Companies that have been through the sufferance of closing on unsatisfying deals are now looking to a disciplined transaction approach adapted to their organization’s needs. Those that have improved the manner in which they identify, track and leverage human capital data throughout the deal cycle are making a material difference to the success of the transaction. Recent research confirms that corporations, learning from experienced acquirers, are actively increasing the attention they give to those matters that have the greatest impact on value creation.

To sum up, there is huge value to be gained from using tangible and measurable solutions to manage human capital during transactions. In the right hands, they can make a difference at every stage of the transaction. The price of getting such deals wrong is greater than ever.