Deal-breakers: Retention, Integration and Culture

A report on the joint M&A Study from Hewitt and The Deal
INTRODUCTION

In today’s business world, merger and acquisition (M&A) activity is an important component within most major companies. Although the pace of this activity has significantly declined due to the credit crisis and the global recession, transactions will remain in the spotlight. In the near term, distressed assets or companies will be acquired, and then as markets rebound M&A will return to prominence as source of corporate growth. The key is to ensure that these transactions are more successful at achieving their ROI goals.

In late 2008 and early 2009, Hewitt Associates conducted two research studies, one among Human Resource Professionals and one among Corporate Development Professionals, to examine how companies globally are managing to secure the value of an acquisition, with a specific focus on human capital. The survey posed questions such as:

- How do some of the world’s most acquisitive companies approach human capital issues during due diligence and integration? How do they intend to improve upon this approach in the future?
- In what ways do human capital issues impact the financial success or failure of a transaction?
- What are the most prevalent human capital risks?
- And, why are human capital issues too often neglected at some stages in the deal process?

The findings are particularly relevant today as the weak economy puts companies under even greater pressure to demonstrate quickly that the deals they make are creating value. Although private equity mega deals have largely disappeared from the deal landscape, most companies say they expect M&A activity to increase in the next two years as they identify good values to help them grow market share and consolidate.

While making deals in a time of recession and high unemployment, it may be tempting for companies to overlook the matter of employee retention and simply trust that their top talent will stay on board. The Hewitt studies serve as a reminder that employees are a company’s most valuable asset in good times and bad and that top talent, if not given incentive to stay, will always be able to find other opportunities. It can be difficult to measure the value of a cohesive and engaged workforce, but Hewitt developed some formulas to do so. The following survey not only underscores how neglecting human capital can erase virtually all of a deal’s value; it outlines some of the best practices for incorporating these less tangible human capital matters into every stage of the deal, beginning with target selection and carrying through to integration.

Table of Contents

<table>
<thead>
<tr>
<th>Introduction</th>
<th>Page 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Protecting Human Capital</td>
<td>Page 3&amp;4</td>
</tr>
<tr>
<td>Key Findings</td>
<td>Page 5&amp;6</td>
</tr>
<tr>
<td>Expert Q&amp;A</td>
<td>Page 7&amp;8</td>
</tr>
</tbody>
</table>
Companies are fond of saying that their people are their biggest asset, but those same companies acknowledged that they often do not do enough to manage human capital through a merger or acquisition. In two new surveys of human resources and corporate development executives, Hewitt Associates found that most companies de-emphasized human capital issues at some point in the deal process, and often suffered major financial consequences. For example, in a global survey of human resources executives, Hewitt looked at 96 companies around the world, which had completed more than $568 billion in total value over the past few years. It used a detailed methodology to estimate that some $54 billion of that total deal value was riding on the rate at which critical employees separated during or immediately following the deal completion. That massive amount would be enough to erase much of the value that the deals had sought to achieve in the first place, meaning that employees who walk out the door following a merger or acquisition often carry the deal value along with them.

There’s not a lot of talk about retaining employees during recessionary times. With so many people losing their jobs, it’s easy to assume that few are going to resign voluntarily. However, while non-critical employees often do remain after a merger or acquisition, the most valuable talent manages to find compelling opportunities. Some 26% of respondent companies in one Hewitt survey said that critical employees departed at a higher rate than non-critical employees during and after a merger or acquisition. Companies that want to prevent key employees from departing after a merger or acquisition, either immediately or when the economy rebounds, need to consider human capital issues at all stages of the deal process, from target selection all the way through to integration.

Organizations typically fail to do that. The value of human capital is often hard to quantify and as a result, tends to receive less attention than metrics that are easy to measure, such as growth in revenue. In fact, while 71% of the corporate development executives Hewitt surveyed said they always considered the achievement of revenue goals in measuring a deal’s success; only 37% said they gave the same weight to the matter of employee engagement. However, since a talented, cohesive and engaged work force influences every aspect of a company’s performance including its revenue growth and productivity, companies that neglect the human capital element in a major transaction are often putting their financial success in jeopardy too. Human resources plays a significant and unavoidable role in determining whether desired deal returns are met.

Although companies continue to pursue mergers to improve operating efficiencies, realize cost savings and expand market share, research consistently shows that many of those deals yield disappointing results. Some 78% of the companies that participated in Hewitt’s global Human Resources survey last year indicated that they had not met or exceeded all of their goals in past M&A transactions. The problem was not specific to any industry, but spanned a range of businesses from energy to consumer durables, retailing, banking and telecommunications. Both surveys also encompassed all different sized businesses, from those with fewer than 5,000 employees to those with more than 20,000.

This collective failure to achieve desired outcomes in M&A is at risk of becoming more pronounced in a soft economy. Although most private equity megadeals have largely disappeared for the moment, strategic deals financed by companies identifying good values are likely to continue. A majority of the companies surveyed said they expect M&A activity to increase over the next two years, and while some deals may be deferred, those engaged in bargain-hunting deals in 2009 will face heightened scrutiny from shareholders wanting to realize value in shorter time frames.

Ironically, companies that fail to meet deal objectives seem to understand, at least on some level, that their neglect of human resources issues contributed to the poor outcome. Asked to rank the factors that prevented them from achieving their deal goals, some 45% of the human resources executives participating in Hewitt’s global survey identified cultural integration as a key problem and 40% cited insufficient attention given to workforce issues. Among the corporate development executives polled by Hewitt in The Deal survey, the level of dissatisfaction with the handling of these issues was somewhat lower, but still significant. The average company also indicated that

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during the deal integration process, it spent considerably more time on other departments including finance and legal, than it devoted to human resources. Hewitt asked companies which practices they were likely to change in future deals and more than half of them said they wished to pursue a more comprehensive human capital assessment of the target company during due diligence.

Why, then, do companies that clearly recognize the value of their employees fail to give them sufficient focus during M&A transactions? One common problem is that human resources is assigned too limited a scope, covering tasks such as benefit and payroll integration, but is not asked to address the overall cultural and organizational design. Issues such as compensation and benefits ranked low in the survey as factors contributing to deal goals not being met. However, many of those surveyed said that inattention to other human capital matters including cultural integration, communication of deal goals and other various “people issues” had caused problems. The human capital issues that are most commonly over-

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Have potential retention costs been quantified before developing cash flow models and pricing for the transaction? Of the companies surveyed, 62% said inability to retain key employees contributed to a failure to achieve transaction goals.

Will cultural integration issues pose specific financial considerations? Of companies participating in the survey, 71% said that cultural integration issues contributed to failed transaction goals.

Have the incremental benefit costs been measured? What are the financial impacts of consolidating benefits and making other organizational changes immediately following the close of the deal, as opposed to one year after the close? Of companies answering the survey, 81% said that longer than expected integration/implementation timing contributed to failure to achieve transaction goals.

Have sufficient capable resources been identified for transaction execution? Some 68% of companies said insufficient capability and competency contributed to transaction failure.

There are many reasons that a company considering a merger or acquisition needs a comprehensive process that considers human capital from the start. Before a company can achieve post-merger success, it must know its target’s culture well enough to feel confident that it can maintain or improve productivity through a potentially lengthy merger, often in the context of restructuring. To do that, it must engage all employees and present a single face to customers. Moreover, a failure to understand different company cultures or practices from the outset may make it harder to achieve integration goals down the road.

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In addition, the H.R. function is often excluded from the earliest stages of a transaction. Although the majority of companies surveyed said they did address staffing and culture during the final integration phase of the deal, only about a third of them said they frequently took human capital matters into account when selecting targets for mergers or acquisitions.

In order to get a good picture of how much human capital may impact deal value, companies need to ask some challenging questions:

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**KEY FINDINGS**

### INDUSTRY MULTIPLE CHOICE RESPONSE

<table>
<thead>
<tr>
<th>INDUSTRY</th>
<th>Number of Employees Worldwide</th>
</tr>
</thead>
<tbody>
<tr>
<td>Materials</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Software and services</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Pharmaceuticals, biotech., and life sciences</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Media</td>
<td>Less than 5,000</td>
</tr>
<tr>
<td>Energy</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Technology hardware and equipment</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Capital Goods</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Commercial &amp; professional services</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Food, beverage and tobacco</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Diversified financials</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Telecommunications services</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Healthcare equipment and services</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Transportation</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Consumer durables and apparel</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Retailing</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Household and personal products</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Real estate</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Insurance</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td>Automobiles and components</td>
<td>5,001-10,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>67%</strong></td>
</tr>
</tbody>
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**How is success of M&A measured?**

- Achievement of Market Share Increase: 86%
- Achievement of Cost Synergies: 80%
- Achievement of Integration Plan Milestones: 77%
- Increased Productivity: 77%
- Speed of Integration: 69%
- Retention of Key Employees: 69%
- Culture Alignment: 61%
- Customer Satisfaction: 59%
- Change in Share Price: 55%
- Employee Engagement: 54%
- Increased Innovation: 49%
- Increased Attraction of Key Talent: 43%

**Percentage of total respondents who attributed medium-to-high importance to failure to achieve transaction goals**

- Insufficient attention/priority to workforce/people issues: 88%
- Cultural integration issues: 83%
- Insufficient/incorrect employee communications: 83%
- Organizational Structure: 83%
- Inability to retain key employees: 77%
- Delayed involvement of HR: 75%
- Staffing selection issues: 74%
- Compensation Integration/Implementation issues: 74%
Top 5 Human Capital issues examined by Human Resource professionals during due diligence of last critical deal

- Retention of Key Employees: 67%
- Organizational Structure: 63%
- Leadership Assessment/Selection: 51%
- Cultural Fit: 51%
- Employee Communications: 42%

Source: 2009 Hewitt Global M&A Study

Top 5 ranked Human Capital issues examined by Corporate Development professionals during due diligence of last critical deal

- Leadership assessment/selection: 37%
- Retention of Key Employees: 31%
- Cultural Fit: 26%
- Performance Management: 18%
- Employee communications: 16%

Source: 2009 Hewitt/The Deal Human Capital Study

Data on pages 33 & 34 sourced from two global research studies; one among human resource professionals, Hewitt's 2009 Global M&A Study, and one among corporate development professionals, Hewitt/TheDeal's Human Capital due diligence study.
HUMAN CAPITAL IS THEIR CURRENCY

**Hewitt LLC principals, Elizabeth Fealy and David Kompare have helped many of the world’s largest corporations maximize the synergies from mergers and acquisitions by sensitively addressing the human capital issues at every stage of the transaction. They spoke with The Deal about some of the common ways companies lose value in transactions and some of the best practices they can adopt to preserve value.**

**The Deal:** This recent survey follows a similar one Hewitt conducted in 1998. What are some of the changes you’ve seen since then in the reasons companies choose to combine through M&A and the way they execute the integration?

**Hewitt:** One trend that was just emerging in 1998 and is now stronger than ever is the increasing role of Asian and Latin American companies in the M&A market. Companies around the world are looking to those markets as a source of growth, while the local companies in those markets continue to mature and look to establish a stronger global presence. The emerging market companies are driven more by cost savings and growth while the mature market companies are driven by increasing market share.

**The Deal:** Has the role of the human resources team during integration evolved over this period and if so, how?

**Hewitt:** The typical role of the HR team does continue to evolve, albeit at an unfortunately uneven pace. The survey results demonstrate that HR teams are more effective in managing benefit, compensation and payroll integrations and these areas present less of a concern. In contrast, HR teams still struggle to provide the strategic support and address more of the cultural and organizational design issues.

**The Deal:** Your latest survey reveals many different views among corporate deal-makers on how value is built or lost during a merger or acquisition. But it also shows widespread agreement that significant value is often lost in one way or another. Do you think companies clearly understand the source of this lost value?

**Hewitt:** Many companies struggle to understand the source of this lost value. Much of this value may be “lost” in the due diligence process where companies overestimate synergy opportunities and end up paying too much for the business. In other instances, companies are slow to realize synergy opportunities. Are economies of scale realized by consolidating platforms where possible, or are duplicative arrangements continued? Are human resources at an early stage?

**Hewitt:** This is unfortunately one of those surveyed said they always considered retention of key employees when measuring the success of a transaction. Still, a significant portion—33%—said they seldom took employee retention into account. Why are so many companies still not addressing this?

**Hewitt:** This may be a reflection of several factors, including a false sense of confidence among buyers. In the currently weak economy, there may be a perspective that individual employees are less likely to leave. With increasingly limited resources, companies may be investing in one area instead of another. There is also often a sense among acquirers that since they are making the acquisition, their talent may be inherently better than that of the acquired organization. This is a tendency that we often caution against, but we still see it from time to time.

**The Deal:** Cultural integration problems ranked pretty high in your survey as one of the main reasons that transaction goals are not met. What is the opportunity for companies to improve their integration skills?

**Hewitt:** The real opportunity is a continued focus and commitment of resources to bridge cultural differences. While there are a variety of cultural assessment tools available, the common mistake is not to follow up on these assessments with a focused course of action to address and bridge the meaningful gaps in culture.

**The Deal:** The survey found that human capital issues are frequently considered during the integration phase of a merger or acquisition, but less so in earlier stages of a transaction such as when a company is selecting a target and finalizing the purchase agreement. Is this a mistake and what value might be gained from including human resources at an earlier stage?

**Hewitt:** This is unfortunately one of the most common mistakes we see. In
failing to thoroughly consider human capital issues in due diligence, you miss your only opportunity to address these potential issues either through a pricing adjustment or protective provisions in the purchase agreement. To the extent human capital issues are missed in the pricing model, it becomes significantly more difficult to allocate the necessary resources in integration.

**The Deal:** Do companies clearly understand the role of human resources in retaining and attracting talent?

**Hewitt:** The role of human resources in retaining and attracting talent is often misunderstood in the context of acquisitions. Too often the focus is solely in the area of building out a financial retention program. While a financial retention program may be important, perhaps equally important are areas such as benefits, career development opportunities, employee communications and organizational design. Companies need to do a better job of committing resources to the broader role that human resources plays in attracting and retaining talent.

**The Deal:** Among the companies you surveyed, human resources departments spent less time on integrations than any department other than communications. Why is their role not larger?

**Hewitt:** Their roles may be limited because of the lack of a strategic focus and an inability to define their value proposition. It is critically important for human resources and communications to be a strategic partner, helping to identify the strategic impact of business decisions and craft solutions to support the business. This strategic focus needs to be coupled with a clear view as to how contemplated actions will add value, such as through specific cost savings, improved employee performance.

**The Deal:** Since the survey was completed, the economy has worsened significantly. How are companies’ motives for consolidation changing during a weak economy and is it more challenging during these times to successfully integrate in a way that minimizes lost value?

**Hewitt:** For many companies, the need to liquidate business units has become an economic necessity. Other companies view historically low values as an opportune time for acquisitions that might not have been possible previously. Couple these trends with companies reviewing their portfolios of past acquisitions for additional consolidation and cost savings opportunities and you can see we are entering a period of unprecedented consolidation.

**The Deal:** How is the notion of employee retention likely to change in a challenging economy where more businesses need to save costs?

**Hewitt:** The general inclination in a challenging economy may be that there is less need to focus on employee retention, as there may be fewer jobs available. The reality is that retention programs have always been focused on retaining your best employees and those individuals will always have alternatives, even in a down economy. We are seeing some companies taking more cost-effective approaches to retain employees, such as offering alternative work schedules and voluntary leave programs.

**The Deal:** Human resources is often associated with broad integration issues such as cultural fit and staff retention. How important are some of the more specialized HR functions such as compensation and benefit alignment to the success of a transaction?

**Hewitt:** Compensation and benefits alignment are critical to transaction success, both in ensuring compliance with legal obligations as well as realizing cost synergies.

**The Deal:** There are many ways to measure deal success. Do you think most companies are measuring this accurately? What additional factors beyond the most popular benchmarks might they take into account?

**Hewitt:** Changing market conditions and the integration of operations can make it difficult to measure broad acquisition success. For these reasons, we encourage organizations to focus on the more discrete elements that translate into acquisition success. Metrics such as retention and growth of key customer relationships, retention of key employees, cost savings and timely integration of technologies are more easily defined and measured.

**The Deal:** Stepping beyond the specific survey findings for a moment, what are some of the best integration practices you’ve observed among some of the world’s most acquisitive companies?

**Hewitt:** The best integration practices consistently begin in due diligence. A key differentiator in companies that integrate well is the level of understanding of the target gained in due diligence and the degree to which integration strategies are factored into the financial model and purchase agreement. As reflected in the survey, 48% of respondents indicated that human capital issues seldom or never influence the financial model and 57% indicated that human capital issues seldom or never influence the purchase agreement. This is truly disappointing. If human capital issues are not reflected in the financial model or the purchase agreement, it may be too late to meaningfully address them in integration.

Another key differentiator is the degree of expertise brought to bear in managing the integration. An experienced project manager can help identify the quick wins or synergy opportunities as well as the places to tread more cautiously. Not acting fast enough in some areas and moving too quickly in others can create problems. If an organization doesn’t have extensive internal expertise in managing integrations, they may be best served by leveraging experienced outside support.

**The Deal:** There are a handful of highly acquisitive companies, but many more that do just an occasional deal and don’t have the benefit of first-hand experience. How can those companies get up to speed quickly on the best integration practices?

**Hewitt:** Short of hiring an integration expert, working with partners experienced in managing integration can help accelerate the integration process and avoid missteps. Unfortunately, the risks and time pressures of an ongoing transaction is often not the best environment to build your acquisition expertise. For this reason, we encourage companies to consider M&A training programs. These one or two-day sessions feature best practices in due diligence and integration, realistic deal simulations and learning in an environment that doesn’t penalize you in the way the real world does.