

PIP SPEAK

THE NEWSLETTER OF
Partners in Performance

Issue 14

Executive Summary

- Most M&A transactions fail
- Those presiding over failed M&As lose their jobs
- 2 root causes of failure:
 - bad deals (poor due diligence)
 - poorly executed post merger intergration
- Many fail because they assume aspects of the new business are like the business they are currently in
 - Many organisations lack experience at doing critical operational due diligence.
- Significant effort should be put into planning for post merger
- Excellence in execution required to capture benefits. If this is not a feature of your organisation – get help

Transaction Services: Making sure your acquisition does not fail¹

Most M&A transactions fail, and CEOs who preside over a merger failure are significantly more likely to lose their jobs than their counter-parts. The key to success is in identifying and eliminating the key sources of transaction failure, which is where PIP’s experience and approach can prove invaluable.

PIP provides clients with comprehensive transaction support services, from due diligence to identify opportunities and mitigate risks, to the design and execution of effective post merger integration plans. In this article, we explore where and why transactions fail – and what can be done to prevent it.

M&A is difficult. In study after study, the majority of M&A transactions are found to have failed. In 4 broad surveys, the rate of failure was estimated to be between 57% and 70%. The price for these failures is typically paid not only by shareholders, but also senior executives. One US-based study found that CEOs presiding over a failed M&A transaction are more than 2.5 times more likely to lose their job than their counterparts.

The root causes of failure can be broadly split into 2 categories: those situations where the deal was poorly conceived/structured (“bad deals”) and those where the process for extracting the inherent value in the transaction has failed (“good deals gone bad”).

Available research suggests that the latter category historically outnumbers the former by approximately 2 to 1 but, with cheap finance and a “cashed-up” private equity sector pushing up multiples paid for assets, it is reasonable to suggest that pressure to do bad deals may be on the rise.

Avoiding Bad Deals

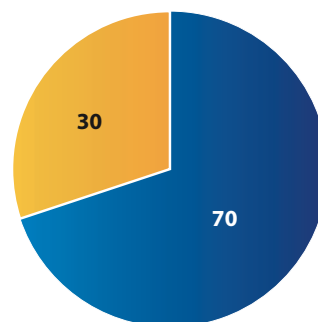
The primary cause of bad deals is a failure of the due diligence process, resulting in an over-optimistic interpretation of the business prospects (including duration and height of the business and price cycles, competitor reaction), potential synergies, →

Merger failures are usually due to poor execution

Causes of Merger Failure (%)

Bad Deals

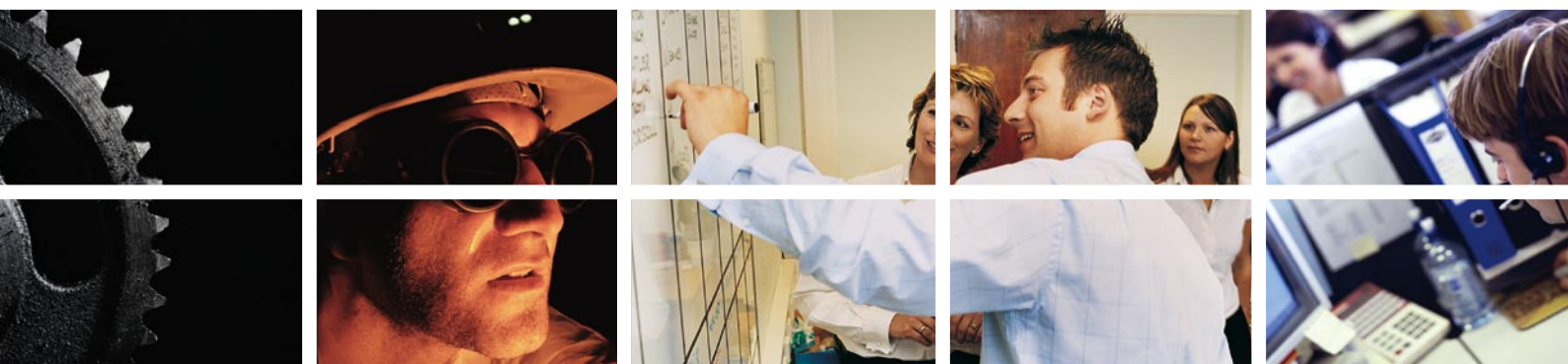
- Paid too high a price
- Expected synergies were unrealistic
- Competitor reactions



Good Deals – Poor Execution

- Poor communication
- Loss of talent (high attrition)
- Project failures
- Loss of customers
- Vision vague, targets not tracked
- Cultural differences

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the scope of operational improvement and (perhaps critically) organisational limitations on the speed and extent of execution.

Most buyers lack transaction expertise and very few can readily allocate industry expertise away from the running of their existing businesses to the short-term intense efforts required to assess target businesses. The tendency is therefore for companies to extrapolate the experiences of their own market and facilities in validating management projections and identifying additional opportunities. This type of resource constraint is understandable for organisations where transactions are not a significant part of day-to-day business of the Group, but it increases the risks associated with assessing the target.

An experience based approach should uncover the low hanging fruit (such as discretionary SG&A) where rules of thumb are typically quite effective. However, what is often missing is a comprehensive assessment of the operational drivers of the specific business and the improvement that **could** be achieved if the target company were taken significantly closer to the full potential or technical limits of these drivers. Establishing this technical limit requires detailed analysis (and a robust methodology) at the level of each key metric – and the source information is unlikely to be in the data that is initially made available for evaluation of the investment. Nevertheless, it is fundamental in order to establish “where the money is” and prioritise efforts post completion. In an increasingly competitive environment, companies wishing to mitigate this risk are therefore turning to external support in the identification and verification of upside opportunities.

Traditional approaches are also weak in assessing management capabilities/systems and the extent to which they can drive change. Reporting Accountants may give comfort that the basic control mechanisms are in place

and management discussions generally probe the issue (although there can be a reluctance to dwell on negative issues when pitching to management) but that still leaves a broad spectrum of possible outcomes. Failure to identify the areas that will need reinforcement post acquisition will result in delays to delivering the forecast improvement (at best) or a shortfall in the level and sustainability of the benefit.

The PIP approach adopts a proprietary framework to establish the effectiveness of the current organisational skills, process and controls and identify the critical gaps that should be

closed (“wiring diagnostic”). Importantly, it focuses on the systems at all levels of the organisation, so that the purchaser is able to identify weaknesses in the process by which senior management intent is translated into operating level behaviours. Diagnostic work focuses on the metrics that are tracked at each level, the disciplines that are in place to ensure delivery against them, overlaps or gaps in accountability and the review processes that close the loop on performance against short term targets.

Improving Execution of Post Merger Integration (“PMI”)

Good deals go bad for a range of reasons, but a common theme in many cases is the lack of detailed planning and poor execution of the integration process post acquisition. Strong management teams rarely lack ideas on how to achieve operational efficiencies, but these ideas usually fail to deliver sustained improvements. In many cases, all initiatives are launched simultaneously without regard for the paralysis that this creates in the organisation.

Lack of a clear vision or prioritised integration plan coupled with poor communication in the early stages may mean companies only become aware of these issues when they begin to haemorrhage key talent or customers from an acquired company. This may well be followed by a series of missed milestones on key projects (diverting increasing numbers of key resources) and the inevitable blowout of integration costs.

On the other hand, successful mergers are characterised by significant effort up front, to ensure that the pre-conditions for rapid change are in place from the moment that the transaction is finalised. Once again few companies have the expertise to develop and execute comprehensive integration plans based on the key sources of value of the newly merged entity and there is frequently the need for

external support to bolster internally available resources. The secret to ensuring that this support is effective lies in (i) engaging the parties early on in the process, and (ii) getting the right balance between structuring/planning and executing.

The PIP approach to PMI emphasises the up-front activity and works closely with clients to ensure that the key elements are in place prior to offering for (and then closing on) an acquisition. Significant transactions are useful discontinuities in the life of a company that management can treat as opportunities to create fundamental change from the top down – enhancing its leadership, strategy and organisational wiring. But this can only happen if the bones of it are well understood up front and goals are sufficiently visionary. In addition, a successful process will typically have mapped out the critical operational decisions that will need to be taken very rapidly once the deal is completed. Amongst these, some of the most important would be (i) setting up and resourcing the integration office, (ii) identifying key people who will need to be retained post-completion (and preparing a retention plan for each), (iii) agreeing a broad organisational structure (with key roles pencilled in), (iv) agreeing on the location of central functions and (v) developing a comprehensive communication strategy to keep employees, customers and other stakeholders informed.

The first few months following completion should focus on getting control of the combined business and beginning to capture the “low hanging fruit” in terms of synergies. Getting control of the combined business implies establishing common management processes and protocols, enacting

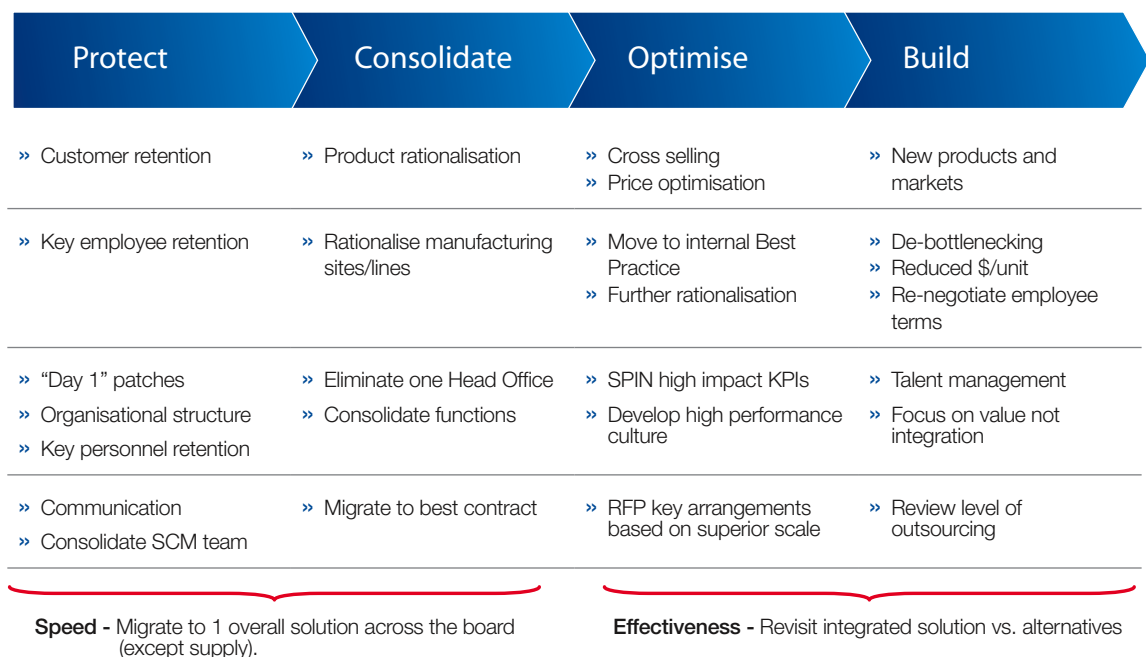
key retention plans, instituting KPIs across the business and setting up the performance tracking reviews. The process of mapping out the execution plans with the full merger team should help identify the low hanging fruit. This typically consists of consolidating the central services (payroll, HR, etc) but may also include some consolidation of facilities, brands, IT systems, etc. Success in this phase is based on the creation and maintenance of momentum through rigorous prioritisation, clear communication and tight accountability. PIP’s track record for making change happen in organisations is the root of its effectiveness in this phase.

Focusing on Value and Building an Improvement Culture in the Organisation

As the PMI process evolves, so the focus of the integration team needs to shift from getting control of the business (where a workable solution now is preferred to a better solution next month) to making the most of the opportunities based on effective execution. In PIP’s experience, most organisations lack the skills, processes, and controls to deliver and sustain operational improvement. Where this “wiring” is weak in the target organisation, it effectively pre-determines the outcome of change and must be addressed.

PIP recognises how difficult the change process can be, and supports management through both the implementation of wiring changes and the development and management of a pipeline of prioritised ideas. The PIP approach builds a capability within the company that generates a fundamental uplift in performance. It achieves this, in part, by ensuring that management at all levels is

■ Setting the pipeline priorities



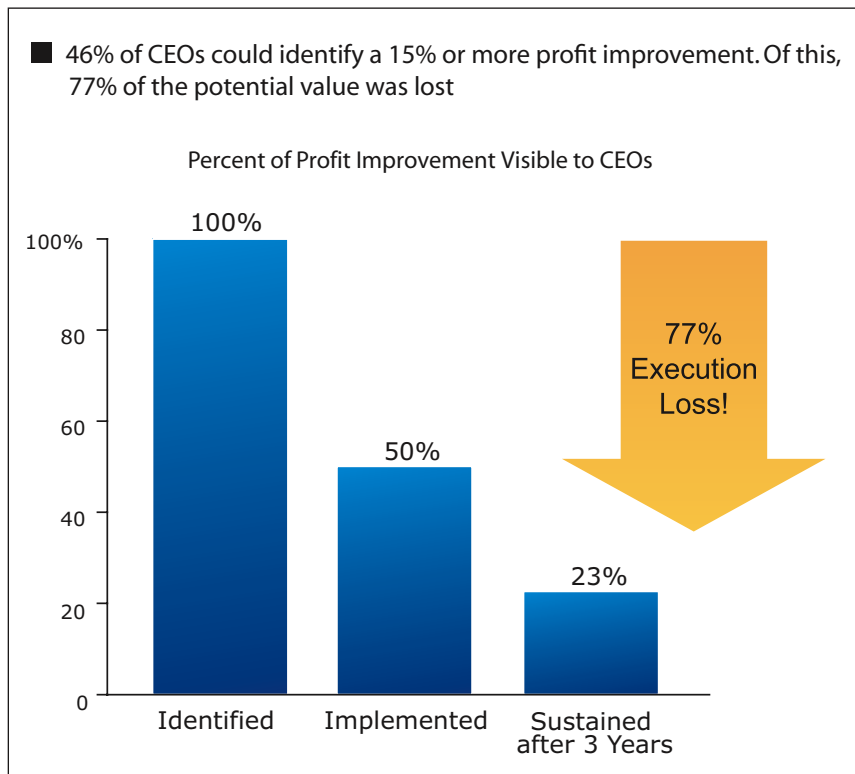
focused on measuring and managing the critical levers of the business. It is striking how many organisations with a clear understanding of the key metrics at a high level are unable to drill down to the detail and find the sources of inefficiency or even the drivers of value in their businesses. Establishing clear accountability for the right KPIs at all levels in the business, and holding effective reviews around them, will typically generate a substantial improvement in results (“what gets measured, gets managed”) to the point at which the root causes of residual underperformance become clearer and are addressed.

The result is an organisation that not only delivers results faster than it would otherwise have done, but also sustains the improvement over time. Indeed, by transferring knowledge and skills to the organisation, it is well positioned to continue improving beyond the period of support.

Summary

Markets are unforgiving of failed M&A and yet many companies either undertake transactions without fully investigating the opportunity or fail to recognise the difficulties involved in capturing the value. The choice is clear – either scale up significantly on the quantity and skills of internal resources dedicated to transactions, or engage additional external support (early in the process) in order to avoid bad deals, improve the outcome of the integration process and help build an improvement culture in the new company that can realise the full potential value of the opportunities identified at the outset.

Why execution support is important Key Findings of PIP survey² :



Key Findings:

- 46% of respondents estimate that their organisation could increase profit by more than 15% if they were able to realise the full potential of the business improvement opportunities available to them, yet 50% of them achieve less than half of the amount identified above (failure to execute).
- Of the savings that are actually implemented, greater than two-thirds of the CEOs were uncertain if these implemented changes would stick. This represents a huge drop-off in potential profits from identified improvements, through implemented improvements, and then to sustained improvements.
- From a CEO perspective, the biggest challenge facing big business today in the area of business improvement, is the inadequacy of execution/implementation skills among managers and staff. Worryingly, few in the survey felt they had a solution to this problem.

²2006 survey of senior Australian management (\$250m+ turnover)

Partners in Performance

Partners in Performance is a firm that builds better businesses. We deliver rapid performance improvements in industrial, resource, manufacturing and service companies, using specialist teams and a hands-on approach to lower costs and increase revenues.

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