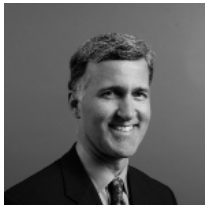


The 10 Steps to Successful M&A Integration

Tailor integration to identify value, keep the right people, and focus on critical decisions.

Hello, my name is Paul Judge, and I'm the editorial director for Bain & Company. Today we're going to spend a few minutes talking with Ted Rouse, the co-leader of Bain's M&A practice, about the climate for deal making and some of the practical steps companies can take to improve the odds of success.



Ted Rouse is a partner with Bain & Company and a co-leader of the firm's M&A practice.

PJ: Ted, welcome.

TR: Thank you, Paul.

Is the recent uptick in M&A likely to be sustained in coming months, or can we expect more swings in M&A activity?

You know, Paul, although we expect the recovery in deal activity to be somewhat uneven—pretty much mirroring what's going to happen in the economy—we do expect activity to continue to rise and really accelerate during the course of 2010, after hitting what turned out to be a five-year low in August. There are several factors we think are going to drive this really renewed interest in transactions. Number one is, if you look at the S&P 500 firms, quite surprisingly for most people, they are actually sitting on more cash than they have ever had. If you look at the end of Q2 2009 and compare it with the same period in 2007, cash on their books has increased from just over \$600 billion to over \$700 billion. So that's a big store of cash available to do transactions.

Secondly, although we know valuations are up substantially this year, the market has done very well; forward-looking P/Es are still quite attractive, capital markets are starting to thaw, and then, lastly, if you look at the private equity players who were a significant portion of transactions two and three years ago, they are coming off of a dismal low. They are down from doing \$500 billion in announced deal value in the first half of 2007 to \$34 billion in deal value in the first half of this year. So they have access to cash, they have access to capital, they will be coming back. So we think all those factors are going to drive a very aggressive renewed interest in deal activity at the end of 2009 and really accelerating in 2010.

Does that mean that now is a good time to buy, or a bad time?

There's plenty of evidence to suggest that this is a good time to buy. Bain research of prior recessions determined that deals that were done during recessionary periods earn approximately three times the excess rate of returns of comparable deals done during the peak periods. So, in general, recessions are a good time to do transactions, and although we're coming out of a recession, this is still a good time if you look at valuations.

And if you're healthy, frankly, it's a great time to do transactions. If you are one of those companies sitting on lots of cash and have a healthy balance sheet, this is a wonderful time.

That being said, it's not a good time for two weak companies to come together. Frankly, rarely is it a good idea for two weak companies to merge, but particularly now where there will be continued volatility in the marketplace. This isn't the time for a weak company to get together with another weak company and think that somehow they're going to solve their problems.

Bain analysis shows that deal success improved pretty substantially in recent years compared with a decade earlier. What's the data, Ted, and what do you consider to be the factors behind that?

Well, you know, you can look at the positive side or the negative side of the ledger in terms of what's happening with transactions. Let's look at the negative side; that is, have the bad deals gotten to be less of a percentage of transactions and, therefore, is risk somehow lower? Our analysis, if you compare a couple of time periods—the three years ending in 1998 and the three years ending in 2005—suggest there is a substantial difference.

In the three years ending in 1998, almost half of transactions earned rates of returns for their investors that were 10 percent or more worse than their peer group. If you roll that forward to the most recent three-year period that we monitored, that number is down to perhaps 25 or 30 percent. And actually, if you go back to the earlier period as well, literally 30 percent of transactions were earning rates of return that were more than 30 percent worse than their peer group index. So that's a very troubling statistic, if you think that that percentage of transactions used to be that bad. So the percentage of deals that are bad is actually getting lower.

On the flip side, it also means that good deals are far more frequent. We're now up to probably 50 percent of transactions looking like they are comparable or better than peer indices.

So, what's happening?

Well, we think there are a couple of things going on. One simple explanation, based on our experience, is that some companies have learned to pursue deals that are closer to their core business. In other words, they are doing things they understand, that actually truly bring synergies, that actually truly bring the opportunity to cross-sell products. So they're making smarter deals.

Secondly, more frequently now you'll see transactions done with cash instead of stock. Now, why does that matter? Well, what matters is this: The organization pays a lot more attention

to the economics when it's actually dollars that they see and pay attention to. When it's stock, for some reason, you're playing with somebody else's money. When it's cash, you're playing with your own money.

And then, lastly, what we've seen is an increase in the percentage of acquirers who are what we refer to as "frequent acquirers:" people who do at least one transaction a year. And it's clear that frequent acquirers are far more successful at getting good rates of return on transactions than people who are episodic and infrequent in going to the market to do deals. We think all three of those factors are really driving the success rates up.

So Ted, does that mean that companies are also getting better at merger integration?

You know, Paul, there's no question about it. One of the benefits of being a frequent acquirer is that you learn a lot about how to do integration successfully. And you build institutional knowledge and the ability to actually keep people around because you're doing deals frequently with people who are experts at it, who are dedicated to that process. And it is clear that there is this relationship between frequent acquirers and success rates.

But there are pitfalls that we keep seeing and keep occurring in the marketplace, even though people are getting better at transactions. Number one: underperformance relative to the financial targets that are stated and are possible still continues to occur. If you dissect individual transactions, although on average they're doing better, they're still underperforming what is possible.

Secondly, there still is a loss of key people in transactions, there still is a retention issue that people have not fully cracked.

And lastly, we still see the performance of the base business for many deals deteriorates during the transaction and in the years afterwards to a degree that causes financial difficulties and problems for a number of these deals, at least relative to the returns that the investors expect.

Is this mainly a result of not moving fast enough?

You know, speed in integration certainly matters. You can't wait for a long period of time and let things calm down to go do the work that's required to put two companies together. On the other hand, the indiscriminate application of the accelerator to everything that you could possibly do in the integration process is equally dangerous. The amount of activity in an integration can overwhelm an organization if you choose to try to do everything all at once at a rapid rate. So you have to be careful about speed.

What we find is, you have to go back to first principles: You have to clarify what your deal thesis is. What are the four, five or six things that will really drive value in the deal, and likewise, what are the two, three, four risk factors that will cause problems? And then in those areas, really drill down in what you have to do, and move very fast on those issues, while taking your foot off the gas on the remainder and moving at a much more measured pace on the rest.

So, yes, speed matters, but selectively. Focused speed on those things that are really going to make a difference and drive the success of the deal.

The typical approach is to set up a program office, staff it with a critical mass of senior managers and have them push the integration through following the playbook that they've used in the past. What's wrong with that approach?

While there is definitely a need for a program office to keep the effort focused—I mean, every integration that we work on has a program office, and sometimes it's called an integration office, sometimes it's called a program office; we actually like to refer to it as a "Decision-making Office" and I'll come back to that—but there's a real danger with a program office that it can become a cookie-cutter approach and a slave to a predetermined process, where I have a routine, I have a schedule, and we follow it religiously. And having a schedule is important, but effective merger integration requires taking an approach that is tailored to the type of deal you are doing in those circumstances and making sure that you adjust your schedule and your rhythm to that particular type of transaction.

Let me mention a couple of things in that regard. First, again, you go back to the investment thesis—What are the few things that drive the value of the deal?—and build your schedule and your integration program around that deal thesis.

Secondly, I like to begin a conversation with anyone who's doing a transaction around, Is this a scale deal or a scope deal? And by "scale deal" I mean, Are you acquiring something that basically is the same as what you do today? Is it the same kind of business, and, thereby, you need to consolidate—and can consolidate—everything that you do. Or is it scope in nature?—meaning, am I acquiring something that is new to me, that is a new product or a new geography or a new channel that is taking me in a new direction? Under those circumstances, how I manage the integration will be quite different. I will integrate much less.

So all of these factors need to be pulled together when you're thinking about the program office and how it's orchestrated. So you need a program office; you've got to have it in order to be successful, but you've got to tailor it and make it nuanced to the nature of the deal.

In addition, I mentioned we're starting to call a program office a Decision Office. It's interesting. We found that by focusing on the decisions that have to be made, instead of activities, instead of timetables and schedules and delivering reports back to the integration office, what we find is that you get better results, it happens faster, it takes less energy and you get much more alignment with the organization. Instead of thinking of the program office as a process and a template manager, think of it as managing a series of decisions and organize around those key decisions. It enables you to, again, stay focused on what's important and make people accountable for making the right decisions and being engaged in the process.

Interesting, Ted. Is there such a thing as a "merger of equals?"

That's a very interesting question, Paul. Although there are certainly deals where two companies are of the same size and capability, it would be exceptional for them to be true equals. Someone is generally the acquirer, and someone is the company being acquired, and control is rarely shared. In fact, the only place I ever see it is in a joint venture. It's not a merger. That's why we call it a joint venture.

That being said, when two companies of comparable size come together, it is vital that the acquirer—the company who has unequal power in the equation—works very hard at attracting and retaining key people, and on determining how to create a combined culture and decision-making style that's going to be motivating for both organizations. You know, the indiscriminate exercises of power in a deal where you have two companies that are pretty comparable in size, well frankly anywhere, is only going to alienate the individuals and the organization you're acquiring. And you are going to actively drive people away from your organization—the very people you need to be successful. So that requires being really thoughtful about how you make decisions about organization structure, how you select people; it requires thinking about culture and really trying to find a way to find a middle ground and selling the vision internally to really win the hearts and the minds of both organizations.

Is that really practical? So often people inside the two companies are skeptical and worried about the dangers following a deal—am I going to lose my job?

That's a very valid point, Paul. In any acquisition, you have to address the most basic question that people are thinking about, which is, OK, I understand that there are synergies and I understand that this is an attractive deal, but what about me? How does it affect me? And that requires good communication broadly about the potential opportunities the merger creates for the company's products and services and the growth potential. So you're selling the vision.

It also requires that you couple that with individual conversations about what the opportunity is for that person. Now you can't do that with every single person in the organization. It's impractical, it's impossible. But what you can do is focus that on the top 5 to 10 percent—the key leaders who actually are the influencers around the organization, the people you have to retain to be successful—and get that group motivated and excited about the total opportunity and about the individual opportunity for them. And interestingly some people think, Well, does that mean I actually have to be able to tell each person what their new job is and what it's going to look like going forward immediately? And the answer is, No. You actually can communicate what you believe is possible for the transaction and the types of opportunities and when you're going to resolve issues about specific jobs. And that will last quite a while. That will be quite motivating for people, assuming you're clear about when you'll be able to get back to them with specificity about opportunities for them inside the company.

In fact, one of the great benefits of being a frequent or experienced acquirer is that you earn a reputation within your own organization and elsewhere for creating opportunities for individuals—not just for shareholders, for individuals. And so when you go and do a transaction as someone who has a proven track record of creating that opportunity, you get a lot of leeway with your own organization. People will be excited about that and will be

patient about when they need to hear about what's in it for them.

Does that deliver real benefits, or does it just feel good?

This is more than just "feel good," Paul. There is no question that if you look at the things that go wrong in transactions, one of the issues I mentioned is getting the value and underperformance relative to the synergies that are out there and the total benefits. The other is around people. And again, retention of key individuals, defections to competitors, those are critical topics in integration. They're critical drivers of success. And so all these things around managing the culture of the two organizations, building a reputation for being a successful acquirer, these all build around your ability to actually retain people, thereby having a much more successful track record on average than the infrequent acquirer.

Thanks for your time, Ted.

Thank you, Paul. And for those listening to this recording, I encourage you, if you have additional questions, to contact me at ted.rouse@bain.com or reach out to any of my Bain & Company partners.