ACT SWIFTLY TO REDUCE
DUPLICATE HEAD COUNTS.

USE EXTREME CARE IN ANALYZING COSTS.

# MAKING 1+1=3

RECOGNIZE THE
POWER OF CULTURE.

DON'T UNDERESTIMATE THE CHALLENGE OF
MERGING INFORMATION TECHNOLOGY SYSTEMS.

## Summary

Mergers that seem strong in the planning stages often fail to live up to their promise. The solution? Develop a plan that makes sense and then follow through on every detail to achieve the synergies — and the returns to investors — that first prompted the combination.


Most mergers come up short of their goals. Avoiding these five key pitfalls can help companies realize their full potential.

BY MICHAEL MURPHY AND MARK MILLER

The primary goal for companies that merge is for the combined enterprise to be stronger on the top line, more efficient and far more profitable than each company had been on its own.

The best private equity firms excel at picking merger targets that will enhance the value of companies in their portfolios. They will look for compelling opportunities to increase market share, extend product lines, expand manufacturing capabilities or push into new geographic regions. Sponsors have carefully modeled the cost savings and related operational synergies. So why do as many as four out of five mergers fail to fully realize their merger objectives?

Consider a merger of two companies with combined revenues of $500 million. A reasonable expectation of annualized savings in this case equates to 8% to 10% of revenue, or approximately $50 million. But often enough, two years after the deal has closed, the new corporation may have realized cost efficiencies of only $10 million — dealing investors $40 million in unachieved savings each year, inhibiting margins and profitability. If the merged companies are in an industry in which the average valuation is seven times EBITDA, the impact of an incomplete integration in this case may decrease the valuation by hundreds of millions of dollars.

All M&A transactions have their own intricacies, and it can be a challenge to consolidate manufacturing facilities, legal and regulatory departments, supplier agreements, customers and sales channels, information technology, supply chains and each of the other functional areas of the business. There are many ways for a flawed integration to erode the anticipated returns on private equity's invested capital. But as we have seen from our intimate work in many of these transactions, overlooking any of these five common pitfalls guarantees that an investment will not realize the full value envisioned.

**Cutting too little too late.**
Probably the toughest task facing merging companies is deciding how many employees, including senior and middle managers, to eliminate. Many companies wait too long to reduce duplicate head counts, assuming — or hoping — that revenue will expand quickly or that internal politics will cause delays.

Two merging automotive supply companies made this mistake, failing to anticipate an economic downturn that occurred a few months after their deal closed, drastically reducing sales. Despite deep personnel cuts that were then made across the company, it was unable to bring about cost reductions fast enough and ultimately had to file for bankruptcy, wiping out equity. In hindsight, it was clear that if the company

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had eliminated excess jobs starting the day after the transaction closed, the resulting savings would have provided the company a buffer sufficient to avoid violating key debt covenants despite shrinking revenue.

An alternative approach was taken by two publishing companies that merged. But instead of going only far enough to meet merger model synergy targets, management took a more aggressive approach of planning for additional economies. After 18 months, the combined company had exceeded its cost synergy targets by more than 80%. That overachievement of synergies allowed the company to keep its costs in line with unanticipated revenue losses and to survive in an economic climate that was particularly hard on media companies.

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**Not understanding true profitability.** It might seem obvious, but if a company cannot accurately quantify the cost of producing individual products and supporting customers, it becomes nearly impossible to make informed decisions about how to eliminate duplicate costs, rationalize product or service lines, or understand where investment will generate the highest returns. Inefficient companies tend to analyze profitability in terms of gross margins for each operating unit rather than to look at the profitability more directly by individual product and/or customer, for example. By breaking down profitability by customers, products, service offerings and manufacturing plants before merging, two printing companies learned what was and was not working. They avoided folding unprofitable elements of the businesses into the merged company, instead electing to churn the bottom tier of the combined customer base, collapsing small business units into a more efficient infrastructure, exiting two major customer contracts and shutting down 20% of the manufacturing capacity.

In contrast, operating with inaccurate assumptions about line of business profitability could also stop a merger cold, as it did for a communications company that was embarking on acquiring a large competitor. During due diligence, it became apparent that the acquiring company was not nearly as profitable in key business segments as originally assumed. Without the necessary cash flow and valuation to raise funding for the acquisition — and finding itself out of strategic options in a consolidating industry — the would-be buyer was acquired by another company a few months later. Had the company dug deeper in analyzing its costs before embarking on an acquisition, it would have realized it had to fix its cost structure first and assert more control over its destiny.

**Getting IT wrong.** Merging databases and IT systems is often the most challenging — and most time-consuming — element of merger integration. Yet companies routinely minimize the difficulties. As a rule of thumb, merging the IT elements of two medium-size companies with combined revenues of $500 million to $1 billion will take 18 months to two years and cost a third to half of a normal year's IT operating budget.

But until the systems are thoroughly consolidated, the merging companies could endure a heavy "swivel chair" burden, with employees forced to work with multiple computer applications and operate unrelated software systems to complete transactions.

Merging corporations also have to be concerned with database capability and accuracy — a step one telecommunications company ignored at its peril. In trying to rush the integration of its systems with those of a company it had acquired, the company was forced to "flash cut" the acquisition's databases — essentially importing the data and going live with minimal testing. Almost a third of the combined company's invoices ended up having incorrect addresses, and half contained errors six months after the integration of the two systems. Annoyed customers stopped paying their invoices, reduced their monthly services and/or turned to another provider, which ultimately forced the company to file for bankruptcy protection.

Contrast this experience with that of a transportation company that acquired a major competitor a few years ago. The acquiring company had exhausted accounts receivables of 28 days sales outstanding (DSO) while the target achieved 47 DSO. Before integrating the acquired company's customer and billing data, the firm went through an intensive database cleanup to eliminate erroneous customer information, align the necessary fields, and confirm billing terms and mechanics. Once the database was modified, the acquiring company was able to smoothly integrate the customer and billing IT data into its own system and was easily able to perform root cause analysis on the high DSO customers. As a result, the acquired company's DSO was reduced to 35 days, and $9 million in cash flow was accelerated.

**Not sweating the small stuff.** In advance of closing a deal, merging companies typically establish a program management office (PMO) to oversee transaction integration activities. This is the nerve center, a unit that coordinates thousands of tasks and tracks their progress against the integration plan to make sure the merger will close on the target date. It also identifies potential impediments throughout the pre- and post-close periods with enough lead time to permit them to be addressed. But too many PMOs passively tick off completed tasks, rather than proactively forcing adherence to schedules, confronting issues and pushing senior managers to make decisions.

There is an enormous amount of interdependency in an integration plan, with every area of a business affected by when and how well other business areas plan and execute their part of the integration — and it falls on the PMO to keep all the moving parts synchronized. At any given moment after the close, the PMO should know how much of the integration has been completed,

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how much it has cost and what else is needed to achieve the targeted benefits.

Another critical role of the PMO is to coordinate communication about the merger with employees from each company, managers not directly involved in the integration, suppliers, customers, and government and regulatory agencies. The PMO needs to manage expectations and to minimize the spread of rumors and speculation that can damage the new company.

**Forcing the issue on corporate culture.** Companies may democratically try to merge their ways of doing things, or the acquiring firm may attempt to force its culture on its target. Neither works. After a successful integration, a new corporate culture will emerge on its own, helped along by leadership from top managers. Involving middle and upper management from both organizations in setting a path for the merged company will help avoid the perception that there are winners and losers and, ideally, will promote people, processes and technology that are the "best of the best" from both companies.

Private equity sponsors, hedge funds, capital markets, bankers and companies all realize that M&A is about creating value through revenue and cost synergies. But finding and capitalizing on those synergies can seem paradoxical: It involves charting an integration path that is sufficiently comprehensive (without paralyzing the organization) and rapid enough that executives focus without promoting the "ready, shoot, aim" mentality. A carefully considered and managed integration that aligns with the transaction's strategic objectives is most likely to deliver the returns that made the merger so compelling in the first place.

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