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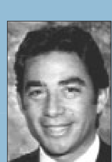
FROM THE FIELD

Staying Cool

When Deal Pressures Mount

Imagine for a moment that you, as the chief executive officer of a publicly traded corporation, are about to make the biggest business decision of your life. Stacked before you on a conference table are the papers required to complete a merger between your company and one of almost equal size in a related industry. The room is crowded with people, some of whom you know well and some of whom you barely recognize. Your trusted lieutenants look as if they haven't slept in days; they'll be glad to have the deal behind them. Across the table, the CEO of the company you're about to buy wears a wry smile; he's about to make his shareholders very happy.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Doubts creep into your mind. You know the odds are against you. You're familiar with the research that indicates only about three of every 10 big mergers pay off in the long run. Most of the rest fail outright, and those that don't fail produce marginal returns at best. You know as well that integration will be a long and often-painful ordeal and that it may well put your own job at risk. Yet you also realize that your investors are demanding strong future growth in sales and earnings, and that it's unlikely you'll be able to fulfill those expectations organically — you have no choice but to make acquisitions. As you reach for your pen, you feel as though you're damned if you do and damned if you don't.

What you're experiencing are the natural effects of what we've come to call the m&a paradox. The paradox goes something like this: Most acquisitions fail, but few companies succeed without doing deals. It's become virtually impossible, in fact, to create a world-class company through organic growth alone. An examination of the *Fortune 100* reveals that most companies on the list are themselves products of past deals. One of the crucial and unavoidable challenges facing business leaders today is reconciling the low odds of deal success with the need to incorporate acquisitions into their growth strategies.

In this article we examine the distinctive qualities of the top dealmakers and show how they stay focused on a few critical decisions at each major juncture of the deal process.

Why Is It So Tough?

A whole range of factors conspires against smart dealmaking. Acquisitions tend to be rare events for companies and they often are carried out in a frenzied atmosphere in which big and complex decision have to be made quickly.

As the process unfolds, the pressures to complete the deal intensify. Usually, there is a small army of outside specialists involved — investment bankers, accountants, lawyers, actuaries, debt analysts, consultants — and most have strong incentives to push the deal toward a successful conclusion. A company's own executives also tend to become deeply interested in the deal's success. Filled with the thrill of the hunt, they hate to see the prey escape. Finally, the executives of the company being bought are intent on portraying their business in the best possible light to maximize its price. The information they supply tends to be well filtered and not entirely reliable.

Such situations can trip up even the most sure-footed executives and lead them to abandon the rigor they bring to other important business decisions. Emotion, rather than reason, can guide their choices. And the more inexperienced they are with the unique dynamics of dealmaking, the greater the likelihood of serious — sometimes disastrous — missteps.

So how do you break the m&a paradox? The answer is, be disciplined in your dealmaking.

Our research and experience argue that deal success is not random. The top dealmakers employ specific tactics and behaviors that dramatically improve the odds that a deal will succeed. Rather than engaging in complex megamergers, these companies instead execute a series of smaller, lower-risk acquisitions, gradually scaling up and institutionalizing a "success formula." And rather than wasting time on excessive numbers crunching or inch-by-inch integration techniques, they focus on the critical decisions that make or break a deal. To do that, they follow four key imperatives:

- Targeting deals according to a sound investment thesis;
- Determining which deals to close and which to walk away from;
- Prioritizing which aspects of the businesses to integrate and which to leave independent; and
- Developing contingency plans for when deals inevitably go off track.

How should you pick your targets?

Successful acquirers begin with an "investment thesis," a statement of how a particular deal will create value for the merged company. A compelling investment thesis explains why and how an acquisition stands to improve the existing core business.

When Bain surveyed 250 senior executives who had done major deals, 43% confessed that they had failed to begin the m&a process by defining a strong investment thesis.

Merger strategy can't be separated from business strategy. To create an investment thesis, you must understand the basis of competition in your industry — basically, how your businesses make money and how they compete. Most companies compete primarily on the basis of cost position, brand power, consumer loyalty, real asset advantage, or government protection. The best acquirers know their core strengths and target deals that enhance them.

Which deals should you close?

Once you've determined whether an acquisition makes strategic sense, you have to assess whether it makes practical sense. Will you be able to fulfill the investment thesis? Is the company what it appears to be? Are the terms of the deal attractive?

Too often due diligence becomes a "check the box" exercise, collecting reams of data but failing to tell executives what they need to know to decide whether to consummate the deal. The best dealmakers zero in on the "big" questions — the ones that, once answered, will demonstrate whether there is a match between the target and the acquirer's investment thesis. What's critical in due diligence isn't how much you know but determination of what you should know and don't know and nailing down that information.

Unfortunately, that kind of disciplined due diligence is an exception. When Bain surveyed 250 executives involved in m&a, only 30% expressed satisfaction with the rigor of their due diligence process.

Private equity firms, arguably the best practitioners of due diligence, disparage the lack of focus inherent in most acquirers' efforts. Says John Connaughton, Managing Director of Bain Capital, "We always chuckle when we hear that [prospective acquirers] have sent in 50 people to the data room and 35 people to the presentation, and they all try to go back to their offices and write memos and then try to reintegrate at some high level. It's probably more a distraction than it is a cohesive integration of the diligence side."

Private equity firms answer the big questions by building a proprietary view of the target and its market. They take a critical outsider's view of a company and do not take for granted anything about its future prospects. They then test what they've learned against predetermined "walk-away" criteria. If any of those tests leads to irreconcilable doubt, the next step is obvious: They walk away from the deal.

Where do you really need to integrate?

The best acquirers work on the challenges of integration as an adjunct of their diligence activities. They plan for ownership early and focus on getting the few most important facets of integration absolutely right.

While many companies take a holistic, work-plan-centric view of integration, only a few integration activities really matter in determining the success of a deal. If taking a holistic approach makes you take your eye off those few key activities, that can be a recipe for trouble.

Mergers aimed at creating economies of scale require near-seamless integration — up, down, and sideways — to achieve savings and improve asset utilization. The holistic approach is valid in such cases, but companies need to home in first on integration activities that will achieve the largest costs savings and revenues gains. Mergers aimed at extending product, customer, or geographic scope require only selective integration around areas of business or operational overlap. In all cases, move quickly and ensure that the majority of people stay focused on the base businesses.

What should you do when the deal goes off track?

Journalist Harrison Salisbury, when asked what he had learned from history, said, "Expect the unexpected." That's good advice for managers executing mergers. No deal goes exactly as planned. Assumptions are proven wrong. People quit. Competitors take advantage of disruptions. Customers get upset. What sets world-class acquirers apart is how they prepare for inevitable difficulties and react when the master plan goes awry.

Focus and discipline are crucial; the worst thing to do is to panic. You need to deliberately separate the inevitable post-merger problems from those that signal that something far more serious is at work.

The process is much like the medical diagnostic procedures doctors use to determine whether symptoms are related to a passing illness or a more serious condition. You need an early-warning system that tracks a few crucial measures on a day-to-day basis and diagnoses problems. The measures may draw on customer, supplier, employee, or financial data. Any anomalies in the data signal a need to intervene quickly — addressing blips in elements like service levels, operations, or employee retention. In some cases, the system will uncover chronic rather than acute problems.

Here, the need for unbiased and unsentimental discipline reaches its peak. Ask yourself: Can we fix the situation? Should we make the investment required to turn around the company? Or should we admit to irreconcilable differences and sever the union? If markets have shifted but your investment thesis holds, a turnaround can succeed. If not, it's time to cut your losses and move on. Many bad deals have turned into disastrous deals simply because managers failed to dissolve them soon enough.

The CEO who has a well-articulated strategy and a solid business system is far less likely to pursue a value-destroying deal than a CEO in strategic trouble.

Doing It Right: Kellogg's Big Win

What does strong discipline look like in practice? **Kellogg Co.**'s acquisition of **Keebler Cos.** provides an illustration.

At the dawn of the 1990s Kellogg was one of the most successful brands in business history. Products like Kellogg's Corn Flakes were staples of the family breakfast table. The company was very profitable, with top-tier operating margins and a leading share of the ready-to-eat cereal category. It was growing, and it enjoyed a remarkable ability to raise prices just enough to generate the profit surprises that stockholders love.

But by the middle of the decade, Kellogg's business was getting soggy. Post, the No. 3 competitor, had initiated a cereal price war that demanded an aggressive response from Kellogg. **General Mills Co.**, No. 2 in the category, took the market-share lead. At the same time, retailers, tired of what they perceived as Kellogg's high-handed ways, began to step up their offerings of store-brand products, calling on companies like **Ralston Foods** to supply them at cut-rate prices. Consumers also were increasingly turning on their backs on cereal; that once-ubiquitous bowl of cereal that started the day was deemed unnecessary in time-constrained families. Kellogg's stock dropped by almost 20% in the late 1990s in an otherwise booming market.

Carlos Gutierrez, a long-time Kellogg executive was named CEO in 1999 and he sketched out three priorities: make traditional products more appealing, look beyond ready-to-eat breakfast cereals for the engine of future growth, and change the company's culture so it could execute plans more quickly.

Gutierrez saw some encouraging signs. People liked to snack on cereal-based products during the day, and Kellogg offered such products as Nutri-Grain Bars and Rice Krispies Treats. Between 1996 and 2001, the hand-held breakfast bar category grew 8% annually even as demand for ready-to-eat cereals declined 5% year after year. But making a big push into the snack market raised a fundamental problem. Kellogg lacked access to a direct distribution channel — the best way to deliver snacks — and Gutierrez knew it would be difficult and costly to build a direct distribution channel from scratch. He would have to buy one.

Enter Keebler, the country's No. 2 cookie and cracker maker. It wasn't Keebler's cookie-making prowess that excited Kellogg but its direct-store-delivery (DSD) system. Rather than ship products to retailers' warehouses, Keebler employees drove up to stores every day in panel trucks and stocked fresh snacks directly onto the shelves. The system allowed the company to generate high product turnover and exert great control over merchandising — an important advantage over most competitors, whose products went through the retailers' logistics systems.

Kellogg saw gold in Keebler's DSD system, and its pursuit of the company provides a textbook case of dealmaking discipline at each of the four crucial decision points:

Target-picking — The deal fit tightly with Kellogg's growth plan, and the investment thesis was clear, focused, and compelling: Buying Keebler would add one to two points of top-line growth and give Kellogg a direct distribution channel that it could rapidly fill with an expanded snack-food product line. Some analysts claimed that the deal would likely dilute earnings per share to $1.30 a share from $1.75 in the first year after closing and that the merged company would add $4.6 billion in debt. But the stock market actually applauded the deal. From the time the merger was announced to a year after it was completed, Kellogg's stock rose 26% — outperforming its peers by 11%. It appears that the investment community bought into Kellogg's investment thesis, and the upside of building on Kellogg's core cereal business offset the downside of dilution.

Deal closing — Kellogg focused its due diligence on the few variables that would drive payoffs. Could Kellogg seamlessly move its snack products into the Keebler distribution system? Due diligence suggested that it could. Could Kellogg achieve cost savings large enough to help offset the cost of the acquisition? Due diligence cautiously determined that the deal could deliver $170 million in cost synergies by year three. This justified the $42 a share paid for Keebler. Kellogg actually was able to beat the synergy estimates by a wide margin, making the deal even more valuable than projected.

Focusing integration — Kellogg did not get bogged down in a massive integration effort in the immediate wake of the deal. Diligently following its investment thesis, it focused on getting its snack products into Keebler's system as quickly as possible. Gutierrez and his team realized that, in many respects, this was a reverse merger — Kellogg was moving its snack business into Keebler's operation, not the other way around. Keebler had the proven expertise in snacks and direct distribution, so Kellogg stepped back and put strong Keebler managers in charge of expanding the snack business. David Vermylen, then the president of Keebler, committed to staying on board for three years and overseeing much of the integration effort.

Correcting mistakes — Despite the decision to give Keebler executives control over the snack business, cultural conflicts emerged soon after the deal was completed. Keebler was entrepreneurial and cost-focused, with a history of growing through acquisitions; Kellogg was none of those things. Keebler CEO Sam Reed had been instrumental in the company's success and was an icon to employees. His departure within a year after the deal closed dispirited many of Keebler's people, leading to an unexpected exodus of talent. This became a critical issue — directly affecting the investment thesis — when Vermylen left the company with a year and a half still left on his contract.

Kellogg suddenly had to scramble to keep the deal on track. Gutierrez believed that the best action was to focus on the key driver of his investment thesis: getting the benefits of DSD. He put John Bryant, the highly respected CFO of Kellogg USA, directly in charge of the integration effort. Bryant put aside his other duties to ensure that Kellogg's snacks would move through Keebler's DSD system on schedule.

Once the key strategic imperative was fulfilled, Kellogg could address the broader integration issues, particularly the culture clash. An effort was launched to create a new set of corporate values and a program was established to regularly exchange managers between Kellogg and Keebler in order to share skills and perspectives. In the end, Kellogg found it needed to apply its culture throughout the merged company to capture all the benefits. This is consistent with the findings of our studies, which suggest that scale deals like Kellogg-Keebler require assimilation of the target, including cultural assimilation.

When Discipline Fails: Newell's Big Mistake

Another recent merger in the consumer products industry — **Newell Co.**'s 1999 acquisition of **Rubbermaid Corp.** — reveals the high cost of weak discipline.

When Newell approached Rubbermaid about a merger, it looked like a deal from heaven. Rubbermaid was very profitable and growing quickly. It was a blue-chip firm with a long history of innovation and a reputation as a smart brand marketer.

Newell was a veteran buyer. For three decades it had aggressively built shareholder value by acquiring businesses like Sharpie pens, Levelor blinds, and Calphalon cookware. Because both companies sold household products through essentially the same channels, Newell stood to reap considerable cost savings by combining operations. At the same time, it expected to enjoy the benefits of Rubbermaid's high-margin branded products — low-tech plastic items that ranged from laundry baskets to toys — while strengthening a number of weak links in its supply chain management.

Rubbermaid's executives were encouraging, provided that the deal could be done quickly, and Newell rushed to complete the $5.8 billion megamerger — a deal 10 times larger than any it had done before.

But the deal from heaven turned out to be the "merger from hell," as *Business Week* dubbed it. Newell shareholders lost 50% of their value in the two years following the closing and Rubbermaid shareholders lost 35%. In 2002, Newell wrote off $500 million in goodwill. "We paid too much," former chairman and CEO Daniel Ferguson admits in retrospect.

The failure can be traced to errors at each of the key decision points:

Poor target-picking — Newell knew its growth strategy required a big acquisition because its prospects for organic growth from existing products were limited. With Rubbermaid, Newell thought it was building scale and gaining a strong brand — just what it needed to go head-to-head with buyers at big discount chains like Wal-Mart and Target. But at a deeper level, the deal did not fit. While Rubbermaid and Newell both were selling household basics to the same customers, the two companies had fundamentally different bases of competition. Rubbermaid competed on innovation and brand while Newell emphasized low-cost production. Their production processes and costs were different, as were their value propositions. They were actually in very different businesses, and Rubbermaid's strategy wasn't going to work for the markets that Newell was relying on.

What sets world-class acquirers apart is how they prepare for inevitable difficulties and react when the master plan goes awry.

Bad deal decision — Although Newell had made many modest acquisitions, Rubbermaid was something entirely different. Neither minnow nor fish, Rubbermaid was a whale — 10 times the size of the largest acquisition Newell had ever attempted. Rubbermaid also had worked hard, within legal bounds, to make its business look a lot prettier than it really was.

By agreeing to complete such a huge deal after only three weeks of due diligence, Newell doomed itself to a cursory examination of Rubbermaid — one that provided no time to ask critical questions about the health of the business. Beneath Rubbermaid's well-polished exterior, there was a raft of problems, from extensive price discounting for wholesalers to poor customer service to weak management. Newell never had a clear sense of what the company was really worth. Recalls Ferguson: "We should have paid $31 a share but we paid $38."

Overintegration — Newell took an undisciplined, broad-brush approach to combining Rubbermaid's complex operations into its own. The putative investment thesis — to broaden Newell's scope in branded products — should have called for selective integration. Instead, Newell attempted to "Newellize" Rubbermaid, and squeezed out what little top talent was left at the target. Newell predicted $300 million in cost savings and $50 million in revenue increases in the first two years after deal closing. But when the dust settled in 2001, Rubbermaid had delivered no new sales and only $230 million in cost savings, most of it wiped out by increases in the price of polymer resins, the most important of Rubbermaid's raw materials.

Poor corrective mechanism — Newell, a low-cost producer of largely unbranded housewares, had to learn how to leverage a high-margin brand when it bought Rubbermaid. But it sorely underestimated this challenge. A warning system should have set off alarm bells — as synergies failed to materialize and gaps in know-how surfaced. But it took years to fix the problems.

There is a silver lining to the story, however. Newell ultimately learned important lessons, although getting the acquisition on track entailed jarring disruptions to the business. Ferguson notes, "We had to replace a lot of people. The guys now running Newell understand brand power and how to market it. That's a revolution. It takes a different mind-set, a different group of people." Ferguson ultimately saw that he needed to move the company into turnaround mode, but it took a while for him to find the right person to lead the charge. Two years after the deal closed, Joseph Galli, a veteran of **Black & Decker Co.**, was hired as CEO, and his fresh perspective began to stabilize the situation.

Leading the Way

The most important lesson from studying cases like Kellogg and Newell is that in the end, decision, discipline, and leadership converge. The CEO who has a well-articulated strategy and a solid business system is far less likely to pursue a value-destroying deal than a CEO in strategic trouble.

Companies that know who they are, and where they want to go, make the best deal decisions. The troubling truth is that such companies are the exception, not the rule. Most senior executives we talk to about why they do deals cite a need to "do something," to grab growth or to paper over deep problems in their own companies. They don't talk much about the need for a disciplined, constant pursuit of businesses that strengthen their core.

By bringing rigor to a handful of key decisions, you will master the merger. And you will accomplish more than that. You will wield one of the most powerful corporate tools and gain control of your organization's fortunes. And that is the true promise and potential of mergers and acquisitions. ■

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