

The 'why' and 'how' of merger success

The effects of mergers have been carefully studied many times, often with the conclusion that the results reveal few benefits for any of the stakeholders. In this article, based on experience, the authors set out golden rules to guide managers to success.



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Mergers are back.

Strategic alliances, hostile takeovers, all-cash buyouts, bear hugs and stock deals all have surpassed the Internet on chief executives' agendas. For now, at least, e-business does not pay the bills.

Indeed, TheStreet.com's Internet index fell 78% in 2000, while the total market capitalisation of the top 10 mergers completed rose 50%. Moreover, the top 10 new deals announced in 2000, totalling \$600 billion, included prominent plays at industry redefinition – such as General Electric's attempt to acquire Honeywell, and the AOL and Time Warner marriage. Clearly, mergers have re-emerged as a master tool of strategy.

Mergers today are altering the nature of competition in industries, harking back to transactions in the early 1900s that boldly created the likes of DuPont and General Motors. This contrasts with the more recent history of mergers and acquisitions, which includes a corporate craze for diversification in the 1960s and 1970s and leveraged buyouts fuelled by high-risk, high-yield debt in the 1980s. More often than not, leveraged buyout transactions, such as Kohlberg Kravis Roberts' takeover of RJR Nabisco, amounted to corporate restructuring or 'active investing' – an effort to squeeze value out of an underperforming business. Such deals, while significant, did not change the rules of competition. And by the year 2000 these types of transactions had greatly declined. One article in the *New York Times* reported, 'Leverage buyouts now play little role in shaping corporate America. In the first nine months of last year they accounted for less than 2% of all acquisitions, down from a high of 34% in 1988' (Atlas, 2001).

Shifting strategy

The late 1990s saw both an increase in mergers and acquisitions and a fundamental shift in their motivation. None of the largest acquisitions were merely about swapping assets. Each had a stated strategic rationale. Some were conceived to improve competitive positioning, as in Pfizer's takeover of pharmaceuticals competitor Warner-Lambert. Others let acquirers push into highly related businesses. Recently, Central European oil companies

have started to band together in a bid to fend off such powerhouses as Royal Dutch/Shell Group.

Cable powerhouse Viacom's acquisition of broadcast mainstay CBS has allowed Viacom to deploy CBS's assets to promote its cable offerings, and vice versa. Still other deals were geared to redefine a business model – for instance, new-media force AOL's deal with old-media empire Time Warner, completed in January 2001.

Yet, succeeding at mergers and acquisitions has never been easy. (For evidence on how a merger can go wrong, see Box 1.) Several well-structured studies calculate 50–75% of acquisitions actually destroy shareholder value instead of achieving cost and/or revenue benefits. There are five root causes of failure:

- Poor strategic rationale, or a poor understanding of the strategic levers.
- Overpayment for the acquisition, based on over-estimated value.
- Inadequate integration planning and execution.
- A void in executive leadership and strategic communications.
- A severe cultural mismatch.

Setting rationale

Of the five, getting strategic rationale right is crucial. Being clear on the nature of the strategic

BOX 1: Down the drain: Quaker Oats and Snapple

Quaker Oats bought Snapple in 1994 to build product depth in the healthy-beverage market segment. But it mistakenly assumed it could simply sell Snapple through Quaker's Gatorade supermarket channels and Gatorade through Snapple's small, independent, convenience-store distributors. Distributors and end-customers disagreed with Quaker's logic. Snapple distributors, who had effectively built the brand, balked at having to give up the profitable supermarket accounts. Loyal Snapple consumers, drawn to its homespun, relationship-focused positioning, felt alienated when Quaker marketed Snapple in the same fashion as its national flagship, Gatorade. Quaker's failure to closely consider the new customer value proposition proved costly. Quaker divested Snapple in 1997 for less than one-fifth the price it had paid for it just three years earlier.

levers is critical for both pre-merger and post-merger activities. Indeed, failure to do so can trigger the four other causes of failure.

And then, of course, there is the question of speed. Speed is essential to successful integration, but not speed for speed's sake. Those managing the integration process must know how to carefully make tradeoffs between speed and careful planning. To keep the value of a merger from evaporating, leaders need to manage the integration process actively, and steer a course that leads the new organisation to its stated strategic goals as swiftly as possible.

There are six key rationales for pursuing mergers (Figure 1).

1. Active investing

Leveraged buyout companies and private equity firms engage in 'active investing' – acquiring a company and running it more efficiently and profitably as a stand-alone firm. Typically these transactions improve performance through financial engineering, incentive compensation, management changes, and stripping out costs. Private equity player Bain Capital's purchase and restructuring of Gartner Group illustrates the power of active investing or 'squeezing the lemon'. With honed operations, Gartner became a premier broker of computer information, its margins expanding from 10% to 30%. Active investing can, and often does, add value. However, active investing is truly the domain of leveraged buyout and private equity firms such as Bain Capital, a company independent of Bain & Company. For corporations, a more strategic rationale is needed.

2. Growing scale

Mergers most often aim to grow scale, which does not mean simply getting larger. Rather, success requires gaining scale in specific elements of a business and using these elements to become more competitive overall. For instance, if materials cost drives profit, then purchasing scale will be key. If customer acquisition is more important, then channel scale will be critical. Getting scale-based initiatives right requires the correct business definition and the correct market definition. This can be difficult because, over time, the definition of scale in an industry can change drastically.

For example, a sea change in the economics of pharmaceuticals led to the mergers of Pfizer with Warner-Lambert, and of SmithKline Beecham with Glaxo Wellcome. For decades, pharmaceuticals were

FIGURE 1: Strategic rationales

Play by the rules		Transform the rules	
Active investing/ performance improvement	Scale	Adjacency expansion	Scope Redefining business models Redefining industries
High predictability of value High functional overlap		Low predictability of value Low functional overlap	
<ul style="list-style-type: none"> • Speed is critical • Focus on operational issues • Plan actions pre-dose to realise 80% of deal value 		<ul style="list-style-type: none"> • Sacrifice speed for most strategic issues • Focus equally on strategic and operational issues • Develop new business opportunities • Plan for impact on rest of organisation • Rationalise and cost-cut where beneficial 	
		<ul style="list-style-type: none"> • Sacrifice speed to get right strategic outcomes • Focus on strategic issues • Seek operational improvements • Retain talent • Develop strategy • Cut costs opportunistically • Create flexible action plan 	

a national or regional business. Regulatory processes were unique to each country, and barriers existed that made drug introduction to foreign markets difficult. Distribution and regulatory costs needed to be spread over the maximum proportion of local markets. Today, many of those barriers have diminished, while the costs per successful drug development have risen exponentially. Research and development can and should be spread across the entire global market, covering more countries, more products, and more types of diseases. In the June 2000 Harvard Business Review, Jan Leschly, recently retired CEO of SKB, remarked candidly: 'What really drives revenues in the drug business is R&D.'

3. Building adjacencies

The next most common impetus for mergers and acquisitions is to expand into highly related or adjacent businesses, as in the Viacom example. This can mean expanding business to new locations, new products, higher growth markets, or new customers. But most importantly, the additions should be closely related to a company's existing business. Chris Zook, in *Profit from the Core: Growth Strategy in an Era of Turbulence*, provides empirical evidence that expanding into closely related businesses through acquisitions drove some

of the most dramatic stories of sustained, profitable growth in the 1990s: Emerson, GE, Enron, Charles Schwab, and Reuters, to name a few. When Travelers Group acquired Citicorp, the merger gave the two companies a complete range of financial-services products to cross-sell to their combined customers across a broad range of global markets.

4. Broadening scope

In mergers geared to broaden the scope of products or technologies, a serial acquirer systematically buys specific expertise to either accelerate or substitute for a traditional new-business development or technology R&D function. A serial/scope acquisition model has been successfully executed in a number of industries, such as financial services (GE Capital), Internet hardware (Cisco), and chip manufacturing (Intel). For these firms, major ongoing investment to scan for new product concepts or technologies is an integral part of their growth strategy. For most of these firms, organic development would be too expensive, too slow, and/or would dilute focus on their existing businesses.

5. Redefining business

Deployed strategically, mergers and acquisitions can redefine a business. This is an appropriate

strategic rationale when an organisation's capabilities and resources grow stale very suddenly due to, for example, a major technological change. In such cases, a firm cannot quickly refresh its technology or knowledge by making internal investments and incremental adjustments. When telecommunications equipment provider Nortel embarked on a strategic shift toward Internet provider-based working infrastructure, Nortel transformed its business model through a series of acquisitions. Since January 1998, the company has acquired 21 businesses, including Cisco's competitor, Bay Networks, to refocus from supplying switches for traditional voice communication networks to supplying technology for the Internet. Nortel utilized mergers and acquisitions strategically to make what CEO John Roth calls the company's 'right-angle turn'. While hit hard in 2001 by a downturn in fibreoptics, Nortel has nevertheless become Cisco's chief rival.

6. Redefining industry

Sometimes a bold, strategic acquisition can redefine an entire industry, changing the boundaries of competition and forcing rivals to re-evaluate their business models. For example, the AOL-Time Warner merger could potentially rewrite the rules for communication and entertainment. Beyond creating new distribution channels for content, and new content for the Internet, the merger could allow the new company to choose to take profit in either content or distribution, depending on customers' preferences. No other traditional content or distribution competitors have this choice. Similarly, several analysts believed GE's attempted acquisition of Honeywell would have fundamentally altered relationships in the aircraft industry, among operators, maintenance providers, leasing companies, manufacturers, and parts suppliers. Before the European Union derailed the merger one analyst quoted in the *New York Times* said, 'I think GE just bought Boeing, and Boeing doesn't know it yet' (Zuckerman, 2000).

Letting the 'why' inform the 'how'

A clear, strategic rationale for an acquisition is critical, but not enough to guarantee a successful deal and merger integration. The rationale helps to identify the right target and set boundaries for negotiations, but the hard work remains of bringing two companies together effectively. Nonetheless, the 'why' informs the 'how'. The right strategic rationale will inform the preparation and valuation

of the merger. The strategic rationale should also inform what leadership and communication style to adopt and how to plan for post-merger integration, including cultural integration.

In acquisitions seeking to gain scale, pre-merger planning can be done 'by the numbers'. One can, in advance, calculate goals for combined market share and cost reduction, plan steps to achieve them, and create measures of performance improvement. This type of merger places great demands on a chief executive's ability as a manager to cope with complexity. The task may not be easy, but at least the leader can craft a plan before the transaction and execute it after the merger.

But in bolder mergers, where parties seek to redefine their industries, the numbers may not be as precise. The companies involved will have a post-merger model for operations. However, that model will change as industry rules change and as competitors react. In such a profoundly uncertain environment, vision is critical and must come from the top of the organisation. A strong leader must cope with flux by confidently and effectively communicating the strategy and vision. The post-merger integration plan will have to be much less detailed and much more flexible than that of a scale transaction, leaving room for leadership to adapt its message to a rapidly evolving competitive environment.

This, then, is where speed comes in. Said Hewlett-Packard CEO Carly Fiorina after announcing a \$25 billion deal to acquire Compaq in September 2001, 'Clearly the potential of this combination is compelling, but we understand the magnitude of the challenge and the need for discipline and speed.'

Fusing at full speed

When Internet equipment maker Cisco Systems completes an acquisition, it aims to assimilate the technical know-how of the new company under its corporate umbrella within 100 days. Cisco aggressively seeks to keep the highly skilled people that made the target attractive and to incorporate new products into Cisco's development pipeline. With that strategic end, Cisco has developed a comprehensive approach to integration that works. Cisco's track record for merger integration stands strong, having integrated more than 60 acquisitions from 1996 to 2000.

Consistent with Cisco's approach, in every merger integration the companies involved must

pass three basic milestones, marking three phases that require active management. These phases include: establishing the vision, planning the integration, and executing the plan.

If you are merging to capture benefits of scale, 'you must act fast', says Tony Johnston, Regional Director of British American Tobacco Asia-Pacific. Johnston led the regional team in the integration of Rothmans with BAT's Asia-Pacific operations. 'The longer you take to make decisions, the more risk you take.' He would know. The BAT-Rothmans total effort spanned more than 70 countries and involved numerous plant closures, three major antitrust queries, and the melding of two head offices. He completed most of this mammoth task in a year.

According to Johnston, success depends on identifying very early the key people to lead the organisation, and removing the people likely to block the process. During the early stage, a sense of urgency is essential. 'Don't allow endless debate; an 80% right solution is almost always better than delay,' Johnston says. In tandem, merging companies need frequent, two-way communication with employees and affected communities to air concerns and alleviate anxiety.

Acquisitions intended to achieve scale or operating improvements are the simplest to plan. Since (by definition) a high overlap exists between the two businesses, there is often a common technical understanding between the management teams. This understanding makes it possible to map out essential actions in advance and delegate tasks to transition teams. But senior executives need to remain engaged to arbitrate on delegated issues that have become difficult to resolve. Johnston recalls, 'There were times when too much was at stake, and it was impossible for the country guys to be neutral. I had to intervene more than I would have liked ... to break logjams.'

Mutual understanding makes scale-based integrations simpler to manage, but that does not make it easier. If the benefits of merging are easy to spot, the acquisition price usually reflects the value of these benefits. As a result, managers, under pressure, make deeper cuts and drive further performance improvements than the market expects. In these cases speed becomes most critical.

In the BP and Amoco merger, chief executive John Browne met the speed challenge. Working out of a 'war room' in London with an around-the-clock integration team, Browne filled all the senior management jobs and completed most of the cuts in the first 100 days of the merger. By reducing

headcount more than originally planned and divesting a variety of assets, the company completed the projected \$2 billion savings in one year.

Keeping customers in the forefront

In a merger aimed at expanding into adjacent markets, customers or product segments, the big prize comes from growing revenue. This often comes atop opportunities to benefit from economies of scale. To win the revenue prize, a good part of the integration effort needs to focus on defining the new entity's value proposition to customers and determining how to bring it to market. Teams from both sides must work together to develop a new marketing plan for the combined company.

Witness baby equipment makers Graco and Century's integration approach: Part of the integration team tackled opportunities to increase scale and reduce cost – in this case, administrative headcount cuts and consolidated sourcing in Mexico. The rest of the team focused on the revenue opportunity, wrestling with such issues as: Would customers accept a Graco-branded car seat – one of Century's core products – despite the Graco brand's strong association with strollers and baby carriages? Would trade customers value the combined product offering enough to maintain or expand shelf space? Was there a customer-driven reason to keep two like products, or should the company reduce the number of different models it sold?

After hammering out answers based on each side's customer knowledge, the combined company expanded product lines under one another's distinctly positioned brand names. Together they now serve a broader range of customers and command expanded shelf space. Graco and Century tempered their urge for speed with careful consideration of critical strategic issues.

Communicating the vision

Executives who use mergers to take a business in a fundamentally new direction face further integration challenges. Typically, opportunities exist post deal closure to both reduce costs and expand into highly related market segments. Executives must divide their energy between these and the more elusive sources of value. To create something entirely new from the two companies, leaders need to communicate the new company's vision, and motivate people to channel their energies in the direction desired.

Bold transactions that endeavour to change an industry's rules of competition present the greatest risk, and the greatest difficulties for integration. Industries are never redefined in a 100-day period, and rarely even in two years. The success of these deals depends on influencing the customer and competitive landscape – a landscape undefined at the deal's close. So, where should a company start? Ask AOL and Time Warner, as they journey on perhaps the most ambitious merger in history. Vice Chairman Kenneth Novack describes the blended companies' goal: to 'combine our unique mix of creative, editorial and distribution assets to connect, inform and entertain people everywhere, transforming the ways in which they communicate and receive information' (interview by Katie Smith Milway, email, 6 February 2001). Achieving this will not be easy.

In this environment, leaders need to communicate forcefully a clear vision. The challenge lies in quantifying and understanding this type of deal. Therefore, the companies' leadership must make the case for the merged entity that maintains its market value and retains sceptical employees. Leaders must likewise continue to steward and promote the value of their individual businesses – it is hard to recoup a drop in standalone performance, particularly if the value of putting the two companies together takes time to emerge.

Beyond presenting the deal to external and internal stakeholders, the management teams need to pursue two initiatives in parallel. The first pursues short-term objectives – for example, cost reduction, overhead consolidation, or divestment of non-core business units – all typical steps in integrating mergers. Speed matters here – indeed, success in this initiative can help win market confidence and buy time to move more slowly on other fronts. Also, cost reductions can provide funding for longer-term strategic objectives. Just a few weeks after AOL Time Warner became one entity in January 2001, it announced a series of ambitious cuts amounting to around \$300 million annually in personnel costs. Since then, it has set more ambitious cost and revenue objectives. Affected by a drop in advertising spending and a slowing economy, AOL Time Warner announced further cuts in August of 2001 still hoping to meet its financial targets. By doing this, AOL Time Warner intended to send a clear message: Shareholders should not have to wait long to see some value in the merger.

Managing three phases of integration

Once executives have considered the particular challenges posed by the strategic rationale behind the merger or acquisition, they can move ahead with active management of the three phases of integration. Phase 1 sets the stage by articulating the vision and naming key leaders. Phase 2 designs the new company's organisation and operating plans. Finally, phase 3 makes the integration happen by aggressively implementing plans that bring the vision to life.

Phase 1: Set the stage

The leaders of the merger should articulate a compelling strategic vision for their combined companies and identify their top leadership team before announcing their intention to merge. This will comfort and mobilise constituents by answering four big questions straight away: Where are we going? Who will lead us there? What are the obstacles along the way? How might this impact each stakeholder, individually and collectively?

Phase 2: Design the new company

After announcing the intent-to-merge and appointing a leadership team, the corner office needs to involve the rest of the organisation. Step one: Divide managers between those driving the transition process and those running the base business. Make each accountable for achieving specific goals, so their eyes remain on both balls during this period of uncertainty. Step two: Design the organisation and operating plans to realise the value and achieve the vision.

Phase 3: Make it happen

Once the two organisations sign the deal, the new company can begin to tackle the challenge of actually merging.

- *Day one:* dawns with a whopping to-do list. Hundreds of basic tasks – from registering legal details to changing invoices to editing the receptionists' welcome scripts – must be checked off urgently just to maintain business as usual.
- *Day 10:* Make all the major announcements by this point. If there will be only one headquarters, say so. If factories or other facilities will close, identify how many. Do not shy away from

bad news – people would rather hear the worst than be held in suspense.

- *Day 100*: By now, the new company should be operating as one company and well on its way to seeing value from the two to three high priority sources. Within 90 days of an acquisition by Cisco, the integration team has put together management systems, consolidated suppliers, made outsourcing decisions, slapped a Cisco label on the acquired company's products, and channelled new research and development projects into Cisco's pipeline.
- *Beyond 100 days*: Much of the value of mergers and acquisitions appears after the first one hundred days. Managers need to turn their attention to opportunities they may not have anticipated when they conceived the deal. At the same time, transition teams may still be working – and must stick to their aggressive schedules. After one year, most integration activities should trail off and those managers in charge of

day-to-day operations should take on full responsibility for delivering results.

Chief executives face few challenges riskier than integrating two businesses, and employees face few situations more stressful than mergers. Meeting this challenge requires leaders map a path to integration that aligns with strategic intent. This way, leaders can guide their companies through the inevitable uncertainty of merging as swiftly as possible, and capture the value that prompted the deal.

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