

The Human Side of Due Diligence: Protecting the M&A Investment

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A highly diversified financial services company acquired a large regional bank. The companies had widely divergent cultures and growth strategies -- acquisition and diversification in the first, organic growth through customer service focus in the second. Within 3 months, incompatibilities between the cultures of the two companies caused a wholesale defection of the Human Resources department of the acquired company, resulting in confusion for bank employees, especially in the retail branches. The acquiring company required changes in systems and staffing patterns that resulted in a near breakdown in customer service in many of the acquired bank's branches and in the Customer Service Center. The acquired bank lost 10% of market share within 12 months of the acquisition.

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In the fast-paced world of Mergers and Acquisitions, at the beginning of every transaction is a vision for the future of a newer, bigger, better operation where everything is rosy and profits are there for the taking. As in this example, the reality may turn out to be quite different. There are many reasons to merge with or to acquire another company: greater market share, diversification into a related group of products or services, expansion up or down the supply chain, gaining cutting edge expertise for new product development. But consider this: roughly seven out of ten mergers and acquisitions fail to deliver on the financial expectations of the investor or corporate buyer. By most recent estimates, a minimum of 25% of the U.S. workforce will be directly affected by M&A activity in the coming decade. This figure will be considerably higher for some industries, such as financial services, healthcare, and hospitality, where the activity is expected to accelerate from current high levels. Business leaders and the investment community will continue to place a significant part of

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Corporate Leadership
Council, 2003

their resources and their strategic focus on various forms of acquisitions and mergers in order to achieve growth and financial stability. This adds up to one word: change. Change has a direct and profound impact on people, organizational systems, and business operations. Failure to understand and to develop strategies to manage the impact of such change poses a direct threat to profitability and the preservation of equity value.

This insight is not new: experts in the management field have been delivering this message to companies for at least a decade. Witness this pronouncement from a study published in 1994: "There is increasing evidence that cultural incompatibility is the single largest cause of shortfalls in projected performance, departure of key executives, and time-consuming conflicts in the consolidation of businesses." (Ernst and Young, 1994). Experts continue to find this to be true today, citing alarming statistics: "Up to 85% of M&A failures are attributable to problems in the integration of employees and the management of cultural issues in the merger or acquisition." (Corporate Leadership Council, 2003). We must accept the fact, therefore, that cultural match and the integration of employees are not "soft" issues, but in fact have a direct effect on employee retention and productivity, customer relations, and return on investment.

Organizational Culture and M&A

The word "culture" when applied to the topic of M&A may be one of the most misunderstood terms in the management field. Organizational culture springs from many sources, but on a concrete level, it means how things are done in a company. Culture is manifested in policy and procedures, organizational structure, and everyday behaviors, both formal and informal: Is a workgroup judged on its ability to produce high volumes of work in a short time, regardless of a 10% error rate, or is flawless work the desired goal? Does information travel informally, or are there strict rules that must be followed? Is the

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**Conference Board,
2002**

company decentralized, or are corporate services and decision-making centralized at the corporate level? Are decisions made slowly or quickly? What is the level of teamwork vs. a top-down approach to getting projects accomplished? Does the company promote from within or go outside to find the talent it needs? How does "bad news" travel, and how does leadership deal with the messengers? What is the orientation to change?

Whether it's a merger, a spin off, or a stand-alone acquisition, how the culture adapts to new ownership will have crucial implications for the success of the deal. "Differences in leadership style, systems of management, decision making and communication are the most difficult to resolve," wrote Laurence Schein for the Conference Board report on M&A in 2003. "Early detection is key." We tend to think about "cultural match" as applying to a merger, but understanding the culture can be just as important for a stand-alone acquisition, because key cultural characteristics of the target company will be very important in determining how the company adapts to change in general and to the new ownership. In a roll up, the issues are similar to a merger: the parent will expect the target to adapt, to some degree, to the ways of doing things that the parent wants.

Beyond Due Diligence: Why Deals Fail

Planning for the impact on people and organizations should be an integral part of business planning and strategy for any merger or acquisition. Too often, preparation for the deal stops short of adequate assessment of these issues. Indeed, the required due diligence process, although of crucial importance, often does not go beyond fundamental financial, employment, and legal matters. "Due Diligence is powerful but it has its limitations." So wrote the authors of a report by the Conference Board in 2002, continuing: "It can't spot the workforce and cultural factors that have direct implications for succession management, retention, promotion and development,

A Fortune 500 Electric Utility acquired a regional Gas Company as part of a long term growth strategy. The executives of the parent company assumed that, even though the employees of the Gas Company were accustomed to the management style of the family that had owned the company for generations, simply preserving the levels of compensation and benefits of the acquired company would take care of any issues of adjusting to life in a large corporation. Human Resources and all associated benefits programs were taken over by the parent. Gas Company executives all left within six months. Workers Compensation claims increased 50%, surpassing reserves, and negotiations of a new labor contract was highly contentious.

identification of key business drivers, and goal setting. It's not going to show you how your management team is going to adapt to the new ownership or the new parent." (Conference Board, 2002) Corporate leaders are coming increasingly to understand that managing these issues must become an integral part of their stewardship of these important and far-reaching transactions.

Neglecting the cultural and employee-related aspects of M&A can put at risk the most thoroughly planned and well-researched transactions. Costs directly related to the impact of a merger or acquisition on people and organizations can eat away at factors fundamental to value preservation, such as customer loyalty and market share. It is not unusual, however, that in keeping their eye on the ball in one area, those responsible for the success of a transaction may lose sight of other crucial factors. In one highly publicized financial services merger, the combined company was achieving its cost savings, but it was losing 1.5% of its customer base per month because, while that institution was good at measuring cost savings, it had not developed an adequate means to track and measure customer retention. Interviews with sales and customer service staff revealed that changes in customer service procedures required by the "dominant" company had alienated some clients and had significantly decreased the motivation of staff from the acquired company.

Workforce Factors: The Costs

Downstream workforce costs. The loss of customers experienced by the financial services company described to the left was directly related to the impact of the merger on its employees. Downstream costs can also result from internal workforce issues, factors long recognized as having significant effect on profits and value. For example, we know that unless closely managed, the emotional stress, personal insecurity and challenge to employee morale engendered by a change of ownership has a direct effect on costs that are known to be sensitive to management and

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Harvard Management Update, September 2001

workplace climate issues. These costs appear as increased levels of turnover, absenteeism, disability and medical payments, and Workers Compensation claims. A survey of 177 combining companies showed one in five reporting increases in workers' compensation costs of between 50 and 100 percent, despite the fact that one third of these companies had decreased their head count. A 2003 study reported that health costs were 70% higher for workers reporting depression than for non-depressed workers, and 46% higher for workers who felt they were under a lot of stress. These effects apply not only to the ranks of salaried workers, but for key management staff as well.

Productivity losses. Productivity can be affected also through the effects of change on individual work performance and the performance of teams and work units. A well-circulated issue of the *Harvard Management Update*, published by the Harvard Business School in 2001, and just as relevant today, commented on the cost to productivity of employee uncertainty in the midst of a merger or acquisition. The issue cites this startling statistic: *"People are normally productive for about 5.7 hours in an eight-hour business day. But any time a change in control takes place, their productivity falls to less than an hour."* (*Harvard Management Update*, 6:9, September 2001). This loss in productivity goes beyond mere wasting of time in worry and water cooler talk. After a merger or acquisition, employees who feel uncertain about their job security and mistrustful of leadership regarding the sale may be unmotivated and averse to risk. They will not come forward with new ideas, communicate with leadership, or be creative. The tendency is to try to maintain a low profile and do the minimum, staying "under the radar."

Loss of key employees. Planning for who among your employees will continue on after the merger or acquisition is a key ingredient for success. More often than not, however, this planning is limited to a narrow fixation on payroll and percentages; a shrinking in

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the employment rolls is often part of the plan, not only in a merger where synergies are expected but in an acquisition as part of the striving for efficiencies. Many top managers will in fact say: "Why do I need a retention plan? Actually, I am counting on losing 15% of my workforce through attrition!" But is this manager thinking about *which* of his or her employees will be lost to the company? In addition, in formulating a retention plan, those in charge of an acquisition will often limit their focus to a small handful of top people, ignoring people at the middle and the line levels—leaving valuable staff vulnerable to poaching by competitors. An acquisition or merger can create conditions in which a company is at risk for losing just those people who may be critical to immediate and longer-term business goals by virtue of their management skills, knowledge of business systems and processes, and intellectual capital. This can have consequences, not only downstream, but for the transaction itself.

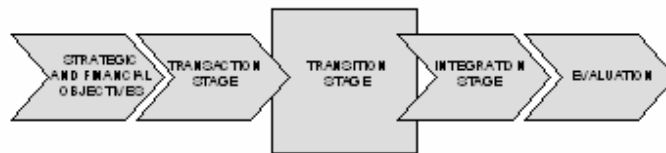
The phases of the deal

The tasks of integration. The term "integration" is now regularly used in conjunction with M&A. After "organizational culture," it may be the term most subject to misinterpretation. There are two common misconceptions: the first is that integration is limited to achieving synergies of organizational systems and human resources. The second is that the work of integration begins after the deal is closed. According to David Schweiger, a management consultant and expert on M&A, the integration process begins well before the transaction is completed. He proposes the following model to describe the phases that comprise the key elements of the integration process. According to this model, deals proceed in phases. Once the strategic and financial objectives have set the acquisition process in motion, the principals carry out required due diligence and negotiate a price and terms. But the work of the Transaction Phase does not end there. In fact, several additional tasks, closely linked to the goals of this phase, should be undertaken if the financial return desired from the

transaction is to be realized. It is at this point, before the deal is closed, that These tasks can be summarized as the following:

1. Gather crucial information

The first task of integration is to assess the degree to which the organization is equipped to develop integration planning, and to carry out ongoing monitoring and evaluation. In order to accomplish this, those responsible for the implementation of the deal must gather crucial information about the culture, the workforce issues, and the degree of readiness to carry out the transition successfully. Performing the tasks outlined below will allow for (1) planning for effective implementation of the deal and (2) the development of the processes and procedures required to implement those plans.



after Schwabger, 2002

2. Establish transition management processes and infrastructure. There must be people assigned to carry out the work of successful transition and integration, and, depending, on the company, this should be a coordinated group of stakeholders. This group is sometimes called a Transition Team. It is also important that the right person be designated to lead the effort. For this important role, the job of Transition Manager is becoming increasingly accepted as best practice. Additional key components are an internal communications plan, a retention plan that reaches beyond the 4 or 5 top people, and an approach to implementing transitions in compensation and benefits systems.

The primary purpose of these core elements, such as the team and manager mentioned above, as well as systems for monitoring and measuring attitudes,

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performance, and costs, is to ensure continued active management of the deal through the transition and integration phases. This includes building in "listening posts" to increase awareness of trouble spots and early warnings of cost factors. This corresponds to Schweiger's evaluation phase, which achieves the dual purpose of monitoring current deal and providing learning for future deals. In this way, each company can establish its own M&A best practice on the basis of experience.

3. Assess downstream cost factors

As discussed above, workforce costs associated with integration tend to be the least considered and planned-for aspect of the transaction, but may account for the difference between achieving financial goals for the company or the investors and falling short of expectations. Preventing or controlling these costs means understanding them in the transaction stage so that effective solutions can be developed and monitored for as long as is necessary through the integration phase.

Identifying the Barriers

The components of effective Transition Readiness – transition team, transition manager, robust internal communication, broad-based retention planning, and metrics-based monitoring -- have become accepted as best practice. Yet only a small fraction of the thousands of companies involved in acquisitions and mergers each year realize the benefit of this knowledge and these techniques. Why do corporate leaders pay insufficient attention to the human elements of a merger or an acquisition? To a person, they will give you the same answer: the pace is too rapid, time is too scarce, and cost pressures are too intense to pay attention to anything but the most immediate issues concerning the legal and financial mechanics of completing the deal. And indeed, the realities of M&A – time pressure and the need for secrecy, do exert a powerful influence on the conduct of top managers during the first phases. Schweiger points out that the two main drivers affecting the

timing of integration activities are 1) the availability of information and 2) access to and active cooperation of the target. These drivers, however, because of their very importance, are also the key to understanding and overcoming these barriers to effective integration. There are three:

Barrier 1: Time and money pressures

“This is good stuff,” says the CEO, “I’ve talked to the consulting companies and what they say makes sense. But I’ve seen the price tag. Don’t ask me to spend more money now when I am under the most pressure to cut costs. And don’t ask me to commit my people to extra meetings or interviews when they are stretched beyond the breaking point getting this deal done and running the business at the same time!” Attention to time windows and cost factors becomes super-charged during the transaction process. Getting the deal done takes the focus off other issues, however important they may be for deal success. Experts agree that due diligence is often hurried, resulting in inadequate prediction of potential pitfalls. Buyers may make up their minds early in the process that they like the target, and in fact it may make sense in terms of a growth strategy, but then they neglect to look deeply enough into important characteristics of the target. What a potential buyer finds out may not make him or her walk away from the deal, but it will provide important information about steps to help ensure that the investment pays off. Every potential exposure to risk deserves attention.

Barrier 2: Limited access to managers and employees.

During the steps leading up to closing, knowledge about the pending transaction is shared only with a small group of people. This can lead to the erroneous conclusion that any organization-wide transition planning must be held off until the deal is inked. In fact, access to key people is crucial in the transaction and early transition stages to identify key issues in planning and the development of any needed systems

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to guide the transition and integration processes. Furthermore, it is essential that these same key people be actively involved in an organized, focused planning effort. All too often, for example, Human Resources departments are not involved in front-end planning, but relegated to carrying out transition plans and compensation and benefits changes in the weeks and months after the closing. They are not involved in planning for the actual implementation of these changes, particularly regarding the crucial aspect of internal communications.

Barrier 3: Unavailability of properly focused and scaled solutions

M&A consulting solutions are often expensive, affordable only by large companies. In addition, in these engagements, the focus may be limited to the expertise of the consulting company, e.g. cultural integration, human resources transition, communications, strategic planning, cost reduction, risk management, executive selection and coaching.

Confronting the Barriers: Turning Challenge to Opportunity

These barriers can appear formidable to the CEO or management team attempting to meet the complex requirements of deal completion while carrying on business operations. However, they should be confronted directly – leaders should not allow themselves to be discouraged from taking these issues on. Precisely because these challenges are so much a part of the landscape of M&A, it is important for corporate leadership to actively seek solutions that are affordable and that take into account the real financial and time pressures attendant to any deal. Those responsible for the deal should keep two things in mind as they undertake the transaction:

- You are the stewards of the deal. The job does not end with the inking of the agreement. It has just begun.
- Integration proceeds in phases. Effective

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- stewardship begins with seeing the big picture from the beginning, establishing a vision, maintaining awareness of goals as you go, and then applying metrics and monitoring as part of a two-way communication strategy.

With these points in mind, several best-practice principles should be kept in the forefront:

Team-based, coordinated leadership. If a transition team is organized at the very beginning of the merger or acquisition process, the challenges of limited time and financial resources and limited access can be successfully confronted through innovation and coordinated activity. A great deal of valuable information can be gathered in a relatively short time from a small group of inner-circle managers in the pre-closing period -- information that will yield potentially huge benefits in the form of early planning. Once the deal is done, information gathering can be opened to the wider employee population in the form of sampling surveys and interviewing of key managers and supervisors. This will help ensure that two-way communication facilitates identification of issues and maximizes teamwork and loyalty over the short term and long haul. Team-based planning in the transaction phase also allows for full coordination of crucial stakeholders such as Human Resources. A 2004 study of M&A notes that General Electric, which has consistently increased shareholder value through acquisitions, always has a Human Resources executive involved as a key player in pre-and post acquisition activities. Building teams with broad stakeholder representation also allows leadership to identify gaps in competencies and so that skills can be gained or assistance brought on board.

Communication. Communication is the most valuable commodity for the successful implementation of a merger or acquisition. The specific communication objectives change for every phase of integration. As the deal moves through its phases, information changes and the circle of knowledge grows. Nothing is a secret for long, and leaders must be prepared, not

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only for what they know is coming, but for the unexpected. Leaders should follow a phased approach to communication, in which planning is sensitive to continuing information flowing from multiple organizational levels about the progress of integration. Again, if resources or expertise are lacking, leadership can seek out help.

Access vs. risk. A key feature of every acquisition is the activity of collecting information about the target as part of due diligence. Experts in the M&A field write about the need to find a balance between the drive for growth that motivates all deals, and the importance of paying the right price. Of course, these are closely linked: in order to know whether to go ahead and how much to pay it is crucial to have the right information. Insufficient, inaccurate or misleading information leads to overvaluation and to difficulties in realizing business goals down the line. This principle is well-established with respect to financials, sales synergies, and legal and business exposures, such as employment law liabilities and environmental exposures. It is less well recognized with respect to the organizational, employee, and cultural issues discussed here. Risks can be mitigated through representations and warranties and direct risk transfer solutions, but this should always be balanced by gathering proper information in time to help ensure that value is protected. Prevention through the timely gathering of good information is sometimes neglected because of a overzealous commitment to an overall strategy, or a rush to do the deal for other reasons. Sometimes, however, it happens because of a simple lack of tools. Nowhere is this more true than in relation to the very real risks to deal success described above.

Leveraging leadership to achieve economies. Again, the solution lies in leadership taking a proactive role in managing the transition through all its phases. When company leadership assumes stewardship of the transaction on a continuing basis, assistance can be within the reach of even mid size companies. When leadership focuses on proper and timely

Measurement and delivery methods now allow for scaling of assessment, monitoring and cost containment solutions to suit enterprises of all sizes.

assessment and good coordination between stakeholders, the strengths already present in the company can be leveraged and outside assistance can be utilized efficiently.

Conclusion: A Leadership Issue

Neglecting the cultural and employee-related aspects of mergers and acquisitions can put at risk the most thoroughly planned and well-researched transactions. Armed now with this knowledge, we might pose the following to the corporate leader engaged in or contemplating a merger or acquisition: You have spent much time and energy scrutinizing your business' competitive position and marketing strategy in order to create a successful growth strategy. You have fulfilled and surpassed the legal obligation to ensure that you are covered for your risks, and that you are well positioned with respect to providing compensation and benefits to the employees of your newly acquired or combined company. *But have you planned how to ensure that they feel secure that the change will keep them whole, and that the transition will proceed smoothly through the organization?* You have looked and looked again at costs and found efficiencies wherever you can, *but have you considered the downstream costs that will increase due to the stress of organizational change, such as disability, workers compensation, healthcare and turnover?* Finally, you know that the sale makes good business sense for the company, and you are genuinely excited about it. *But are you equipped with a plan to communicate this effectively throughout your company, to the men and women upon whom you are relying for the success of the venture?*

Mergers and acquisitions are about growth and new beginnings. These are not soft concepts - rather they are inextricably linked to issues of corporate survival: the need for innovation, to enter and compete in global markets, and to acquire new expertise to ensure the future of the enterprise. Stewardship of the new combination or acquisition requires an assessment of the systems designed to take care of

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people and assure the success of the organization. As much as this involves well-designed procedures, clearly set out roles and responsibilities, and reliable analytics and metrics, the heart of the process is communication, which cannot be effective without the involvement and visible commitment of leadership. It is the role of top leadership to articulate a vision for the future, communicate it effectively at the time of transition and on an ongoing basis throughout integration, and to install processes to ensure ongoing, two-way communication with all levels of your organization as events unfold.

Communication is not a soft skill, a desirable option to be considered when other issues have been put to rest. Rather, it is a requirement for financial success, because low morale, high turnover, direct costs in workers compensation and healthcare expenditures and lowered productivity will all have consequences for the level of return on investment. Leaders cannot assume they can and will know everything. But they do have a responsibility to put into place the structures that will maximize their awareness as they go forward. Leaders who confront change effectively are rewarded with superior business performance on the part of their employees. A 2002 Watson Wyatt survey of more than 12,000 U.S. workers shows a clear correlation between successful change management and business performance. Over a three-year period, the total return to shareholders of companies whose employees believe their employer is effectively managing change averaged 29% increase, versus 5% in shareholder losses for those companies whose employees think change is being handled poorly. Avoiding the human issues in M&A is a costly gamble. Proper planning for the management of people issues in a merger or acquisition should be a top priority.