Mergers and Acquisitions: How do you Increase the Value of Two Companies Joined Together?

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Introduction

There are few things that generate excitement and speculation like the announcement of a business combination. Almost without exception, the management promise of every merger and acquisition is to increase stakeholder value. However, it seems that this is not what typically happens. As evidenced by a 2008 study by KPMG, 42% of deals do not increase shareholder value. Worse, the same study indicated that 45% of deals actually destroy shareholder value. So with almost 90% of M&A deals failing to deliver on management’s promise of increased shareholder value, it begs the question – what is going so terribly awry? More importantly, what must be done to ensure that M&A deals do in fact deliver the maximum value possible? This paper answers both of these questions.

Sources of value and causes of the destruction of value – The Value Gap

Shareholder value is measured as the increase in stock value associative with the merger. Because, rationalized, stock value is reflective of long term earning capacity of the company, a proxy for increased shareholder value is the net present value of increased cash flow due to merger synergies.

The hope is that with a merger, shareholder value will be increased by emergent synergies that include cost reductions achieved through economies of scale, the combination of duplicate corporate functions, and streamlined sales forces; capital efficiencies achieved through rationalized assets and the combination of duplicate facilities; and revenue enhancement effected though product development synergy (new products), shared marketing skills, and combined distributions. The synergies after the deal is made that can add energy, creativity, and enthusiasm for new opportunities is referred to as Emergent Value. Emergent Value is created by taking advantage of complimentary resources at all levels, finding more profitable uses for assets, achieving both strategic and operational fit, discovering new market opportunities, and selling products to existing customers In addition, reinventing processes, shedding obsolete practices, and capitalizing on the creativity and excitement evoked as new colleagues interact can play a role in generating Emergent Value.

The expected increase in value, while often achieved to some degree, is largely offset by situations that occur during the post-merger integration of the two companies. This produces what is called a Value Gap. A Value Gap refers to the difference between the expected value of the post-merger company as measured by the sum of the independent values of each of the companies plus the value of the emergent synergy compared to the actual value a year or two after the merger. Major factors that contribute to the value gap include:

- Integration
- Inexperience
- Lack/loss of vision
- Management wars
- Culture clashes
• Failure to manage risk and change
• Poor communication with stakeholders

The result is the Value Gap: the unhappy coincidence of achieved value offset by unanticipated challenges, resulting in less shareholder value from the merger and a degeneration of the merged companies as evidenced by the following:

• Prices rise, quality falls, customers leave
• Alliances and supplier relationships degrade

Transition—the critical period

Most executives would be quick to point to a lack of synergies, an unrealistic vision, or an outrageous premium price for the reason a business combination fails to deliver value. While these factors can certainly sabotage the success of the combined entity, even the best-structured business combination can be sabotaged by another pitfall—poor post-merger integration (PMI). It is PMI that can most often lead to the Value Gap, but it can also provide opportunities for the creation of additional value.

In simple terms, a business combination can be considered to have two phases – the Transaction Phase (making the deal) and the Transition Phase (post-merger integration).

The Transaction Phase is the sexy part during which the deal is negotiated and then announced. The results of this phase are largely a function of deal-making negotiations. Typically, unless there is a big surprise during the post letter of intent due diligence, the financial structure of the deal is set.

The part that gets less attention is the Transition Phase, or the post-merger integration (PMI). This is the phase during which the disparate companies are integrated and combined. Very little attention has been given by business thought leaders toward addressing the challenges of post-merger integration. In an article in the Journal of Organizational Dynamics, business scholar Marc Epstein, PhD states that “it is the actual execution of the merger strategy through the pre-merger and post-merger integration that appears to have the least understanding.” A focal point of this article is to address some of the most common areas of PMI/transition misunderstanding.

First, it is important to understand that not all mergers are the same with regard to effort. As shown in Figure 1, there are three types of mergers, each requiring different levels of effort for post-merger integration. In the first type of merger, the companies continue to function largely autonomously after combination. This type of merger is most common among very large companies who want to retain different operations, even after the merger, and is referred to as coexistence. Because all that is required for a coexistence merger are consolidated financial reports, there is very little post-merger integration effort.

A second type of merger occurs when a larger company is acquiring a much smaller company, and the operations of the smaller company is going to be absorbed into the operations of the larger company. This is referred to as absorption. An absorption merger requires more effort than for a coexistence because the surviving entity’s systems and processes supplant those of the absorbed entity, and there is some training for the team of the new company, and configuration of the systems involved. With an absorption merger type, the history and existing systems of the absorbed company is usually left behind, so there is little or no integration required. The third type of merger occurs when the intent is to keep the best of both companies, and selectively integrate the operations, people,
and technologies into a single new company. Referred to as synthesis, the third type of merger is a complete integration of two separate companies to a single, “better” company. Synthesis mergers require the most effort because an assessment is done to evaluate all the people, processes, and technologies of both the companies, and to design and construct a new company from the disparate pieces of both organizations. Systems are integrated into a cohesive whole, people are reassigned to new jobs with new responsibilities, and processes are redesigned to streamline operations and reduce costs.

Figure 1: Level of Effort for Different Types of Mergers

<table>
<thead>
<tr>
<th>Merger Type</th>
<th>Process Transition Method Based on</th>
<th>Effort Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coexistence</td>
<td>True Blue Gold Rush</td>
<td>2</td>
</tr>
<tr>
<td>Absorption</td>
<td>True Blue Gold</td>
<td>7</td>
</tr>
<tr>
<td>Synthesis</td>
<td>Blue Gold</td>
<td>77</td>
</tr>
</tbody>
</table>

Regardless of the type of merger, focusing on core processes (sales, support, and order management) reduces the level of effort required for the post-merger integration. Design processes to present one consistent face to the customer. Deliver the benefits of merger synergies visibly to customers – new products, better service, more for their money. Create and staff interim processes to sustain the quality of products and services through the transition. In Figure 1, the effort level for each merger type is represented in column two. By focusing on only the core processes, the effort is greatly reduced both for the absorption merger type and for the synthesis merger type. Reducing the effort in post-merger integration reduces the costs, enabling the combined company to recognize value from the merger quicker.

For a coexistence, the transition should be fast and relatively inexpensive. The work required to impose controls to generate appropriate management reports is minimal. That said, there might be unexpected incompatibilities, limited process synergies, little process improvement, little buy-in from employees, and no real economies of scale.

For an absorption, more effort is required, generally on a magnitude of 10 times the effort of a coexistence. The operations and assets of the absorbed company are integrated into the existing systems and technology of the acquirer. The best can be absorbed, the rest discontinued. This is not as easy as it sounds. The acquired operations and assets may not fit into the new organization well. Some strengths of the acquired company may be lost. The absorbed employees may not fit in well and might feel they have second-class status.
For a synthesis, even more effort is required because the purpose is to take the best processes from both companies. This can create unique challenges but provides the greatest upside potential for emerging synergies. There are more emergent process-improvement opportunities. Because of the complexity of a synthesis, interim processes are needed during transition and there is a risk of losing focus and momentum. Regardless of the type of merger, the transition time frame available to create value is short.

After the transaction and deal close, the next six months are critical. Leading up to the close and day one of the transition period, 40% of the changes that will ever be initiated are set. This, of course, includes the changes mandated by the structure of the transaction agreement. At 3 months 65% have been initiated, and at 6 months 85% have been initiated. The remaining 15% of initiatives must build on those of the first six months. At around six months, for better or worse, the newly formed company settles into a steady state. Because the timeframe is so short, the way the transition is managed is critical.

Three ways to manage a transition

There are three ways to manage a transition: Too Little, Too Late, and Just Right.

Too Little

Because deal-making is the cool, high-profile phase of a merger or acquisition, and there is a misconception that a good deal guarantees a successful merger or acquisition, there is a temptation to limit the transition effort to the day one hoop-la. This is a mistake. According to Kenneth W. Smith of Mercer Management Consulting, “The deal is won or lost after it’s done.” The short attention span of the Too Little approach can result in the transition team feeling abandoned and disincentivized, resulting in confusion and paralysis, disintegration, and arriving at the six-month steady state with a large Value Gap.

Too Late

In this scenario, top management puts all their attention into closing the deal, but interest ebbs after the closing. They fail to impart their vision, knowledge, focus, and momentum to transition management. Transition-phase visioning, planning, and organizing do not start until the deal is closed (or they never occur at all) as the transition teams rush into action. Furthermore, events race ahead and are out of control—losing customers, key employees, and shareholder value in the chaos. Time, money, and energy are burned in firefighting and fixing mistakes. In the Too Late scenario, the momentum for a good transition begins to ebb even before the close, and then after close the transition effort is a rush to catch up. Without a clear vision from management the transition team is at best guessing what needs to be done, resulting in continual undoing, redoing, and repairing. The result is reaching the 6-month steady state with mixed results.

Just Right

In this scenario, management begins the transition effort almost immediately after the letter of intent is signed. By planning and lining up resources early and communicating a vision and plan to the transition team, by day 1 the transition is fully under way. Properly handling the transition effort makes it clear to all parties that the transition effort is to be taken seriously – it receives adequate resources; planning is an integral part of transaction due diligence; the transition team is fully engaged and ready to go on day 1; the best people from both companies design the new company; a rapid implementation reduces the cost of the transition; and the design of the processes allows the team to seize opportunities for synergy to emerge and persist. The result is reaching steady state while avoiding the Value Gap and having created emergent synergies.
Key success factors of the integration process, helpful in avoiding the value gap and maximizing the possibility of achieving emergent synergies, are proactive integration along with maintaining speed and momentum.

- Proactive integration, which means planning, monitoring, and adjusting how the integration process is being affected to maximize value, requires treating the transaction and transition as a single unified process, relying on experienced and trusted leadership, having a well-defined vision and focus, and provisioning adequate resources.
- Speed and momentum are critical, and it is important to stay ahead of events, strive to realize merger value early, take quick action on people issues, and sustain energy and enthusiasm.

The Transition Plan

Using a top-down perspective, key to ensuring a successful transition is establishing and communicating the goals of the merger—the future state and the value it will deliver.

Then a Transition Plan, an actionable program to focus the process of achieving the plan, should be developed. This program will include:

- **Tasks** (changes and deliverables) required to complete the plan; teams, people who will design and implement the future state; and resources, the tools and facilities the teams will need.
- **Targets** (measurable milestones toward realizing the value), which should include accountability in the form of personal and team responsibilities for hitting targets and incentives, rewards for hitting targets.
- **Priorities** (critical tasks and targets for attaining the value) focusing on the tasks that create the highest value, understanding that even in the best plan, resources are limited and choices must be made.
- Finally, **Change Mechanisms**, methods and manners by which unexpected opportunities can be seized and surprise problems can be addressed.

In addition to the Transition Plan, related but discrete, it is important to establish a Process Plan, a People Plan, and a Technology Plan. Each of the Transition, Process, People, and Technology Plans must support the achievement of the vision and the value it promises. The following are the Why, How, and What questions that should be asked when developing these mutual, vision-supporting plans.

Processes—Designing the synergies into the new business

**Why?**

*Key Business Strategies and Synergy Opportunities*

- Why are we merging?
- How will we know that we are successful?
- What are our integrated operational strategic goals?
- How will we consolidate to achieve maximum benefit from both organizations?
People—Realizing merger value by getting the best to give their best

Clearly, a successful merger requires the higher motives to prevail at all levels of the organization—that is necessary. Maslow defined three levels of human needs. The most basic are survival and must be satisfied before the higher levels are reached. In a business sense, the survival behaviors are those that people exhibit when they are concerned. A critical success factor is to minimize these survival type behaviors because they are destructive. In a business context, the social level is demonstrated by company loyalty, feeling good about his/her job, their opinions are respected. At the highest level, Self-actualization, the person is eager to go to the new world, is free from anxieties, and is able to develop emergent synergies, fulfilling others’ needs (not us and them).

Analogous to the Maslow Hierarchy of Needs theory which defines the behavior patterns of human motivation, people involved in a merger need to feel secure and appreciated before they can become productive in the newly created organization. Employees who are unsure about their jobs or roles act in a survival mode, leading to fear and distrust, jockeying for position, rigidity and resistance to change, paralysis, distraction, collapse of productivity, resentment, sabotage, litigation, the best people resigning, and the worst people becoming resigned. These effects should be minimized. Instead, an effort should be made to maximize the results of employees acting from what
Maslow describes as self-actualization. These self-actualization behaviors lead to a sense of ownership of the new company; eagerness to contribute to the change; freedom to focus on new processes and systems; constructive criticism and input; being welcoming of new colleagues; generation of creative ideas; and discovering emergent synergies at all levels.

Technology—Enabling the new enterprise without delaying the transition

Disparate and discrete data and information systems are a significant hurdle in the integration process. The key success factor for technology enablement in a merger entity is to plan technology integration from the top down and implement it from the bottom up. From the top-down perspective, the technology planning should review the requirements of the business from the perspectives of both organizations, and then implement the integration of the required technologies bottom up. First, the combined organization should integrate the hardware components such as networks, servers, storage, telecommunications, and other equipment. After the hardware component is stabilized, then integration, connectivity and sharing of data and applications should be addressed. Finally, once the technology has been integrated, the organization has a foundation for changing and streamlining business processes and reallocate resources that are required to align with the top-down vision of the combined organization.

Post-merger integration steps that add value to mergers and acquisitions

Focusing solely on the consolidation of core processes significantly reduces the time, effort, and costs associated with the merger, leverages the synergies of both companies, and increases the likelihood of success. Successfully carrying out the following post-merger integration steps in order can add value to a merger or acquisition for those using Oracle® E-Business Suite (EBS):

1. **Align calendars and charts of accounts with the acquiring company.**
   Post-merger, your business will look very different than it did when you originally implemented your calendars and charts of accounts (COA). The gap between your COA and how you need to track your business should be addressed in the first 60-90 days after the acquisition. Rather than attempting to create multiple “fix” spreadsheets to bridge the gaps, deploy automated solutions designed to quickly streamline data integration and transfer, such as eprentise® FlexField® software for aligning the new COA and eprentise Reorganization software for aligning calendars across organizations.

2. **Investigate statutory and regulatory requirements in all countries in which the combined entity will operate.**
   Establish or revise tax structures and regulatory compliance features for each individual country in which the company operates and submit necessary regulatory filings and/or reports to the Securities and Exchange Commission. Determine how many different COAs the company currently has, and begin working on a plan to adopt a single global COA for the entire business. Selecting a reporting unit that accommodates both GAAP and IFRS rules facilitates a seamless transition.

3. **Revalue assets and date placed in service.**
   The new GAAP rules require that all assets have a date placed in service as of the date of the acquisition, the value of the acquisition (i.e. fair market value – usually net value) of the original asset cost, and the depreciated value. In EBS, this is technically accomplished by using eprentise Reorganization software to revalue the assets in new asset books.
4. **Align versions of Oracle EBS.**
Aligning operations with inconsistencies, different meanings of data, or even different patch levels requires a huge manual effort for reconciliation, translation, and maintenance. Either patch or upgrade all of the EBS versions so that all are at the same level. Adopt a company-wide patch program to install, test, and implement so that there is consistency in the functions of the applications, and so that business processes are repeatable across the organization.

5. **Consolidate instances.**
Consolidation drives collective agreement on how the business should be run, what data assets need to be shared, and how business processes should be standardized on a foundation of common enterprise-wide operating procedures. eprentise® Consolidation software automates the process of combining disparate EBS instances to reduce duplication, inconsistencies, and inefficiencies, thereby reducing costs. eprentise Consolidation generates all of the required code to resolve gaps, standardize data, align set-up parameters, and synchronize business processes across multiple EBS environments, resulting in a single EBS instance, and a single source of truth, with all the history from both organizations.

6. **Reorganize within a single instance to align Sets of Books (or ledgers), Legal Entities, Operating Units, and Inventory Organizations to standardize business processes and leverage synergies of both companies.**
Without alignment and standardization of business processes, companies are unable to capitalize on the strengths each brings to the merger, which can lead to lost value and risk of failure. In the past, companies seeking to align core E-Business Suite configurations had two options: create cumbersome workarounds that could result in inconsistent and inaccurate reporting data, or undergo a costly and time-consuming reimplementation of their EBS. eprentise® Reorganization software enables companies to remodel an existing instance of EBS without a loss of history, without a reimplementation, and without building bridges to reconcile information gaps.

**Conclusion**

A merger is one of the most exciting—and disruptive—events in the life of a company. It presents opportunities to leverage synergies, offer new and exciting products and services, and increase shareholder value. With the right post-merger integration planning and a focus on key success factors and core processes, companies can avoid the Value Gap and put in motion a transition plan for its people, technology, and processes that establishes a foundation for success now in the future.