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Perspectives on merger integration
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A new generation of M&A:

A McKinsey perspective on the opportunities and challenges

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By Clay Deutsch & Andy West

Despite continued uncertainty, signs point to a surge in M&A activity that will be ambitious in both scope and profile. Even M&A veterans will require new tools for analysis and integration to manage these deals for maximum benefit – new organizational efficiencies, market expansion, employee development, product innovation, and profit.   Mergers often accelerate in the second half of a downturn, which is where the economy seems to be these days. Prices are low. Competitors may be weakened. Businesses that may have disdained overtures, likely or unlikely, may be more receptive. Unusual numbers of executives and boards report seeing opportunities to make “once in a lifetime” deals.

At the same time, economic uncertainty has left many organizations cautious. Executives may be excited about the prospects, but their boards may be less convinced and willing to act because they doubt the company’s ability to manage an ambitious deal successfully.

A McKinsey survey of almost 90 M&A professionals conducted in mid 2009 showed new interests and attitudes toward mergers. Nearly half of those surveyed believed the deals they manage would “increase in transaction value” over the next three years. Respondents expressed great interest in using M&A to move beyond existing lines of business into new strategic areas and build their R&D portfolios.

Of course, most acquisitions will remain focused on more traditional sources of value closer to existing lines of business, but any of these deals may bring opportunities to create transformational value that reaches far beyond the potential of conventional integration strategies. The survey and the M&A success of McKinsey clients indicate that transformational value can increase the return on an acquisition 30-100 percent.

Identifying transformational value opportunities and managing mergers that stretch a company’s capabilities in new ways require a dramatic departure from the traditional approach to integration that has emerged as best practice over the past 10-20 years – using templates, checklists, and strong process management to avoid risk. Even now, this approach produces M&A failure rates of 66-75 percent.

These numbers have reinforced the risk-avoidance mindset and encouraged deal assessment focused on answering two questions: Can we afford it? Can we buy it? But, as many acquirers discover to their (and their stockholders‘) dismay, the ability to buy may have nothing at all to do with the capacity to own.

Old vs. new approaches to integration

Building integration capabilities requires a new approach to managing the deal. In the traditional integration approach, the integration leader, teams, and consultants focus on preventing anything bad from happening until the deal is done. In a rapidly paced process, they try to secure a quick close and leave the issue of how to make the combination work for later. They aim to minimize risks and realize the cost savings associated with reducing redundant operations and people.

But many deals need to look beyond the value that justified the transaction, opening the aperture to find new sources of synergies and value. The survey showed that the due diligence in most deals can overlook as much as 50 percent of the potential merger value. Survey respondents also admitted that due diligence is inadequate in more than 40 percent of their deals. Companies clearly need to improve and expand their due diligence.

Great integrators understand that two very different types of value can emerge in most mergers – combinational and transformational. But because identifying and capturing transformational value requires a different and more difficult approach, most deal teams concentrate on the combinational at the expense of the transformational.

Certainly, limiting operational risk is essential to keeping the business running smoothly during integration. But the survey found that too few companies, including very experienced acquirers, are getting even the combinational basics right. They don't plan and execute a thoughtful, end-to-end integration process. They don't put the right leadership in place. And they don't hone the skills needed to realize fully even the most obvious value from the merger.

When companies falter on these fundamentals, they have little chance of identifying and capturing transformational value. Success here requires:

- Deeper, stronger integration skills and intense management commitment
- An integration approach that's flexible enough to allow leadership to pursue sources of transformational value along with combinational value
- Rigorous analysis and integration management that exceed the capability of too many companies and M&A professionals.

In the recovering business environment, more and more companies are considering bold, transformational moves. They will need to expand their M&A capabilities to handle deals outside their existing business lines, do more and/or larger deals, and identify and capture both transformational and combinational sources of value.

This calls for a new methodology and toolkit built around four distinctive capabilities that can close the skills gaps identified in the survey of M&A professionals.

Rigorous analysis of the value potential of the merger

This begins by rejecting the traditional risk-avoidance mindset, recognizing the need to look beyond traditional sources of value and being willing to ask the question, "When we own this asset, what are all the ways we could create value with it?" Taking a more expansive view to identify and quantify synergies requires a systematic approach that can locate value creation opportunities which often exceed due diligence estimates by 30-150 percent.

This broader view requires considering three layers of value creation:

- Protecting the base business, which includes efforts to preserve pre-merger value and maintain the core business
- Capturing traditional combinational synergies, which includes efforts to achieve economies of scale and enhanced efficiency
- Seeking select transformational synergies, which are often ignored, but are aimed at radically transforming targeted functions, processes, or business units.

Within each layer, companies have three options for realizing value:

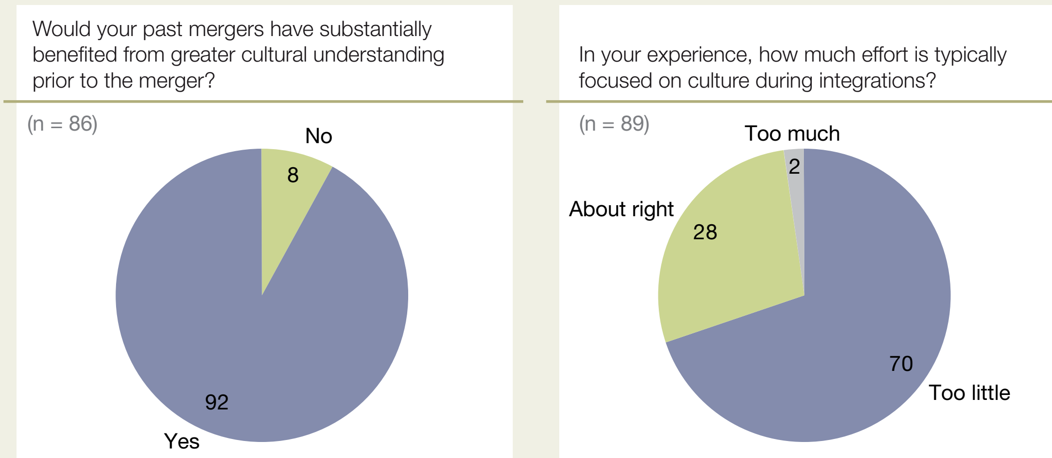
- Capture cost savings by eliminating redundancies and improving efficiencies
- Improve the balance sheet by reducing such things as working capital, fixed assets, and borrowing or funding costs
- Enhance revenue growth by acquiring or building new capabilities (e.g., cross-fertilizing product portfolios, geographies, customer segments, and channels).

Intensive focus on the corporate cultures involved

Ninety two percent of the survey respondents said that their deals would “have substantially benefitted from a greater cultural understanding prior to the merger.” Seventy percent conceded that “too little” effort focuses on culture during integration.

Exhibit 1

Need for more attention to culture
Percent of respondents

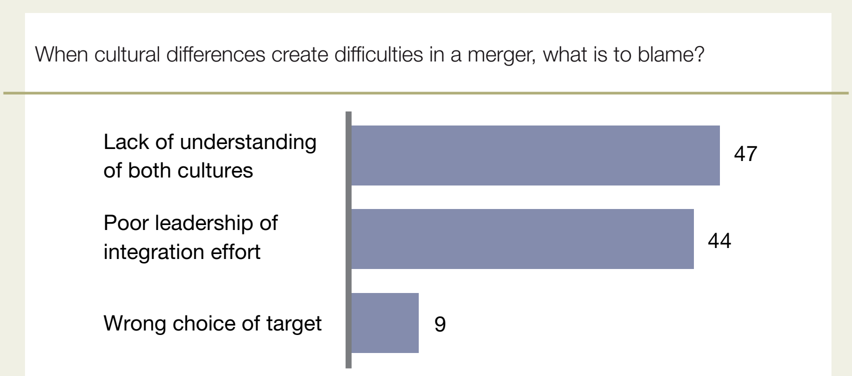


SOURCE: 2009 Post Merger Integration Conference Survey (New York and San Francisco combined)

Part of the problem may be that, especially when integrating companies are in the same or similar businesses, their top executives tend to assume they are “just like us” and dismiss the need for deep cultural analysis. Likewise, when the CEOs in a deal get along with each other, they tend to assume that their companies will get along equally well. No two companies are cultural twins, and companies seldom get along with each other as easily as their executives might. In fact, the survey establishes that the issue of culture comes down to two fundamental problems: understanding both cultures and providing the right amount and type of leadership.

Exhibit 2

Cultural and leadership issues
Percent of respondents (n = 89)



SOURCE: 2009 Post Merger Integration Conference Survey (New York and San Francisco combined)

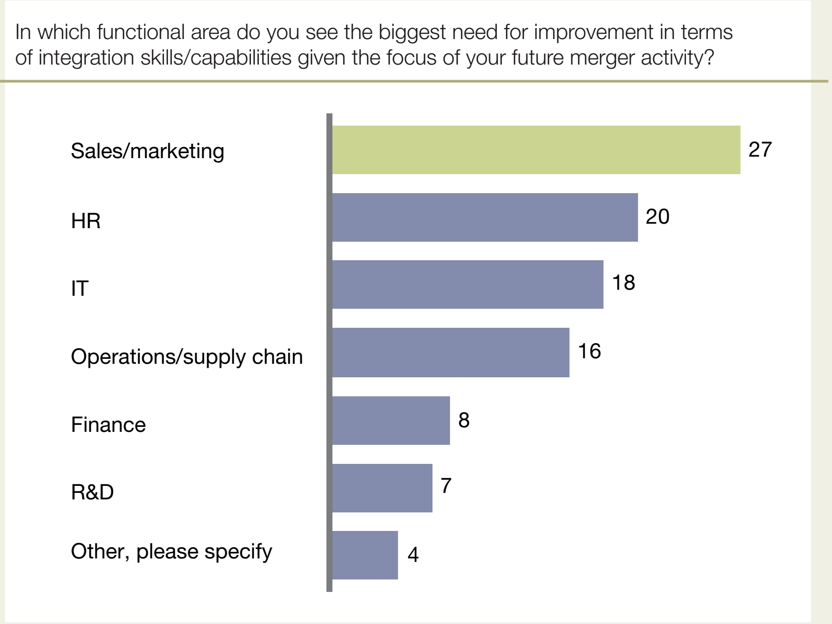
Culture clearly baffles most merger managers – which is probably the reason that virtually none of them use culture as a screening criterion. But few have had a tool for describing and analyzing carefully defined cultural characteristics for each company. McKinsey teams are bringing just such a tool to their clients, enabling them to understand vulnerabilities and similarities in the ways the businesses run and interact. The analysis pinpoints specifically how the companies differ, what is meaningfully distinct, and how to reconcile important differences.

A better approach to sales integration

Almost one-third of the survey respondents called combining and developing the sales functions of the merging companies their greatest integration challenge. As M&A focuses increasingly on growth, a powerful sales force will be critical to breakthrough profitability.

Exhibit 3

Need to improve integration of sales capabilities
Percent of respondents (n = 89)



SOURCE: 2009 Post Merger Integration Conference Survey (New York and San Francisco combined)

Four steps essential to integrating sales forces effectively are often overlooked or missed:

- Share information about the integration process with customers and the sales force. Many companies take the opposite approach and are surprised when postmerger revenue fails to meet expectations.
- Win prominent accounts quickly to build momentum and generate internal confidence in the merger.
- Identify and retain essential support people, as well as sales reps.
- Review the merged portfolio of customers and make tough calls about who warrants new investments and who might be shed or given less attention.

Successful sales force integration also requires excellent execution of the basics, including detailed planning that identifies and taps the best managers and staff, sets ambitious sales targets, creates an effective program for retaining top talent, and spells out the best ways to cultivate the most promising customers. This planning should be an integral part of the merger process that proceeds in parallel with conceiving and valuing the deal, assessing synergies and culture, and devising the end-to-end merger methodology.

A unique period in M&A is looming. It will offer unprecedented opportunities to build new skills and methodologies to get mergers right, recognizing and capturing their transformational value. Successful integration efforts will share two fundamental characteristics: determination to achieve unprecedented goals for value creation and performance and executive courage and commitment to tackle the risks inevitably associated with such ambitions.