Grant Thornton
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The successful deal

For every successful M&A transaction, there are many that fail. Failure means a deal did not achieve the investment targets established at the outset. Worse, a failed acquisition often erodes the acquirer's shareholder value. Based on this definition, studies on M&A transactions indicate that most mergers fail. In fact, study after study suggests that a whopping 90% of mergers fail to meet their investment targets.

"It may not come as a surprise that most M&A transactions fail, but the truth is they don't have to," says Srikant Sastry, Grant Thornton LLP's national managing principal of Advisory Services. "If an M&A transaction is well-planned, both at the diligence and integration phases, then there is a higher probability the execution will result in a successful outcome."

So, why do acquisitions fail? To gain more insight, Grant Thornton spoke with experienced professionals who work on these transactions every day. This white paper provides readers with a better understanding of the steps that should be taken to increase the odds of a successful outcome.

Integration is key

Improper integration is one of the most common reasons deals fail. "I recently asked a client what her biggest nightmare was regarding an upcoming deal. Her answer: how much they had to pay to get the deal done. In this case, the strategic decision had been made to pay to ensure the target company was not snapped up by a competitor. However, she never mentioned the integration process," says Ed Kleinguetl, managing director of Transaction Advisory Services at Grant Thornton. "With the high multiples currently required to get deals, the integration has to be flawless in order to squeeze out the value."

There are six reasons why integrations typically fail: (1) Unclear strategic intent; (2) lack of business alignment between the acquirer and target; (3) poor executive alignment within the acquiring organization; (4) an overly complex integration process; (5) an underestimation of complexity; and (6) difficulty in maintaining core business operations during integration.

"Aligning strategic intent with the integration plan is sacrosanct in terms of capturing value," says Kleinguetl. "Frequently, after the deal is completed, the deal team simply hands it off to the operations team, not really explaining the deal rationale or nuances associated with the target company. Sometimes significant assumptions have been made with regard to synergies, leveraging best practices or ease of assimilation," he explains.

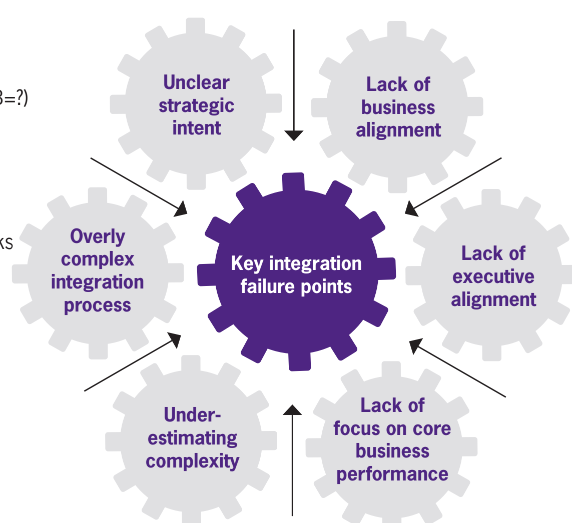
"In numerous cases the deal team has juiced up the numbers in order to make the deal economics work (e.g., being overly optimistic on synergies), and the operations team is left to make things work, which can be difficult," says Kleinguetl. "The acquirer is buying the company with a specific objective in mind. There's strategic intent, but the integration strategy isn't there to carry the deal through to completion. This seems to happen all the time."

Top 6 reasons why integrations fail

Unclear strategic intent
- Integration objectives not aligned with strategic intent
- Lack of clarity on integration approach (A+B=?)
- Poor handoff between deal team and integration team

Overly complex integration process
- Lack of focus on key decisions
- Lack of prioritization of value drivers and risks
- Form over substance

Underestimating complexity
- External factors
  - Size of transaction
  - Foreign operations
  - Business and market risk
- Internal factors
  - Centralized vs. decentralized
  - Technology complexity/reliance on systems
  - Legal entity structure



Lack of business alignment (acquirer and target)
- Clash of ownership and management styles
- Differences in organizational structure
- Cultural disparity
- New market or business entry

Lack of executive alignment
- No common understanding or shared approach
- Executives not engaged with integration
- Wider stakeholder misalignment

Lack of focus on core business performance
- Difficulty completing integration while maintaining high-performing core business
- Inappropriate or inexperienced integration leader
- Lack of resource alignment (constraints)

The truth about synergies

Acquirers usually pursue an M&A opportunity because of the perception of synergies between the acquirer and target. Synergy can come from growth or negotiation strength, as well as cost-saving consolidations. Examples include scale (both sales and procurement); channels to market; expansion into vertical or horizontal adjacencies; and expansion into new markets, including foreign. On the surface, the deal looks like a smart one, and usually the combined company is worth more than the individual companies were before the merger.

The reality is that synergy expectations are rarely realized. A common factor in failures is an overly optimistic preliminary due diligence estimate, resulting from insufficient analysis. A good rule of thumb is to keep an additional 50% of synergy opportunities in reserve. If an acquirer wants to announce synergies of $100 million, at least $200 million in synergy opportunities should have been identified.

While a thorough financial due diligence process is essential, the numbers are not the whole story. A detailed analysis of a synergy opportunity should include the cost of attaining the synergy and the timeline for achieving combination objectives.

CASE IN POINT

In a transaction involving the merger of several injection plastic molders, the team planned to close a particular plant and relocate manufacturing operations to another facility with excess capacity. The numbers looked good on paper. But an existing contract with the customer adjacent to the plant targeted for closure required the plant to remain next door. In this case, it was not simply a matter of missing the synergy opportunity by a fraction: this was a 100% miss!

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There are also unforeseen negative synergies. In one transaction, the strategic intent of the acquisition was to create a seamless service offering that did not currently exist in the marketplace. On paper, the synergistic opportunities looked great, however, the acquiring company provided a more lucrative benefits plan to its employees than the target company's employees. Having employees with different benefit and incentive structures could have thwarted the deal's strategic goal, not to mention that the cost of benefit plan alignment would have outweighed the value of all the other synergies combined. These situations are exacerbated when an acquirer has a team that provides the valuation and diligence, but then passes the transaction to operations personnel, who are left to execute and achieve the objectives.

To avoid such inaccuracies, acquirers need to do a thorough evaluation of the synergy opportunities or take definitive action to determine whether the identified opportunities can be realized. It is inevitable that some synergies will fall by the wayside, which is another good reason to have additional opportunities in reserve. It's always better to under-promise and over-deliver.

"More often than not, acquirers have an unrealistic idea of how much synergy there is between two companies, and they don't often take into account all of the potential challenges of obtaining the expected synergies," says Chris Jones, partner with The Riverside Company. "It takes a lot of planning and follow-through for acquirers to be sure they are getting all the value out of the deal. However, it is worth it as a more successful outcome is likely."

The most successful acquirers validate synergy by evaluating the ease of synergy capture, the timing of synergy realization, the cost of capturing the synergy, the potential risks and appropriate mitigation strategies, and the resources that need to be assigned. A synergy for a manufacturing company was based on better leveraging a raw material supply facility. However, for this synergy to be realized, a capital expenditure was required to upgrade the facility, increasing overall costs and moving the timeframe outside the original window. Thus, successful acquirers often include operations personnel in the diligence and synergy evaluation processes. This ensures that the people responsible for profit and loss own the opportunity and are willing to include it in their budgets.

It is essential to maintain core business strategies during integration. If one loses sight of the customers, a competitor will be ready to give them the attention they want. Remember that your best customers are your competitors' best prospects. The competition will often exploit transactions and sow seeds of doubt with your customers and prospective customers. Constant attention is required with regard to customer communications, service quality and other factors that could leave both the acquirer and target vulnerable to competitor poaching. Whether true or not, clients will often perceive a decline in service because management's attention is focused elsewhere.

Effective acquirers anticipate competitors' reactions to the transaction and develop communication strategies to manage the expectations of customers, prospects and other interested parties. These companies also develop a proactive growth strategy and address branding concerns early on so they are able to communicate any changes to their customers.

"Integration is a very sensitive and important process. In the absence of very clear communication of the plan and resultant benefits of the integration, customers, employees and other important parties in an investment may have feelings of uncertainty. Left unchecked, the acquirer may find a portion of these stakeholders become disenchanted, and in the worst case, defect. It's critically important that you remain highly engaged at every step in the integration process. You must manage for success. It doesn't just happen when you put two companies together," says Gretchen Perkins, a partner with Huron Capital.

Do the diligence

If there is a strong case for synergies and the acquirer is ready to move forward, the next step is to complete rigorous due diligence. Most acquirers spend the majority of their time on financial due diligence (i.e., quality of earnings and assets), which is usually the basis of the price calculation and subsequent earnout provisions.

Beyond the payment calculations, acquirers need to make sure the seller's finances are consistent with what they have discovered. Healthy skepticism is always warranted. The acquirer is investing in future earnings, so it is critical to develop confidence in the ongoing execution of the core business model.

"Acquirers want to make sure the earnings are replicable, and determine the quality of the earnings going forward and how they can grow them," says Daniel Galante, national managing partner of Transaction Advisory Services at Grant Thornton. "It certainly makes good business sense for the sellers to do the best job they can demonstrating the future growth of the company to get the best sale price."

Working capital adjustments and earnout provisions

After the parties settle on the purchase price for the working capital to be transferred from seller to buyer and the deal closes, challenges and disputes can arise. Before finalizing the purchase agreement, an acquirer should agree to the specific assets and liabilities that are being transferred to the acquirer. Everything usually needs to be computed in accordance with GAAP, consistent with the seller's past practice. For areas that are subject to significant estimates (e.g., allowance for doubtful accounts or inventory obsolescence reserves) — where different people may apply different computation methods — an agreed-upon calculation methodology, clearly articulated in the purchase agreement, can minimize the chances of a dispute.

"Everyone wants a smooth transaction. More clarity around the provisions will result in less likelihood of disputes," says Charles Blank, a senior manager in Grant Thornton's Forensic and Valuation Services practice.

Transactions with earnout provisions also have a higher probability for disputes. Earnouts create a situation where the acquirer agrees to pay the seller after the deal based on the achievement of agreed-upon financial metrics for the acquired business. "The problem here is it is very common for the contracts not to have enough detail around the earnout, leaving things open to interpretation," explains Blank. "You have a situation where the acquirers have to run the business how they see fit, and they usually allocate shared costs to the acquired business. This may be adverse to the profitability target the seller was anticipating." Ambiguity in the definition of metrics or how the thresholds are to be achieved is ammunition for companies that might want to challenge an earnout calculation. Greater clarity can achieve a different outcome.

The purchase agreement should define all of the revenues and costs to be included in the earnout provisions; all terms should be spelled out clearly. Consider setting a cap or fix the amount of overhead costs that are allocated to the business. Doing so lessens the chance that the parties may end up in a dispute. "The bottom line is: the clearer, the better," says Blank.

Unforeseen factors such as unanticipated tax exposures can create significant issues that may cost the acquirer down the road. To mitigate these risks, acquirers need to identify historical tax exposures — as well as cash tax-saving opportunities — including the consideration of alternative tax structures. States have become more active and automated in their pursuit of sales/use taxes and employee income withholding taxes.

"Risk identification is the biggest thing. It's very common for us to see issues where businesses have not been filing tax returns in all the jurisdictions they should be filing in. In deals involving closely held, privately owned businesses, there's a tendency to push personal expenses through the business, which can create numerous tax exposures. These are the types of things acquirers need to be looking for," says Chris Schenkenberg, a partner in Grant Thornton's M&A Tax Services practice.

IT due diligence

Businesses use information systems to communicate with suppliers, customers and channel partners. Typically, these systems are used to collaborate internally on planning, approving transactions, coordinating commitments and reviewing results. However, the acquirer may want to extend the current system to accommodate new products, languages, channels and services. An upfront assessment of the current capabilities — including the people and processes used to develop and operate the IT systems — can identify strengths to exploit and weaknesses to address.

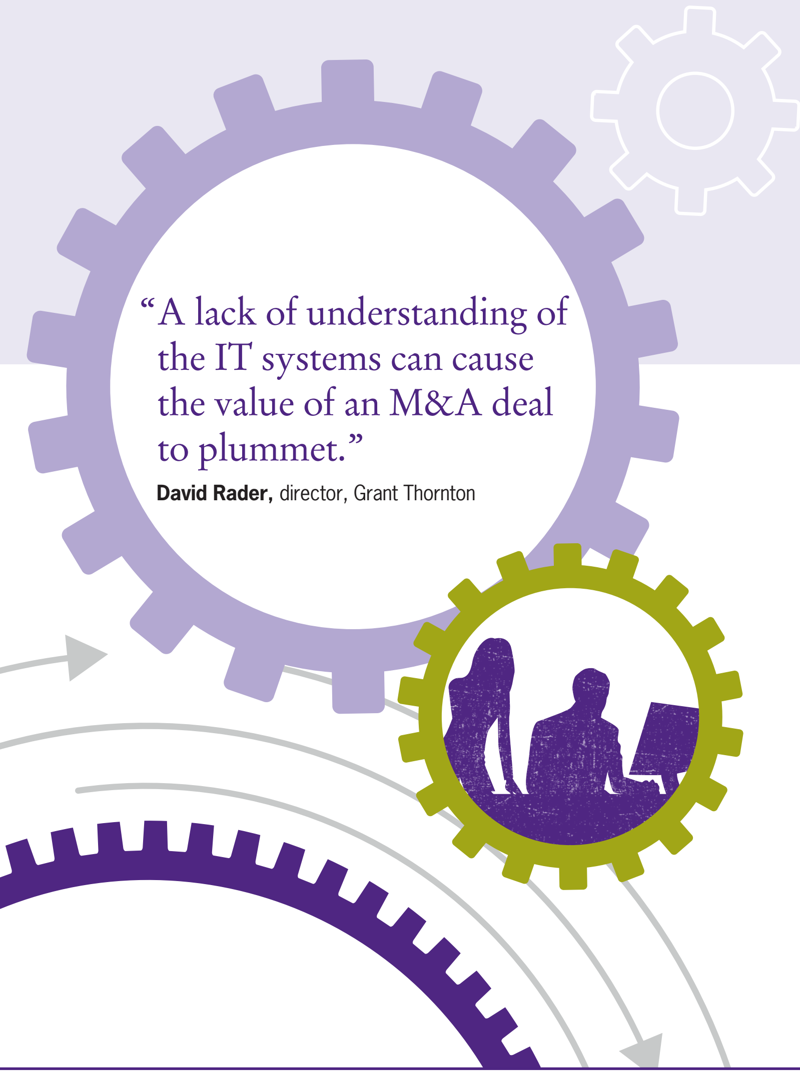
"There's not enough that can be said about the importance of due diligence in the IT space because there are so many far-reaching tentacles and integration pitfalls when it comes to IT," adds Riverside's Jones. "We spend a lot of time doing diligence on IT systems and talent because there are just so many issues that can arise, and we rarely see 'upside surprises' in IT integrations."

CASE IN POINT

IT due diligence of a recently acquired global e-commerce platform revealed unexpected upsides — a system with clever and unique ways of expressing product configuration rules and the ability to extend into ongoing product performance monitoring. In another recent case, the transaction was abandoned after discovering the IT team was located off-shore in a country with multiple forms of risk — political, financial, legal — even extreme weather interruptions.

It's common to find gaps in the security and privacy protections for information about customers, products, employees, R&D projects and, as in Sony's case, internal email. Putting the diligence focus on a single aspect of security, such as encrypting credit card information, is only a portion of the information at risk. Due diligence regarding overall information security can inform the acquirer of vulnerabilities that need to be addressed.

"We see deals run into all sorts of problems because acquirers either did not do a proper assessment of IT at the target company or, in the case of a merger, they didn't take into account how the target's IT would communicate with systems that were already in place," says David Rader, director of Grant Thornton's Transaction Advisory Services practice. "This cannot be overstated: A lack of understanding of the IT systems can cause the value of an M&A deal to plummet," warns Rader.



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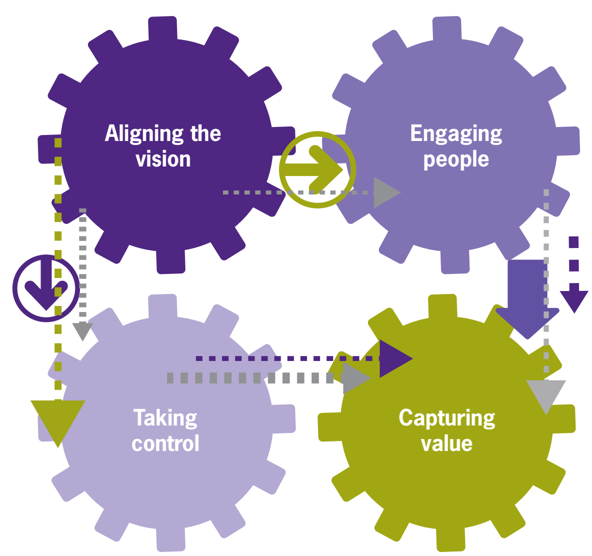
How to get it right
Aligning the vision to capture value



HR and culture integration

People are at the heart of any enterprise. One point of transaction failure is assuming human capital issues will simply fall into place once the deal has closed. Benefit plans, reimbursements, incentive compensation, severance commitments and other factors must all be considered. If the transaction involves foreign operations, this could include significant severance liabilities and dealing with works councils. HR issues are complex, and improperly addressing these matters can lead to talent defection, thereby compromising the ability of the acquired operations to achieve its targets.

"Very often acquirers are purchasing the knowledge of a team today. Understanding the work style at the target company and any concerns from employees about a sale or integration is key. Unhappy employees can result in a decrease in productivity. Human capital is critical to the success of a business," says Sharon Whittle, a principal in Grant Thornton's Compensation and Benefits Consulting practice.

"Most acquirers know enough to assess the compensation packages at the target company and are sure to equalize pay if two companies are being merged, or increase salaries if employees at the target company have been underpaid," adds Kleinguetl. "While these things are important and will create goodwill, they are just the tip of the iceberg."

Bringing two businesses together requires sensitivity to corporate culture. The importance of assessing the compatibility of two organizations should not be underestimated. It is critical to understand the key differences between the companies, as well as their potential impact on the deal. The more the culture is embedded into an organization's DNA, the more imperative a thorough and objective assessment of the potential difficulties of retaining and integrating cultures. It is easy to undervalue the time, energy and resources needed to deliver on integration commitments.

"You can tell how modern or old-fashioned a company is by the parking situation or office layout," explains Mel Wombwell, national director of Leadership and Culture at Grant Thornton UK. She says that companies with casual dress codes, few traditional offices and no designated parking spots are generally more modern.

"It is not easy to integrate a modern company into a more traditional one, but it doesn't mean it's a deal breaker. The starting point is getting management together," says Wombwell. "If the leadership team can agree on a compelling vision or reason for the deal, you can begin to navigate everything else. However, if a deal is completed based just on money, I can almost guarantee you that the majority of employees will be gone within a couple of years."

Accordingly, it is important to pay attention to work styles, decision-making styles and other intangible factors to determine how to bridge these issues. Even if the merger model is A+B=A (an assimilation), there are ways to bridge the cultural divide. It is important to successfully bring together the merging organizations' philosophies so that the cultural value is not lost in the integration process.

EXAMPLE

An IT consulting and outsourcing solution provider once acquired a 20-person Boston-based "think tank" with which the company had previously collaborated in creating unique client solutions. The consultancy had a strong corporate culture and a dress code that reflected the founders' ex-U.S. Navy background. Post-closing, the first representatives of the consultancy visited the offices of the think tank, only to be shocked to find employees wearing shorts, Hawaiian shirts and sandals. In addition, many of the male employees had thick, bushy beards. Under the consultancy's integration playbook, dress and grooming standards were considered a "tight," which meant that target company personnel had to adapt to the consultancy's culture. Can you imagine the impact on employee retention if the consultancy had legislated its dress code on the think tank? After much internal consternation, the consultancy agreed to a relaxed dress code and modified grooming standards for non-client-facing personnel, thus allowing the think tank to retain its distinct work environment.

Wombwell suggests learning as much as you can about the heritage of the company being bought. Gaining a level of trust throughout the organization will go a long way. "It's important to create goodwill. Unfortunately, a negative attitude is more contagious than a positive one. If the human issues are not handled properly, a bad attitude can travel across the company and undermine the morale of the business after the merger," she says. "The sooner you engage both parties and get everyone working together, the better."

Sell-side due diligence

To maximize value and ensure the best price, performing sell-side due diligence is a must.

Sellers should see a sell-side due diligence report as an opportunity to showcase the company and provide potential acquirers with financial and operational information so they can thoroughly evaluate the business and make an informed offer. The report gives sellers credibility while eliminating surprises, maintaining control of the process, minimizing disruptions and maximizing value.

"We do a lot more sell-side due diligence today than we did five years ago. Sell-side due diligence really prepares the seller for the process. It's about minimizing the surprise factor, and it includes risk identification as well as identifying opportunities where there could be tax benefits for the acquirers," says Schenkenberg.

Sell-side due diligence has additional benefits, such as identifying serious acquirers and weeding out those who are just looking for ways to renegotiate a purchase price or take advantage of a competitor. The practice can even help level the playing field by allowing all investors to bid off validated EBITDA, thus reducing the likelihood that the acquirer will renegotiate the price before closing.

"When the seller controls the conversation, they can appropriately frame conversation and discuss any issues that were found. It's always better to be proactive versus reactive," says Galante.

While it doesn't take the place of an audit, sell-side due diligence focuses on value drivers and business considerations that are of critical importance to potential acquirers. "Instead of just turning over your earnings, sell-side due diligence allows sellers to focus on the sustainability of earnings. Sell-side due diligence allows sellers to give color on the quality of earnings and what it can mean for acquirers going forward," explains Galante.

Lastly, when presenting sell-side due diligence, it makes sense to focus on up-to-date information. You want to present a growing company, so it's important to provide financial information from the most recent interim period. To a potential buyer, the true value of a business is the income it will generate for its new owner.

"Sell-side due diligence allows the seller to tell their story the way they want to. It will also lend credibility to the seller, which can have a substantial impact on deal value," says Galante. "The bottom line is reducing uncertainties for the acquirer can go a long way toward achieving a high sale price."

Conclusion

Most M&A transactions fail – but yours doesn't have to. The key to a successful outcome often comes down to planning well and maintaining rigor and discipline throughout the integration process. An outside adviser can also accelerate value capture by providing a much-needed experience-based perspective. "You want to use an adviser that has extensive experience and, frankly, one adviser who isn't afraid to challenge the status quo and who brings a point of view to the table," says Kleinguetl.

Acquirers need to take the appropriate steps and enlist the right help to make the deal successful. "Even though many deals seem very logical, acquirers need to be prepared to ask the right questions, get the right advisers, and follow through until the two businesses are completely integrated," says Galante.

Contributors

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