Managing M&A Strategically: From "Plug and Pray" To "Plug and Play[1]"[*]

Ravi Madhavan
Katz Graduate School of Business
University of Pittsburgh
rmadhavan@katz.pitt.edu

January 2005
Revised November 27, 2006

The last great "merger boom," which coincided with the "irrational exuberance" of the Internet years, came to an end along with the 20th century. Since then, there was a relative lull in the number and size of M&A deals. However, the M&A business began to stir again, soon, with the last quarter of 2004 witnessing several large and complex deals: K-Mart's acquisition of Sears, for example, and IBM's sale of its PC division to the Chinese company Lenovo, as well as the then Ispat Steel's (later Mittal Steel and Arcelor-Mittal) acquisition of ISG in the US. In 2005, there were several more notable transactions, including the closing of Oracle's long-pursued PeopleSoft acquisition. M&A deals were making a comeback in 2005, with Wall Street investment bankers anticipating a busy period ahead[2]. The torrid pace of M&A was sustained into 2006, helped along by low interest rates and an especially active private equity sector.

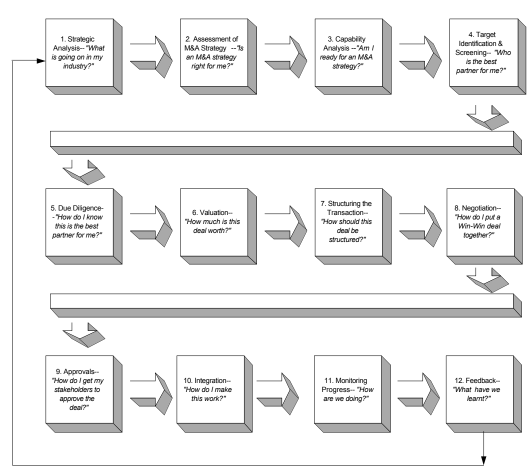
However, will managers do any better with mergers in the years ahead than they have so far? It is no secret that, while M&A have been a staple of strategy in general, there is continuing disagreement about how successful they are. Extensive empirical research by finance scholars suggests that less than half of all M&A transactions can be considered successful[3]. On the other hand, strategists continue to make these big deals. Thoughtful managers often voice some frustration when confronted with this paradox, stemming from a conviction that empirical studies focusing on how stock markets reward M&A deals may not fully capture the practical concerns of the strategist. For instance, the failure rate of internal projects is also quite high, although that fact does not get quite as much visibility[4]. In fact, many managers have told me that, in the rough-and-tumble world of business, even a 50% chance of success may be pretty good! Further, managers often worry about the "do-nothing" scenario: i.e., the implications for the corporation might be worse *absent the deal*. For all these reasons, and more, evidence of extreme risk does not, in itself, seem to hold back M&A activity.

Yet, there is some encouraging anecdotal evidence that managers and firms are gradually learning how to do these deals better. Significantly more attention is now being paid to the *implementation* of mergers than was the norm even a few years ago. Managers and their advisers appear to be doing more to guard against wrong reasoning being applied. A recent Wall Street Journal story quoted a prominent investment banker as saying, "a lot of the transactions are being de-risked. There is so much focus on the due diligence and integration ahead of an announcement."[5]

Against this background, this article presents a framework for thinking about M&A in a more practical—and optimistic—light. I begin with the premise that strategists will often find it necessary to do M&A, due to the imperatives of industry pressures. Even if it's risky, therefore, it is worth thinking about how to make sure that your particular transaction ends up in the "success column" as against the "failure column." I formulate these ideas in the form of seven principles of strategic M&A management[6]. Rather than just doing the deal and then hoping that the integration works ("plug and pray"), these principles will help to ensure a smooth integration process that maximizes the likelihood of realizing the promise of the deal ("plug and play.")

1 The first principle to keep in mind is to *consider all options thoroughly before committing to a deal, and then implement rapidly and in a disciplined manner*. It is all too easy to get caught up in the excitement of the deal, and lose focus on the real reasons for doing it in the first place. This is why it is important to conceive of M&A as being part of a strategy cycle [see figure below, *The M&A Strategy Cycle*], as well as being part of a menu of corporate strategy choices. Remembering this big picture helps to make sure that you have done the necessary strategic analysis, as well as considered all other available options before committing to the M&A strategy. Some analyses have suggested that financial acquirers, such as LBO shops, tend to do much better at acquisitions than strategic acquirers (business managers who acquire firms in order to meet their own growth goals) precisely because the former have a much more disciplined approach.[7] M&A transactions are high-pressure and highly error-prone situations. A cool head and a disciplined approach are crucial if you want to avoid serious mistakes. For example, determining a "walk-away price" in advance is good practice[8]. Another little trick-of-the-trade is to be prepared with background research even before M&A possibilities come up for consideration: Just as major newspapers prepare obituaries and keep them on file *before* they are actually needed, merger masters keep on hand profiles of potential targets and/or other partners before they begin any deal process. In all these respects, the structure provided by the following M&A Strategy Cycle framework will be a good source of discipline. Once the decision is made, rapid implementation is equally important—here too, having an organizing framework such as the M&A Strategy Cycle will be helpful (especially because few firms and managers will have naturally developed routines for M&A, since such deals are occasional events rather than day-to-day transactions for any given firm).

The M&A Strategy Cycle



(c) 2003 Ravi Madhavan

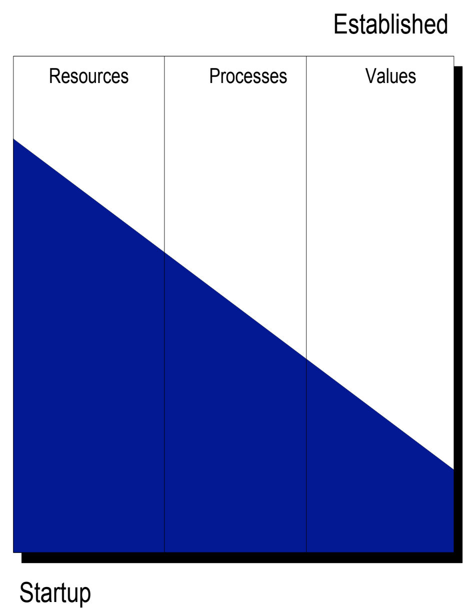
Although space limitations preclude going into detail about each step in the cycle here, two key points should be highlighted: First, it is unfortunately true that many managers tend to focus only on Steps 6, 7 and 8—the valuation, deal structuring, and negotiation phases. Clearly, however, both the preceding and succeeding phases are critical. Second, divestment is an integral part of an effective M&A strategy, whether of non-performing assets, unnecessary adjunct businesses that came with a previous acquisition, or peripheral businesses that distract managerial attention from the core business[9].

2 The second principle is that *M&A can only be successful if the deal is founded on the bedrock of a sound corporate strategy*. Successful acquisitions are typically only the *means* to realize a well-considered strategy, and do not in themselves constitute the strategy. Lou Gerstner, IBM's ex-CEO, put it well when he said, "If life was so easy that you could just go and buy success, there would be a lot more successful companies in the world. Successful enterprises are built from the ground up. You can't assemble them with a bunch of acquisitions…We made lots of acquisitions, but they [fit] the strategy we already had."[10] Similarly, Jim Collins' analysis found that "Sustainable transformations follow a predictable pattern of buildup and breakthrough…The comparison companies frequently tried to create a breakthrough with large, misplaced acquisitions. The good-to-great companies, in contrast, principally used large acquisitions after breakthrough, to accelerate momentum in an already fast-spinning flywheel."[11] In other words, the hard intellectual work of clarifying strategy needs to be done before embarking on the deal. Part of this hard work is to make sure that the assumptions driving strategy are rigorously examined (e.g., commonly held beliefs about consolidation), as well as to give due consideration to whether M&A is the best means of implementing the chosen strategy (e.g., joint ventures may be a feasible alternative).[12] Having done this work ensures that you have a convincing and coherent "story" to tell when it is time to announce the deal. Having a proper "narrative" to support the deal is crucial if you want to convince your stakeholders that yours is a deal to back[13].

3 The third principle is that *due diligence needs to be about more than financial issues*. Given the size and inherent risk associated with M&A, it is often surprising to me that the due diligence process focuses so much on financial and auditing issues and so little on crucial strategic issues. My favorite story in this regard is from a successful high-tech entrepreneur who had recently sold his company to a much larger global company. When I asked him what his greatest surprise had been during the process of selling his company, his answer was instructive: Throughout the due diligence process, he had had to put together some 2000 pages of data for the acquirer to review; yet, only 2 out of those pages related to the core technology resources that the acquirer was buying, and the rest was largely financial and commercial data! This experience is by no means unusual. In contrast, M&A best practice suggests that the due diligence process should viewed as an opportunity to assess not only financial risks, but four other types of risk: strategic risks (e.g., depth of product pipeline), human capital risks (e.g., key people who might leave after the acquisition), cultural

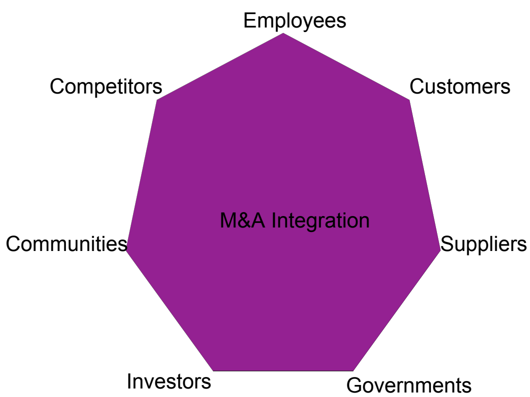
risks (e.g., unacceptable deviations in ethical norms and values), and integration risks (e.g., IT system incompatibilities). If any of these risk categories turn out to be too high, the due diligence process should provide you with the opportunity to walk away; at the very least, it should make it possible to budget for countermeasures (e.g., retaining key people through "golden handcuffs") and to take other "insurance" steps.

4 The fourth principle is that *organizational integration needs to reflect the strategy drivers behind the deal*. While this principle in itself can be a complex subject, the following *resources-processes-values model* captures its central elements[14]. The economic value in a target company may reside in specific resources (e.g., individual scientists, patent stocks), in distinctive processes (e.g., a superior product development capability), or in values (e.g., deep-seated norms about how decisions are to be made). The diagram below suggests that the seat of economic value migrates over the life-cycle of the organization: resources may be most important for an entrepreneurial firm; as it grows more established, however, it develops distinctive capabilities which may be housed in its processes. Accordingly, the R-P-V model suggests that M&A integration has to take into account <u>where</u> the capabilities of the target and acquiring organizations reside: in their resources, processes, and values. For instance, it would be foolish to buy a company because of its processes, and then insist that the acquirer's processes be adopted in full. Cisco's success with its many acquisitions during the late 1990s illustrates this principle: At least part of Cisco's track record with acquisitions stems from its policy of acquiring small companies with valuable technological resources (but few well-developed processes) and then imposing on them the discipline of Cisco's own finely-honed processes (such as quality systems). In contrast, Cisco's acquisitions of more-established units with their own entrenched processes did not go quite as well (e.g., Stratacom).



5 The fifth principle is that *the M&A manager needs to manage seven sets of stakeholder expectations well*. A significant amount of managerial attention is rightly focused on managing employee perceptions and adjustment during the M&A process. However, the other stakeholders are equally important—e.g., experience suggests that merging companies typically lose 5-10% of their customers during the integration period. Two main points can be made about the stakeholder

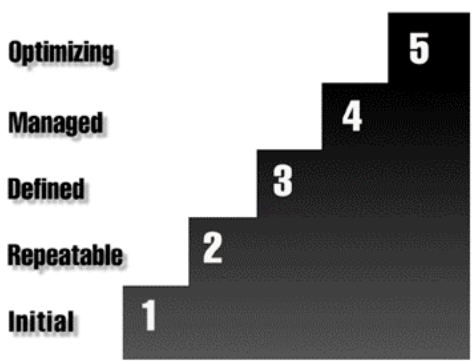
framework: First, the framework provides a simple way to make sure that the impact of the merger on each group can be analyzed and managed systematically. Second, the key is to *manage expectations* well, which implies ensuring that stakeholder expectations are set at appropriate levels and then meeting those expectations. Thus, stakeholder management in M&A is a demanding mix of communication and execution.



6 The sixth principle is that *the integration needs to be tightly executed*, using the best leadership and human resources, as well as following the best precepts of project management. M&A integration is not an occasion for part-time attention or for skimping on resources. You need to make sure that the organizations come together quickly and effectively, while at the same time minimizing the negative impact on business and setting the conditions for positive growth. The integration leader has to have the respect of both merging organizations, and be supported by a tea m with the appropriate skills. If the company is new to M&A, experienced help should be brought in, in the form of consultants and other external resources. Large integration projects can be as complex as other major projects such as new product introduction, so appropriate project management techniques and tools must be applied. Thus, as in other areas of strategy, the smooth execution of the merger ought to be top priority. A couple of tips to keep in mind here: First, it is always helpful to aim for a few quick wins early on, to build credibility and momentum. Second, it is important to make sure that the people responsible for the integration are also part of the negotiation team. Third, even if you bring in consultants, remember that their job is only to help you with the process—the tough decisions still remain your responsibility.

7 The seventh principle is that *managers need to think carefully about whether and what they are learning from the M&A deal*. Many managers (even at small firms) will see multiple deals in their careers, and given the impact of the transaction, a systematic attempt to learn from them will be well worth the effort. Three observations are worth making in this context: First, learning does not happen automatically, it needs to be explicitly managed and measured. Second, learning about rare, but critical events, such as M&A, calls for an approach that is different from our traditional learning approach (which is based on a model of learning from doing the same thing many times over.) For example, such "learning from samples of one" necessitates attending to many different interpretations of the same event[15]. Third, a key goal of the learning exercise should be to make sure that the company ascends the "staircase of M&A capability." The Capability Maturity Model (below) usually associated with software development is a useful guide

here—it represents a progression in capability levels: At the initial level, the company may be successful in particular projects, but only because of the heroic efforts of a few key people. Making success repeatable even for other (later) teams, through institutionalizing success routines, represents a step up. Similar "evolutions" in explicitly defining and managing processes helps to move the company to the higher levels of capability maturity. The overall goal of the learning program should be to make sure that the company is steadily climbing this staircase of M&A capability.



Graphic: http://www.sei.cmu.edu/cmm/cmm.html, accessed June 19, 2003

In conclusion, it must be noted that corporate transformations are an enduring part of the business landscape regardless of the periodic M&A booms and M&A busts. While the newspaper headlines typically focus on megadeals between giant companies, a substantial portion of M&A activity is between smaller companies as well. In fact, government and NGO organizations are not immune either—a recent megamerger that has not often been understood as such was the melding of 22 federal departments into the new Department of Homeland Security. Thus, a well-honed M&A skill set will be of use to managers at all levels in most organizations. The seven principles I have suggested here represent the defining elements of a coherent and disciplined approach to ensure M&A success.

NOTES

[1] I am indebted to Cathy Hayward (2002), "Plug and pray," Financial Management February 2004: 24-25 for the engaging use of the expression "plug and pray" in the M&A context.
[2] Andrew Ross Sorkin (2005), "Wall Street's designs on '05? A boom in merger activity.", The New York Times January 2, 2005.
[3] An extensive and recent summary of this evidence may be found in Paul A. Pautler (2003), "Evidence on mergers and acquisitions," The Antitrust Bulletin Spring 2003: 119-221.
[4] Dennis Carey (Moderator) (2000), "Lessons from master acquirers: A CEO roundtable on making mergers succeed,"Harvard Business Review, January-February 2000: 145-154.
[5] Dennis K. Berman (2004), "Dealmakers got it right in '03, study finds," The Wall Street Journal November 9, 2004.
[6] Despite the voluminous research on the financial aspects of M&A, systematic and cumulative findings on M&A integration are only slowly beginning to emerge. This article is based on currently available best evidence, including empirical studies, case studies, and managerial experience.
[7] Robert J. Aiello & Michael D. Watkins (2000), "The fine art of friendly acquisition,"Harvard Business Review November-December 2000: 101-107.
[8] Robert G. Eccles, Kersten L. Lanes & Thomas C. Wilson (1999), "Are you paying too much for that acquisition?" Harvard Business Review July-August 1999: 136-146.
[9] Lee Dranikoff, Tim Koller & Antoon Schneider (2002), "Divestiture: Strategy's missing link," Harvard Business Review May 2002: 3-11.
[10] Louis V. Gerstner, quoted in Business Week November 18, 2002, pp. 64-70, "Lou takes the gloves off."
[11] [1]Jim Collins & Jerry Porras (2001), Good to Great, p. 186. Harper Collins, New York
[12] Pankaj Ghemawat & Fariborz Ghadar (2000), "The dubious logic of global mega-

mergers," Harvard Business Review July-August 2000: 65-73.

[13] For evidence that cognitive factors play an important role in how investors perceive announcements, see Ravindranath Madhavan & John E. Prescott (1995), "Market value impact of joint ventures: The effect of industry information-processing load," Academy of Management Journal 38(3): 900-915.

[14] Clayton M. Christensen & Michael Overdorf (2000), "Meeting the Challenge of Disruptive Change", Harvard Business Review March-April 2000: 66-75.

[15] James G. March, Lee S. Sproull & Michal Tamuz (1991), "Learning from samples of one or fewer," Organization Science 2(1): 58-70.