Diethard Engel

Inside Post-merger Integration

A Practitioner’s Guide to a Successful PMI Project

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Diethard Engel
Management & Consulting Services
Marc-Chagall-Str. 37
55127 Mainz
Germany

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Introduction

Originally from a Corporate environment, I have been subjected to divestment of the businesses I have worked for more than once. Hence, my exposure to M&A is a very personal one.

I have been responsible for companies undergoing transformation and integration in management or project lead roles. From a professional point of view, these assignments are amongst the most challenging ones I have faced in my career. However, I have had the pleasure to work with great people who wanted no less than the very best for their stakeholders, balancing employee with shareholder needs. Post-merger integration is always people business – and success goes many ways. A smooth integration process, building the foundation for profitable growth, will offer merit to shareholders and employees alike: Job security, room for personal growth, and a positive flow of income.

In this booklet, I share my view on a few core elements suited to increase the odds for a successful program. Do not expect any new or groundbreaking insights: If you are a seasoned management professional, and you have had touchpoints with M&A before, the essence of booklet will be well known to you. However, re-iterating some of the ground rules may still be helpful. After all, the long history of failed mergers serves as an indicator for continued ignorance of some of the basic PMI principles.

Diethard Engel
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Chapter 1

Programmatic Acquirers

Who would have guessed: If you repeat a certain exercise, you will get better at it, both in terms of quality of execution and speed. This is valid in any area of life, including business. Surveys show that businesses following a strategy of growth through acquisition (a.k.a. “inorganic growth”) tend to be more successful than businesses relying on organic growth only. At the same time, analysis shows that singular big deals rarely add shareholder value, but multiple smaller deals do. Why is that so?

Mostly, middle management and their functional teams handle hands-on integration work, even if an external resource or a central department leads the program. This puts a significant strain on employees, and their day-to-day tasks. The integration effort going along with big deals (i.e. deals representing a large share of sales or market capitalization of the acquiring company) increases exponentially with size, leading to inward focus and potentially losing sight of customers, markets and business. Large integrations also tend to take longer - increasing risk even further.

Rule #1: Repeat acquirers enjoy higher chances of success

By their nature, large singular deals are not suited for frequent repetition. The acquirer will have little chance to build sustainable internal capabilities for future acquisitions, based upon multiple post-merger integration experiences. The same applies to businesses not seeking the big deal, but acquiring on smaller scale, in an opportunistic approach: Such acquirers are best suited to seek external support for their post-merger integration process.

Chapter 2

M&A as a Program rather than an Event

Reviews and research have shown that programmatic acquirers are more successful in increasing shareholder value than their peer group.

Programmatic buyers actively pursue acquisitions as a key component of their growth strategy. They acquire regularly, and usually close two or more deals per year. The target companies’ combined sales or market capitalization can be considerable in relation to the buyer’s. In other words: Programmatic buyers know what they are doing, and why.

Programmatic buyers show M&A success is not random: It is plannable, sustainable, and can be a continuous source of growing shareholder value if done correctly. Programmatic buyers do not treat M&A like a project, but rather like a program. The difference is that projects are singular, non-repetitive endeavors, which may follow certain common rules, but those are in general non-systematic. A program prescribes a flow, following a pre-defined governance and given parameters. A program is never ad-hoc.

Rule #2: Successful acquirers follow a pre-defined program

The programmatic acquirer features a detailed M&A operating model, which allows following through on the complete process from strategy to operating model of the combined business.

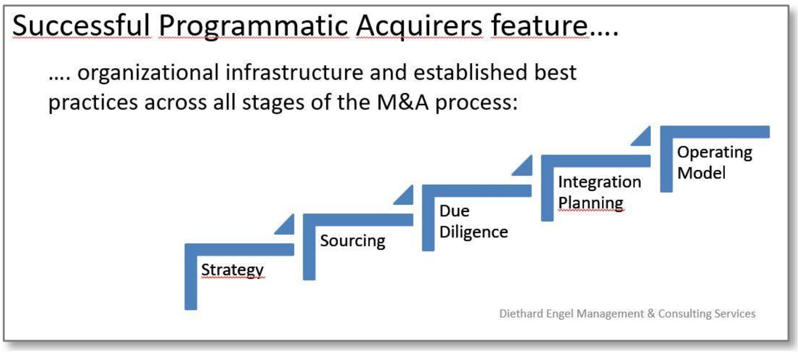

Illustration 1: M&A operating model

The end-to-end M&A operating model includes clear performance measures, incentives, and governance processes. For example, potential acquisitions are not evaluated ad-hoc; instead, any evaluation is based upon a pre-defined model, with clear parameters and decision criteria. Ideally, there is a regular feed of data into a potential target pipeline.

Unless a potential acquirer can point to such program, the use of expert advice is advantageous, already in the pre-deal phase. M&A experts will bring the experience to the table, which the prospect buyer cannot have, lacking the routine in the acquisition process. However, any internal expertise can be build, by hiring experienced personnel, or by using external expertise initially.

Chapter 3

Pre-deal Planning

Once an acquisition target has been identified, and the general strategic fit confirmed, the acquirer will want to shape up the potential integration process.

As said in the introduction: M&A is people business. While the buyer also acquires assets (material and immaterial), it is people who make things work, or not. The PMI Manager must have backing in both organizations, buyer and target. Hence, building relationships on senior level is mandatory. While many PMI Managers are tempted to start out with a host of project management tools they plan to deploy, demonstrating their technical capabilities, gaining commitment is the crucial step: Gaining Senior Management's agreement to, and support of, the general steps of developing the integration plan is absolutely essential.

Once the path towards integration planning has been paved, the integration itself is moving into the focus of activities. Successful acquirers plan integration simultaneous to their due diligence, in fact: Integration planning is an integral part of due diligence.

Good thing is, not everything has to be integrated: Integration may very well be selective. The acquirer's business strategy and the linked desired benefits drive identification of those functions or parts of the business in need of integration. This leads to

Rule #3: Keep it simple

Full integration – all functions, all systems – is rarely required to reap an acquisition's benefits. In fact, performing integration activities besides running a day-to-day business will eat deeply into resources, in both the target and the buyer. Hence, the standard approach keeps integration focused on those areas that are most promising in terms of benefits delivery, while balancing integration risk. Weighing what I like to refer to as the "Three Rs", risk, reward and resource, should be at the heart of integration target setting.

Backoffice integration (for example Finance and HR) is often on top of the list (recognized as "low hanging fruit"), but integration of core functions, Sales and Marketing before all, usually offers the highest reward (but take more efforts, too).

Functional leaders should be involved in developing the integration goals and in gauging potential benefits. A structured goal definition process from general deal benefits (e.g. "market access") to detailed objectives (e.g. "sell N units of product A at price Y") will demonstrate how benefits can be achieved, and what is needed to get there.

As a result of this process (which takes time – it's not a one-day workshop), the acquirer will have a detailed list of benefits, measures and activities required to achieve them, and – maybe above all – Management agreement on both sides that this is what it takes to integrate successfully. The result of the process represents the Holy Grail of integration planning, the Target Operating Model (TOM). The TOM details what the future organization will look like, what will be integrated for which benefits, and – equally important - what will be left alone. The TOM gives a strategic, risk-balanced view on the future state of the joint operation; it will serve as the blueprint for integration, should the deal be closed.

Chapter 4

Drivers of Success

Everybody has heard horror stories of terrible M&A failures, destroying value and potentially bringing down entire businesses. On the other hand, many Corporations make M&A a continued success. They share a common recipe.

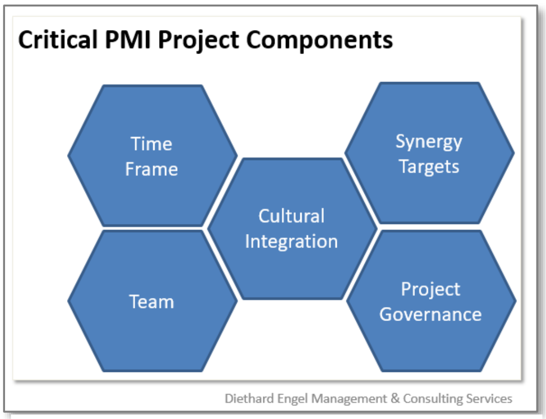

Illustration 2: Pillars of a PMI Program

Luckily, there is no need to invent the wheel over and over again: There is plenty of evidence from scientific analysis, market surveys and case studies that it's a handful of components which decide whether or not a project setup will lead to post-merger integration success. Generally, successful acquirers sport

- A strong team;
- Strict project governance;
- Well-defined synergy targets;
- An ambitious timeline for completion;
- A people-centric approach to cultural integration.

Getting all of this right will not guarantee integration success, but will certainly increase the odds for successful completion of a post-merger integration process. Admittedly, it is all but easy to get an integration right; however, at least there seems to be a proven path towards a successful project.

An acquisition and its integration is likely to affect the entire organization, its structure, processes and behavior. That is why I rather like to refer to PMI projects as transformation programs. (Linguistically, "program" seems to carry a little more weight than "project".) Running a transformation program means serious business - you will want to get it right under all circumstances. It all starts with selecting the right people to help you with it.

Rule #4: Resource your program with top people

As one of my colleagues said once: Availability is not a skill set. Your integration team should consist of handpicked, strong leaders, coming from both sides of the deal, buyer and acquiree. A dedicated team lead, a skilled PMI Manager, can be resourced from the outside (consider an interim manager with methodical and implementation expertise), but the rest of the team should be from within the organizations, if possible.

Integration activities will take up time – a lot of time, while business continues. This may put an undue strain on the resources, and should be considered already in the setup. Adding functional backup to deal with day-to-day business while the department head is distracted with project work is a proven response.

The integration team structure will reflect the strategic business intent: The target operating model dictates the functional (and/or regional) areas of integration (compare the previous chapter, Pre-deal Planning). The integration team is built to align with the integration topics. Usually, the team is organized by work streams, with each work stream representing one integration area. The relevant functional manager should lead the integration work stream. Ideally, there is a good balance between the buyer and target in leading and staffing the work streams, for example representative of business size.

Chapter 5

Project Governance

Most successful acquirers set up their M&A projects in a strong and controlled environment. In a nutshell, here is how they do it.

Empirics show that project governance is an enabler to unlock synergy achievement, hit (or beat) the integration timeline, and promote cultural integration, too. In that sense, project government is the glue that keeps the project whole and together. Therefore, if the acquirer gets project governance right, the probability for hitting the original acquisition goals increases.[1]

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[1] Some argue though that strong project governance is rather an indicator of being well organized, and that planning and organization would be the drivers of integration success in reality. For our purpose, this is an academic discussion because we will try to get all drivers of success equally right.

Rule #5: Strong project governance enables integration success

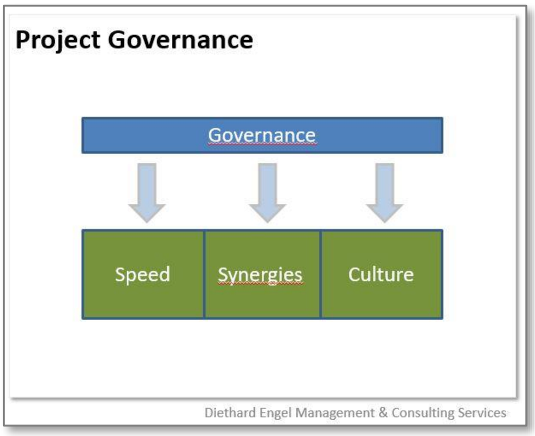

Illustration 3: Project Governance has a direct impact on integration performance

Project governance defines roles and allocates responsibility and accountability. It also sets the rules of engagement, in particular how to derive decisions, and how to control the project in order to ensure efficient use of resources. Project governance rules should be set prior to close. The Steering Committee usually formally acknowledges the rules, and communicates them within the organization.

The steering committee is the decision making body (a.k.a. Steering Group, Program Leadership Team….) which ideally includes representatives of both corporations, buyer and target, in a balanced way. Since steering committee decisions frequently have large impact, top-level management participation is mandatory. Other members are usually recruited from the general stakeholder group, including shareholders, potentially banks or representatives of the advisory board.

A constant flow of accurate information into the steering committee will drive early risk recognition, thus enable risk, and not issue, management. The most common conflicted subject is availability of resources to run the project and implement initiatives according to an agreed project plan. It is the steering committee's responsibility to review, and in doubt change priorities or scope, reallocate resource as needed, change requirements, or timeline. Pre-defined reports and decision memo formats support busy managers in the evaluation of alternative scenarios for informed decision-making.

Chapter 6

Synergies

Synergy planning delivers key input to the valuation model – an essential building block for any acquirer buying a business for integration. Hence, effective synergy delivery is a key success factor in PMI.

Usually, acquirers buy a business at a price above its stand-alone value: Most buyers will want to apply changes to the business operations in order to improve it, so to justify the on-cost. Such changes are supposed to deliver financial benefits, a.k.a. synergies. Numerous integration projects show those businesses integrating core functions, such as Sales & Marketing, generate larger synergies than those concentrating on support functions, such as Finance & Accounting.

The Target Operating Model developed pre-deal will largely prescribe which areas and functions shall be integrated, and when. Unfortunately, deep integration requires more effort, increases the risk, and takes more time.

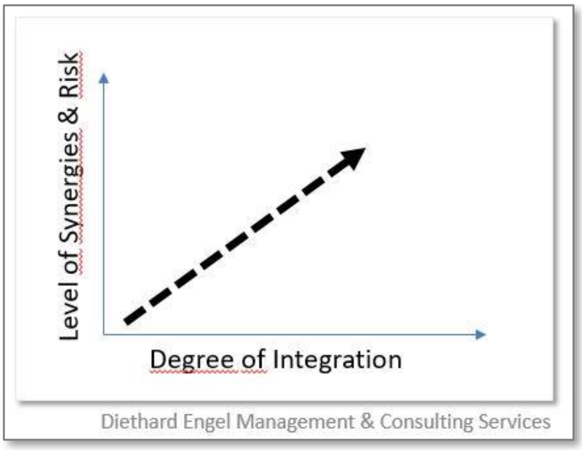

Illustration 4: The deeper the integration, the higher reward and risk

Many successful acquirers integrate select support functions swiftly, followed by more complex core functions after an extended preparation time.

By-and-large, synergies differentiate into customer-facing synergies (access to markets or customers, technology for new products….) or those targeting reduction of expenses (material cost, people redundancies, infrastructure). In any case, due to their importance in the acquisition's financial model, synergy projects require measuring and follow-up. Since both value and timing of cash flows impact on ROI, each synergy project has to have a timeline and a clear set of KPIs attached to it. It does make sense to be sure that processes are in place to be able to measure those KPIs; KPIs that remain unmeasured are highly unlikely to be met. For example, where "New Products as % of Sales" has been defined as a KPI, one should know what exactly qualifies as a New Product Sale (totally new, new variant, existing product in new market, how long is a product new, when does measurement start….). In addition, once the features of a KPI have been defined, a system (IT-based or not) should be in place to track these parameters, across both companies, buyer and target.

Rule #6: Deal targets are unlikely achieved without tracking.

A timeline and a milestone plan should support each synergy target. Milestones describe an event (status can only be "achieved"/"not achieved"), but not a course of action. Hence, action planning must underpin each milestone. The chosen level of granularity has to allow the functional owner to monitor progress adequately. Functional stakeholders have to update Senior Management routinely on synergy projects, progress and risk. At least sponsoring Senior Managers should be engaged, should use and share relevant KPIs consistently, regularly and openly. Synergy planning, measuring, monitoring and progress communication will increase the likelihood of achievement significantly.

Chapter 7

The Need for Speed

Empirical studies show that successful acquirers integrate swiftly. There are two major reasons to act fast.

I do not intend to run the details of financial modeling by you (and honestly believe there are others much better suited to do so), but any manager should at least understand the core principles behind a financial evaluation. Financial models used to gauge planned monetary benefits of an acquisition can be very complex indeed, but largely depend on only three factors. In summary, these determine the return on investment (ROI)[2]:

a) The investment amount (a.k.a. purchase price);
b) The sum of anticipated future net financial income/cash flows;
c) Time.

Actually, "time" is relevant in two aspects, namely the point at which the purchase price is paid (cash out), and obviously at which points in future the anticipated positive cash flows are going to be generated (cash in).

In many investment cases, future income and cash flow are supposed to improve over historic performance under previous ownership. A major driver for such planned improvement are synergies (compare Chapter 6). If synergies are generated later than originally anticipated in the financial model, the ROI is going to react negatively. Since the purchase price is a fixed determinant in our mathematical equation, the only other driver to balance a negative time impact with is the amount of synergies generated:

[2]There are other factors, too, but the three listed ones should suffice to illustrate what I am trying to show in the context of PMI.

While late payment will diminish ROI, increased amounts of future payments will improve it. (However, in my experience I have never seen synergies exceeding the original plan enough to compensate for their late delivery.)

The other – non-arithmetical – reason to integrate fast is the human factor: People like clarity. The faster a new organization takes grip, and the faster new processes are being implemented, the easier employees can be kept engaged. Dragging out change over an unnecessarily extended period in time is counterproductive. The momentum built with acquisition and integration start slows dramatically after the first 100 days. Hence my

Rule #7: Procrastination does not add value.

Integration should follow an ambitious timeline: Benefits from synergies flow faster, growing an earlier base for future development and growth. In addition, people are more likely to stay with the program if initial changes bear visible fruit swiftly.

Determination of the right pace, though, is the tricky part: If the timeline is too aggressive, employees view objectives as not attainable, which leads to frustration. If it is not aggressive enough, there is no progress, and people lose focus.

A healthy mix of fast-paced change and longer-term objectives is the proven answer: Integration of back office functions[3] like Finance/Accounting and HR is often sought to be completed within the first six months after closure, and more complex integrations of core functions should be completed within a year. The "need for speed" is one of the reasons why the integration team should be on board as of Day 1.

Chapter 8

Merging Culture

Understanding corporate culture is difficult - that's why it's ignored in many post-merger integrations. It does not have to be like this.

Cultural integration has proven to be a key success factor in merger execution: Many acquirers claiming a successful integration say they have considered cultural aspects in the PMI process. In order to be able to address culture, obviously one have a common understanding of "culture" first. In short, corporate culture is the sum of all elements impacting on people or organizational behavior.

[3] IT Integration is covered in Chapter 9

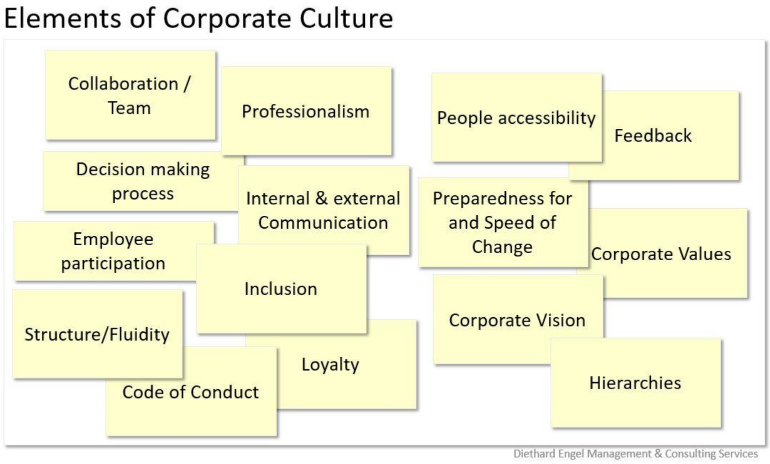

Illustration 5: Corporate Culture as a sum of many elements

Culture is qualitative by nature, and therefore difficult to measure, however, that does not mean it would not be measurable: Rankings or ratings are frequently used to gauge non-quantitative parameters. Identification of those elements meaningful to a specific target culture is key to a successful integration: Symbols, stories and rituals on one hand, and specific behaviors and processes on the other dictate how people feel and act.

Illustration 6: Spheres impacting on Corporate Culture

Corporate culture is directly reflected in leadership behavior. Therefore, change to culture requires change to leadership behavior, which leads to my

Rule #8: Cultural change often transpires to change to leadership.

Acquirers should know who will lead in future, and whether the designated leadership will live the desired culture. “Walk the talk” is more than just a proverb: It is what employees see, and eventually imitate. Depending on the scale of cultural gaps, bringing in outside leadership may be an option worth considering.

The degree of formality in a business may determine the amount of leadership change an organization can endure: Knowhow and personal relationships are assets an acquirer has paid a price for. However, the less formal an organization, the more it relies on leadership and continuity. This may limit the ability to stipulate cultural change through leadership team changes.

Trying to change an entire business culture may overwhelm the organization. Rather think about a few elements that are key to the success of the new (joint) business, and target these for change. As a result, the team will focus on managing meaningful differences, and not take away cultural elements which are not critical to business performance, but important to people and their microcosm.

Chapter 9

IT Integration

In chapter 7, we have discussed common integration sequencing, namely integrating straight-forward back office functions like Finance & Accounting first, followed by core functions, for example Sales & Marketing. IT seems to fall through the cracks. It shouldn't.

First things first: If an IT business acquires another IT business, obviously IT is anything but infrastructure: It is the very core function. In the PMI scenarios I am looking at, IT is merely an enabler: It is the backbone of any standard industrial manufacturing business, and so it is for most service providers, for banking and insurance firms. Without IT, there are no business systems, no ERP, no management of complex projects; there is no communication, neither by email nor by phone. IT for many businesses is vital. Touching IT systems, switching platforms, or even releases, can be a very demanding project, in terms of risk, resources human and financial, while the immediate reward seems limited. Still, there is a reward, and a common IT platform may not fuel growth in the long run, but at least a fragmented IT environment does not limit growth either.

So, where to begin? I recommend going to back to the TOM (Target Operating Model)[4] – or, as I like to call it: The Holy Grail of integration. The TOM dictates integration targets and sequence. If any of these targets are linked to specific IT systems, the acquirer will know which ones need changing, upgrading, or integrating. The focus should be on those systems only which support delivery of the TOM, and hence enable delivery of the strategy.

Rule #9: Swift integration of those IT systems linked to implementation of the TOM

Standardizing any other systems in future still has its merits, but there is no immediate need to act. Rather than making non-strategic IT systems a part of the post-merger

[4] Compare Chapter 3, „Pre-deal Planning"

integration program, they should be tackled for renewal and harmonization in context of their standard product life cycle.

However, in course of the PMI process a couple of IT-related steps should be taken in any case: The new IT strategy should reflect the new combined companies' strategy. Future requirements on IT systems will also determine the qualification needs of tomorrow's IT workforce. A combined IT organization may require less or differently qualified staff. In addition, contracts and license agreements should be checked, and the server and service environment reviewed for harmonization and saving potential.

Chapter 10

Communications

Because M&A is people business, informing and involving people concerned with the program is very important. As opposed to many other work streams, Communications need to be at the ready on Day 1: People will want to know what is going on immediately with the announcement of the acquisition or merger, not later.

While Day 1 communication is a first-level leadership task, ongoing communication can be, and should be, spread out through different organizational levels.

Early employee information should focus on

- the meaning and external impact of the project,
- what is driving the value to customers behind the transaction,
- what is expected from the employees,
- how and when the implementation of the vision will take place.

Illustration 7: Communication Tools

To a normal employee, change is worrying. That is the reason that common employee questions target the change aspects of the program. Employees are very little concerned with what the acquisition means to the company and to financial earnings. They worry about the meaning of the transaction to them, personally and professionally. Ongoing communication should address these questions respectfully, and openly. Difficult discussions must not be avoided.

HR may function as the communication center and catalyst, but communication must not be an exclusive HR task. Deployment of various communication tools in parallel has proven to be most effective.

Summary: Nine Rules of Post-merger Integration

Any PMI Manager (or any other manager leading a PMI-related program, or a part of it) will face a host of challenges, one of them being to juggle priorities between integration activities and day-to-day business. Following the rules set out in this booklet will support decision-makers in concentrating on the very essence of a PMI-program. There are no guarantees, but heeding the rules will increase the probability for a successful, value-adding and satisfying PMI process. Let me recap the core principles I advise Management to follow:

Rule #1: Repeat acquirers enjoy higher chances of success

Having developed a routine process of acquisition and integration, proven in frequent M&A activities, increases the likelihood of success.

Rule #2: Successful acquirers follow a pre-defined program

Compromises in selecting the acquisition target may lead to underperformance. A strong governance should set the borderlines of what is and what is not acceptable.

Rule #3: Keep it simple

Full integration is rarely the concept for success. Carefully select those areas targeted for integration depending on the “Three Rs”, namely risk, reward, and resource.
Develop a Target Operating Model (TOM) and stick to it.

Rule #4: Resource your program with top people

Availability is not a skill set. Post-merger integration is a challenge, and should be handled by people with a proven record of accomplishment.

Rule #5: Strong project governance enables integration success

The entire organization needs a dependable framework, a given set of rules to stabilize a fast-changing environment.

Rule #6: Deal targets are unlikely achieved without tracking

A meaningful set of KPIs, related to acquisition and integration goals, should serve to measure success, and identify deviations from target. Unless measured and communicated, KPIs are not helpful.

Rule #7: Procrastination does not add value

Once a direction has been determined, go for it. Delays in achieving benefits are very difficult to catch up, and may prevent achievement of the goals set out in the financial model.

Rule #8: Cultural change often transpires to change to leadership

So much has been said about cultural integration, and how important it is. Picking those leaders living the target culture will get you a long way.

Rule #9: Integrate IT systems linked to implementation of the TOM only

It is easy to get lost in a complex IT integration. Rather target those areas in IT that are important to delivery of the business strategy, and integrate them only.

Much of the above sounds like common sense, and in most cases, it is. However, many failed integration attempts illustrate that a post-merger integration process is not as simple as it sounds. In fact, PMI is a very complex endeavor, involving people, behaviors, (competing) targets, different processes and systems. I have certainly not discussed all and every aspect of an integration project a PMI manager should consider. PMI takes planning, preparation, targeted execution, and communication effort. It binds resources and distracts from the day-to-day business. Yet, growth by acquisition is a proven means to outperforming competition and industry peers. A failed integration though is costly and can bring down an entire company, alongside its management. Therefore, I recommend not only your acquisition process be guided by knowledgeable external advisors, but in doubt the integration process, too.

Christopher Kummer, president of the Institute of Mergers, Acquisitions and Alliances, a research organization in Zurich, Switzerland, said once "Nothing compares to what comes after you acquire the business." He is right – hence this booklet.

About the Author:

*Based out of Germany, Diethard Engel is an independent consultant and interim manager, focused on **Business Transformation, Post-merger Integration / Carve-out and Executive Finance**. He has run multiple post-merger integration/carve-out projects for international businesses.*

Diethard Engel
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