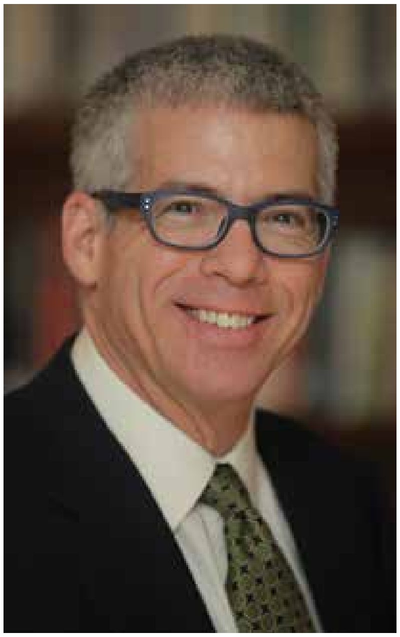
Anticipating post-closing M&A surprises

Here is a framework for corporate boards evaluating acquisitions. Post-closing surprises should be viewed as likely possibilities to be prepared for rather than presuming that surprises are simply avoidable through good diligence.

By Joseph Feldman and Harry M. Jansen Kraemer Jr.

When management proposes an acquisition, the corporate directors' key roles as sounding board, risk manager and enterprise steward are put to the test. After all, many opportunities enabled by acquisitions may seem strategically compelling, decision timeframes may be truncated, and external advisers may convey more enthusiasm for how to get the deal done rather than whether to do so or what must be done after the closing. Inevitably, much is on the line.

Acquisition discussions reflexively focus on strategic fit and assessment of valuation, with "completion" of due diligence seen as a security blanket to comfort the envisioned scenario of success. However, our recent research suggests that addressing the inherent uncertainties of acquisitions might be enhanced through greater consideration of post-closing surprises. Specifically, post-closing surprises should be viewed as



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possibilities to be anticipated and prepared for, rather than presuming that surprises are simply avoidable through good diligence and strategic vision.

Our research has included interviews with nearly 100 company executives, corporate directors, and advisers. Consistently, they reported that post-closing surprises significantly impacting value expectations are more typically found outside of typical *confirmatory* due diligence areas. Overreliance on diligence checklists and a single financial projection may underemphasize important pre-closing preparations in areas with highest surprise risks. These especially include talent/organization, customer/market, and integration-focused operations assessments. Of course, these critical areas fall directly within the scope of directors to support and challenge management as they seek growth and value through acquisitions.

Ask the basic questions

"Sometimes it's not about asking the tough questions ... sometimes it's about simply asking the basic questions." The sources of acquisition disappointment may be familiar, though that doesn't preclude missed opportunities for doing the basics well. Indeed, "sometimes it's about simply asking the basic questions" about the deal economics, integration planning, and preparation for post-closing surprises.

Perceived or real urgency to close a deal can also confound adequate focus on the basics. A housewares industry executive reflected on a deal with notable post-closing surprises, "More rigor would have helped. The acquirer was so enamored with owning the new company they looked for the 'best' in scenarios." And an information technology executive added: "One of the biggest mistakes acquirers make is they get emotionally attached to making the acquisition and lose patience during the due diligence process."

Among the basics of deal economics are clear identification of the few key drivers for projected cash flow, anticipated deal synergies (whether enhanced topline growth or expense savings), and thoughtful sensitivity analyses. One health care director expects clarity in a discussion of "what do you have to believe" for realization of results under a range of different scenarios, and, for each such case, what plans are in place to ensure execution risks have been well-considered. Finally, this director cautions that assertions of "the financials aren't great, but don't worry, it's *strategic*" are inherently problematic and no substitute for appropriate analyses and plans.

Check this checklist for proposed acquisitions

- **High-probability surprise risks are knowable** — not specifically, of course, though prepare for the unexpected with customers, competition, organization and other "people-intensive" areas.
- **Beware of due diligence checklists** — checklists are selectively valuable, though may create a false sense of completed preparedness for post-closing business operations.
- **Organizational predictability is unlikely** — management should especially prepare for the unexpected with the acquired leadership team, sales organizations, and those whose work-life is impacted by the deal.
- **Something else** — each deal requires consideration of surprises that are unlikely found on checklists; and so, ask "what if…?"

— Joseph Feldman and Harry Kraemer

The basics of integration planning must go beyond "where does it report, where will the equipment go?" or as an activity relegated to a "post-closing initiative." When it comes to integration planning, a director for family-owned businesses advises, "Don't assume it's thought through if all you're talking about is the transition."

In preparing for ongoing acquisition integration and its inherent uncertainties, imagination becomes an essential ingredient to effectively considering a range of alternative futures that might require action by management. According to Patrick Marren, principal of the Futures Strategy Group LLC, a leading scenario-planning consultancy, "While scenario analysis can always be a useful exercise, the greater uncertainty and newness associated with acquisitions — and the natural narrowing of focus that may accompany the examination of any acquisition target — may make such 'outside-in' thinking far more critical to a successful acquisition. It also allows them to 'rehearse the

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Unexpected sources of acquisition wisdom

- "Not everything that counts can be measured. Not everything that can be measured counts." —*Albert Einstein*
- "I like friends who have independent minds because they tend to make you see problems from all angles." — *Nelson Mandela*
- "Predictions are difficult, especially about the future." — Niels Bohr
- "In preparing for battle, I have always found that plans are useless, but planning is indispensable." — *Dwight D. Eisenhower*


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Nelson Mandela

- "The future is certain; it is only the past that is unpredictable." — *Contrarian 'adage' from Soviet Union days*
- "It ain't what you know that will hurt you. It's what you think you know that just ain't so." —*Mark Twain*
- "It's what you learn after you know it all that counts." — *John Wooden*

— *Joseph Feldman and Harry Kraemer*

future' in a far deeper — and broader — way than merely going down a checklist ever could."

Make sure the cultures fit

"If you're sure the cultures won't fit, alarm bells should be going off." Organizational certainty for most acquisitions is an oxymoron, an inherent contradiction. "Proper assessments of people who aren't your employees may be impractical," counseled a senior vice president of human resources with two decades of acquisition diligence and integration experience. "That said, acquirers should temper their optimism that the target's management will be just fine. Planning for more changes, perhaps many more changes, in the target's team would be sensible in most cases I've worked with."

From the corporate board perspective, organizational planning and preparation for post-closing surprises are essential to maximizing the likelihood of realizing value from the deal. In addition to potential surprises related to incompatible corporate cultures, both planned and unplanned departures of key executives may impact the combined businesses in unexpected ways.

The leader of a manufacturing company described the management team of an acquired business as "totally competent in running the business; totally incompetent in doing things differently to grow it." And a middle-market company board member reflected, "We found out after the acquisition that the management team did not talk to each other. During negotiations they had presented the team as a tight group, and in reality they had very diverse views regarding the future of the company."

Another director with experience primarily on public company boards suggests that management undertake a systematic assessment of the acquired company's management. On the basis of a discrete rating system, plans can be made for those executives who are:

— essential to retain,
— important in transition,
— less critical, or
— (perhaps most importantly) too uncertain to determine.

The result is not a rigid plan, rather a baseline from which to begin.

Make the tough decisions on personnel

A private equity investor and corporate director of a health care firm reflected, "A better review of personnel prior to the acquisition would have made for a smoother transition. The challenge with this acquisition (or any acquisition) is making difficult decisions on personnel prior to the transaction and managing the planning with the potential risk the deal does not close or the business is disrupted by the acquisition during the diligence phase."

Acquiring a business often reflects the assessment of whether the target company's leadership and organization have operated effectively, and the outlook for their doing so in support of future growth and value to the acquirer. It is important to recognize that post-acquisition ownership may bring new expectations, different priorities, and often an accelerated plan for growth, any of which may lead to organizational surprises.

And finally, there's the "island problem." The acquisition of an innovative, entrepreneurial, even scrappy company may be a highly attractive path for firms seeking new competences and new means of competing. Such firms may be led by one or more individuals seemingly essential to the business, and perhaps those individuals will become fabulously wealthy post-closing. And so the "island problem" is a way to envision that potentially critical employees may decide post-closing that there's simply someplace else (someplace warm) they'd rather be. As with many other post-closing surprises related to key people, advance preparation for a range of possibilities is essential.

Modesty and humility are advisable

The CEO of a consumer products company encountered a major customer loss shortly after an acquisition closed. While this possibility had been theoretically considered, in reality the impact required a few years to recover. The CEO reflected, "We hadn't adequately tempered our projections for year 1 post-closing to account for the unknown; doing so would have been prudent vis-à-vis our investors, without needing to ease expectations from our sales team or retained management."

Acquisitions are among the most far-reaching, ambitious business decisions that senior executives may face in their leadership of a company. And so while bold vision and high confidence may be more readily associated with and essential elements for acquisition proposals, a financial services corporate director describes acquisitions as potentially "fraught with peril" and so advises that deal decisions be approached with "modesty, humility."

Another director with public and private company experience across numerous health care firms observes, "If you think about how hard it is for a leadership team to forecast the results of their own business, how can they be more confident as to the results of a business that they've never run."

Among the benefits of scenario planning is the opportunity to explicitly, and humbly, consider a range of alternatives reflecting uncertainties outside the immediate control of management or the company. Acknowledging such possibilities and the expected choices that might emerge is responsive to the counsel offered above.

Looking ahead

"Great strategy, planning and integration execution are essential, but not sufficient to ensure success with acquisitions. There will be surprises," reflected the chief executive officer of an industrial products company.

And while unforeseen developments may sometimes limit an acquisition's impact, other surprises can also prove quite positive as previously unforeseeable opportunities are realized.

Directors of acquiring firms should encourage a broad view of pre-closing diligence, considering both traditional "confirmatory" diligence along with more subjective efforts to understand an uncertain future. After all, companies prepared to consider acquisitions among their options may thereby achieve growth and competitive position that is otherwise unachievable. ■

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