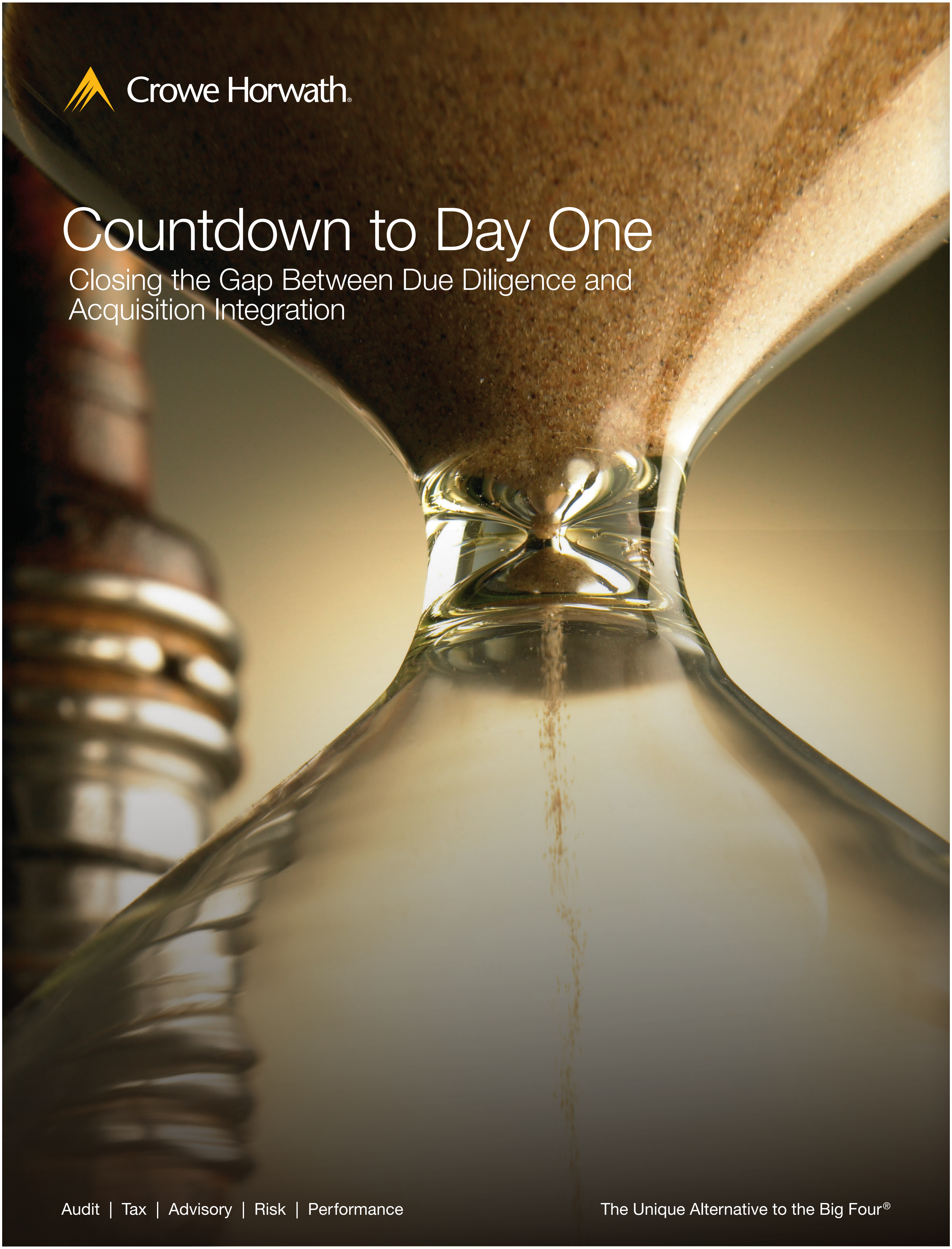

Crowe Horwath

Countdown to Day One

Closing the Gap Between Due Diligence and Acquisition Integration

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Post-deal integration can make or break the long-term value of a deal, but integration is also typically costly, complex, and full of risk. The solution is to treat due diligence and integration planning as part of a single, seamless process – an approach that gives organizations the time and information they need to make smart integration decisions.

For businesses of every size, the process of integrating an acquisition is fraught with high expectations, complexity, and hard deadlines. Even given these challenges, however, it is disturbing that more than half of acquisitions fail to achieve their desired rate of return.[1]

What's behind these disappointing results? For most acquisitions, realizing market share gains, cost savings, and other strategic and financial benefits identified during the targeting and due diligence processes depends in large part on how quickly and effectively the acquired companies can be integrated into existing operations. In many cases, firms underestimate the difficulty and complexity of the post-deal integration process. Overly optimistic projections run afoul of hidden risks and conflicts, including many that arise within the acquiring company itself. Targeting and due diligence tasks occur independently of integration planning and post-close execution activities, and these activities may also suffer from a lack of proper preparation or resource allocation. A lack of communication between stakeholders in various phases of the mergers and acquisitions (M&A) process can lead to misunderstandings, missed opportunities, and unnecessary post-close complications.

In this article, we will discuss why it's important to address acquisition integration issues early and often during the deal-making process – and why so many companies fail to do so. We will also look at how companies can close the gap between due diligence and acquisition integration, allowing them to mitigate M&A risks and ensure that deals achieve their full potential.

Anticipating the Complexities

The specific priorities and complexities of an acquisition will vary based on the type of acquisition. The planning for these should start well before a purchase agreement is signed at the conclusion of due diligence. For example:

- A **merger of equals** will take advantage of the best practices, technology, and talent across both the acquiring and acquired organizations.
- A **turnaround** may require rapid and dramatic structural changes as well as leadership changes.
- **A bolt-on acquisition** may complement existing product offerings and take advantage of existing distribution systems but also could require some realignment of organizations and business processes.
- A **carve-out** acquisition will require gaining separation from the previous parent, and historical financial statements may not reflect the new fully burdened costs of doing business in a different organizational structure.
- A **market entry** acquisition will expand sales opportunities but bring with it complexities of serving new sales channels and geographies.

Each type of acquisition – and there are a variety of others – has different implications for exactly how the integration planning and execution process unfolds, starting with the earliest phases of the due diligence process.

A Vital Window of Opportunity for M&A Success

Every part of the M&A deal life cycle, beginning with the earliest stages of interest and due diligence, can have a profound impact on post-deal integration. No matter how circumspect and discrete they might be, for example, initial requests for information during due diligence and in-person visits will attract attention and create anxiety among employees. Once an acquisition is announced, this anxiety will grow, and it may also spread to customers and business partners.

As a result, the integration process must focus first on stabilizing the acquired company. A 30-day post-close stabilization period needs to focus on the acquired firm's customer base, supply chain, employees, transactional processing, and operational controls; the objective is to minimize short-term risks of disruption or diminished performance.

During this 30-day stabilization period, it is also imperative to prevent "negative synergies" due to lost revenue or reduced employee productivity. On the people side, the management team must be prepared to answer stakeholder questions, such as who is in charge, who will report to whom, and how compensation and benefits plans will change. They must also, to the best of their ability, address questions about intentions for product lines, suppliers, and facilities.

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Integration Planning: A Risk Assessment Checklist

Every company realizes that the post-close integration process carries a number of risks. In spite of this, Crowe Horwath LLP has found that many companies overlook significant sources of risk during their integration planning process.

The following checklist can help your company identify and begin to address the most important sources of these risks:

- ☐ Are there open lines of communication between your due diligence and integration planning teams?
- ☐ Are the teams' activities coordinated from the early stages of due diligence?
- ☐ Is there a sense that a combination of the companies is too complex to manage or to fully mitigate the potential risks without help?
- ☐ Does your team base its expectations on a shared set of clearly defined deal metrics and objectives?
- ☐ Is your company attempting to handle the acquisition integration with internal resources and staff, especially if it does not make acquisitions frequently?
- ☐ Is your company prepared to execute with speed in the first 100 days to take advantage of this window of opportunity?
- ☐ Is your company prepared to make major structural changes required to maximize deal value?
- ☐ Is your company able to test critical system and process changeovers prior to Day One?
- ☐ Is your company limiting its search for deal synergies to cost areas, as opposed to also identifying opportunities for performance improvement?
- ☐ Has your team identified and assessed integration risks due to:
  - ☐ Different sales structures?
  - ☐ Limited leadership capabilities?
  - ☐ Geographic challenges?
  - ☐ Different compensation schemes?
  - ☐ Customer service hiccups and revenue loss?
  - ☐ Talent defections?
  - ☐ Cultural differences?

In more strategic terms, the first 100 days after a deal closes provide the best period of opportunity for making major structural changes to both the company that is being acquired and the acquiring company. This is the time to restructure sales territories; discontinue product lines; merge disparate financial, IT, and human resource systems; and close redundant facilities.

Once this 100-day window closes, these changes can provoke more resistance and become much harder to make. Missing this window can undermine the efficiency gains and market synergies that justified the acquisition in the first place. In fact, a slow or haphazard transition is one of the biggest reasons why deals fail to achieve their objectives.

It should be clear that simultaneously stabilizing a company and executing major structural changes requires a tremendous amount of preparation and coordination. Business leaders must prioritize opportunities and critical activities and then execute their plans flawlessly. They also must mitigate a host of risks identified during due diligence and integration planning, including those related to conflicting sales structures and compensation plans, leadership alignment, governance structures, cultural differences, and the myriad other issues that arise when two businesses are merged (see sidebar).

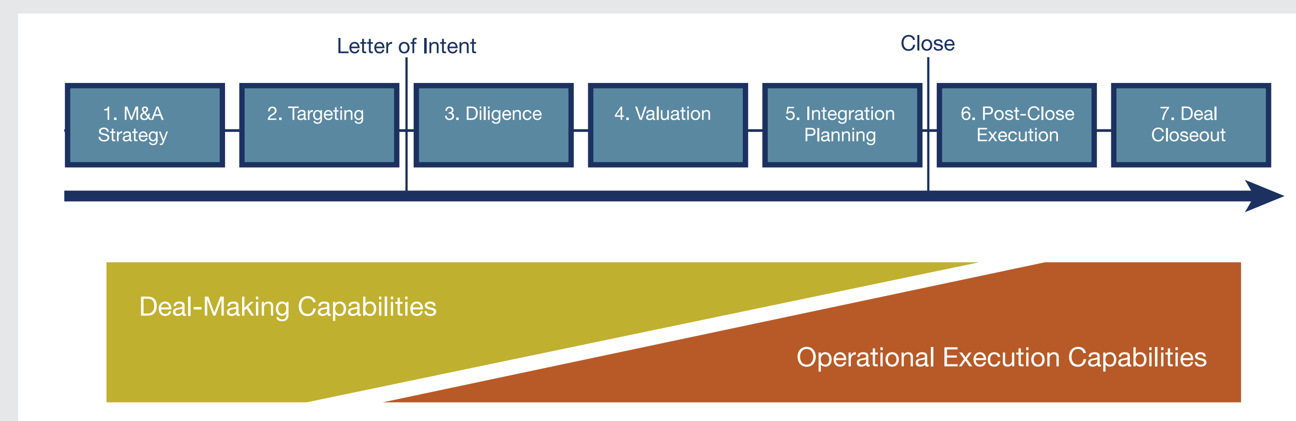
The Disconnect Between Due Diligence and Integration Planning

The most logical way to achieve these goals is to treat the M&A deal life cycle as a single integrated value chain – not as a series of discrete (and often disconnected) steps. Yet there are a variety of practical reasons why such a seamless hand-off doesn't always happen.

Early on, only a firm's corporate development team and senior leadership are likely to be involved in targeting. Then, based on potential conflicts of interest, a company's board of directors or lenders often will demand that independent analysts perform financial due diligence on the targeted company. Other specialist firms may do the market research and operational due diligence. All of this independent work can prevent any single stakeholder from getting a holistic view of the deal and of the integration planning process.

In other cases, leadership teams focused on business strategy and financial benefits often fail to appreciate the complexity and amount of work required during integration planning and execution. Centralizing core administrative services, for example, or consolidating distribution

M&A Transaction Value Chain



The best way to build a successful integration plan is to ensure that it integrates seamlessly with due diligence. Early on, a deal is largely theoretical and strategic, but increasingly it hinges on tactical execution as it comes together. The siloed structure of the typical buyer often undermines a seamless transition – whereas each step in the M&A deal life cycle should inform the next.

networks and sales channels – frequent elements of an integration process – are major undertakings for any business even under normal circumstances.

The integration process also can go awry when a company underestimates the pressure it places on existing internal capabilities. Consider a hypothetical situation where the CFO may take responsibility for finance, the CIO plans to tackle IT systems, the chief operating officer oversees rationalization of the operations, and the vice president of human resources steps forward to handle the personnel issues. As engaging as such work may be for these executives, each of them already has a full-time job that consumes significantly more than 40 hours per week. A few weeks in, these stakeholders are likely to be consumed with their "regular" duties. Therefore, they tend to integration tasks only when those tasks become extremely urgent rather than beginning to work on them during the due diligence process or tackling them on the aggressive schedule required for a smooth integration.

The first step to address these challenges is to recognize the closely intertwined nature of due diligence and integration activities. This is especially true when looking at five areas where what happens before Day One will have a profound impact – for better or for worse – on what happens to the value of a deal afterward.

- **Human resources.** The due diligence period is the right time to identify employment liabilities, confirm organizational capabilities and leadership commitment, and analyze retention, compensation, and cultural risks. The integration team can then proactively address these issues and use Day One to execute essential business activities such as payroll and benefits enrollment where glitches could affect employee morale and productivity.
- **Sales**. Merging two companies with different incentive plans and sales cultures can be much more difficult than many business leaders anticipate. At the same time, this task poses some of the biggest and most immediate risks to revenue and customer loyalty if it is not done well.
  Consider the example of a company with a direct-sales force that plans to acquire a firm that sells primarily through distributors. The due diligence team might project significant sales synergies and margin benefits coming from moving the acquired company to a direct-sales model. When the acquiring firm takes a broader view of the integration process, however, it might recognize that the distributors actually control the customer relationships, thus posing a major financial risk. It is much easier for the due diligence and planning teams to recognize and address such a risk when the teams work together.
- **Information technology**. Coming together to operate as one company necessitates realignment of the business systems and tools in order to simply execute the order-to-cash cycle. A proper due diligence process identifies hidden costs, dependencies, and technology risks that might impair organizational growth, business continuity, or the ability of system tools to deliver on the investment. This process, in turn, supports the creation of a technology integration road map with realistic timelines and budgets for critical tasks such as migrating to a single enterprise resource planning system.
- **Operations.** The operations function produces and delivers the goods or services of the firm, and merging two companies often presents opportunities to reduce overlap in capabilities and capacities. In fact, capacity optimization and purchasing advantages often are two of the most significant complementary strengths targeted by integration. Properly charting this course during due diligence not only can strengthen the investment thesis but should provide a clear plan for value creation upon acquisition.
- **Finance**. Whether the new acquisition will be a stand-alone subsidiary or fully absorbed, its legal and financial structure and even banking relationships will change. On a tactical level, the month-end close process and financial statements will have to be combined, and typically there are efficiencies to be gained by combining the accounts payable and accounts receivable functions. Formulating a plan with an eye on transactional efficiency can help the acquired firm avoid problems collecting cash and paying employees and vendors.

Good Advice for Every Level of Acquisition Experience

The second step, for many acquiring firms, is to work with an M&A adviser who can see beyond the information and functional silos and disconnects that often separate due diligence and integration planning. By recognizing the relationship between these two activities, such an adviser can help acquiring firms avoid many of the post-close challenges that can delay or dilute the value of a deal. Working with an adviser also clearly is useful for firms that have limited resources or that don't routinely make acquisitions.

Firms that make frequent acquisitions naturally tend to execute the integration process better than those that do infrequent deals or one-offs. The former often use step-by-step playbooks and checklists that cover 90 percent of the tactical "table stakes" work that must be done in every deal, such as orienting new employees, integrating financial systems, and assigning new email addresses.

But even frequent acquirers, in the flurry of tactical execution, can lose sight of underlying organizational and growth objectives. M&A advisers who have experience with all types of acquisitions, and the resources to help execute the integration plan, can increase the odds of success while continuing to build a company's internal capabilities for future opportunities.

For any acquiring firm, the bottom line is that every significant deal represents a major investment of time, effort, and opportunity. Due to their potential benefits and inherent risks, acquisitions are significant career events for a company's leadership, and they are also important learning opportunities for executives, functional managers, and employees alike. The right M&A adviser can help minimize the risks of an acquisition and maximize the benefits – in both cases by orchestrating a seamless transition between due diligence, integration planning, and other significant phases of the deal life cycle.

How Crowe Can Help

Crowe is committed to providing the best solutions to fit your business needs. We offer a flexible, scalable approach – ranging from individual, focused solutions in discrete functional areas to fully integrated, end-to-end support along the M&A value chain. Crowe solutions can help you realize the value that originally drove the deal while also embedding tools, skills, and techniques that will enhance the success of future acquisitions.

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[1] "Study after study puts the failure rate of mergers and acquisitions between 70 and 90 percent. ..." ("The New M&A Playbook," by Clayton M. Christensen, Richard Alton, Curtis Rising, and Andrew Waldeck, Harvard Business Review, March 2011); "More than half (51 percent) of survey respondents admit falling 'somewhat' or 'significantly' short of their desired rate of return on completed transactions. ..." ("Critical Pillars for M&A Success Survey Report," Crowe Horwath LLP, February 2014).

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