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Topic: Due Diligence – The Softer Side

How to use Soft Due Diligence to ensure success in M&A transactions

Due diligence – what is it?

Essentially, it is looking at a transaction with all of the care appropriate to the particular situation. If you are involved in a merger, or an acquisition, the level of attention for your examination of the deal should be fairly intense. More often than not, people equate due diligence with an examination of the financial and legal aspects of the transaction. But there is obviously much more to making any specific transaction successful. For example, there is the matter of business strategy, and there are the people issues – the softer side of due diligence.

The softer side of due diligence

In the context of merger and acquisition (transactions that always call for some level of due diligence) *people issues* are cited as the top reason for the failure of the merger (or acquisition) integration process, and there are a lot of failures. Depending upon which articles you are reading, 50 to 75 percent of all mergers are evaluated as "unsuccessful." Even so, inclusion of a thorough examination of the human dynamics of the transaction is unusual in most due diligence investigations. This is surprising because among the human dynamics are many elements that are very important to the success of any business transaction. Here are a few of the major elements:

- Management talent: The level and compatibility of leadership talent and management styles is a vital element. This is especially important in view of the fact that identifying and filling leadership positions early in the merger integration process is essential.
- Retention: Success in retaining individuals key to continuing success and the work force required for continuing production is crucial to any major transaction. Retention is mostly a matter of human dynamics.
- Culture: An understanding of the compatibility of the cultures of the companies involved in the transaction (and closely related to that, an identification of the values that are important to those companies) is necessary to any assessment of the level of effort required to achieve a successful merger integration.
- Competencies: To ensure success it is necessary to catalog and provide for the functional capabilities, resources, methodologies, information, organizational structure, etc. required in order to achieve the strategic objectives of the *new company* to be created by the merger or acquisition.
- Commitment: Performance levels will be impacted by any major transaction. Quickly building commitment within the work force to the accomplishment of new strategic goals is one of the first tasks of management.

And, last, but certainly not least, is the fact that soft due diligence is required in order to design a merger integration process that will ensure success, and is also required in order to accurately estimate the cost of successfully completing the merger or acquisition. Integration costs can be substantial and can be a significant factor in the decision to continue merger or acquisition action with a particular candidate.

What's at stake?

In today's *merger math* one plus one never equals two! On the revenue side, one plus one must equal more than two for a successful merger. On the cost side, one plus one must equal less than two for success. Due diligence is the best way we have to determine whether these goals can be achieved. Soft due diligence is our best window into merger integration – its complexity, strategies, costs, and likelihood of success. Therefore, the information that soft due diligence yields is essential in the assessment of both the cost and revenue sides of the equation, and can be significant in the bottom line decision about whether or not to go forward with the transaction.

Realizing the possibilities

In realizing the full potential of your company there are significant prizes to be won with merger or acquisition. One objective would be to win market share by increasing your customer base and expanding your channels to market. Another would be to obtain more competencies, methodologies, technology and know-how to provide products and services of superior value. It is possible to achieve these objectives through bold internal building and growth strategies or through some external move such as merger or acquisition. In the successful employment of either approach (or some combination of the two) there will be major changes within the company, and there are a number of success factors to be considered in evaluating the company's ability to successfully implement these

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changes. In due diligence each of these factors must be evaluated in terms of its contribution to rapidly achieving the overarching strategic business goals that are at the root of the major performance improvement being contemplated.

Change – the context of accomplishment

It is important to realize that each of the success factors (which are treated below) must be evaluated within the context of the major organizational changes that will occur as a result of the merger, acquisition, or other major performance improvement initiative. These types of changes are necessarily disruptive to the organization, and that has a powerful impact on the people within the company(ies).

The human psyche seems to be *change averse*. One of the biggest reasons for this is the fact that with change comes confusion, ambiguity, and uncertainty. People know that familiar structures and ways of doing things will change, and, they do not yet know what will replace them. There is a deterioration of trust and people go into *self preservation* mode. Perhaps the newspaper cartoon character Pogo said it best: "The certainty of misery is better than the misery of uncertainty." Statistics associated with productivity during major change clearly tell us that a great deal of energy is removed from productive endeavors and applied to speculating, worrying, resisting, and complaining. Experience indicates that in *all* cases of major organizational change there is a productivity loss, the only questions are how severe will it be, and how long will it last. Due diligence seeks to answer these questions and provide the change agents with ideas about formulating a strategy appropriate for minimizing the adverse impacts associated with major organizational change.

The success factors

In my work with merger, acquisition and other types of major organizational change I have come to rely upon ten critical factors to evaluate and prepare for success in these endeavors. They are listed and briefly explained below:

- Perspective: The perspective, or attitude, with which the transaction is approached. Is it a "winner takes all" approach? Here the stronger company gets its way in just about everything. Or is it one in which the *new company* (many times referred to as "New Co.") takes the best from each company to be better than (and different from) either of the predecessor companies?
- Business Rationale: A strategic and compelling business rationale about how the unique strengths of the parties to the transaction will be leveraged to win in the competitive marketplace. This rationale should be used in setting standards for most of the other success factors.
- Organization & Management: The organizational and management structure that will be required to best leverage the strengths of the contributing companies to accomplish a new, more aggressive set of goals.
- Leadership: Define the leadership talent that is needed to formulate and implement the required changes, and build the commitment of the work force to the accomplishment of the new strategic business goals. Compare the leadership talent available within the parties to the transaction to that which is needed.
- Productivity: The capability to design and aggressively implement actions to deal with productivity issues during the change *and* rapidly move to a higher level of performance in New Co. than existed in the predecessor companies.
- Resistance: Given the new goals and changes required to accomplish those goals: identify the likely resistance to the changes, assess the capabilities to quickly and effectively overcome that resistance.
- Retention: Identify key talent, key individuals and organizational competencies crucial to the achievement of the new goals and business strategies, then evaluate the abilities to design and rapidly implement an appropriate retention program.
- Commitment: The degree to which commitment exists and/or can be cultivated to the new compelling business rationale and strategic goals of the new entity that will be created by the transaction.
- Communication: The health of existing communication systems and the capabilities that can be marshaled to design, implement and maintain the rich information exchange required to implement change, pursue strategies, and accomplish goals.
- Speed: Success can sometimes depend on how fast changes can be designed, implemented and successfully completed. The capacity for action, sense of urgency, and ability to respond rapidly must be evaluated and compared against the requirements for accomplishing the company's new goals.

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There are books to be written on the relationship of each of these factors to effective due diligence and successful merger integration. A few highlights are provided in this brief article.

Everything is related to everything

Each of the success factors listed above is related in a number of ways to all of the other factors. The simplest interrelationships are these:

- Cultivating a correct perspective for the transaction, defining a compelling business rationale that is normatively correct, and designing appropriate management and organizational structures – all need to happen very early in the process. Each of these elements, especially the compelling business rationale, strongly influences the manner in which the balance of the success factors are used in due diligence and in designing a good merger integration program.
- Rapid and substantial attention to overcoming resistance, maintaining retention and building commitment all contribute immediately to productivity issues. Good programs to deal with retention, resistance and commitment will result in smaller and shorter decreases in productivity than would otherwise be the case.
- Communication, leadership and speed are the primary vehicles with which merger integration is accomplished and are, therefore, appropriate subjects for thorough evaluation during due diligence.

Compelling Business Rationale

There must be a business rationale for the transaction that is compelling and inspiring. This rationale forms the purpose of the new entity that is being created. It is the centerpiece of all communication. It must describe the business purpose (that which is to be accomplished), the strategy to be used in accomplishing that purpose, why that will win in the marketplace, and why all of this is good for everyone who has a stake in the company.

Once the compelling business rationale is defined, organizational and management structures can be designed and implemented. Then work can flow much easier in maintaining retention, overcoming resistance and building commitment.

Productivity is another word for performance

Improving the overall performance of the company is usually the basic reason for any major transaction. In the time frame immediately after a major transaction is announced the most obvious indicator of performance is productivity.

Deal with productivity issues head on. Share expectations for productivity and performance candidly with the work force. Begin immediately with a well designed program to overcome resistance to the changes that are going to occur in order to make the transaction successful and realize more of the full potential of the company. And, carry out an aggressive program of retention carefully targeted at key individuals and those with competencies essential for the immediate and long term future.

Resistance: Changes are unsettling and resistance to change *always* occurs! Know that resistance is out there; invite it into the open. It is better to know the nature of the resistance so appropriate actions can be taken. Driving resistance underground merely compromises the company's ability to deal with it.

Recognize that it is human nature to resist change. Craft a good program filled with information about the "why" and "what" of the changes. Pursue that program tenaciously until all changes are fully implemented. Along the way, reinforce the behavior of those who respond well to the changes; make it clear that the changes are going to occur; and to those having difficulty with the change, listen and provide assistance to help them deal with the changes.

Retention: With any major change, people re-evaluate their options. Talk to any HR professional; they will affirm that it is much less costly to spend a lot of extra effort on a well designed retention program than it is to replace people who leave. Compose an individualized retention program for each person who is key to the success of the transaction and the new, improved business entity. Know which human resources are essential to success and make an investment in retaining them.

Leadership: Ultimately, it is the job of leadership to make the transaction a success and to realize the new, more aggressive, strategic business goals of the improved company. This is accomplished by building commitment within the work force to the company's new strategic goals and objectives. The compelling business rationale and a proactive and intense communication program are the keys to making this happen.

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Tell people "why" by being able to explain the business rationale in a compelling way to everyone in the company at his or her level. The communication program should be crafted to: (1) find out what people are concerned about, (2) address those concerns, and (3) share as much information as possible as soon as possible.

Top leadership must be very personally involved in the communication program. All leaders must be coached to *under promise* and *over deliver*. And, the effectiveness and success of the communication program must be accurately monitored on an on-going basis.

Conclusion

Merger integration and effectively managing the changes associated with any major business transaction are not easy. Neither is the soft due diligence required to identify and evaluate the elements required for success. However, the risk of failure is high and the consequences of failure in these aspects of important transactions are significant.

Make the investment to do things right. It is much better than the likely alternative. Be organized. Obtain the right resources and commit those resources. Monitor the process, and expect and measure results. Look for ways to accelerate the change process.

Expect uncertainty and a certain level of discomfort. Be candid and know that it is okay to admit that you do not have all of the answers just when people want those answers. Changes generate energy. Be pro-active to channel this energy in a positive direction – do not allow it to *go negative* through inaction. The new mission, goals and strategies point the way to doing this. Help people take responsibility for being a part of finding new ways to meet challenges and accomplish the new company goals.

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