Middle Market Methods™

Value Creating Solutions in Private Equity

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A Tale of Two Integrations

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Integrations could result in the best of value-creation times—or the worst of value-destruction times. (Apologies to Charles Dickens for the pun.) Deal teams deftly analyze the buy versus build decision relative to their investment thesis hold period. Indeed, roll-ups to defragment an industry segment is a common strategy. Consequently, acquisitions are common in the lower middle market. Despite Bain & Company's ("Bain") observation of general improvement across the private sector in realizing the projected economic benefit of acquisitions, the statistics still show significant execution risk. Integrations are much harder than they look. Boston Consulting Group ("BCG") imparts that about half of integrations fail to meet expectations for value-creation.

Why are integrations so hard? The shortlist includes:

- *Inexperience.* Leadership teams may have never been exposed to an integration, much less being responsible for doing one. McKinsey & Company ("McKinsey") indicates that only one in five acquisitive companies possess the requisite integration experience. Accordingly, there is an inherent skillset deficiency. Not surprisingly, BCG reports a strong correlation between experience and results.
- *Bandwidth.* Employees had day jobs before the acquisition integration "opportunity" appeared. Excess capacity to tackle an integration simply does not exist. Even so, key employees must make time and/or non-integration competing priorities must be triaged. Procrastination is an anathema to realizing integration synergies.
- *Change-management.* All change requested of employees tends to be greeted with suspicion unless/until a compelling case is made for why the personal impact of change is neutral-to-good. This is particularly problematic for integrations whose rationale may be cost reduction from functional consolidation. Even though cost reduction from consolidation may not be part of the integration strategy, skepticism prevails until the appropriate, credible messaging gains traction.

This newsletter installment shares some field-tested tools and techniques that mitigate middle market acquisition integration execution risk.

The Acquisition Strike Zone

Among the intriguing discoveries of the Middle Market Methods (“M3”) practice is the frequent disconnect between deal teams and portfolio company leadership teams on the characteristics of an acquisition best fit. Simply put, many do not invest the time to define a strike zone. Whereas certain criteria addressing product/service complement and geographical expansion may not be contentious, the fact remains that most integrations fail to meet economic expectations due to cultural conflict. The majority of small businesses encountered by M3 have not rationalized their cultural framework, including corporate values that will guide the organization through pursuit of the investment thesis. If the same is true of the acquisition target, then how do the parties determine compatibility?

The solution has four parts. *First*, the portfolio company acquirer should be able to describe its own culture and leadership style. *Second*, diligence should capture the cultural descriptors for the company intended for acquisition. This should be done by a vendor with the proper credentials. *Third*, the acquiring portfolio company leadership team and the private equity deal team should assess the compatibility of the two—with the assistance of the vendor. *Fourth*, a plan should be formulated for how any disparities should be reconciled should the transaction consummate. Indeed, the disparities may be irreconcilable. Therefore, and unless the integration plan entails some major maneuvers to engineer compatibility, the wiser move is walking away from the transaction because the odds are against success.

The acquisition strike zone aligns stakeholders on the characteristics of a good fit.

Planning Before Owning

Buyers should commence planning during diligence—irrespective of consummation. This includes what the combined organization will look like and a Day 1 Communications Plan. Why? Acquired company employees want to know three things as a precondition of focus:

- Will I have a job?
- Who is my boss?
- What happens to benefits?

Especially for customer touch-points, reconciling overlap is critical. Customers are inherently suspicious of any communication that starts with “in order to better serve our customers.” Baloney. Double baloney if the customers lose their primary contact.

Consider the Frederick Herzberg motivational model for understanding the employee perspective. Herzberg posited that there are hygienic and motivating factors in the workplace. The hygienic factors are the “must-be’s.” They cannot motivate and may only demotivate by their absence. Unless the demotivators are neutralized, employees cannot focus on the upside. Job security, reporting structure, and benefits are hygienic factors.

Even if the acquirer does not know the answers to some questions, the acquirer is ethically obligated to describe the process by which the “right” answer will be derived—and how those adversely impacted will be treated. Suppose an integration objective is combining two operational platforms into a single location. The buyer may not actually know which site is best, but the odds may be against the potentially adversely impacted employees believing such a claim. How, then, does the acquirer communicate this? The recommended path is creating a cross-functional team that is empowered to explore the alternatives and recommend a solution. Retention bonuses should be provided to key employees who explore the scenarios. Separation packages and outplacement support should be provided to those who may be eventually adversely impacted. The guiding principle must be the Golden Rule: “Do unto others as you would have them do unto you.”

Plan to own irrespective of the probability of transaction consummation.

The cross-functional team approach is recommended for all functions that will be integrated—even if integration does not mean centralization. There are numerous reasons. One is the identification of best practices that should survive integration. Another is change-management: authors of solutions are also protagonists for their implementation. Practically speaking, the project team members have invested personal capital in their recommendation; thus, distancing themselves from their own proposal is unlikely. Identifying counterparts for each integrating function for both acquirer and acquiree ahead of Day 1 (i.e., the effective day of ownership change) is advisable, as announcing the integration teams’ leadership is a subset of the Day 1 communication.

Wait a minute! Are we not in the planning stage? Sure. The point is that Day 1 communication must be ready. Proactive communication is imperative because nature abhors a vacuum. Leaders never fully recover playing defense in response to false messaging that inherently floods informal communication channels.

Project Management

Generally speaking, project management is one of the most unheralded skillsets in business. Integrations are the poster children of project management. Integrations are complex. Not only are there complexities within functions, but there are also complexities across functions. These complexities include critical path issues, i.e., a requisite order of events for accomplishing the objective. Depending on the complexity of the business model, the inventory of integration plan tasks ranges from several hundred to a few thousand. (Yes, a few thousand!)

The integration governance mechanism is a shadow of the general organizational governance model. A steering committee referees any points of contention. A sponsor (typically the CEO) assures that resources are available, and obstacles are removed. Since no one in the C-suite typically has the bandwidth to lead the integration, a master project manager (a/k/a integration leader) does so by CEO proxy. The integration leader should be a coachable "hi-pot"—a high-potential employee with aptitude, attitude, and ambition who is itching to demonstrate leadership potential. The acquiring CEO might consider the integration leader coming from the acquiree to promote the integrity of the process.

Project management skills are essential to integration—and have value beyond integration.

In light of the high probability that integration skillsets do not reside within the company, the acquirer may opt for an external subject matter expert ("SME"). SMEs endeavor to coach the acquirer to develop integration as a core competency. This is highly relevant and practical for companies who intend to be actively acquisitive.

The Toolbox

Several tools reinforce the probability for success. Some examples are itemized below:

- Non-negotiables

Leaders sometime place a softer edge on the term "non-negotiables" with euphemisms such as "guiding principles." Non-negotiables define what will and will not happen in the integration. The non-negotiables include points like customer retention, consolidated salesforce, a single brand, one benefits package, best practice adoption irrespective of source, and cultural objectives. Non-negotiables are a subset of the Day 1 communication plan.

- Communication plan

Day 1 communication is sacrosanct. Not only does it establish the tenor of the integration, but the Day 1 communication establishes expectations for how the organizations will be kept informed on the progress of the integration process. Additional aspects of the communication plan include a frequently asked questions (“FAQ”) inventory, town halls, and other messaging of predictable cadence.

- Functional team project charter

Charters memorialize the game plan for each functional area. Templates abound. Among a charter’s most important content is scope. Scope depicts what the team has latitude to change versus what is off limits. Another important charter content item is assumptions. Assumptions alert supervisors within a function—as well as supervisors across functions—what resources (typically a people signal) are needed and when in order to complete the integration within the prognosticated timeline.

- RACIX

Jay R. Galbraith promotes a tool called RACIX, an acronym which stands for **r**esponsible, **a**ccountable, **c**onsulted, **i**nformed, and not applicable (**x**). Each company should itemize task inventory per functional area for comparison and contrast. This includes who is ultimately responsible for making sure that the task gets done and to whom the responsible party delegates accountability for doing the work. Sometimes, SMEs (internal or external) must be consulted to get the task done correctly the first time. People not party to the decision, but affected by the decision, must be informed. Finally, some people—the x’s—need to stay out of the way.

The RACIX tool is practical and priceless for revealing how functions of similar names, e.g., operations, differ in how they execute. Present state RACIX for each company is a stepping stone toward creating an integrated future state RACIX. X’s are particularly relevant to future state, as some stakeholders essential to the “old” way of doing something are no longer involved for a particular task according to the future state way of doing something.

- Workflow diagram

The Chinese proverb that a picture paints a thousand words is highly relevant to successful integrations. A cross-functional workflow diagram in Microsoft Visio clearly depicts the order-to-cash cycle for the business model. Analogous to RACIX, the workflow diagram can pictorially depict each company for comparison and contrast toward a future state version of workflow.

- Gantt chart

A Gantt chart is a timeline representation of the project plan for traversing from the autonomous present states for each company being integrated toward the stable future integrated state. Microsoft Project is the software staple among the project manager community. Data elements of a project plan include task specification, ownership, start date, end date, and critical path. Critical path, or “predecessor” in Microsoft Project parlance, establishes task order. For example, suppose three tasks each take 30 days to complete. Further suppose that the tasks must be completed in a particular order. The Gantt chart tool makes clear that completing the three tasks will consume 90—not 30—days.

What About Dickens?

Will Rogers was perhaps a more colloquial and humorous philosopher than Charles Dickens. Rogers quipped that “good judgment comes from experience, and experience comes from bad judgment.” The acquisition integration wheels need not be reinvented. Simple tool adoption may avert a complex mess. Whether an integration leads to the best—or worst—of value-creation times is a matter of adherence with best practices. Those who eschew best practices invariably feel the pain of value-destruction. Remorse may be insufficient for full recovery. Those who embrace best practices are not immune to obstacles and impediments, but they are more likely to realize the benefits of the envisioned value-creation for the integration.

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