

# JOURNAL OF BUSINESS STRATEGY

January/February 2001

## M&A RISK MANAGEMENT

Michael Connor

*Integrating knowledge assets, not hard assets, requires the most care when combining two businesses.*

**B**usiness arithmetic is different from the arithmetic you learned in school. The combination of two companies never seems to equal the sum of the parts of the two companies. It's either more or less, two and two never quite resulting in a nice, predictable four. Sometimes, happily, a successful five appears, other times a disappointing three or even a disastrous, terrible two.

But as our economy makes the transition from its long-traditional manufacturing focus to one based on service and information, a comprehension of the realities of business math is fast emerging as a critical skill. The true value of such business combinations as mergers, partnerships, and acquisitions increasingly depends upon the successful combination of knowledge, experience, ideas, know-how, innovations, patents, and processes, and not on the historic yardstick of hard assets. Such deals can no longer be merely "earnings positive," they must be "knowledge positive" as well.

LSI Logic Corporation, for example, a preeminent supplier of custom high-performance semiconductors, in 1998 bought Symbios, a pioneer in small computer system interface (SCSI) technologies. One year after the acquisition, Chris Dixon, director of Strategic Customer Marketing at LSI Logic, highlighted the knowledge value of the Symbios deal. "Customers perceive us as being a much stronger company than we were before the acquisition," he said, "recognizing that our IP portfolio can help them advance their businesses like no other company can."

But with this trend toward knowledge positive deal making come pitfalls as well as rewards, challenges in valuation and in implementation previously not encountered. More than ever,

deal makers must provide meaningful, accurate valuations for ethereal attributes such as knowledge—and not just plugs for presumed synergies. Boards and executives, and managers at all levels, must implement the transfer and combination of knowledge, seeing to it that knowledge-based assets do not get lost in the transition and ensuring that two and two do indeed make a high-performing five.

One way to succeed at this is to employ methods for managing "implementation risk," that is, the risk that a strategic project such as a merger or acquisition will neither proceed as planned and budgeted, nor achieve its targeted (or promised) return on investment. Since it is an axiom in business that a high percentage of proposed company combinations don't work out as planned, this is not an idle endeavor. In fact, it's been estimated that as many as one-third of all projects today are cancelled before completion.

### Understanding the Human Component

Employees in combining firms typically express doubts and fears about the feasibility of the project, the impact it will have on the organization, and the impact it will have on them individually. For example, almost every newly initiated project rates low in credibility with many of the employees who will be affected, who see the plan as just another management fad unlikely, in the end, to be carried out. As a senior manager once observed, "The further you get from the mother ship, the more everything looks like the program of the month."

Moreover, many employees pessimistically expect that even if the plan were carried out, it would deliver only marginal benefits to the overall company while making their own

situations worse. I observed a striking case of this when two Fortune 100 companies combined in 1999 to form a \$24 billion diversified technology and manufacturing company. Billing the merger as “the powerful combination of two diverse global leaders with complementary strengths,” industry analysts alike agreed the new, combined organization would become “a powerhouse.”

## More than ever, deal makers must provide meaningful, accurate valuations for ethereal attributes such as knowledge—and not just plugs for presumed synergies.

Inside one of those companies, however, one heard a different assessment. “Will the work we do today still exist in the future?” asked one plant worker. “Will my position still exist in the future?” posed another. Their manager added, “We’re unsure of the requirements for new jobs. Will they be based on experience or degrees?” Yet another wondered, “If you don’t have the ‘piece of paper,’ are they going to give your job away to someone who does, even though you may have all the experience?”

Largely psychological and social, the implementation risk brought on by such employee mistrust is especially prevalent in knowledge positive business combinations. Hard assets can be transferred with the stroke of a pen. But truckloads of organizational knowledge and know-how can only be taught, person to person, often over a period of months or years. John Brown, Group Chief Executive of BP Amoco, has noted, “The wonderful thing about knowledge is that it is relatively inexpensive to replicate if you can capture it.”

That’s a big “if,” however. Employees of combining knowledge-intensive organizations must be willing and able to talk together, work together, and learn from each other. They can’t, however, if their organizational culture make communication too difficult. If rules and regulations, for example, get in the way of working things out, there will be no cooperation. Employees also won’t be willing to

cooperate if they feel cheated or forced to participate in what they view as their own demise.

Unfortunately for most projects, implementation risk is too easily overlooked. Mergers fail, not because the deals aren’t solid financially or strategically, but because “the human-capital component is misunderstood,” says Dennis C. Carey, vice chairman of the

executive search firm Spencer Stuart U.S. Business executives, bankers, financial experts, and lawyers who make these deals take comfort in numbers and regulations because such elements are graspable, quantifiable, trackable over time, and actionable. But moods, feelings, suspicions, organizational cultures, and social norms? Just the opposite. These are seen as unmeasurable, impossible to track, defiantly unactionable.

### Gauging and Managing Implementation Risk

Such discomfort notwithstanding, real experience shows that the opposite is so. Implementation risks can indeed be grasped, quantified, tracked, and acted upon, even before a business combination is attempted. Doing so permits effective management of such risks as two or more businesses are knit together into one new, larger and more capable organization. A means of accomplishing this is by calculating the combining companies’ “Readiness Quotients.”

Under this method, companies can pinpoint attitudes and social norms that determine organizational acceptance of change, thus indicating how people will behave (or *not* behave). They can conduct Readiness Quotient (RQ) sessions throughout the organization, with anywhere from five to 50 employees per session responding to a very pointed set of questions about their perceptions of the credibility, organizational impact, and individual impact of the business combination. Statistical analy-

sis of their quantified responses yields several useful measurements, including a single risk measure ranging from +100 (good) to -100 (head for the hills) that gauges the likelihood of project success.

RQ sessions are repeated throughout the integration process, a component that is particularly valuable for anticipating emerging problems and flagging commitment. This steady refinement of the change agenda keeps the overall integration process progressing smoothly and illuminating weak spots so that strengthening actions can be initiated to keep the change effort on course.

### Navigating Implementation Risk AFTER the Deal

As a rule of thumb, the credibility of an integration leader following a merger or acquisition depends on his or her ability to act quickly, fairly, and completely. For that reason, this is clearly not the best time to rely on guesses or hunches about what people are thinking. RQ can be extremely useful during the post-merger period to get all the issues out on the table and deal with them quickly and in a credible and effective fashion.

For example, a leading academic medical center bought a physician-owned primary care group in order to improve the center’s competitive position, but after the purchase, it could count few significant results. When an RQ was taken, it was found that that all parties—management team, medical directors, and administrative personnel—were united in doubting that the two parties could credibly become one integrated organization. One director noted, “Top management has to understand that both the organization’s vision and its credibility are in question because our physicians do not believe that the newly combined institution has the requisite skills to make this work.”

These revelations reflected a fundamental disagreement about strategic rationale. While the business managers believed that “working together as a team” was the key to successful growth, the medical professionals believed that “listening to our patients and satisfying their needs” was more

the key. The potential knowledge value of this combination was thus evaporating inside a disagreement about where to properly focus energy and attention: inward on the integration of medical and business personnel or externally in the direction of patients.

Such fundamental disagreements about strategies are prevalent in almost every business combination. Following every deal, management should expect not only conflict and foot-dragging, but honest, downright confusion among employees. A quick, effective “cut-through-the-underbrush” is needed.

### **The credibility of an integration leader following a merger or acquisition depends on his or her ability to act quickly, fairly, and completely.**

For example, the Readiness Quotient program quickly identified in our medical case where the constituencies remained apart.

Such a quick, accurate definition of the obstacles to integration provides the foundation for jump-starting the merger integration process. But such a fast take-off isn't a permanent solution. In a later stage, called Continuous Integration, lessons learned in previous stages are institutionalized, all the while guided and monitored by RQ. In this way, the integration team seeks to ensure the combination's return on investment

by making sure new knowledge positive strategies, structures, and cultures remain in sync over the long haul.

### **Avoiding Implementation Risks BEFORE the Deal**

As for the initial valuation stage, in knowledge-positive deals, implementation risk is too often treated cavalierly or naively when not ignored altogether. For all of the energy that goes into the analysis of potential synergies, far too little time and thought are devoted to planning how the new organization will gain and retain these

synergies and what stumbling blocks might be expected. In the words of one manager from an acquired company, “I didn't know how strong our culture was until we were acquired.”

Given such high risk that knowledge value might be lost in the implementation of a merger or acquisition, companies should quantify that risk beforehand and factor it into both the valuation and the ultimate decision to combine or not to combine. Benefits of such an assessment will include:

■ Increasing the accuracy of the valuation, by gauging the level of risk that

people could walk right out the door following the merger, taking their “know what” and “know how” with them.

■ Providing a valuable counterweight to the emotional forces at work during the pursuit and pricing of a deal.

■ Allowing a deal to include some kind of fact-based integration strategy: What plans need to be put in place to make sure it all turns out knowledge-positive?

■ Convincing the dealmakers to, in some cases, turn down a deal that looks good initially on paper.

Business combination is and will always be an extremely delicate and tenuous process. For success, a principle key is to identify and understand as quickly and completely as possible the stumbling blocks that may impede integration and slow the accelerators needed to move things forward. Only by employing such methodology can knowledge positive deals be navigated in a manner that allows managerial efforts to be fully in focus where and when they will matter most. ♦

---

*Michael Connor is managing director of Meridian Consulting, a Boston-based management consultancy specializing in the design and development of business processes and enterprise-level technologies that build business value. Email: [mconnor@meridian-us.com](mailto:mconnor@meridian-us.com).*