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Perspectives on merger integration
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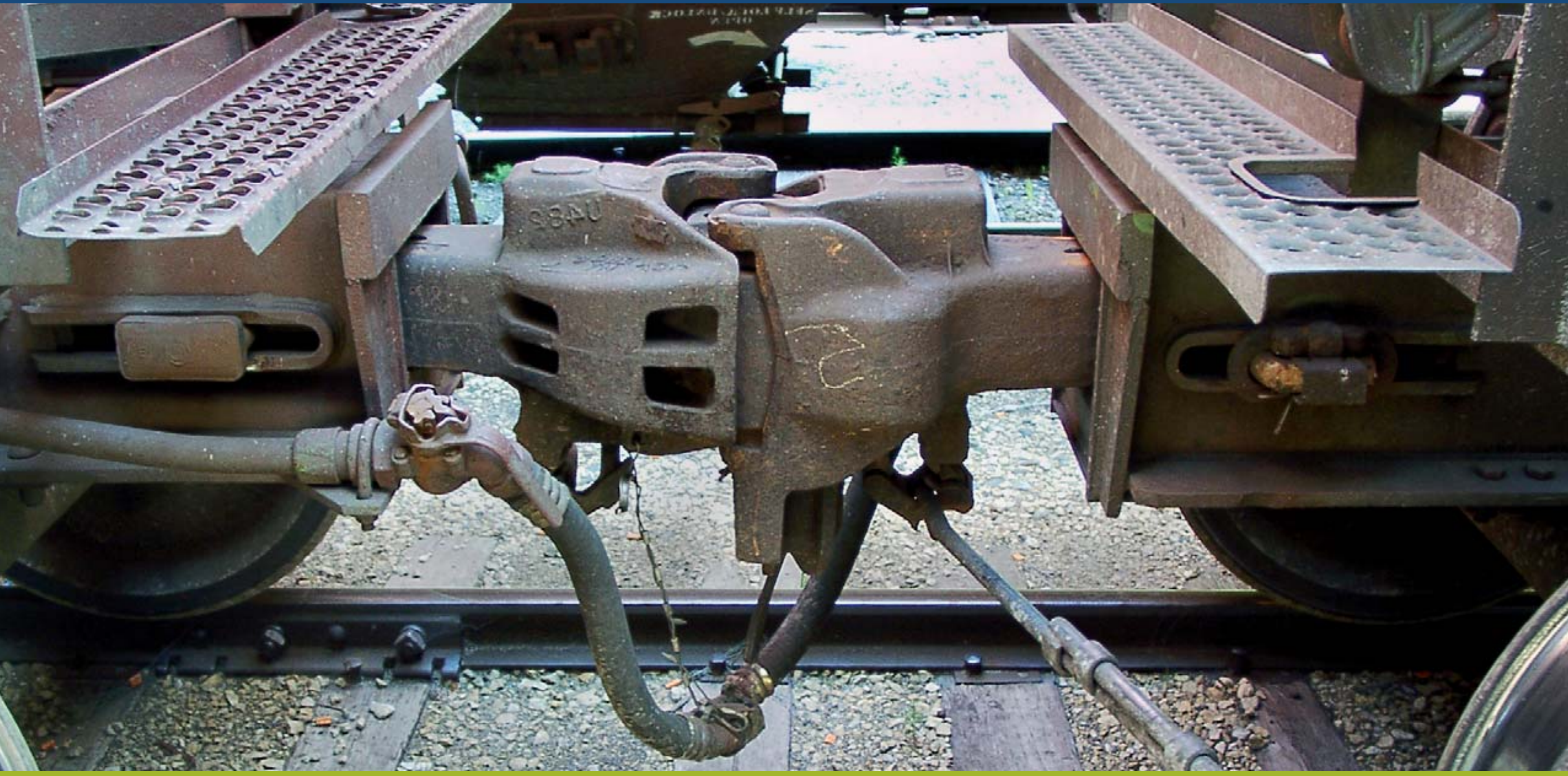
A McKinsey perspective on creating transformational value from mergers



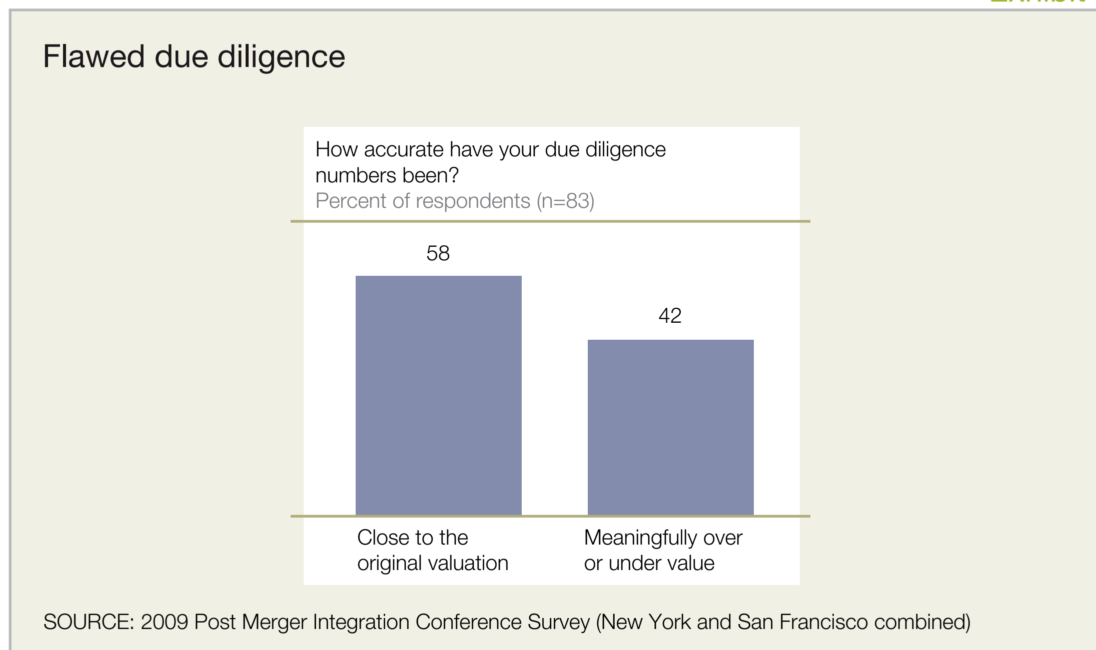
Beyond risk avoidance: A McKinsey perspective on creating transformational value from mergers

By James McLetchie & Andy West

Most mergers are doomed from the beginning. Anyone who has researched merger success rates knows that roughly 70 percent of mergers fail. Over time, this statistic has created an entire culture and practice of merger integration focused on avoiding failure: processes, IT solutions, checklists, and workplans, all crafted to ensure that integration avoids doom by sticking to its plan. "Don't overcomplicate integration" is a common mantra. "Just follow the process and you will not fail" is another.

The problem is that avoiding risk can conflict with realizing the full value at stake in the merger. The issue begins with the fact that due diligence has only limited ability to set accurate expectations of the total synergies available in a deal. A recent McKinsey study found that 42 percent of the time, due diligence conducted before a merger failed to provide an adequate roadmap for capturing synergies and creating value.

Exhibit 1



In addition, the risk-avoidance mindset usually translates into an intense focus on pure process that can actually hamper an organization's ability to adapt and capture emerging or unforeseen sources of value from a deal.

For example, in one unsuccessful software deal, a relentless focus on running the process limited discussion of the real opportunity, which lay in leveraging two very different sales models for top line growth. Specifically, integration teams concentrated almost entirely on tracking detailed interdependencies, leading to pages and pages of process analyses. Integration leadership spent relatively little time thinking about the game-changing opportunities to create value, e.g., driving implementation of new but practical approaches to cross-

selling. In this case consistent over-attention to process and under-attention to value creation resulted in the merged company's stock price lagging the market and its primary competitor.

Yet M&A is critical for long-term survival. McKinsey research found that acquirers who truly outperform over time strike the right balance between traditional best practices, or "combinational" activities, and "transformational" activities – those that maintain the flexibility to identify and capture new sources of value which emerge during integration planning.

Great integrators begin by distinguishing between combinational and transformational opportunities and then pursue them in tandem. To generalize, successful integrations capture combinational value, but the best integrators find specific transformational opportunities that go beyond these basic synergies to create tremendous additional value.

Striking the right balance – implementing traditional best practices where appropriate without limiting flexibility where required in the search for value – requires three actions that go beyond risk avoidance:

- Taking an expanded view of value during integration and setting the right stretch aspirations and targets
- Looking beyond current integration approaches to capture targeted opportunities for transformation
- Committing fully to targeted transformational efforts.

One caveat: this article focuses on capturing value from mergers, not pricing them. Acquirers are rightly risk-averse in what they pay for, and pricing inherently risky transformational value into a deal before integration planning has taken place is not necessarily appropriate. But once a deal is concluded, restricting integration planning to the necessarily conservative synergies that formed the basis for the transaction price is equally unwise.

Taking an expanded view of value and setting the right stretch aspirations and targets

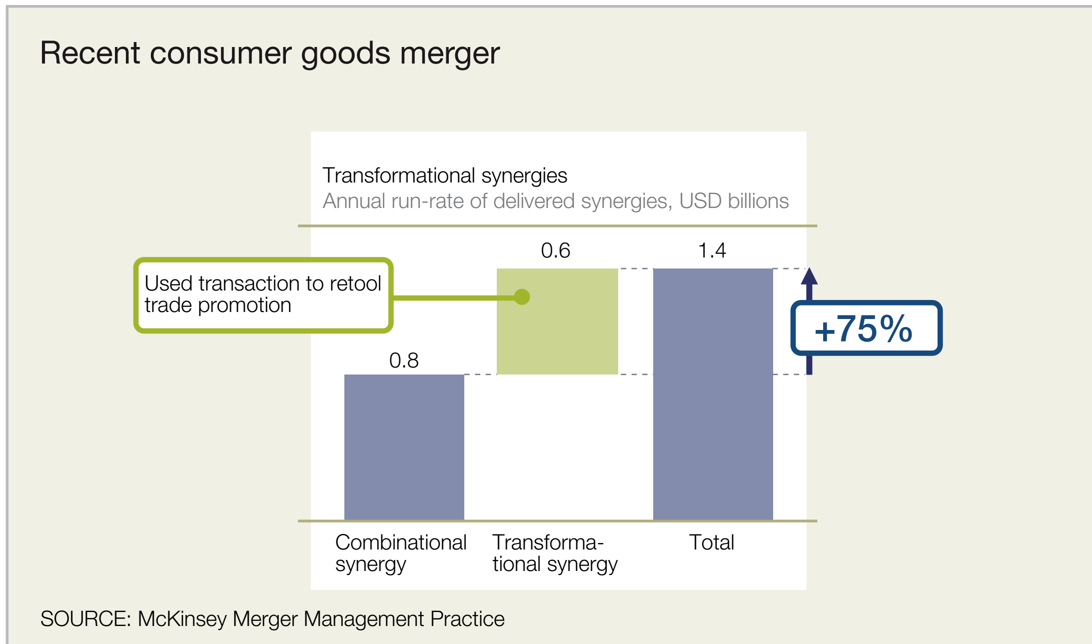
To understand the sources of value in deals, we organized all value into two categories – combinational and transformational. While this is an obvious oversimplification, it reflects genuine tendencies in most mergers and enables us to identify characteristics that differentiate truly successful mergers from merely average ones.

Combinational synergies rely on merging operations, resulting in scale economies and/or basic scope economies (for example, cross-selling existing products), as well as protecting value by ensuring business continuity. These synergies are the least risky, easiest to quantify, and most easily managed with a repeatable process (such as synergy benchmarks). They also represent the type of value that is most often the cornerstone of valuations. Not surprisingly, most integrations work predominantly on combinational synergies – often underplaying more complex, more profitable sources of value.

Transformational synergies, in contrast, typically come from unlocking one or more long-standing constraints on a business. This change can come from the impact of the merger itself or the role it plays in "unfreezing" the organization. Transformational synergies represent huge potential for breakthrough performance.

But because transformation involves complexity that often exceeds management's capacity, it can also bring the business to a grinding halt. Management needs to focus selectively – on a handful of targeted functions, processes, capabilities, or business units that make breakthrough performance possible and financially worthwhile.

Consider the recent merger of two major consumer goods companies. Recognizing the superiority of the target's innovative approach to distribution management, the acquirer assigned its top integration team the task of figuring out how to incorporate that approach into its own entrenched distribution practices. Their success boosted the value of the deal 75 percent.



Companies contemplating transformational synergies must assess their readiness to capture each opportunity but must not shy away from an opportunity simply because it looks risky or falls outside a pre-set process or due diligence baseline.

The McKinsey study built a database of large transactions (where the target represented a meaningful enough proportion of the acquirer's business to affect share price) and identified a subset of companies whose performance improved significantly after a merger or acquisition. Profiling several of these companies in detail showed each able to move beyond combinational sources of value and find something truly transformational to capitalize on.

Consider a recent high tech merger in the top portion of the performance profile. An entrepreneurial, low-cost manufacturer with a presence limited to one region acquired a player with a larger global brand and leveraged that company's network for high-margin leadership in all markets.

The company not only did an adequate and structured job in approaching the combinational aspects of the merger, but also made significant investments in ensuring the realization of the more transformational aspects of the deal. The company replaced over 35 percent of the senior management team with outsiders expert in realizing the new vision of the organization. Corporate headquarters moved from the acquirer's geography to a new geography that represented the future of the business. The company also seized the opportunity to radically change its go-to-market model and supplier relationships.

Early realization of significant cost synergies, e.g., procurement and supply chain, funded the more transformational strategic shifts, but the view from the beginning had been that the deal should trigger transformation. The result was major value creation. Whereas the acquirer's total return to shareholders had lagged the industry by an average of 42 percent in the two years before the merger, it outperformed the industry by 27 percent in the two years after the deal.

Another example is an automotive merger that created tremendous value by rebuilding the acquired company's traditional relationship-based procurement system, replacing it with a profit model that

cut costs dramatically. The combinational aspects of the deal did not go ignored, but they also did not prevent the organization from dismantling a process and program that represented 20 years of operations excellence. The effort helped to define the company as a global player – embracing a new model that represented the next 20 years of procurement excellence.

Simply focusing on bringing existing programs together or absorbing the acquired processes into the parent's would have been much easier, but would have meant less risky integration at the cost of truly transformational value. The chosen course required radical change in the company's culture and real leadership and focus by the executive team, but was clearly worth the investment

Looking beyond current integration approaches to capture targeted opportunities for transformation

Just as combinational and transformational synergies differ in nature, so do approaches to capturing them. For example, the mantra in pursuing combinational value is: simplify, de-risk, be practical, do things fast. Value comes from managing and effectively limiting options, instead of creating new ones, and moving quickly to prevent the integration from distracting attention from "real" business. The focus is on managing process and ensuring that baseline joint operating capabilities are in place on day #1. Best-practice managers seek to:

- Limit the changes in how a business runs before and after legal close
- Focus ruthlessly on hitting announced, typically conservative synergy targets
- Deploy ever more refined process management tools to ensure that, as one leading serial integrator put it, "we never invent anything twice or make the same mistake again."

Capturing combinational value in these ways is the appropriate territory of classic program management offices.

Transformational approaches, on the other hand, are usually far more fluid and experimental, as they reach into unfamiliar territory and likely involve unusual combinations of people, process, and technology. Transformational value creation can therefore be quite disruptive for those involved.

Transformational activity typically proceeds on a longer timescale, allowing time for brainstorming, testing, piloting, and building capabilities. Maintaining momentum and energy usually requires some early wins to earn permission for transformation, but efforts to capture transformational value are likely to run well beyond the traditional 90 days of integration planning.

The success of transformational approaches typically hangs on:

- Creating a cross-functional team dedicated to locating breakthrough opportunities
- Setting bold goals for value creation
- Providing incentives with real upside for breakthrough performance.

Capturing transformational synergies demands disproportionate senior executive time. The CEO in the consumer goods merger mentioned above met twice as often and twice as long with the breakthrough team lead than with the leads of the other 12 integration teams; the breakthrough team delivered more than 40 percent of the total synergies.

Setting aspirations involves more than setting a high target – it's about stretching people along multiple dimensions and rooting the stretch in well-investigated facts. Managers should start by systematically exploring synergy ideas across cost, revenue, and the balance sheet. They should ground the aspirations in analytical insight, not gut feel, to avoid having to negotiate what is or is not a reasonable stretch.

The best examples we uncovered used the analytical process of setting synergies not only to anchor but also to ratchet up aspirations. After reviewing detailed synergy plans and realizing that a different organizational

construct could yield far more value, one CEO demanded that certain teams linked to his transformational themes come back with "twice the synergies, delivered in half the time." While hugely challenged, they delivered. (See the sidebar on cross-functional synergy workshops.)

Transformational efforts typically run in parallel with established integration processes, so each approach can operate at its full potential. To understand how these efforts can work in parallel, consider a global mega-merger with a multi-billion-dollar cost synergy commitment. In a two-day synergy workshop, leaders identified, quantified, and prioritized both combinational and transformational value levers.

The combinational levers included plans for immediate reduction of overlapping headcount and overhead costs and procurement synergies arising from consolidating vendors and reducing duplicative spend on marketing and IT.

The team also defined a number of "model-shifting" initiatives, including a new industry-changing sales force model to deliver more product to customers more efficiently – in other words, having a smaller sales force get more product into customers' hands. The shared services team located opportunities to redefine the support model far beyond existing practices, capitalizing on opportunities in sales administration, IT, procurement, finance, legal, and even R&D. Other teams found other such "radical" ideas. In all, these ideas generated an additional 30-50 percent in revenue growth and cost reduction opportunities.

The company implemented the sales force model just after deal close and sequenced the shared services changes after a major ERP initiative. By looking at the deal and sources of value early and more comprehensively, integration leadership defined and sequenced the transformational opportunities in line with the immediate combinational plans.

Cross-functional synergy workshops

Many companies contemplating their merger options find that they get farther faster by organizing synergy workshops of cross-functional teams than by completing cycle after cycle of business plan templates. In a recent pharmaceutical merger, this approach uncovered almost 40 percent more synergies than a rigorous bottom-up spreadsheet-based approach had identified.

These one- or two-day workshops look for ways to meet synergy targets and then create realistic plans for achieving the targets.

The teams develop initial ideas for reaching the targets, analyze data to see if the ideas will work, and then brainstorm options that might capture even more value. The focus is on new ideas and challenges, not numbers.

The entire group reviews the ideas and agrees on which to pursue. By the end of the workshop, targets are often reset at higher levels, and people have committed to the plans.

These workshops are intense, but people are energized by the opportunity to engage with colleagues in shaping ideas. They leave with much greater ownership of the targets and plans – partially because they had the space to debate concerns about what could and could not work. There's also a palpable sense of relief at not having to fill in yet another template.

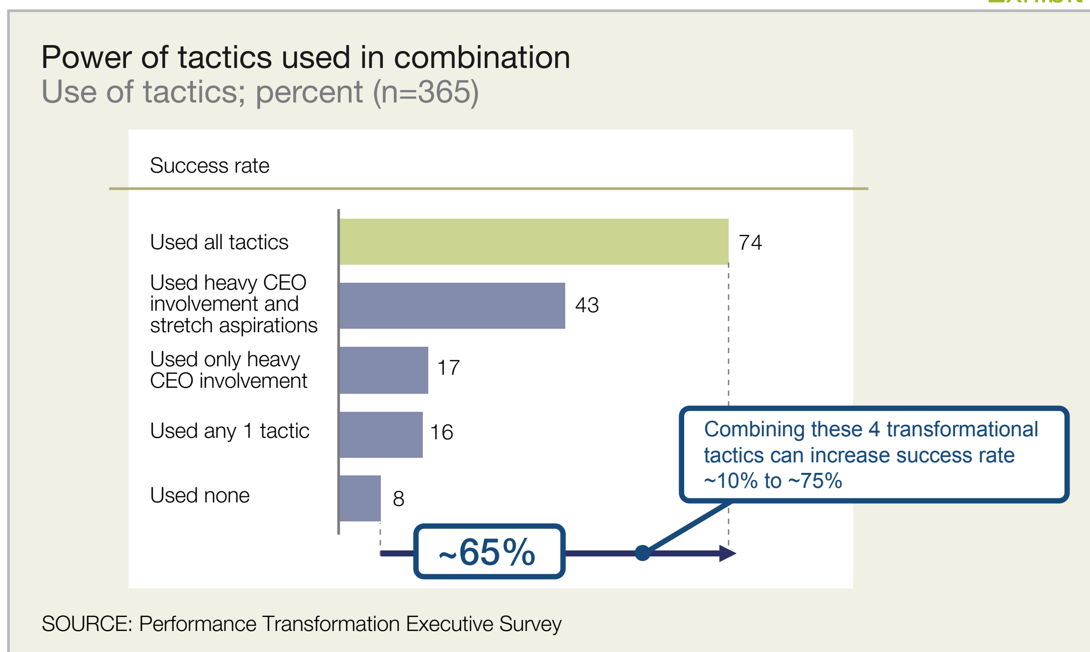
Committing fully to targeted transformational efforts

The courage to move beyond risk avoidance is the starting point for creating transformational value in a merger. When pursuing transformational synergies, successful companies expand their core integration approach in four ways:

- The CEO or business unit leader participates actively in the effort to capture transformational value (for example, by personally leading key initiatives).
- The company sets clearly defined stretch aspirations, in financial or operational terms, that represent a genuinely new level of performance.
- Staff feel ownership for changes, do not focus excessively on process, and are energized and mobilized to develop new ideas to create value.
- The integration has a readily understandable structure, with distinct responsibilities and parallel efforts to pursue combinational and transformational sources of value.

A recent study of over 365 managers involved in 310 deals between 2003 and 2008 found that success requires commitment to employing all four tactics. Mergers that did so were much more likely be self-rated "extremely successful" than those that deployed only one or two tactics.

Exhibit 3



Mergers offer exciting opportunities to shape new business models, innovate, ramp up growth, and deliver breakthrough performance. While classic integration management is essential for controlling the many risks that mergers create, it often stands in the way of the complex, strategic efforts needed to capture transformational opportunities. Those efforts require unparalleled aspiration and commitment from CEOs and other senior leaders, often repaid with the most memorable moments of their careers.