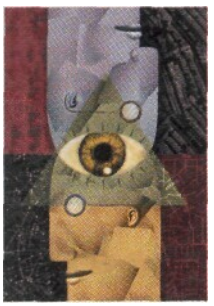
Integrate Where It Matters



Many studies have shown that the most treacherous time in the failure-strewn business of mergers comes after two companies tie the knot, when they attempt to combine operations. Surprisingly, however, they often destroy value not as a result of inattention to detail but through excessive zeal in their integration efforts.

That's because acquirers, recognizing the many potential dangers that lurk in the merger process, often attempt to immunize themselves by painstakingly mapping out comprehensive, detailed plans for blending every aspect of operations. What they don't realize is that in following their careful, well-intentioned efforts, they could be digging their deals into the grave. The reality is that too much integration can block companies from realizing the benefits of a merger just as easily as too little can. And, in some cases, overintegrating can do far more damage.

Consider Novell Inc.'s $855 million acquisition of WordPerfect Corp. in the 1990s. The marriage between the leader in the corporate networking market and one of the historic front-runners in word-processing applications was intended to create a formidable competitor to Microsoft Corp. Once the deal was signed, Novell launched a broad and extensive integration program. "The devil is in the details," one Novell senior vice president told *Softletter*, a trade publication of the software industry. As *Softletter* reported, "success [for Novell] depends on thousands of nitpicking decisions that can tie up senior management for a good 16 to 18 months."

In an attempt to attend to all those details and decisions, Novell's management team sought to fully assimilate WordPerfect's different product and service lines, sales groups, culture and business model into its own. But Novell's comprehensive efforts to assert control and impose the Novell personality on WordPerfect's operations sparked intense culture clashes that sidetracked the company. While Novell was preoccupied with trying to keep integration on track, key product launches fell behind schedule. That presented Microsoft with the opportunity to muscle in on Novell's turf and steal market share both in word-processing software and networking products. Novell's performance and stock price dropped sharply. WordPerfect's sales sank 17% in fiscal year 1994, the year of the merger.

In January 1996, less than two years after the acquisition, Novell unwound the deal, selling WordPerfect to Corel Corp. for about one-seventh the purchase price. By then Novell's stock price had been cut almost in half from where it stood the day before the merger was announced. As Novell's experience illustrates, in fast-moving, intensely competitive markets, companies that get bogged down in merger integration can pay a heavy price.

How Much Is Enough?

It's not as if companies are blind to the strategic and tactical thickets that clot the path to successful integration. In a recent Bain & Co. survey of 250 global executives, respondents said two out of the three top causes for the failure of mergers related to integration. "Ignoring integration challenges," cited by 67% of respondents as a major factor in disappointing deal outcomes, topped the list; while "problems integrating management teams and/or retaining key managers," cited by 61%, came in third. Most executives also understand what drives success: 80% of respondents asserted that integration efforts must be "highly focused on where the value is in the merger."

Where the value is — and the lengths an acquirer must go to capture it — varies from deal to deal. To zero in on the value and determine what it will take to realize it, acquirers should turn to the deal's underlying rationale — what the M&A industry calls an "investment thesis" — as a

Many merging companies make the mistake of integrating too much, too soon. In certain cases, a more selective approach is the best way to realize the deal's anticipated value.

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guide. Generally, a deal either enhances the acquirer's core business in some way or represents a completely new and separate platform for investment (known in this case as "active investment"). If a deal enhances the core, it either grows a company's scale of operations (by adding similar products or customers with the intent of lowering costs and growing market power) or expands its scope of operations (by combining companies that offer each other one or several new products, customer segments, channels or markets, and a chance to grow revenues).

To determine what it will take to realize the merger's value, acquirers should turn to the deal's underlying rationale or investment thesis as a guide.

These three types of investment theses - active investing, growing scale and growing scope — require different degrees of merger integration. If an acquired company is the first plank of a new platform, for example, it will probably require the bare minimum of integration. Private equity firms, which acquire companies specifically to improve their value and to exit at a profit by reselling the business or through a public offering, are the quintessential active investors. They typically limit their integration of a diverse portfolio of companies to inserting some new management talent into each business and strengthening financial-reporting requirements. But the type of deals that enhance scope or scale requires executives to pay much more attention to integration.

Selective Integration

Deals that enhance scope require careful integration of the two companies in order to be successful, but only in discrete areas. An acquisition that expands a company's product scope, for example, may require extensive integration in overhead functions and distribution but not necessarily in manufacturing and R&D. The best approach may be to keep lines of business or cultures separate or to impose a new corporate culture only on operations that directly overlap.

Companies that acquire to improve scope and then integrate the firms selectively earn returns above their industry's average. In a recent study, we looked at the scope acquirers whose stock had outperformed that of their industry peers one year after the deal's announcement. We found that all the high performers had blended acquisitions partially or minimally. But when we looked at the scope acquirers whose stock had underperformed, we found that only one-third of them had integrated partially or minimally; the rest had blended companies significantly. While many other factors may contribute to companies' success or failure, the data support the case for selective integration in deals based on scope.

Illinois Tool Works Inc., a frequent acquirer of industrial businesses, provides an excellent example of how less can beget more in scope deals. ITW's main aim is to squeeze value out of complementary assets, rather than to generate synergies by combining operations. W. James Farrell, who became CEO of ITW in 1995, spent over $6 billion to buy more than 200 mostly small, mostly private companies over six years. Today, the Glenview, Illinois-based company manufactures everything from plastic soda bottle carriers to paint sprayers, operating in 44 countries and employing 48,700 people.

ITW keeps its acquisitions almost entirely independent. It focuses on a simple model for boosting the stand-alone efficiency of its acquisitions; it calls the core of this approach its "80-20 process." The idea is that companies obtain 80% of their revenue from the top 20% of the products they sell to a small number of key customers. Accordingly, at ITW's 600-odd small, highly specialized businesses, local managers have broad authority to manage their units with little assistance from headquarters — provided they live by the 80-20 rule and focus primarily on top customers and products.

Rather than blend operations, ITW integrates control functions. Headquarters handles taxes, auditing, investor relations, R&D support and some centralized HR functions. Otherwise, the businesses are self-supporting, with headquarters helping to point them in the right direction. Such selective integration has paid off for the company. From the time Farrell took the helm in 1995, the deals he has struck have helped ITW more than double revenues to $10 billion in 2003. In that same period, the company's stock price increased fivefold.

Less integration has also proved to be a winning strategy for Sears, Roebuck and Co., following its

acquisition of catalog retailer Lands' End Inc. At first, analysts reacted skeptically to the deal when it was announced in the spring of 2002. Though the deal rationale seemed sound — Sears' apparel lines desperately needed the lift that Lands' End could provide — many saw the two companies headed for a crippling culture clash. They wondered how slower-paced Sears could maintain Lands' End's famed customer service and nimble supply chain.

Sears responded by leaving Lands' End largely untouched, integrating only a few back-office functions, like purchasing. "This is not about cost cutting," Sears CEO Alan Lacy wrote to employees. "Sears wants Lands' End to retain its character and momentum." Understanding that many of Lands' End's loyal, affluent customers were uncomfortable with the connection to the low-priced megaretailer, Sears kept the Lands' End customer interface separate, allowing the acquired company to retain its distinctive service style. Instead, Sears focused mainly on selling Lands' End apparel in its stores and sharing information about the combined customer base. By the final quarter of 2002, the introduction of Lands' End clothing had helped boost Sears' retail operating profits by 10%, while Lands' End catalog sales remained as strong as ever.

Comprehensive Integration

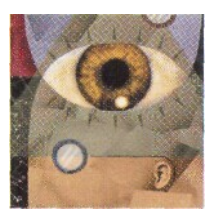
Unlike deals meant to enhance scope, acquisitions that seek to boost scale require extensive integration of operations. Success requires the full integration of all activities to capture the value that inspired the deal. In the study cited above, we also looked at the scale acquirers whose stock had outperformed that of their peers one year after the deal announcement. All the high performers had integrated fully, but less than half of those whose stock had underperformed had integrated comprehensively; the rest had blended companies only partially or not at all.

One well-known, albeit extreme, instance of a comprehensive scale integration is that of British Petroleum Co. Pic's acquisition of Amoco Corp. in December 1998. BP's CEO, John Browne, had observed the mistakes made by other companies that had taken a hands-off approach to integrating their scale investments. He realized that to capture all the benefits in such mergers, "you have to create a single organization with common processes and standards, common values and a way of working which everyone can recognize."

Browne moved swiftly to achieve that goal. Within 100 days of closing the Amoco deal, he had filled all the top management jobs, identified most of the staff reductions — including 10,000 layoffs — and imposed BP's structure and management style on the new company. BP's assimilation of Amoco was so thoroughgoing that it inspired an insider's joke: "How do you pronounce BP-Amoco? Answer: BP. The Amoco is silent." Some senior executives at Amoco quit in frustration. Even so, BP achieved its projected $2 billion in cost savings within the first year, 12 months ahead of schedule. Its stock emerged as a top performer, rising nearly 11% during the first 100 days and outperforming the oil-and-gas stock index by 17% one year after the deal was announced. Such results demonstrate that John Browne was able to master the complexity of assimilating one company into another and capture the full benefits of increased scale.

Blending Rationales

Some deals blend objectives. For example, an active investor may invoke the benefits of scale before "rolling up" several companies in an undervalued industry and later exiting. And rationales for corporate deals may incorporate elements of both scale and scope. When blending objectives, it's especially important to set priorities for employees, customers and shareholders regarding where and when integration is needed in order to achieve the gains predicted by the investment thesis. The experience of Philips Medical Systems, the medical-diagnostic and patient-monitoring unit of Royal Philips Electronics N.V. of the Netherlands, shows how to do that.



Philips Medical makes imaging products, such as ultrasound and MRI equipment, and competes fiercely with Siemens Medical Solutions and GE OEC Medical Systems Inc. Between 1998 and 2001, Philips Medical acquired four companies in rapid succession. The rationale was that as hospitals formed buying groups to cut costs, Philips needed a broader product line *and* greater market share to stay competitive. The acquisitions moved Philips from a distant third-place position to parity with Siemens, the number two player, and filled critical gaps in its product line.

Capturing the benefits of this roll-up required a major integration effort. In October 2001, with

the last of the deals completed, Philips deployed 17 "synergy search-and-rescue" teams over a six-month period. Their mandate was to identify the greatest potential for both cost savings and increases in revenue.

From an initial list of about 500 initiatives, the teams first pursued the highest-payback tasks, such as integrating individual product lines. They delayed the longer-payback ones, such as redesigning the imaging technologies supply chain or integrating the sales force for products that required different selling skills. Throughout the process, William Curran, former CEO of Philips Electronics North America Corp., which oversaw the Philips Medical Systems program, kept his colleagues focused on the biggest prizes. "I admit that we paid less attention to the teams where the cost synergies were small," says Curran. "We were off doing the job where the money was."

After five and a half months, the teams had identified three times the synergies (cost savings and higher revenue) originally quantified. The largest payback came from IT integration; the next largest from combining the sales and service staffs for CT scanners, X-ray machines and MRI machines. Philips Medical surpassed its goal of achieving €230 million in synergies by 2004, announcing the realization of €342 million in February 2004.

The Flip Side of Focus

By focusing integration efforts, companies not only reap the benefits of the merger sooner; they also counteract a force that often derails deals: employee distraction. As the Novell experience demonstrates, the gravitational pull of integration activities can draw attention away from the base business — just when companies are most exposed to competitor attacks. Limiting integration efforts helps frontline employees keep their firepower focused, a critical element of merger success. Indeed, the most successful mergers allocate no more than about 10% of managerial talent to the integration effort. They wholly dedicate just a handful of leaders and keep other managers abreast by involving them in steering committees that meet regularly.

Those are principles the leaders of Singapore-based Keppel Offshore & Marine (KOM) clearly understood when that company was formed through a merger of two businesses in 2002. The two outfits, Keppel FELS Energy & Infrastructure Ltd., which builds and repairs offshore rigs, and Keppel Hitachi Zosen Ltd., which repairs ships and converts container ships into oil storage vessels, were both majority-owned by the Keppel Corp. and had partly overlapping businesses that occasionally even competed against each other. Because 2002 was a boom year for the industry, KOM's CEO, Choo Chiau Beng, realized he could not afford to let integration efforts distract the staff from landing contracts and completing projects on time and at cost.

Choo kept employees focused by naming the company's new leaders early, integrating only a few, high-return functions and making strategic use of incentives. In the combined company's first year, he handed out 10% of all integration-related savings — which totaled close to 20 million Singapore dollars — not only to members of the small integration team but also to others who kept the base business humming.

Choo's efforts paid off when the newly combined company won an order during the integration process itself — one that the firm's leaders felt they clearly would not have won before the merger. And despite the incremental costs that are associated with any merger, Keppel went on to achieve record results in 2002, with combined revenues up 35% and profits up 169% over 2001. Further, Keppel exceeded its cost-saving and revenue targets by 100% within six months of the deal's close.

In the end, acquirers like Keppel, BP, Philips, ITW and Sears know from experience what many deal makers have suspected all along: that successful merger integration can make or break a deal's trajectory. But they also know something that only a much smaller group of companies understand: By integrating only where it matters most to sales and profits, on the basis of their investment thesis, they can vastly improve their odds of merger success.

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