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TITLE:

The Value Proposition for Mergers and Acquisitions (M&As)

ABSTRACT:

This study postulates the challenges corporations face in remaining focused on the core value proposition and benefits that were identified in the pre-acquisition stage of a M&A. Too often, it takes a considerable amount of effort and tenacity to convince corporate leadership in the executive board room of the importance for effecting an IT assessment early in the M&A process. While the executive leadership almost always supports financial and/or operational due diligence, IT assessment due diligence, is often neglected until the post merger phase or later.

Several mergers and acquisitions were identified and analyzed and the results consolidated. This paper expounds on the cultural and organizational factors that often contributes to and results in the acquiring organization not being as prepared for a costly and problematic IT integration months or years after the sale was sealed. Notwithstanding the synergy that is to be gained from the acquisition and the financial benefits that are often meticulously calculated, efforts to merge two or more systems that were never assessed and planned for may erode all business synergies and financial gain that were identified in the pre-acquisition stage. This study reveals that in the pre-merger phase, financial/operational due diligence is just as important and as critical to the success of the M&A as is IT assessment due diligence.

Keywords: project management, merger, acquisition, due diligence.

Introduction

In today's business environment which emphasizes governance and risk management as well as operational and financial efficiencies, M&A activity is creating some challenges in some organizations (Mukul, 2005). M&A is a corporate strategy that deals with the buying, selling and combining of different companies that can aid, finance, or help a growing company in a given industry grow rapidly without having to create another business entity from ground zero.

The year 2008 and the first half of 2009 have been historic for the world economies as financial markets and businesses endured some significant challenges and disruptions that were unprecedented. Earnings for several Fortune 100s were drastically reduced. Billions of US dollars in capital were lost, rating agencies downgraded many companies and the pressure was on to reduce expenses and improve earnings. Staffing reductions became the norm and many investments and product initiatives were tabled. Nevertheless, a few companies are in a position to execute M&A transactions in spite of all the disruption and mayhem in the economy.

Definition

Although the term "merger" and the term "acquisition" are often used together or interchangeably, the two terms have slightly different meanings. When one company purchases another company and absorbs the other company's operations and stocks, then it is an acquisition. In an acquisition, the acquired or targeted company eventually ceases to exist while the acquiring company continues to operate as usual, albeit offering new services or products as a result of the acquired products and/or services. When two companies with similar or comparable negotiating power combine their operations and agree to conduct business as a new entity, then the transaction is a merger. In a merger the two companies cease to exist, each company's stocks are surrendered and a new company stock issued in its place.

There are times when these two terms are used in industry in a cultural context as a "perception" indicator of how senior management of the entity's involved view the M&A. The term merger is often used when executives make an extra effort for making the takeover experience a friendly one. The term acquisition is used when the takeover is considered unfriendly – when the target company, against the goal of the bidding company, does not wish to be taken over. Regardless of whether the transaction is perceived by executives as a merger or an acquisition, the bringing together of two companies is meant to create synergies that makes the value of the combined companies greater than the sum of the two parts. The success of an M&A depends on whether the synergies are achieved.

Synergy

Synergy is the notion that the value and performance of two companies that are combined will be greater than the sum of the separate individual companies. Synergy is supposed to lead to cost savings or revenue growth, which often result from one or more of the following tangible benefits: 1) staff reduction, 2) economies of scale, 3) new technology and 4) improved market reach and industry visibility. However, achieving synergies can be a very challenging feat for some organizations. Synergy is the goal of an M&A. So, when the expected synergy is not achieved, the M&A is considered a failure.

According to CNN Online, M&A activity in the United States is off 45% by dollar value in the first half of 2009, compared with the first half of 2008. There have been several M&A transactions within the last couple years. A few of the most challenging transactions did not meet their objectives, such as, Delta's purchase of Northwest, Ford's purchase of Land Rover and Jaguar and Bank of America's purchase of Merrill Lynch. It is remarkable then that there are still a few companies that are able to successfully pull-off an M&A and meet their objectives.

Company A

Company A is one of the largest property and casualty providers in the mid-western United States. The organization is a product of a merger and acquisition giving rise to its relatively large size in comparison to its competitors in the property and casualty insurance industry. Revenues for 2008 were US \$24.5 billion and net income for the same fiscal year was 2.9 billion. Company A offers a wide range of insurance and surety products and services to businesses and individuals in every state within the United States as well as in several international markets including the United Kingdom, the Republic of Ireland and Canada. Company A has almost 300 years of combined experience managing risk with integrity, innovation and discipline.

Company A – Structure and Culture

Company A has approximately 33,000 employees. The company is organized into three reportable business segments: 1) Business Insurance, 2) Financial, Professional & International Insurance; 3) Personal Insurance. Business Insurance is comprised of approximately 20 different product offerings. Financial, Professional & International Insurance is comprised of approximately 4 product lines and Personal Insurance is comprised of 2.

Company A is a relatively large organization and has a hierarchical top-down structure. There are several presidents, vice presidents and senior vice presidents within the company leading each functional area (Technology, HR, Finance and Legal etc.) and each of the major product lines. Administrative functions are centralized although there are a few functions that are decentralized.

The corporate philosophy of managing the balance between risk and reward, both on the liability side and on the asset side of the balance sheet forms the company's core culture. The company carefully assesses compensation for the risk they take on and so underwriting and investment strategy decisions are handled with the utmost care and thoroughness from top to bottom within the organization. The company has demonstrated this through the various sales of subsidiaries and run-off businesses (international and local) in recent years.

Company A - Case Study

On April 1, 2004, two industry leaders merged, combined their operations and listed the new company stock under a new symbol. Prior to this M&A, both companies had prior experiences completing M&A transactions of their own; they completed acquisitions in 1996 and 1998. To provide an idea of the impact of this merger, one of the companies had a net income of US \$1.7 billion in 2003 and the other had a net income of US \$660 million for the same period.

The 2004 merger cost approximately US \$18 billion and brought together skilled and dedicated employees with similar performance-based cultures and underwriting skills. The merger also created a stronger national distribution network across all product lines. One of the two companies alone had a market capitalization of approximately \$27 billion (BusinessWire). In this M&A transaction, the merger terminology was indicative of the "perception" indicator referenced earlier in this paper. The smaller company acquired or bought the larger company and so the term merger was used to make the takeover or acquisition experience a friendly one for senior management at the acquired entity.

In order to deliver on one of synergies promised - 10% savings that equated to about US \$350 million - more than 3,000 jobs were cut. Other synergies included: economies of scale, increased market share and higher profits. Upon closing, which is otherwise referred to as post-merger, Company A brought together several product offerings and the strong management teams from the two companies. Also, Company A began working on integrating some of the back-office solutions and information systems that supported the business. Some challenges did arise.

An unprofitable investment franchise was sold off, an unexpected charge of US \$1.63 billion was absorbed to increase reserves for future claims, putative class action and individual lawsuits were brought against the Company and the gains expected at the end of 2004 were down significantly. Conversion of business systems that were slated to be completed in 2005 for policy issuance and Commercial and in 2006 for claims and Specialty business were delayed.

There was a \$284 million (28%) increase in general and administrative expenses in 2005 compared with 2004, which primarily reflected the impact of the merger. In addition, the 2005 total included \$43 million for investments made for process re-engineering and to support business growth and product development, primarily in the Personal segment. These factors were partially offset by the benefit of expense efficiencies achieved since

the completion of the merger. Claims and claim adjustment expenses of \$15.44 billion in 2004 were \$6.32 billion higher than the comparable 2003 total, primarily reflecting the impact of the merger.

The company stock lost nearly 13 percent of its value shortly after the merger was completed. Prior to the close date in April 2008, a merger and acquisition team was pulled together comprised of executive management. Due Diligence was carried out by the executives often with the help of senior managers who reported to them. Questionnaires and face-to-face interviews were the instruments used to gather pertinent information from the target company. Interviewing was the common method used. Scorecards were developed, business drivers identified and the expected results to be realized after the completion of the sale was documented.

An audit of the integration phase of the merger revealed that while there was documentation and evidence of the financial due diligence, not much was developed for the IT due diligence assessment that was supposed to have been completed. Questionnaires that honed in on general computing controls etc. were on-hand and were located, but none of these valuable questionnaires were completed. The executive for information technology assured internal audit that an IT due diligence was performed, but that the outcome and decisions provided were verbal. The core systems that were acquired underwent some significant application enhancements that were necessary to allow for the applications to process transactions in such a way that the resulting journal entries were seamlessly fed to the corporate general ledger (GL) system.

Organization B

Organization B is also a property and casualty provider, but is headquartered in the northeastern United States. A relatively smaller competitor, Company B's revenue and net income for 2008 was a fraction of Company A. Revenues for 2008 for Company B was US \$2.7 billion and net income was US \$105 million. Market capitalization for Company B was approximately US \$2 billion.

Company B acquired three much smaller privately owned companies. Only two will be addressed in this paper as the third acquisition is currently ongoing. Both acquired companies offer specialized services and so Company B acquired both entities to get a foothold in each of the specialized markets. The first acquisition was completed in June 2007 for US \$10 million, the second in March 2008 for approximately US \$29 million and the third in December 2008 for US \$100 million.

Company B - Structure and Culture

Company B has been in existence for over 100 years; Company B maintains twenty-five local branch sales and underwriting offices mostly in the northeastern and mid-western regions of the United States. Administrative functions are centralized in the company's headquarters in the northeastern United States. The key to Company B's business

proposition and corporate strategy are winning agents. Agencies are appointed based on profitability track record, financial stability, professionalism, and business strategy. Once appointed, Company B monitors the agents' performance and takes action as and when necessary to change these business relationships.

The executive leadership team is relatively lean and is comprised of nine executives having responsibility for the main functional areas (Legal, HR, Technology, Operations, Finance and the first two major lines of business). The word often used to describe the organizational culture is "weird". Company B had some challenging times earlier in this decade. The company was almost taken over by the state in which it operates due to its poor performance. The leadership returned to its core competency and purpose and rid the company of its unprofitable life insurance portfolio that almost put the company out of business.

Company B - Case Study

Company B has three major lines of business: 1) Property; 2) Commercial property and casualty; 3) Other property and casualty and has approximately 4,000 employees. A number of the IT services have been outsourced. A corporate development and strategy team was formulated in 2006 specifically to champion and execute the company's growth strategy. The team's first test was the June 2007 acquisition. The team executed the acquisition using the following major processes:

1. Due Diligence
2. Pre-Close Playbook
3. Pre-Close plan
4. Integration plan
5. Transition to ongoing operation

Due Diligence took the form of prospecting and researching potential acquisition firms and conducting preliminary due diligence tasks. Strengths and weaknesses as well as risks and dependencies were identified, commented on and presented to executive management. The Corporate Development Team performed the Due Diligence and provided the information to the executive leadership team. The executive leadership used the due diligence information in their "no-go" or "go" decision. This was followed-up on with on-site visits depending on the mutual interests between Company B and the targeted company.

A tentative agreement was entered into once the "go" decision was reached at which point the Corporate Development team engaged the respective functional areas and developed the Pre-Close Playbook. Project management services were called in to assist with project management planning and execution. All critical tasks and dependencies needed for the completion of the sale of the targeted company were identified and a timeline developed. Items covered included:

- a) HR – retirement, defined benefits, payroll and transition of employees at the acquired.
- b) Finance & Accounting – Pre-merger Insurance Reporting, SEC reporting requirements, acquisition & purchase accounting, expense allocation.
- c) Loss Control
- d) Marketing
- e) Procurement
- f) Real Estate/Facilities – Leases and assets.
- g) Reinsurance – for exposures and reserves.
- h) Treasury – acquisition transaction, bank accounts, debt.
- i) Investments – Asset management.
- j) Compliance – Complaints, state and government affairs, licensing.
- k) Actuarial – Transition reserving
- l) Information Technology – Disaster recovery & business continuity

The senior managers from each of the above fore-mentioned areas developed project plans and reported into a program manager who was responsible for effecting the M&A transaction. The program manager reported to the director of corporate development and had a project manager assigned to the project to coordinate tasks and ensure the individual team's deliverables were completed.

While internal audit observed that project plans were developed by each area, the plans were not kept up-to-date and the project manager was unsuccessful in ensuring that the plans were updated and consolidated and rolled-up into one plan. Each area operated in silos although cross functional team meetings were scheduled and held. Once the sale was officially concluded, the M&A project was determined to be in the "Integration" phase, also known as post-close and a different project manager assigned.

Integrating the targeted company's GL into Company B's corporate GL system was among the top priorities as was the integration of the back-office and information systems that supported the acquired company's core businesses. The cost benefit analysis performed after the acquisition led Company B to not integrate the technology solutions of the acquired, but rather leave the solutions as disparate and independent systems. Other functions were integrated including HR, finance, reinsurance etc. and new systems developed.

During the integration phase, internal audit observed that the project plans were not kept up to date and that a number of the applications and information systems at the acquired had some weaknesses over general computing controls. Some basic security functionalities were missing. User access could not be disabled or changed once established. There was a high risk for loss of institutional knowledge around information technology if critical IT personnel were lost and certain systems were not well documented. Network and application level accounts of terminated employees had not been disabled and periodic reviews of access had not been performed. Several accounts were being shared among many users. The use of shared accounts makes it difficult to trace a transaction back to the specific user.

The March 2008 acquisition followed a similar process as the June 2007 acquisition. The major difference was in the integration phase. The back-office processing systems and applications were integrated fully albeit with some weaknesses over general computing controls. The project planning process improved somewhat, but several plans were not kept up to date to reflect an accurate and current state of the M&A project.

The December 2008 acquisition also followed a similar process. The integration of the back-office systems and applications that supported the acquired business is proving to be a significant challenge financially and organizationally. The challenge with integrating the GL was compounded by the need to include a sub-ledger reconciliation process for the acquired. Because of acquired company's reliance on a manual process for performing calculations for reinsurance purposes, Company B developed a solution to automate these calculations. This effort now involves in excess of 30 full-time resources and is currently eight months behind schedule. This integration effort is currently on going and is being run by teams from the finance and IT departments. Weekly meetings are often canceled and communications of the progress unavailable.

Analysis

Company A

The determination to succeed once the M&A deal has commenced, especially after an agreement is signed is a significant contributing factor for the executives proceeding with the M&A at all costs. The acquiring organization once committed to the M&A is more apt to conceal or simply downplay pertinent information that may otherwise signal a need to reconsider the commitment or even a withdrawal of the M&A offer. Wall Street analysts were relentless in their criticism of Company A for not disclosing the magnitude of the US \$1.63 billion charge absorbed to increase reserves for future claims. This should have been revealed during due diligence and should not have come as a shock to shareholders. The explanation provided was that the two companies faced restrictions on the amount of information they could share before the merger. They could not complete a thorough analysis of their differing methodologies for assessing risk until after the acquisition closed on April 1, 2004. The targeted company would have probably considered turning down the acquisition had they known that a charge of this magnitude was around the corner. Giving Company A the benefit of the doubt that this information was not purposely withheld then raises another concern with regards to the effectiveness of the due diligence process. Company A may well need to overall its due diligence process so that similar information is forthcoming in any future M&A.

The decision by a company to proceed with the M&A depends on the findings from the due diligence assessment (Bhatia, 2007). Due diligence is a methodical approach to identifying and measuring risks and advantages of the potential M&A and the efforts required to mitigate and manage the identified risks. The risk with due diligence is that one can get caught in an analysis paralysis situation where due diligence is so exhaustive and time consuming it offends the targeted company and adds value to the decision-making when it's too late.

The attitude of the executive leadership within the companies involved in the M&A transaction is another factor that sets the tone for how smooth or difficult the integration will be. From the very start of the discussions the relationship at the top between both companies was positive and friendly. The CEO at the acquired company actually served as CEO at the target company several years prior. However, even 'good blood' between the two leadership teams does not alleviate the challenges and havoc that an acquisition can have on the organization when it comes to integrating the companies.

The company succeeded in meeting some of its goals including, economies of scale and increased market share, but missed the mark on higher profits within the 1-2 year timeframe. Although the company gained efficiencies from combining several functions and products, the cost of running disparate systems to support business functions that had to remain separate were costly. Furthermore, the integration of some systems and applications added to this cost and negatively impacted profits. In general the integration projects were over budget and encountered more challenges than anticipated. To avoid further losses, the executive leadership sold of unprofitable business functions alleviating the need to integrate them.

Company B

Company B created a new unit named Corporate Development. This unit was charged with the identification and execution of M&As. The value drivers for all three (3) M&As were similar as follows: 1) reduction in reinsurance cost; 2) Loss control synergies; 3) Growth; 4) Investment income.

While the value drivers were consistent, the targets or measurements for each M&A were different. The value levers were tracked on a monthly basis once the M&A deal was closed. Finance and Accounting shared the ownership for tracking and reporting results to executive management. One of the challenges faced with tracking the value drivers was getting the input data so that the current measurements could be derived. This challenge is further compounded when the IT systems and applications of the acquired company are proving difficult to integrate and therefore data retrieval and sharing between entities is difficult and time-consuming.

Company B improved on its due diligence process with each M&A transaction. Shared drives and SharePoint repositories were setup so that the integration team could reference due diligence artifacts as issues and challenges arose. The company developed a thorough and repeatable project management process within the finance and accounting function. The company was fortunate to have a seasoned business project manager who took charge and did a thorough job in following project management practices for these M&As. The pre-close efforts were mostly driven by the business and so the IT department literally turned itself into an information solution department whereby a project manager from the IT department worked in tandem with the project manager from the business both reported to the executive leadership in Corporate Development. Eskerod and Riis identified this model as a response to challenges faced when an organization has to implement projects that require full project management instead of

technical project management. While the IT department was involved in the due diligence via the CIO or his designee, IT did not perform a comprehensive IT assessment of the applications.

Non IT staff reported the following during due diligence...

“Phase one: build reinsurance application using Access/SQL server, Hyperion Essbase reporting, a separate instance of PeopleSoft for a Program ‘sub-ledger’, and interfaces to and from front end systems, subsystems and general ledger. Integration costs would include automation of the highly manual accounting process, particularly for programs and reinsurance. Current manual process presents an unacceptable level of control risk to the company. Ultimately, we would expect accounting personnel reductions but it’s difficult to determine when and how much savings would occur.”

The effort taken to develop the automated solutions was underestimated and so the project was split into three (3) phases. It was evident that a more thorough IT assessment of the risk and solution was needed and ought to have been completed. IT developers were assigned to development or integration projects when needed; resources were rolled onto the M&A projects in a sort of ad-hoc manner. IT integration projects were consistently overdue and over budget.

Conclusion

Although M&A transactions occur infrequently within an organization, integration and especially IT integration projects need to be managed and controlled just as any other project with repeatable and mature processes (Pareek 2005). If the IT systems are not integrated correctly the synergies that are expected may elude the company. The Information Technology Assessment Due Diligence (ITADD) framework is one proposed solution that may guide organizations through the M&A phases (Sundberg, Tan, Baublits, Lee, Stanis & Tanriverdi 2007). Ideally, a manager or IT auditor in the acquiring company should perform the IT assessment. The five domains proposed by ITADD are: 1) IT Assets; 2) Operations; 3) Human Capital; 4) Business Continuity; 5) Strategy Support. Furthermore, ITADD is comprised of toolkits for each of the 2 major phases: 1) Pre-merger and 2) Post-merger.

Acquisitions and integration of acquired businesses may result in operating difficulties and other unintended consequences. From time to time organizations may investigate and pursue acquisition opportunities if they believe that such opportunity is consistent with their long-term objectives and that the potential rewards of the acquisition exceed the risks. The process of integrating an acquired company or business is often complex and costly. As a result, competent and seasoned corporate professionals should be leading the acquisition initiatives. In general, financial data and factors are explored in much greater detail in an acquisition than IT data and factors. IT management and CIOs are not usually the leaders setting the tone for corporate growth through M&As. A concerted effort must

should be made from the top (i.e. CEO) to follow a structured framework in IT due diligence during the M&A process (Bhatia 2007).

A few significant risks with IT implications include:

- potential disruption of ongoing business;
- ineffective integration of business and IT systems that support the business;
- increase in the inherent uncertainty of reserve estimates for a period of time, until stable trends reestablish themselves within the combined organization;
- diversion of management time and resources to acquisition integration challenges;
- loss of key employees;
- cultural challenges associated with integrating employees.

It should be noted that even with the most effective IT and financial due diligence, there is no guarantee that M&As will be successful. In addition, the ineffective integration of businesses and processes may result in substantial costs or delays and may adversely affect the organization's ability to compete. Also, the acquired business may not perform as projected, and any cost savings and other synergies anticipated from the acquisition may not materialize. The ITADD conceptual framework is being deployed for the third acquisition at Company B.

AUTHOR

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