The Secrets of Operational and Organizational Due Diligence

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Companies that opt to grow by merging with or acquiring another organization must systematically address the due diligence phase of the process. In particular, their leaders must focus on the key issues affecting the target organization's operations and organizational structure. These include distribution channels, consolidation of physical assets, business strategies, value chains and processes, human resources practices, talent retention, and change management. ©2014 Wiley Periodicals, Inc.

The leaders of most private-equity companies, corporations, and privately held companies that have aggressive goals realize the difficulty of attaining double-digit growth without tapping the external engine known as mergers and acquisitions (M&As). Achieving success in M&As requires strong capabilities in financial analysis, assessing environmental exposure, and general legal and tax implications. Two aspects of due diligence present challenges for even the most experienced companies: planning and effectively executing operational and organizational due diligence.

During the operational due diligence phase, data needs to be collected to fully understand the current state of the organization, as well as to identify specific opportunities to realize deal drivers and targeted synergies. This is the linchpin for identifying *where* and *how* specific synergies can be obtained. By collecting this information during the due diligence period, the organization will be all set to use the 100-day implementation period to actually start realizing targeted synergies instead of figuring out what to do. The most critical components of operational due diligence are discussed below.

Review the Target Company's Business Model

A well-designed business model will define the activities required for creating value for customers. It should detail *who* the target customers are, *what* product/service mix creates value for both customers and shareholders, and *how* that value is created.

Exhibit 1 depicts an approach for conceptualizing a target company's business model that comprises a strategic axis, a financial axis, and infrastructure. The strategic axis is made up of four components: value proposition, value configuration, markets and buyers, and distribution channels.

Value Proposition

Value proposition means the reasons why customers would do business with the firm—that is, why they would buy its products or use its services. True understanding of an organization's value proposition is the first step in operational due diligence. This proposition can be discerned by reviewing the target organization's business plan, its customer and market data, and desired product/service attributes to identify new offerings or untapped ways to differentiate from their competitors. Benchmarking competitors and understanding the reasons why customers switch is also helpful in this analysis. It is important to determine whether the current value proposition is sustainable in the long term or, rather, a flash in the pan like the dot-coms were. Savvy leaders engaged in this step look beyond industry norms to identify unmet needs that can optimize organizational performance and enhance the realization of the deal drivers and targeted synergies.

Value Configuration

Assessing the value configuration includes arriving at an understanding of the business strategy and

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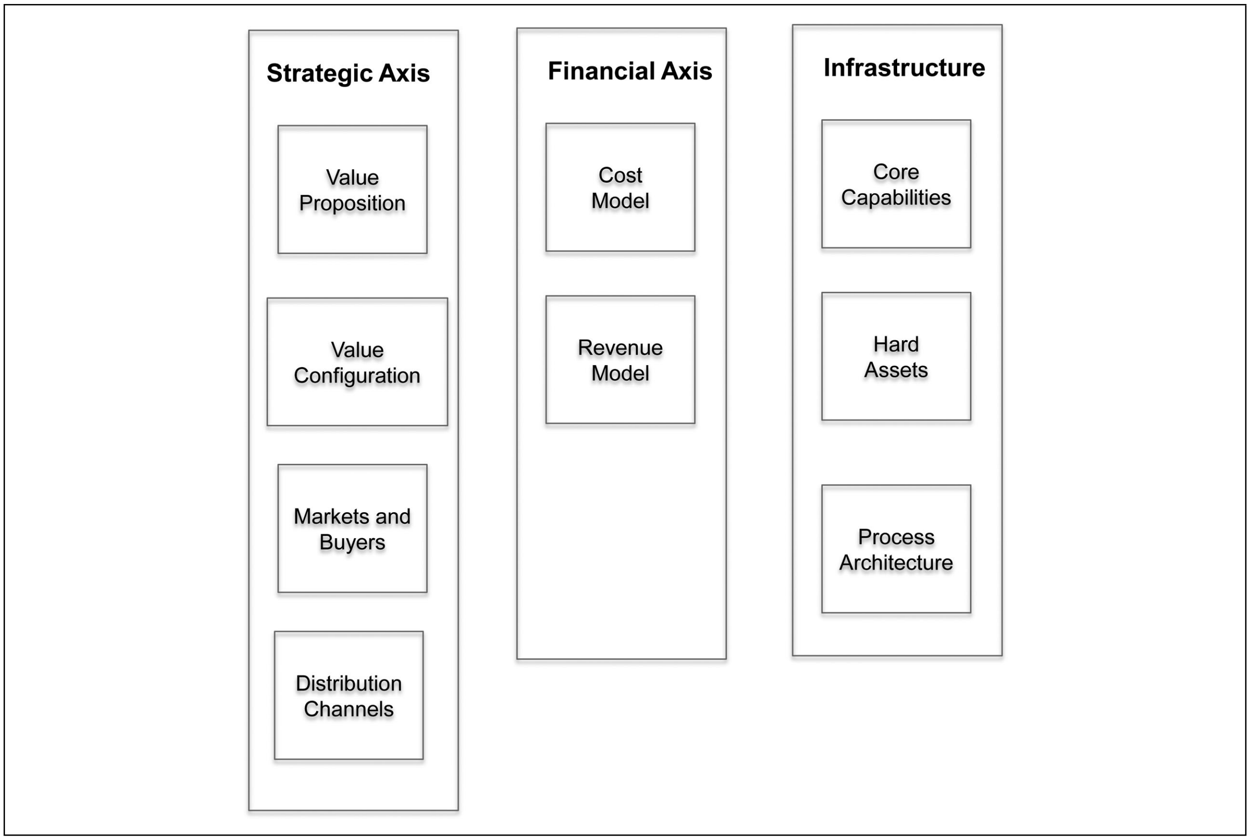
Exhibit 1. Components of a Business Model



supporting tactics. If the target firm is part of an existing portfolio of companies, its business strategy should be aligned with that of the other related organizations in the portfolio. Cross-selling offerings and even leveraging their infrastructure (sales force, supply chain, etc.) can result in streamlining, which will increase revenue and cut costs. Any review should include the cataloging of planned and ongoing strategic initiatives. Often, costs can be reduced merely by stopping or not starting strategic projects that are no longer warranted after the close of the M&A deal.

Markets and Buyers

When one is analyzing the current markets, it is essential to carefully assess threats of new entrants, the probability of new disruptive technology, market size and growth rates, the profitability of market segments, and sources of competitive advantage. Additionally, each customer segment should be reviewed so as to understand unmet needs, potential areas of blue ocean or white space, and new buyers with current or new segments. Many organizations make the mistake of not conducting a thorough analysis of each customer. Not all customers are created equal. Therefore, it is essential to prioritize the organization's customer base around relevant decision filters, like profitability and strategic importance. Success does not come from "being all things to all people" but, rather, from understanding how you "play to win."

Distribution Channels

An organization's distribution channels are a source of both revenue and cost. When analyzing these channels, it is important to focus on the *channel configuration*—that is, the number of intermediaries (such as resellers, wholesalers, distributors, and agents) between the originating company and the consumer. This entails reviewing available data relative to the percentage of revenues by channel and the profitability of each, identifying alternatives, and analyzing how each channel has historically performed relative to the metrics on the target company's scorecard.

A thorough review of the *channel mix* (direct sales force, agents, e-commerce, etc.) also should be completed to map each channel to the appropriate market segments currently being served. This data can be used to evaluate channels in terms of:

- Product availability
- Financial performance (cost, profitability)
- Flexibility/responsiveness to changes in market demand
- Customer satisfaction
- Operational performance (cycle times, reliability, performance to schedule)

The financial axis of the model shown in Exhibit 1 comprises a cost and a revenue model.

The Cost Model

The core element of work at every organization is referred to as the *activity*. These activities are categorized as either *value adding* or *cost adding*. Value-adding activities are absolutely essential to the delivery of the organization's core product or service. A cost-adding activity is one that is considered not to contribute to customer value (for example, inspections). In most organizations, only 10 to 25 percent of the activities are value adding; therefore, the potential for cost avoidance and savings is dramatic.

Traditional cost accounting tracks cost by work functions/units. Although this provides leaders of a function/unit with the information they need to manage, it fails to identify costs as they accrue across several functions. One of the best techniques available to more clearly identify costs is activity-based costing (ABC). The cataloging and quantification of cost drivers—any factors that cause a change in the cost of an activity—are at the heart of this approach. It is not uncommon for an activity to have multiple cost drivers. For example, a production activity may have the following cost drivers: machine operator skill levels, floor space occupied, the quantity of power consumed, machine feeds/speeds, and waste.

> In most organizations, only 10 to 25 percent of the activities are value adding; therefore, the potential for cost avoidance and savings is dramatic.

ABC allows organizational leaders to make informed decisions about lines of business/customers, product mix, process and product design, service offerings, capital investments, and pricing. Understanding the cost model is essential to realizing deal drivers and synergies, as well as to stabilizing the base business postclose and realizing the business plan.

ABC can be implemented by using the following the steps:

1. *Define activities*. Using the process architecture as an input, create a dictionary of activities. Define each activity so there is no ambiguity regarding process boundaries, or key inputs/outputs.
2. *Identify drivers and activity measures*. Use interviews, workshops, and work/process documentation to identify the cost drivers. This activity is usually completed using a discovery process in which learnings are used to continually update the list of cost drivers.

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3. *Assign costs to activities.* This can be accomplished by collecting historical data to map costs to each activity, making sure you have allocated a portion of the cost to each activity on a rational basis. This is critical: If the cost allocations cannot stand up to scrutiny, the result will be a "garbage in and garbage out" scenario.
4. *Assign costs from activities to cost objects.* Two types of costs can be assigned. A *direct cost* is a cost that can be easily and conveniently traced to a specified cost object (for example, how much labor or raw material was consumed during operation X). An *indirect cost* is harder to trace to a specified object (for example, how much electricity is used to support an activity).
5. *Develop performance measurements.* Identify current and future (postclose) performance metrics that are aligned with the deal drivers, targeted synergies, and business plan.
6. *Manage processes and work.* Identify specific opportunities to streamline core and support processes (postclose) by improving the ratio of value to cost-adding activities.

The Revenue Model

The revenue model describes how the company makes money through a variety of revenue flows. Perhaps the most critical part of the revenue model is to obtain consensus on the business drivers. These describe the cause-and-effect relationship between desired outcomes (revenue levels, profitability, customer retention, etc.) and the discrete variables that cause them.

We have worked with more than 150 clients and have been troubled to find that in more than 75 percent of these cases, there was no consensus on exactly what caused top-line and bottom-line financial results at these organizations, even among senior executives. Except for a general level of understanding, most senior teams did not seem to grasp the mathematical relationship between inputs and outputs. The leaders at these companies did not understand *how* their organizations made money. Obviously, when the business drivers are not known and/or the exact mathematical relationship between the business drivers and performance is not clearly understood, it is difficult to optimize performance.

Part of the due diligence process must center on studying historical performance to ferret out the critical few business drivers that cause desired outcomes. A best practice of acquisition integration is to stabilize the base business. Taking the time to collect and analysis data to truly understand how the company makes money and what levers can be tweaked to improve financial performance can facilitate this goal.

An analysis of how sales are generated in a pharmaceutical company illustrates this point. If the field sales force makes "A" number of calls, they will secure "B" number of face-to-face sales meetings with doctors. If the average close rate is "C" and the average revenue per sale is "D" dollars, then you have an algorithm to predict performance and have identified sales calls to doctors as a business driver. A sophisticated postacquisition integration team would make sure there are predictive or leading measures concerning sales calls to ensure that targeted revenues would be achieved. In the event that actual revenues were not meeting the targets, the recommended course of action would be to make more doctor calls.

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We recently worked with a $300 million privately held manufacturing company that acquired an $80 million supplier—a backward vertical integration play. During the due diligence phase, a key part

Exhibit 2. Simplifed Facilities Summary Tool

	Facilities Assessment				Business Case			
Name of Facilities	***Location***	***Purpose Use***	***State of the Art Yes or No***	***Age***	***Annual Costs***	***Strategic Importance***	***Cost of Closing***	**Notes/Assumptions**
Manchester	Arkansas	Mfging	No	15+ years	$16.4MM	Low	$3.9MM	Move line to Mexico
Harper	Houston	Corp	Yes	3 years	$3.6MM	Medium	$1.36MM	Unlikely to sell
Hatton	New Orleans	Mfging	No	12 years	$2.8MM	Medium	$4.5MM	Access to low-cost labor, environmental cleanup
Piedmont	Baton Rouge	Sales	No	7 years	$754K	High		Next-to-largest customer
Main Street	Shreveport	Corp	No	11 years	$621K	Medium		Proximity to key customers; close and consolidate

of the 100-day plan was to stabilize the base business to make sure revenue levels did not precipitously fall. The stabilization focused on:

- Continually communicating to customers to describe the value drivers and the strategic purpose of the acquisition, with careful attention to soliciting their issues and concerns regarding the deal.
- Identifying employees who had key customer-facing relationships and making sure they were adequately addressed in the talent retention plan.
- Confirming what the business drivers were and making sure that no activities were undertaken to adversely affect them.

> The success of an integration will directly correlate to the quality and depth of leadership of the targeted company.

Review the Target Company's Infrastructure

Infrastructure refers to an organization's core capability and hard assets. Each is discussed below.

Core Capabilities. When you think of Procter & Gamble, world-class product marketing comes to mind. When you think of Apple, you immediately think of highly innovative products. A core capability is defined as the enterprise-wide capability (new product development, general management leadership, operations, etc.) for which the organization is renowned. When completing due diligence, it is critical to collect data to ensure rhetoric equals reality. We have been involved in several due diligence projects where a company's leaders believed that their firm was well managed only to find out that, in fact, it was not. Indeed, in some markets, once an organization achieves a certain critical mass it cannot help but be profitable; it makes money in spite of itself. The success of an integration will directly correlate to the quality and depth of leadership of the targeted company. It takes time to "change out" weak leaders, making it more difficult to stabilize the base business during acquisition integration.

Hard Assets. Bricks and mortar represent the largest single potential area in which to cut costs. Assessing the target company's physical assets (see **Exhibit 2**) is best completed in conjunction with the organization structure review. Identifying duplicate facilities provides an opportunity to close offices, distribution hubs, and manufacturing plants. This can result in benefits to the balance sheet through the sale of these assets, as well as considerable cost reduction. The general steps to follow in this endeavor are given below.

1. *Identify the specific information you need to collect*. The easiest way to do this is to start with the decisions you want to make as an outgrowth of due diligence and then work forward to identify what data you need to collect and how. Among the questions to consider are:
   - Which assets are owned and which are rented?
   - Where are assets located relative to the availability of human capital?
   - Can the asset be sold and, if so, at what price?
   - Is the asset state of the art?
   - Is the asset leveraged or fully paid for?
2. *Develop a catalog of all facilities*. For many large companies, what appears to be a simple task can lead to embarrassment. Fortune 1000 companies often cannot answer two simple questions: How many people do we have on the payroll? What and where are our physical assets? The most common place to start looking for answers is the appropriate financial reports (10-K forms, balance sheets, etc.). The supply chain function, which often has some responsibility for physical assets, also can be used to confirm the accuracy of the findings. Human resources (HR) can be the final arbiter, since they should know where employees are located.
3. *Analyze the data to make facilities decisions*. At this point in the process you should have collected all the data necessary to make the decisions identified in Step 1. Among the questions to address now are:
   - Does it make sense to sell and lease back specific facilities to free up capital?
   - Which facilities are duplicative? Can they be closed?
   - Does the existing facilities footprint closely align with market and customer requirements?

Conducting an Organization Structure Review

Information technology (IT) and organization structure represent the next two most important areas for cost synergies. Our collective experience suggests that up to 80 percent of the overall cost savings relative to postclose integration results from asset consolidation, organization restructuring, and IT rationalization (sunsetting applications and consolidating, outsourcing, or offshoring IT functions). The data for an organization review are commonly collected using a variety of approaches, including document review (process flows, cost data/budgets, customer feedback, management reports, etc.), interviews of leaders and key employees, focus groups, and observation. The steps for completing an organization structure review are detailed below.

> Fortune 1000 companies often cannot answer two simple questions: How many people do we have on the payroll? What and where are our physical assets?

Review the Business Strategy. Understand how the demands of the marketplace, customers, and competitors will affect the structure.

Review Historical Performance Trends. Try to isolate performance that is negatively affected by the structure.

Understand How Work Flows Across the Current Structure. Note long cycle operations, bottlenecks, and areas where there historically have been performance problems.

Review Existing Structure and Identify Structural Problems. This entails:

- *Identifying the number of job classifications*. A potential red flag is a disproportionate number of job titles and/or several variations of the same job, such as associate director, director, senior director, and executive director.
- *Categorizing the type of structure*. Note whether the structure is functional, geography/market,

matrix, process, or hybrid. Each has is strengths and weaknesses in terms of flexibility, responsiveness, and cost.
- *Identifying the number of levels.* If there are many layers between the president and the entry level, there probably will be opportunities to eliminate layers of management and streamline communications and decision making.
- *Defining span of control.* This relates to the average number of people reporting to each manager. One major red flag: having a number of leaders to whom no one reports.
- *Assessing the inputs/outputs of each function/department.* Processes connect work to a structure in the same way that cartilage holds bone together. Look at the inputs and outputs of each function. Determine to what degree both internal and external customers value these outputs or work products. Bear in mind that for every report that is not used, there are employees on the payroll generating costs and not adding value. Identify specific functionalities, such as training, reporting, and measurement, that are found in multiple units. This, too, can be a red flag, suggesting unnecessary cost and head count. It may be possible to combine some of this redundant functionality into one unit to realize an economy of scale. Finally, identify functions that are not aligned with the mission of each major unit. Carefully evaluating whether these functions should be performed can yield additional savings in head count.
- *Collecting cost data.* Review budgets and do a deep dive on head count. Do not be misled by looking only at full-time employees. Review data on part-time workers, contractors, consultants, and seasonal staff. Excesses in any of these categories can signal inefficiency. Work with the finance business partners to compare labor costs to revenues, to competitors' benchmarks, and so on.
- *Summarizing findings and recommendations.* Identify alternative designs by benchmarking other organizations and modeling changes to core processes. Subject all design alternatives to financial analysis (internal rate of review, net present value, cost-benefit analysis, return on investment) and risk analysis. Model or pilot test major changes to structure to ensure that they can be put into operation.

Subject all design alternatives to financial analysis (internal rate of review, net present value, cost-benefit analysis, return on investment) and risk analysis.

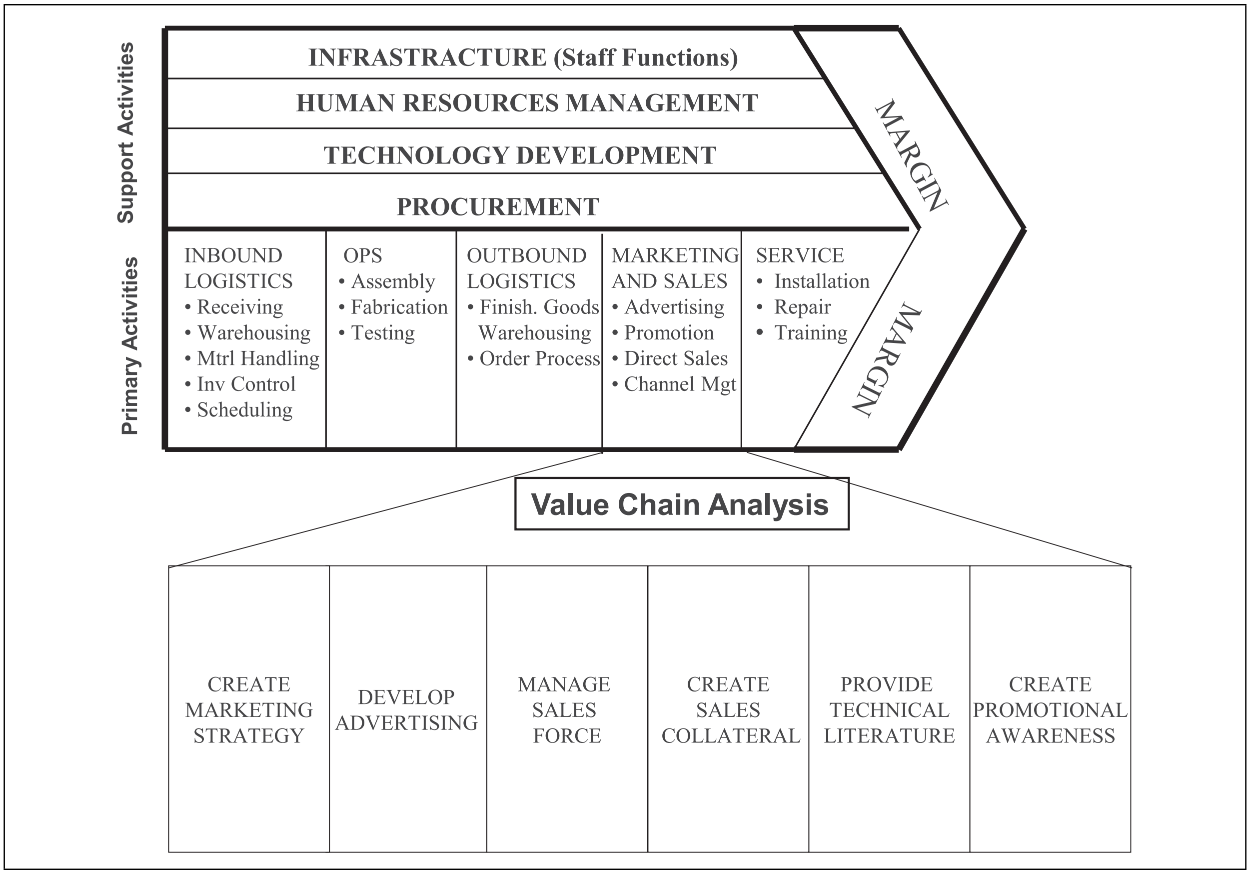
For a recent client, a $2 billion high-tech manufacturer, the key value driver was growth via geographic expansion. After the due diligence process uncovered the potential to considerably reduce costs via organizational restructuring and asset consolidation, a cursory benchmarking review of a competitor's business model/structure was completed. The business model review focused on:

- Identifying the type of structure;
- Which functions were insourced/outsourced;
- Which functions were centralized and which were distributed in the field; and
- Which functions were onshore/offshore.

This analysis was done in tandem with a detailed review of the client's structure, with particular emphasis on understanding all forms of head count (permanent, part-time, subcontractors, consultants, etc.), costs related to structure, levels of leadership, and spans of control. After a financial and risk analysis was conducted, the following short- and midterm modifications were made:

- Four R&D centers were consolidated into two. The savings from head count reduction amounted to $32 million, and operating costs were cut by $51 million.
- Redundant assets were consolidated and/or sold or leased back, resulting in an additional $29 million in cash generation.

Exhibit 3. Example of a Value Chain



Review the Target Company's Business Processes

To fully understand how work gets done in the target company, it is essential to analyze the value chain and review the process hierarchy.

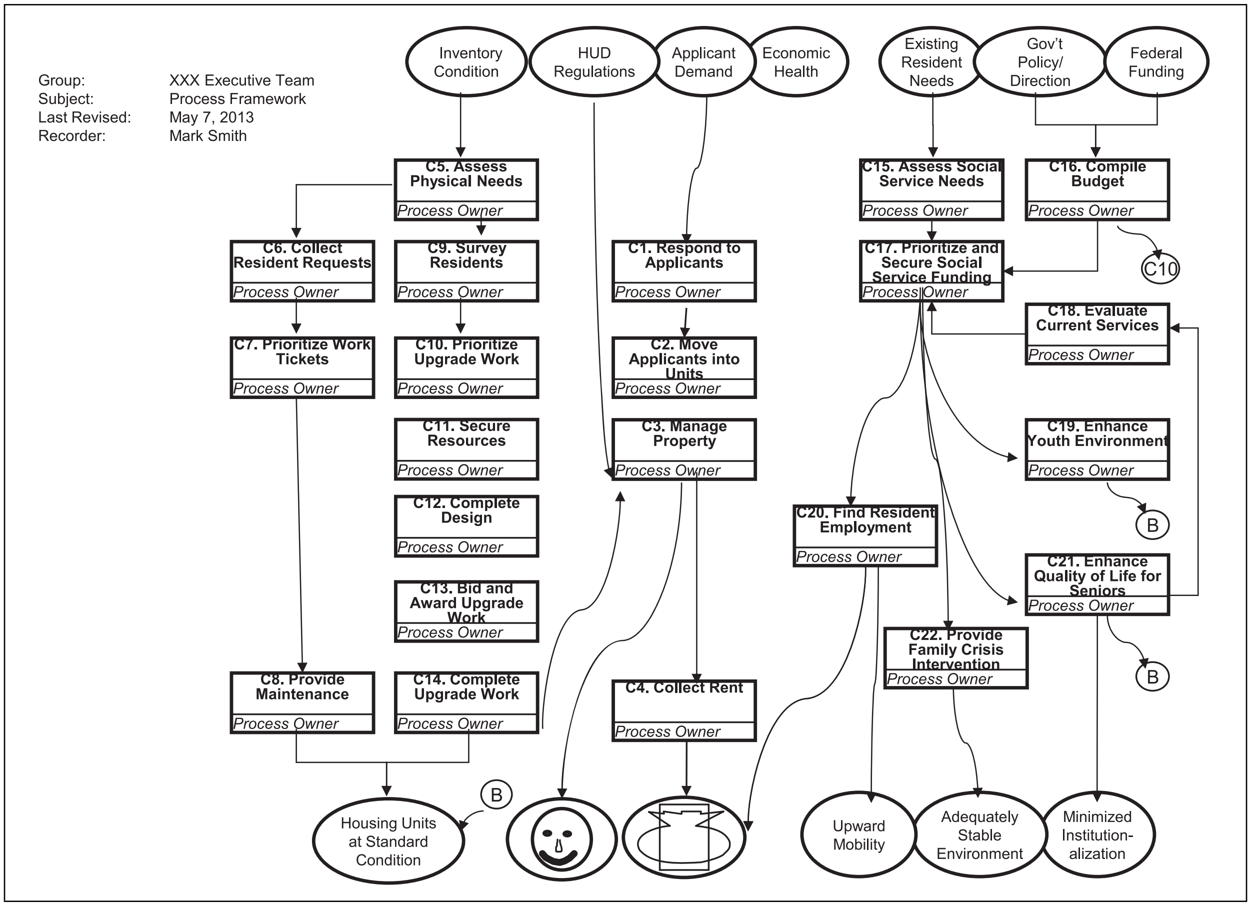
Completing a Value Chain Review

A value chain is a visual depiction of an organization that can be configured at different levels of detail. By documenting and comparing different parts of the parent company with the target company, competitors, and other world-class performers, you can quickly identify potential cost savings, areas for divestiture, and outsourcing opportunities (see **Exhibit 3**).

You can create value within the target company, or you can obtain much more utility by extending the value chain to include upstream interactions (with key suppliers) and downstream interactions (with channel partners). The value chain will allow you to:

- Identify how the target company's value chain of activities is currently configured and compare it to that of competitors to identify specific ways to improve performance; and
- Create better alignment between the target company and its suppliers and channel partners, with the expectation of considerably reducing cycle times, operating costs, and head count while enhancing profitability.

Exhibit 4. Sample Process Hierarchy



Carefully Review Your Business Processes

A process hierarchy (see example in **Exhibit 4**) is similar to an organizational chart. It can be configured in various formats or displayed in top-to-bottom text that notes all the core and support processes, with each broken into subprocesses.

A process hierarchy can be used to understand the major chunks of work that are completed across the target company. It can also be used to identify which processes are interdependent and which have the greatest impact on profitability, customer satisfaction, and cost. A process hierarchy can be invaluable in answering the following questions:

- Which are the core process and which are the supporting ones?
- Which processes are suffering in terms of performance?
- Which processes are likely to have the greatest impact on achieving the business plan, deal drivers, and targeted synergies?
- What potential modifications should be considered to achieve those outcomes? Do any processes need to be redesigned or reengineered?

Conducting Organizational Due Diligence

HR personnel usually are responsible for organizational due diligence. Their level of participation,

Exhibit 5. First-Pass Organizational Due Diligence Question Categories

Organization Structure
- Employee organizational charts by location and function
- Detailed headcount information over past several years

Employee Information
- List of current employees under consideration for inclusion in the acquisition
- Bios and CVs for key staff
- Turnover, termination, and leave reports

Organization Culture
- Results of any employee surveys

Organization Talent
- Results of talent reviews, including nine-box data for management-level employees
- Overview of knowledge management system and corresponding data

Compensation Information
- Executive compensation and work contracts
- Bonus plans
- Commission plans
- Other plans, including profit-sharing plans, stock programs, and incentive compensation programs

Benefits Information
- Copies of all major and ancillary health/ social benefit plans, such as medical, dental, vision, life, accidental death, and disability insurance
- Copies of all retirement, pension, and severance plans
- Any open issues, for example, outstanding claims, disputes, or loans

Agreements
- Copy of employment, confidentiality, intellectual property, severance, and other agreements
- Copy of open contracts for HR services, such as training contract agreements

Policies
- Copy of employee handbook(s) and associated polices

Employee Relations
- List and description of ER issues
- List and description of safety issues and complaints

Employee Development
- Copy of training records and plans
- Budget and services provided by internal/external provider

Independent Contractor Information
- Copy of all contractor agreements, such as confidentiality, intellectual property, and noncompetition agreements

Expats/Employee Relocations
- List of all expatriates and term/status of their engagement
- Copy of relocation contract and policy

however, often depends on the perceived value they bring to the organization. HR functions that have a track record of acting as strategic partners are always integral to the earliest stages of due diligence (that is, before the decision to execute the deal has been made). Transactional-oriented departments tend to provide only administrative services associated with integration.

First-Pass Data Collection

As with the operational component of due diligence, accurate input from and about the target company is critical to obtaining a meaningful assessment of the organizational aspects of the deal. Although every potential transaction is different and requires a unique analysis, savvy HR teams begin the engagement with a comprehensive list of questions. **Exhibit 5** contains common categories of inquiry within the HR realm, as well as sample content. An actual list would be far more comprehensive and targeted to the specific situation.

One US-based, multimillion-dollar health care organization recommends taking this approach to the next level by tiering questions according to level of potential impact. Although all information obtained from the first-pass inquiry is important—for example, employee lists, job descriptions, and training plans—some items, such as turnover statistics, pending legal action, and compensation and benefits costs, can have a direct impact on expected deal drivers.

Posing questions helps highlight potential showstoppers or unforeseen costs and risks early in the process and can save considerable time and effort down the stretch. It can also guard against "deal-fever"—when stakeholders feel too personally vested in the transaction to walk away. Finally, if the target organization is healthy, the tiering approach avoids overloading the organization's personnel with deal-related tasks. This is especially helpful when acquiring smaller organizations that may not have the wherewithal to manage their end of an acquisition while running the business.

Depending on the makeup of the due diligence evaluation team, some topics may be covered by multiple parties. For example, although HR uses a variety of systems, this topic may fall under the purview of the IT representative. Nonetheless, the HR representative should prepare a robust block of questions on relevant systems and then cross-reference the answers with IT. At a minimum, the investigation should secure the following information:

- List of HR systems;
- Purpose and type of each system;
- Purchase date and contract, including all related fees and change orders;
- Description of system support services (in house, vendor); and
- Description of the functions of the tool and of the data elements within it.

If the target organization has a union or operates in an area that has a workers' council, the due diligence team will need to make additional inquiries. This will involve understanding which union has the majority stake (if there is more than one), the level of employee participation, and the legal framework, including any forms of cooperation and codetermination that apply. Understanding the collective bargaining agreement and historical disputes is also helpful in conducting the analysis. Close partnership with local legal representatives is critical to ensuring that no local law with costly downstream implications is overlooked.

> Posing questions helps highlight potential showstoppers or unforeseen costs and risks early in the process and can save considerable time and effort down the stretch.

Dive Deep Into the Basics

The information obtained from an initial inquiry will depend on a variety of factors. These include:

- How the target organization's key stakeholders and decision makers view the transaction;
- The acquiring/partnering firm's place in the pecking order if there are multiple bidders; and
- The skill with which the staff at the target company answer the questions that are asked.

A perceptive deal team can use the responses for insight into everything from the likelihood of success to the difficulty of eventual integration, but the primary task at this stage is analysis. The deal team should review the compensation and benefits programs, as well as broader HR policy, to determine potential risks, costs, and opportunities.

Reviewing Compensation and Benefits Programs

The cost of employee benefits is a critical factor in HR due diligence. Though rarely a showstopper, any fluctuation between overt and hidden costs is sometimes enough to give the deal team pause. A thoughtful, comprehensive analysis of all benefits programs, coupled with clear recommendations on the level of integration, is key to a successful transaction.

Exhibit 6. Sample Compensation and Benefits Summary Analysis

Total Compensation Components	Recommended Package to Be Offered	Implications to Acquiring Organization	Implications to Target/ Employees	Variation to Standard
Base pay	Maintain current base pay raising X staff to within salary ranges within 18 months	$XK increase in base pay	*Increase* in pay for X employees	None
Bonus	Remain on target's plan year 1 Convert to new plan year 2	None—target payouts equivalent in aggregate	*Decrease* in target payout for all staff except XXX	XXX to stay at 5% bonus target
Benefits	Convert to standard package	$XK annual increase	*Increase* in coverage (from 12% to 18% of pay in aggregate) XX *decrease* in cost to employees (depending on plan chosen)	None
Paid leave	Convert to standard package Recognize target employee service	None Target to pay out paid time off (PTO) prior to EE transfer	*Decrease* in perceived time off from 4 weeks PTO	X key employees to receive min. of 3 weeks
Management incentive plan	50% of pay bonus to X key execs in 2 years if earnings targets achieved	$XK increase in bonus if targets met	*Increase* in bonus to five key execs if targets achieved	N/A—Varies by transaction
Equity	Provide stock options	$K total stock options	*Increase* in equity for X employees	Grants limited to VPs and above

Some companies have a de facto strategy of transitioning all acquisitions onto the corporate benefits platform. Although this strategy can be efficient, passing the costs of a rich benefits program to a small company can erase the value of the deal or significantly affect the acquired company's ability to meet its business plan.

This strategy also can have dramatic implications for a key stakeholder group: the acquired employee population. Though fluctuations of out-of-pocket benefit expenses can vary, even a marginal increase can carry a heavy cost in negative perception. Although senior employees are unlikely to leave solely because of a rise in health care premiums, entry-level employees who might be particularly hard hit may look for other opportunities. This retention risk could escalate to other worker categories if the cumulative effects of change build to a substantial real or perceived loss. Therefore, the due diligence team should consider tailoring the benefits package to ensure that is meaningful to employees at every level of the organization. In addition, the HR team should gather insight on all programs and provide a clear win/loss view from the perspectives of the target company, acquiring organization, and the target's employee population. When presented in conjunction with supporting details, such a summary (see **Exhibit 6**) will enable management to make smart decisions about the level of integration required.

Too often, information on basic benefits and employee programs is doled out in sporadic and haphazard fashion, which creates distrust among employees and erodes their confidence in the acquiring organization's leaders. In addition to helping these leaders make practical business decisions, a comprehensive compensation and benefits summary will help HR effectively communicate with employees during the integration phase. Though not intended to sugar-coat tough messages, a well-planned presentation provides the opportunity to keep the overall theme upbeat and prevent employees from focusing solely on perceived losses.

Catalog and Review HR Practices

Although compensation and benefit practices often get the most attention during due diligence because of their immediate impact on the bottom line, the HR team also should develop a thorough understanding of all relevant organization/people metrics and trends, including any financial, legal, or liability issues. Items as diverse as open employee relations cases and the number and status of expat assignments and relocation commitments should be investigated to understand current and future cost obligations, as well as potential risks.

Prudent HR due diligence teams will review and catalog all programs, practices, and policies, including performance management, human capital planning, talent acquisition, and succession planning processes. Each needs to be evaluated in terms of the deal drivers and acquisition integration targets. The focus of this review should be to understand the cost implications and potential synergy targets.

Although many HR due diligence teams merely provide side-by-side comparisons of compensation and benefits offerings and HR polices, one global life science organization empowers its HR department to provide in-depth analysis and recommendations based on findings. Taking their cue from the deal drivers and integration strategy established by the broader cross-functional deal team, the HR deal team is expected to deliver a comprehensive due diligence report that not only highlights risks and potential synergies evident from the side-by-side, but also provides detailed day 1 and 100-day plans.

The Importance of Providing Value-Added Analysis

The information collected thus far provides a reasonable starting point, but if organizational leaders want to ensure a successful integration—one that minimizes risk and maximizes targeted deal synergies—they have to dig even deeper. The following activities will ensure that their analysis is complete.

Although most of the members of the due diligence team will focus, and rightly so, on financials and the strategic deal drivers, HR should take a more holistic view of the organizational construct.

Map the Cultures of the Parent and Targeted Company

One of the greatest and often neglected risks to integration and long-term organizational health is conflicting corporate cultures. History is littered with transactions that looked good on paper but were doomed to failure because of unrecognized or ignored cultural hurdles.

HR should take the lead in this area. Although most of the members of the due diligence team will focus, and rightly so, on financials and the strategic deal drivers, HR should take a more holistic view of the organizational construct. Specifically, HR should develop a tool to visually compare and contrast the culture of the parent and target companies. Areas of divergence should be noted, and HR should take the lead in developing and executing a culture alignment plan. This will ensure that the culture of the target company is tightly aligned postclose to the deal drivers and to the acquired organization's business plan.

The degree of cultural alignment required will depend on the level of integration sought. If an

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organization intends to leave the target as a separate business, perhaps integrating only the selling, general and administrative (SG&A) functions, there may not be a need for full-scale cultural alignment. If, however, the purchasing company plans to ultimately integrate the target fully, a deeper analysis should be provided. In these instances, HR should provide:

- Culture mapping analysis,
- A comprehensive risk assessment,
- A summary of the organization/people-related risks,
- A timeline and costs associated with completing a cultural integration, and
- A culture alignment plan.

The M&A landscape is littered with transactions that failed, at least in part, because of culture clashes. The 2000 AOL/Time Warner deal, which tried to combine overvalued new- and old-world media giants, had a crippling effect on the combined organization's stock price. In 2005, Sprint acquired rival Nextel for $35 billion in the hopes of competing with industry leaders Verizon & AT&T, but by 2008, the organization had written down 80 percent of Nextel's value. The failure was blamed in large part on the opposing cultures: bureaucratic Sprint versus entrepreneurial Nextel.

Today's M&A success rate hovers around 30 to 40 percent, with clashing cultures cited as at least a contributing factor in most cases. And yet, despite the lessons of history, many due diligence teams glance past the topic, preferring instead to focus on items that can be easily quantified.

Evaluate Leadership

Too often, the parent organization's leadership team ultimately ends up replacing incumbent senior leaders from the acquired organization without completing a thorough talent assessment analysis. In many cases, this oversight results in duplicative roles or the wrong leaders selected for key positions. Confusion ensues, leading to diminished productivity, executive brownout, and ultimately the doling out of costly severance packages.

Perhaps one of the most critical roles HR can play is to develop a transparent process and supporting assessment instruments to evaluate the target company's senior management team. Ideally, incumbents should be ultimately categorized as follows:

- Strong performer, must retain;
- Okay in present job, but needs development;
- Should be in job with less scope; or
- Release immediately.

The challenge, of course, is acquiring enough reliable data to make informed decisions about the effectiveness of the target's leaders. Often subjective in nature, standard performance review data offer little help, and internal 360s are often gamed, especially if executives knew the deal was in the works. Raw business performance data, in conjunction with valid third-party assessments, typically produces more reliable insight. HR leaders should also look at the organization's structure (with an eye out for duplicative roles), talent pipelines, and culture for clues as to what skill sets are needed.

> Perhaps one of the most critical roles HR can play is to develop a transparent process and supporting assessment instruments to evaluate the target company's senior management team.

Develop a Redeployment Strategy

M&As can lead to the displacement of great numbers of employees. Even if the organization already has a defined employee severance policy, its leaders should consider using the various channels and techniques for redeploying staff, which can ease the burden on both the company and its former employees. These include skill banks, retraining programs, accelerating natural attrition, offering an early retirement package, instituting "up or out" programs, providing termination consulting arrangements, and loaning employees to government or community organizations. Having a comprehensive strategy for redeploying unneeded resources enables the organization to:

- Decrease costs associated with hiring and training of new employees,
- Reduce severance costs,
- Leverage knowledge management and retain organizational memory,
- Enhance employee perceptions and loyalty, and
- Maintain employee morale and company image.

Typical redeployment programs offer a variety of services to help employees transition to the next stage of their career. These include:

- Emotional assistance—aiding employees with the psychological effects of transition;
- Job posting—establishing an internal job bidding system;
- Sponsorship—asking other parts of the organization to find appropriate opportunities;
- Resume book—providing an electronic or paper summary of the qualifications of all displaced employees;
- Retraining—providing company-paid training to enhance employees' skill levels;
- Testing—offering job-interest testing and psychological and skill evaluations; and
- Outplacement services—including resume preparation, networking forums, and job search training.

Given the highly emotional nature of the redeployment process, seamless communication is key. To ensure the success of the program, HR should:

- Communicate the program to employees,
- Identify future capabilities and competencies needed,
- Quantify surpluses and shortage areas,
- Develop a process for assessing employees,
- Develop a process for placing candidates, and
- Periodically evaluate the above programs to assess impact.

Given the highly emotional nature of the redeployment process, seamless communication is key.

Develop and Execute a Talent Retention Plan

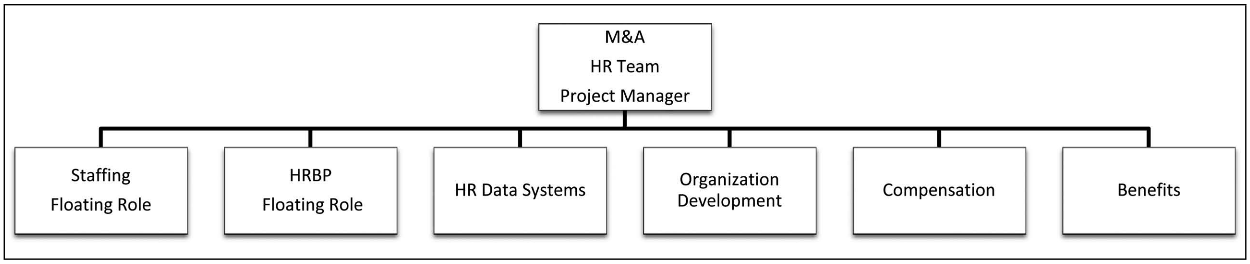
Although many organizations have a talent process in place to review and retain key internal resources, it is typically based on a subjective, long-term view aligned to their talent management and succession planning processes. Often, the definitions associated with these programs, such as "potential" and "key talent," are vague or simply inappropriate for M&A transactions. This results in unreliable talent assessment decisions.

Since it takes a great deal of time to create retention plans and they require considerable financial resources, organizations would be wise to parcel them out according to actual need. To ensure that they are geared toward the right talent population, HR should develop a well-crafted plan that begins with a clear definition of key talent. The major elements to address should include:

- Unique technical skills and other skills that are difficult to replace, and
- Key customer relationships.

In addition to highlighting current key talent and retention plans, the program should also include a forecast of key talent loss and specific actions for reducing it. Acquiring companies caught in the rush of deal fever often skip this critical exercise entirely or hand out blanket retention bonuses in the hope of stabilizing the key workforce. History indicates, however, that stay bonuses only delay the inevitable.

Exhibit 7. Sample HR Due Diligence Subteam



The life science organization noted above leveraged the information obtained during due diligence to develop a thorough analysis of key talent as well as an understanding of true retention risks and the external market for comparable skills. This assessment helped put a realistic lens on concerns and shape prudent retention programs.

Proactively Address Change Management Issues

Research indicates that only 30 to 40 percent of the M&A deals are successful in producing forecasted synergies. One of the largest contributing factors to this deficiency is not adequately addressing change management issues, such as:

- Stakeholder assessment/alignment,
- Communications,
- Capability gap assessment, and
- Organization alignment.

HR has an opportunity to provide critical leadership in this area by providing a comprehensive plan to manage the change process, not as a separate work stream, but as an integral part of the project. If done correctly, this work can be outlined during the due diligence phase, expedited during the first 100 days to produce quick wins, and carried forward for the duration of the integration process.

Pulling It All Together

To be effective, the due diligence process needs to be orchestrated via a central program office. This begins with a core deal team of key business stakeholders as well as subject matter experts from various disciplines throughout the organization. Most often, core members include representatives from the legal, finance, IT, HR, communications, and corporate development functions, as well as the applicable business unit heads. Depending on the nature and size of the transaction, they can also include staff from other functions, such as supply chain/operations, marketing, quality, and facilities. Regardless of team makeup, it is important that all parties be briefed at the start of the due diligence process on the following:

- Overview of target—company history, size, structure, etc.;
- Deal drivers and expected synergies;
- Nature of transaction—competitive bid, unsolicited offer, etc.;
- Receptiveness of management; and
- Intended level of integration/integration strategy.

Also using this team-based approach when composing subteams will provide consistency of purpose and structure. It also helps ensure that key subject matter experts are brought to the table for initial analysis and to provide insight into long-term integration issues. For example, in the HR space, it is unlikely that one person will have the wherewithal to lead all elements of the transaction, even if fully dedicated. To be effective, a subteam should consist of both core and floating members, as presented in **Exhibit 7.** Team roles will depend on the structure of the organization's HR department. Some parties may play duplicate roles (for example, one individual covering compensation and benefits). Regardless of structure, it is important to have all competencies represented and a clearly defined project manager to organize workflows. Also, it is important to balance centralized functional competencies, with floating roles that align to different business units and geographies. This will ensure a balanced view of the due diligence inputs.

In the race to achieve and maintain competitive advantage, organizations need to do more than rely on organic growth and simple product line extensions. They need to tap a variety of external growth engines, including M&A. In these cases, their leaders must establish a well-trained, experienced cross-functional team that can not only tackle the intricacies of due diligence, but provide a seamless handoff to those who will bear the burden of managing the integration process.

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