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Governing the Transformation

"Would you tell me, please, which way I ought to go from here?"

"That depends a good deal on where you want to get to."

[Source: Lewis Carroll, Alice in Wonderland, 1865]

"Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."

[Source: Winston Churchill, 1942]

Starting with the end in mind

Unlike usual approaches, this M&A series runs in reverse by starting with the end in mind; that is, at the fourth stage of the M&A lifecycle - the transformation of the combined enterprise.

Why is this? Almost any company with enough ambition and access to funding can make an acquisition, assuming deal availability. There are no barriers to entry, nor regulatory checks and balances, except in special circumstances (for example, APRA clearances in the banking and wealth management space, prospectus-funded acquisitions, foreign investment review etc.).

So, typically, most companies start at the beginning of the process, work their way through it, more or less, and often end up in a place they never anticipated, or worse, deeply regret.

Boards, executives and management are judged on results. Therefore, rather than simply being 'activity centric', and just doing things that seem to make sense, step by step, it is worth first reflecting deeply on what is intended to be the end result from a transaction. The focus on an outcome, orientates the executive and board to the 'where' and 'why' of an acquisition, before they start down the path. And knowing where they want to end up, they may choose a different path.

I advocate a less conventional approach to planning: that boards, having carefully framed the opportunity with management, should then work 'right to left' across all the factors that executive management and the board need to deal with to get their intended outcomes unscathed. These factors represent the conditions for success for the entire deal.

'Right to left' planning brings important benefits for boards and executives. Remember the old Irish story about the lost hiker asking for directions: "…if it was meself that was going to Letterfrack, faith, I wouldn't start from here."?

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So we will start in the fourth and final stage of a merger or acquisition – **Transformation** – shorthand for transforming the acquired entity and possibly the acquiring enterprise too.

What is the Transformation stage and why is it so important?

This stage is all about ensuring that there is ongoing discipline, deliberateness, and resourcing and accountability to continue to exploit the upside potential from the deal. Here, the board's role includes being an agitator, by pushing and challenging management; a monitor of progress; and a reviewer of proposed investment initiatives.

By the time of Transformation, management will have consummated the deal, worked through the initial Day 1 tasks and plans for the First 90 Days, and mobilised around more significant post-transaction initiatives. It is tempting to declare victory, assume that the necessary momentum has built and will be maintained, and then move on to the next big thing.

The reality is that a transaction is not over when the deal is done. Practice shows that the real work for the executive team is only just beginning at this point. Therefore, the board needs to keep the heat on, especially if the executive team shows signs of inertia. This phase is all about 'maintaining the rage' or, as one executive client of mine called it, 'staying in a state of chronic unease'.

What typically goes wrong?

At this point, usually the deal team has been demobilised. The operational leadership team, having realised the harsh realities of what lies ahead, will either call out that plans and targets were unrealistic and renegotiate these, or call for more resourcing than was originally envisaged. This is not to say that such pushback is not justified, but the early warning sign of a lack of fortitude is when the executive team start walking back from the agreed plans and commitments.

The second key factor is that the CEO or business unit leadership switch prematurely from treating post-merger integration projects like properly governed initiatives, with the necessary oversight and transparency, to business as usual (BAU) projects. As a result, the tempo and discipline of project delivery wane, momentum is lost and the period of goodwill given by investors is squandered.

Transformation Stage

Tips and Traps

What to do right: conditions for success

1. The Executive team must be in ownership
2. Understand the complexity
3. Establish fit for purpose project controls
4. Keep on communicating especially the 'where and why' or case for change

What to look out for:

5. Under-estimating the importance of culture
6. Lethargy or drift – falling off the pace
7. Part-timers and lack of accountability

Remember:

8. Limited overs cricket – run rate
9. Laser like focus on outcomes
10. Focus on hard and soft factors and journey management
11. Don't believe your own propaganda

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Performance is the result of eternal vigilance

Naturally, a board and executive team will have gone into a transaction with eyes wide open and a well-informed view of the deal rationale and outcomes, right?

So begin this last stage by asking yourself: What have we really accomplished since the deal was undertaken? Can we demonstrate those outcomes to the investment market? What are our staff, our customers, our competitors, saying about how we have performed? Where do we need to double down on our efforts to deliver the synergies and outcomes we intended?

The best way to avoid 'looking without seeing' in answering these questions is to invite a mid-stream, independent program review or health check.

Some cautionary tales from the last major M&A wave

Could this be the legacy you preside over as a board member?

CSR's acquisition of Viridian

Subsequent to the 2008 acquisition for $1.2 billion of Viridian glass by CSR, CSR had to make two write-downs: AU$100 million in 2008 and another AU$250 million write-down in 2009.[1] Those write-downs equated to approximately 25% of the original investment cost.

Or this one:

Suncorp and Promina

By early February 2009, the share market value of Suncorp was AU$7.2 billion. "That value means the bank has destroyed all the $7.9 billion it paid for Promina…."[2]. Or as the *Sydney Morning Herald* newspaper put it, on 6 February 2009[3], (the outgoing CEO who had just resigned) "Mr Mulcahy declined to take responsibility for Suncorp's dismal share price performance – it has fallen more than two-thirds from its peak." "I wouldn't think I have any regrets," he said.

Or this one:

QBE across dozens of bolt-on acquisitions

QBE, a serial acquirer, made 135 acquisitions in the past 30 years to expand to 48 countries and approximately 44 acquisitions valued at AU$7.61 billion since Frank O'Halloran became CEO in January 1998. Nonetheless, as Australia's largest insurer by market value, QBE posted a 37 per cent fall in net income for the half year (i.e. in the six months) ended 30 June 2013, which dropped to AU$477 million, as premiums fell in North America, and it set aside more capital for unresolved

[1] http://www.theaustralian.com.au/business/opinion/csrs-glacial-pace-to-demerger-250m-viridian-writedown/story-e6frg9io-1225791508475

[2] http://www.crikey.com.au/2009/02/05/suncorp-battens-down-the-hatches/

[3] http://www.smh.com.au/business/profit-slump-bad-debts-suncorp-in-the-shadows-20090205-7yyu.html

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claims. In the prior full year ending 31 December 2012, net income fell 45% to AU$704 million for the 12 months, citing it as "one of the worst years on record for catastrophe events".

Or this one:

Newcrest and Lihir

"The worst performer this year of Australia's 50 biggest publicly traded companies, has lost more than AU$20 billion in market value since Robinson became CEO in July 2011. The company has struggled as gold plunged from a record and it missed output targets."[4]

Newcrest, which is Australia's largest gold producer, named a new chief executive officer and new chairman in a boardroom cleanout after an AU$6.2 billion ($5.9 billion) write-down triggered an ASIC regulatory probe.

The outgoing chair and the CEO, who was previously Newcrest's chief financial officer, "…had faced dissent from shareholders over the AU$9.7 billion acquisition of Lihir Gold Ltd. in 2010". According to an investment analyst: "It's a step in the right direction... There are so many things that need to change in this business, it's just one piece of the puzzle."

The same analyst asserted that "Newcrest has pretty much been on a downward path, coincidence or not, ever since that acquisition. The biggest mistake all managers make is capital allocation, and that's been true of Newcrest."

And what do scholarly researchers have to say? In a comprehensive analysis of prior studies, Martynova and Renneboog (2008) found that:

"Accounting studies examine the combined operating gains of takeovers. …14 out of 26 studies report a post-merger decline in the operating returns of merged firms…, 7 papers show insignificant changes in profitability (e.g. Linn and Switzer, 2001), and 5 papers provide evidence of a significantly positive increase (e.g. Carline et al., 2002)." In other words, results are mixed, but with most evidence pointing to these being losing events for shareholders.

So what are the key things boards should be looking out for in this stage?

1. Declaring victory prematurely and moving on: management has moved quickly past the acquisition and is either stepping back from synergy / run rate commitments or is simply not talking about them in the hope that everyone forgets commitments made.
2. General inertia and fatigue: given the real work should be happening now, is there an execution team in place feeling a strong sense of ownership and with the stamina to still go after the value?
3. "Don't mention the war"; that is, don't just move on but deal with the fall out and lessons: what learnings should be codified, absorbed and remembered for next time? A post implementation review is not a search for the guilty but recognition that, like any corporate capability, M&A needs transparency of performance, continuous improvement, and executive ownership if you are serious about doing better next time.

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[4] http://www.bloomberg.com/news/2013-10-08/newcrest-to-replace-ceo-chairman-after-writedowns-and-inquiry.html

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Test yourself with five key moment of truth questions

To conclude this stage, ***ask yourself five critical questions on the governance of 'post transaction value delivery'*** by you and your fellow board members***:***

1.	Having made the deal and being well into the post-merger phase, do we have solid grounds to be confident of promised delivery?	✓
2.	Are we seeing credible plans for further value extraction and upside to share with our investors?	✓
3.	Are we taking all our key people and staff with us on this journey? Are we sure?	✓
4.	Are we closely monitoring our working assumptions and key risks and managing contingency plans?	✓
5.	Can we truthfully claim that 1+1 >2 and that early evidence is that the investment is proving well-justified?	✓

Think about these five questions. We will invite you to take a short survey at the end of the final article to assess how M&A capable and prepared your board is.

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