

**MERCER**

Human Resource Consulting

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# Mastering Human Capital Issues in M&A

Australian Research



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# Introduction

Merger and acquisition (M&A) activity continued to boom worldwide in 2006 – and Australia was no exception. Global M&A activity reached a record of US\$3.8 trillion in announced deals, an increase of 37.9% over the previous year's volume. Australian organisations announced deals worth over \$163.9 billion (USD), a 56.4% increase over 2005.<sup>1</sup> A rising stock market, the boom in private equity, and the continuing pressure on CEOs to grow both revenue and profits suggest that M&A activity will only increase in 2007 and for the foreseeable future.

Yet, despite these figures, M&A is hardly the sure-fire winner that this surge in activity might suggest. Mercer research shows that 48% of companies globally had a total shareholder return (TSR) lower than their industry average three years after a deal was done. Similar findings have been reported by other studies: an Accenture/EIU survey found that fewer than half of respondents had captured hoped-for cost savings in a merger, while barely half achieved their revenue goals. While there is some evidence that success rates are improving, and that active dealmakers achieve better returns for shareholders than those who grow organically, M&A, as currently practiced, remains a high-risk option for many organisations.

Why the relatively high failure rates? Both observation and experience suggest to us that while companies are getting better at managing transactional issues such as contract negotiations, financial structures, change of control and asset management, it is the people and culture issues that still provide the greatest challenge, and are still cited most often as the underlying cause of why companies cannot extract anticipated future value. This is particularly relevant for service industries where people are the major asset and the main source of competitive advantage. Who can't recall M&A deals that started with great promise, only to fizzle when key people walked out, relationships with important customers soured, and productivity of employees (of both target and acquirer) plummeted? Or, as one CEO described in an interview for Mercer's Australian research: "In our last four deals, none was as successful as expected. *We made very different mistakes each time, but the common denominator was that people issues were too far down the checklist and too far out in time.*"

In seeking to understand the factors that distinguished successful deals, and in particular the impact that management of people risks has on transaction success, Mercer undertook a major study of M&A in Australia. Sixty one organisations participated, all of which are active deal-makers. Mercer interviewed 20 CEOs or their nominated delegates, and conducted an extensive online questionnaire for HR leaders. Key findings of the research completed late in 2006 included the following:

- Revenue growth – not cost reduction – was the most common expected source of deal value
- Understanding the value human capital brings to the productive capacity of an enterprise is becoming more important when pricing M&A transactions
- Human capital risks in M&A are both the most important for success and the most difficult to manage
- Cross-border transactions require particular attention
- M&A success will increasingly depend on the HR capabilities an organisation can deploy before, during and after the deal is made.

Attention to important human capital issues is critical for transaction success. The sections that follow provide a more detailed discussion of Mercer’s key research findings, followed by recommendations for how organisations can be more effective in future mergers, acquisitions and other business transactions.

## M&A transaction outcomes

In spite of the importance to strategy, and investment of significant financial resources and executive time, M&A transaction results often fall short of expectations.

### Exhibit 1 Assessment of M&A outcomes

Source	Observed Acquisition Failure Rate
Mercer Management Consulting	48% of merged organisations had a total shareholder return (TSR) that was lower than their industry average three years after deal consummation <sup>2</sup>
McKinsey	61% failed to earn cost of capital or better on funds invested <sup>3</sup>
AT Kearney	58% had a lower TSR 24 months after the merger announcement than three months before <sup>4</sup>
Booz Allen & Hamilton	51.3% of merged organisations’ TSRs under-performed relative to industry peers two years after deal close <sup>5</sup>
Accenture / Economist Intelligence Unit	Only about half of respondents believed their companies had achieved the expected revenue synergies, and just 45% affirmed that expected cost synergies had been captured <sup>6</sup>

More recent research undertaken by Booz Allen suggests ‘there is no doubt that the success rate of mergers has increased significantly’ and this is attributed to organisations becoming more disciplined. Specifically, Booz Allen cites three main reasons: more deals involve companies merging in the same industry, boards and shareholders insist on vetting merger implementation plans, and merging companies do more planning of the integration process well before a transaction closes.<sup>7</sup> McKinsey’s 2006 research concludes that companies consistently adding value through their acquisitions share some practices that may explain their success. Namely, they balance acquisitions with organic growth, leverage the entire organisation to drive the process from start to finish and understand how they can use their own strengths to create a competitive advantage.<sup>8</sup>

## Participating organisations

Following is a list of participating organisations that have agreed to be named in this report.

3M Australia Pty Ltd	Federal Express	MBF Australia Ltd	Sanofi-Aventis
Alinta Limited	Feltex Carpets	Media Monitors	Sensis Pty Ltd
Anglicare Victoria	First Data International	Mercer Human Resource Consulting	Sigma Company Limited
ANZ Bank	GBST	Mercy Health & Aged Care	Sinclair Knight Merz Pty Ltd
AustralianSuper	GE Commercial Finance	Metcash Trading Limited	SKILLED Group
Brambles Industries	IAG	NRMA	SPC Ardmona
Centro Properties Group	ITW Construction Products	OneSteel	Symantec (Australia) Pty Ltd
Chandler Macleod Limited	Johnson & Johnson Medical	PMP Limited	TR Corporation
Coles Myer Limited	Kraft Foods Limited	Qenos Pty Ltd	United Group Infrastructure
Diebold Australia Pty Ltd	Lucent Technologies	Raytheon Australia	V/Line Passenger Pty Ltd
Dun & Bradstreet (Australia)	Marsh Pty Ltd	Ricoh Australia Pty Ltd	Vision Australia Limited
Ericsson Australia Pty Ltd	MaxiTrans		Wesfarmers Limited

# Revenue growth is focus for deal value

*Revenue growth – not cost reduction – was the most common expected source of deal value.*

Accordingly, companies are investing most heavily in capabilities and customer facing roles that will drive revenue growth. Workforce strategy, targeted recruitment, succession planning, development, and aligning reward programs with organisational goals are critical elements, yet these are rarely considered pre-deal or as strategic investments for the future.

## Investments for revenue protection and growth

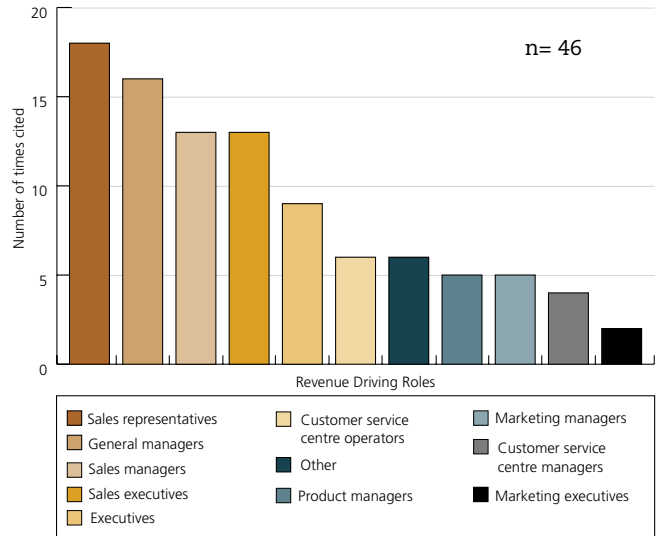
Given the clear focus on revenue, it is critical that organisations make investments to protect current revenue *and* to grow it. In such a competitive market for talent that the uncertainty around M&A activity can result in employees with other options, including key revenue generators, heading for the exits. Organisations that are making investments expressly to protect revenue said they are investing primarily in employee retention. Communication to customer-facing roles and customer-supporting roles is the next most cited investment to protect revenue.

To grow revenue, organisations told us they are making investments in establishing new roles; putting new people with new skills into key roles; training customer support staff; and realigning sales incentive programs.

With hindsight, organisations that did not invest reported that if they had it to do again they would invest more to protect and grow revenue, particularly in retention programs; training for customer-facing roles; and sales incentive redesign.



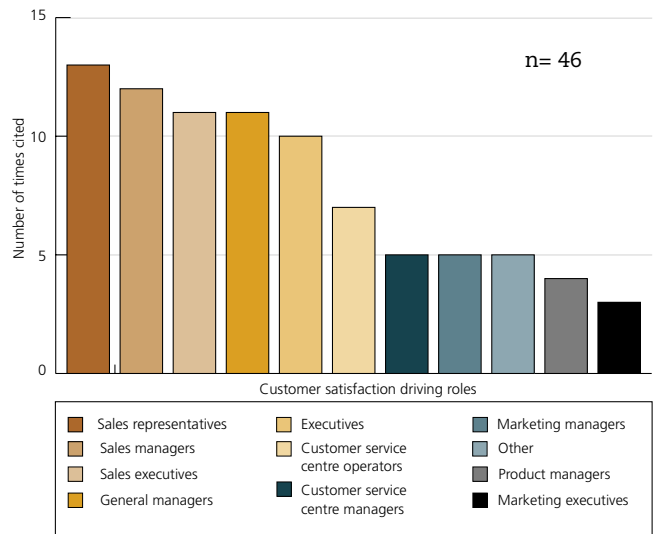
**Exhibit 2 Which roles drive revenue?**



Sales representatives are key to driving revenue in all types of transactions, with general managers becoming more important as the focus for deal synergies shifts from cost reduction to revenue growth. Sales representatives and sales managers, as well as marketing managers and executives, become more important in terms of driving revenue in cross-border transactions, as compared with Australia-only transactions. Customer service roles are seen as much less significant in cross-border transactions compared with Australia-only transactions.

Across all types of transactions, organisations reported making investments in the people best positioned to support or enhance customer satisfaction: sales representatives, sales managers and general managers (Exhibit 3).

**Exhibit 3 Which roles drive customer satisfaction?**



These results, however, don't tell the whole story. In 'bolt-on' transactions, organisations were less likely to take actions to drive customer satisfaction. In cross-border transactions, sales representatives, sales managers and sales executives were seen to be more significant drivers of customer satisfaction than in Australia-only transactions. Also, product managers, marketing managers and marketing executives were seen to have a more significant impact in cross-border than in Australia-only transactions. The only role seen as more important in Australia-only transactions was customer service centre manager.

One chief executive commented, *'With regard to customer satisfaction, I see an enormous link between HR issues and achieving this. [More than once] we have changed people because of customer reactions'*.

### How does HR impact on revenue?

In more than one-third of transactions reviewed HR reported not being involved in any efforts to drive customer satisfaction. In cases where HR was involved, they most frequently worked directly with general managers to redefine sales compensation strategy to reflect customer satisfaction measures, redefine workforce models, and improve communication to employees about customer satisfaction.

- HR was more likely to work with general managers on these issues when the synergy focus was revenue growth
- There was no appreciable difference in HR involvement between cross-border and Australia-only transactions
- In transactions where integration rather than 'bolting on' was the focus, HR was more involved in redefining sales compensation and increasing communication to employees about customer satisfaction.

It takes more cleverness to realise value when the primary expected source of deal value is revenue growth rather than cost reduction. When organisations focus on revenue synergies, leaders must understand what will drive future value and invest in these areas, placing the right emphasis and resources on drivers of revenue protection and growth.

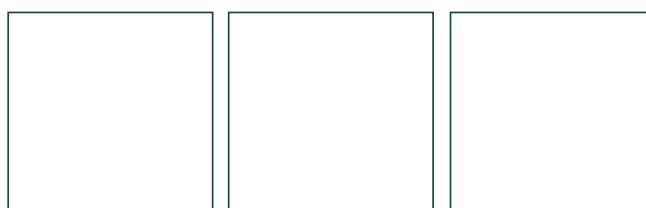
These research results suggest that often HR is not significantly involved in the people programs that lead to revenue growth, even in the critical area of incentive design. This is true outside of the deal-making context as well, to the detriment of many organisations in service industries. HR teams can become so focused on managing payroll, benefit programs and other routine operational concerns that they do not engage in the strategic issues that support revenue growth and profitability.

Timing and speed with which an organisation can implement programs and operational plans to drive revenue growth also is a factor for how quickly people become productive. Anticipation of challenges, effective planning and having the right resources available will increase the chances of successfully realising expected value from revenue growth.

### Human resources link to revenue

The correlation between customer satisfaction and organisation revenue (and profits) is both intuitively clear and supported by abundant empirical research undertaken by Mercer and others. Notable among these is the service-profit chain work cited in the Harvard Business Review in the early 1990s – few studies have done so much to affirm the impact of HR on the bottom line. This research traced a chain of causation from its endpoint, revenue growth and profitability, back through the many factors that affect it: from customer satisfaction to employee retention and productivity to employee satisfaction to internal service quality. Service quality, the first link in the chain, is supported almost entirely by HR-related factors: workplace design, job design, employee selection and development, and rewards and recognition.

James L. Heskett, Thomas O. Jones, Gary W. Loveman, W. Earl Sasser, Jr., and Leonard A. Schlesinger, "Putting the Service-Profit Chain to Work"; *Harvard Business Review*, March-April 1994.



# Human capital value

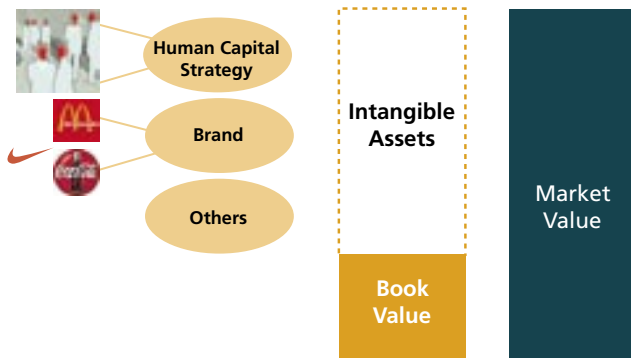
Understanding the value that human capital brings to the productive capacity of an enterprise is becoming more important when pricing M&A transactions. When finance executives and their advisors are pricing a deal, part of the consideration is the value of intangible assets which can include brand value, reputation, research and development, innovation and organisational capability. Increasingly more emphasis is being placed on intangibles, with their real value being in the contribution made to the bottom line result and the prospect that an acquirer can leverage them for future profit.

With many of these intangibles it is the people that make the difference. For instance does the company have a strong service orientation or culture? Is this reflected in how employees deliver the brand promise? Are teams looking for new and innovative ways to service customer needs? And does the culture translate effectively into a strong reputation in the market? Having a sound strategy and negotiating the right price go only so far. Maintaining and improving the productive capacity of the workforce through clever implementation is critical to transaction success.

## What we mean by human capital

Human capital is the sum of the skills, experience, knowledge and other attributes in the workforce that can contribute to business success. Human capital has both tangible financial and intangible value (Exhibit 4). The tangible is measured by the cost of payroll, benefits and programmes designed to develop the workforce (which can be quantified at any point in time); the intangible is the value measured over time of the building of organisational capability (skills, experience, knowledge, attitudes, commitment and engagement).

**Exhibit 4 Human capital value**



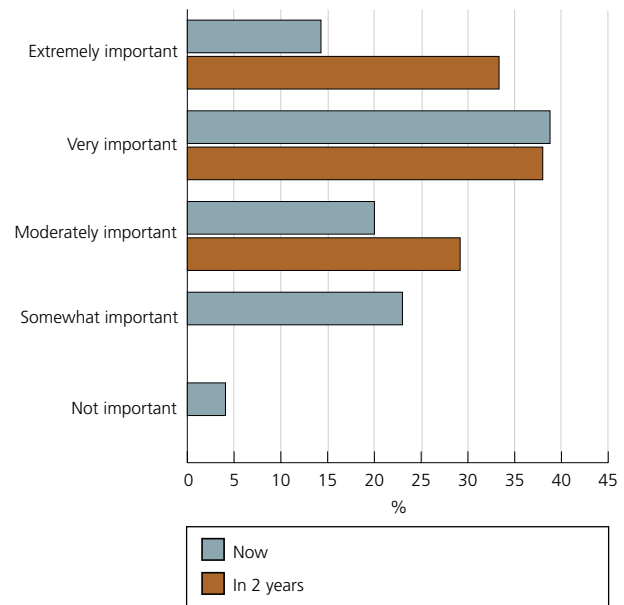
One way to think about your organisation’s human capital strategy is to consider what is in place to ensure that you are getting the best return (e.g., productivity, creativity, etc.) from the resources you invest in people. Human capital strategy includes both the organisational practices and the workforce characteristics that drive outcomes.

## Business leaders’ view of human capital

Two-thirds of HR leaders surveyed reported that their business leaders view human capital assets, on balance, as a source of value rather than a cost.

Also, the importance of human capital value in pricing transactions is expected to increase, with 71% of respondents predicting that it will be very or extremely important in two years’ time.

**Exhibit 5 Importance of human capital in determining deal price**



These findings mirror a Mercer study done jointly with CFO magazine in the US in 2003, in which 45 percent of chief financial officers reported that human capital is an important factor to consider in the price of an acquisition. Fifty-nine percent predicted that it would be very important in the future. Twelve percent of CFOs surveyed said that managing human capital during M&A was one of the three most significant challenges for their organisations.<sup>9</sup>

## Human capital drivers of business performance

Determining the value of intangibles, including the value of human capital, is likely to require more sophisticated approaches over time. But it is important to keep the real issue in focus. Once a deal has been done the *real work* is in ensuring that the value of 'intangibles' (however this is determined) becomes tangible and drives future profit. One way to do this is by clearly identifying the most important drivers of business performance and investing in programs that support these as a matter of priority.

Consider four basic categories of behavioural drivers: personal, social, organisational and models. Two of these are manageable in business change processes and two, generally, are not. Recognising this fundamental difference in behavioural drivers is the first step in developing and executing a practical approach to implementing an organisation culture aligned with expected business outcomes.

It is difficult, and perhaps inappropriate, for organisations to attempt to change personal and social drivers of behaviour. However, we can and should aggressively manage **model** and **organisational** drivers to impact business performance.

**Model** drivers represent the behaviour of others, whether peers, leaders, coaches or role models. Behavioural models first and foremost must be the leaders in an organisation, starting with the very top leader.

**Organisational** drivers, both formal and informal, include vision, values and work environment, along with human capital drivers such as:

**People** – whom the organisation hires, develops and retains

**Processes** – how work gets done

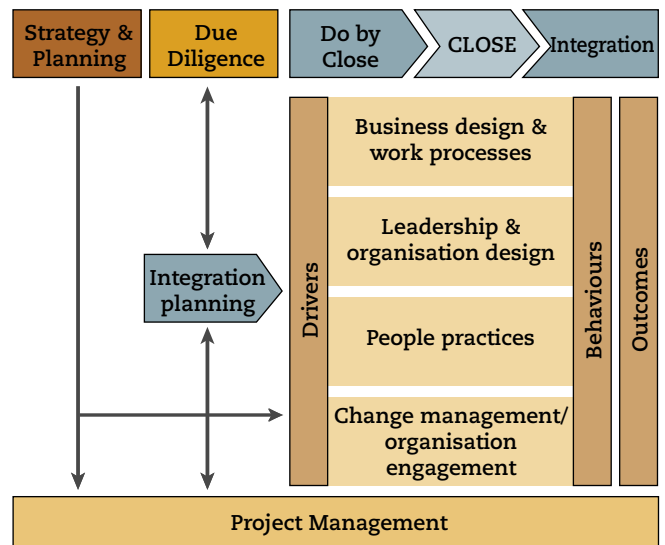
**Management structure** – how work and people are organised

**Information and knowledge** – how information is shared

**Decision making** – what decisions are made and by whom

**Rewards** – how people are recognised for their contributions

**Exhibit 6**  
Planning integration to capture maximum value



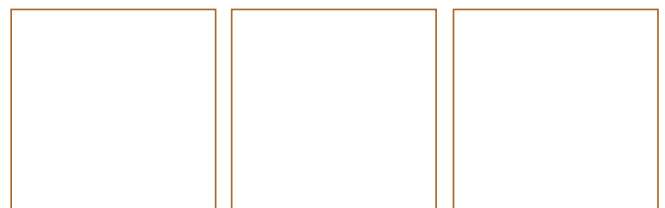
Again, people are the key, and how organisations deliberately identify and lead required changes often will make the difference between success and failure. Leading behaviour/cultural change is implicit in successful integration.

### Executive insight

*'To capture the full value of human capital:*

- *Focus on integration, even through the due diligence period*
- *Get access to the people as early as you can and, without fail, meet with everyone within two to three weeks of completion*
- *Put the right leaders into the right roles right away*
- *Get the culture right*
- *Manage performance at a corporate level and cascade this through.*

*People start to get it after two years; three to five years out is when we know if we got it right.'*



# Managing human capital risk in transactions

**Human capital risks in M&A are both the most important for success and the most difficult to manage.** This has been true over time, across national borders and whether we ask chief executives or HR leaders. And even experienced deal makers admit they are not getting it right every time.

Importantly, price paid for a transaction assumes the same or a greater level of productive capacity of combined workforces *after* a deal as was the case before the deal, and herein lies the risk. On announcement the productive capacity of both workforces typically drops as people speculate about the future more than they focus on creating value in the present. Value will continue to erode until business leaders take deliberate steps to provide clear direction and stability through strong leadership, communicate effectively and consistently, reinforce behaviour that shapes the desired culture, and drive required changes throughout the organisation.

## Approaches to managing risk

Every M&A transaction involves risk – to shareholder value, employee relationships, customer relationships and operational effectiveness, to name a few. Managing risk is a major focus for deal teams, on both financial and non-financial dimensions.

More than 68% of organisations in this study reported using formal processes for managing M&A risk (i.e. taking a systematic approach to identifying potential adverse outcomes, estimating the probability of those outcomes and resulting costs, and building risk avoidance and mitigation plans).

However, 16% of organisations that completed the survey do not manage human capital risks in the same way as other risks, in spite of the potential impact on transactions. In organisations that do not manage human capital risks formally, most HR leaders cite a failure to involve HR in the early stages of deals as the main reason.

More than half of chief executives interviewed told us that in their transactions, human capital risks get the same attention other transaction risks do. For the organisations where this has ‘not always been the case’, the move to handling human capital risk in the same manner as other risks has come as a result of sometimes bitter lessons learned in earlier transactions or undertaking more challenging deals in terms of managing people issues. Says one CFO, **‘The number and nature of transactions has changed; for example, private equity firm activity has had a big influence. Changes to risk models are due to having more emphasis on identifying upsides and asking how we can realise value more quickly’.**

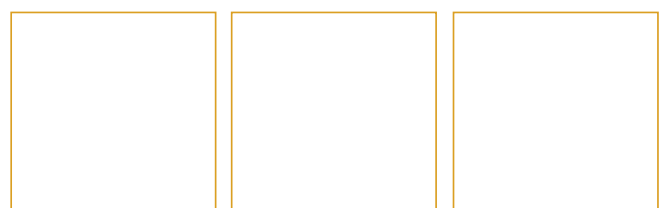
Chief executives also commented that they were nowhere near as structured in quantifying and measuring human capital risk as they were with other types of risk. **‘We don’t measure; rather we identify and think of ways to mitigate if the worst happens’.** **‘The key difference in handling human capital risk is that we are more subjective because it can’t be assessed or quantified as well as other risks; for us, it is more about putting processes in place for handling things if they go off the rails’.**

## Human capital risks

Transaction risks related to human capital include:

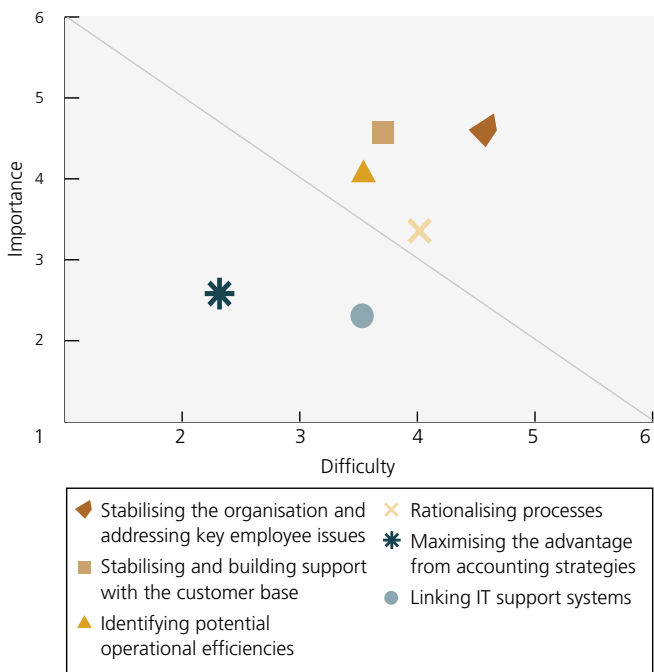
- Unanticipated financial liabilities (e.g., unfunded pensions, change of control provisions, restructuring costs)
- Loss of key people
- Reduced productivity in the lead-up to completion, as well as in the post-deal period
- Disruption to sales and customer service
- Industrial disputes
- Legal concerns and liabilities.

Not attending to these risks can result in significant financial and reputational consequences for organisations.



Chief executives agree with HR leaders that 'stabilising the organisation and addressing key employee issues' is both the most important and most difficult integration focus. Eighty-two percent ranked it either first or second in importance as compared with 60 percent of HR leaders. Just under half of CEOs ranked it first in difficulty as well, with 65 percent ranking it either first or second in difficulty.

**Exhibit 7 Executive perspective on human capital risk**



Said one chief executive, *'It is critical to get the people issues right. We walk away from deals when the culture is not right if we don't believe we can change it, or change it quickly enough. Where deals have not worked, invariably the people issues were the reason. People fit and culture are the most important to the success of deals'*.

CEOs were more bullish than HR leaders when assessing capability to address key employee issues; still nearly one-third ranked this as fifth or sixth out of six when compared with other capabilities necessary for supporting transactions.

So, what can organisations do to manage people risks most effectively? The most important first step is to give these risks due attention and emphasis, which will bring critical people issues into focus well before a deal is announced. This in turn will focus due diligence on the immediate price impacts as well as on the identification of human capital risks to capturing value once the transaction is completed. Pre-deal planning for how these critical people issues will be handled reduces risk significantly, and will ensure that a realistic timeframe for capturing value is considered in the pricing model.

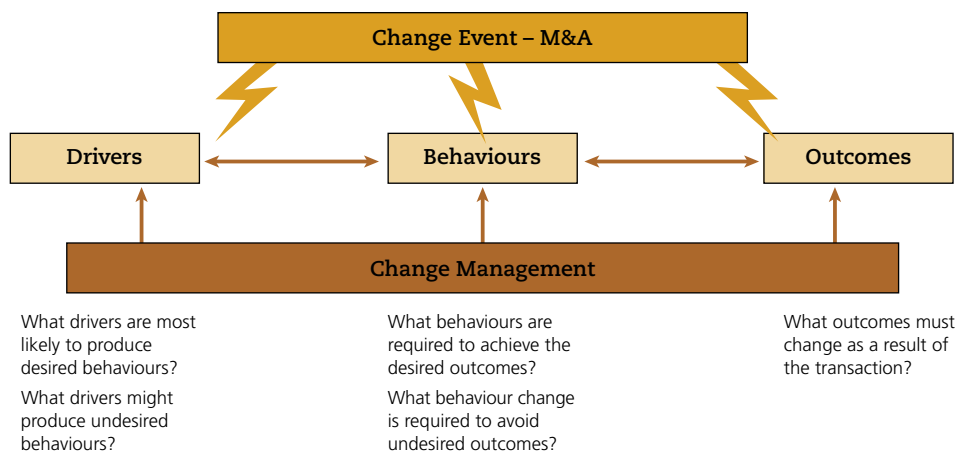
### Cultural alignment is the cornerstone for successful integration

First, let's define what we mean by culture. By considering culture practically, rather than academically, the issue becomes less about "culture" and more about individual and organisational behaviours and the results they produce. On that basis, an organisation's culture is the aggregation of those individual behaviours which make up how work gets done.

"Sixty-seven percent of respondents point to cultural integration as the most important people issue and the most critical success factor in an M&A transaction – more than, for example, business process integration", *The Economist Intelligence Unit White Paper, 2006*. Further, "Culture, and the integration of cultures, is the major reason behind the failures and the most difficult area to get right in combining organisations", *Chinese Entrepreneur, September 5, 2005*.

## Exhibit 8 Defining culture in M&A

Consider three elements – drivers, behaviours and outcomes – in a form of systems thinking. *Drivers influence individual behaviour and the aggregation of individual behaviours produces outcomes.* Considered another way, if an organisation desires a different set of outcomes, individual and collective behaviours (i.e. culture) will have to change. And if culture needs to change, then different drivers must be in place to cause behaviour change.



In a vacuum, culture – the way people behave – is irrelevant. Only when “culture” is in context, does it become relevant. The environment within which culture exists and the *outcomes* which result from typical behaviours determine whether a culture is good or bad. Logically, a culture is considered good if it produces the desired outcomes; a culture is considered bad if the desired outcomes aren’t produced.

Being clear about the kind of culture that is needed to produce expected business outcomes and the path to achieving this culture is fundamental. It is imperative to understand the current cultures of organisations so that investments and timeframes for change are realistic. Only then is deliberately and effectively leading cultural change possible.

As the cornerstone for managing human capital risk in transactions, cultural alignment must be implicit in the integration planning process. Once organisations understand the culture they are aiming to create it is then possible to determine which drivers (and hence structures, programs, policies, practices) will most effectively produce desired behaviours. Integration priorities must be determined based on the expected impact of projects undertaken.



Success, of course, will hinge on the capabilities of executives and line managers to understand, buy into and lead required cultural change.

Overlaying a deal making culture (e.g. clear, consistent communication regarding business context, direction and accountabilities; measurement and tracking; a bias for action; understanding that it is more important to get the people elements of the integration 80% right and moving forward in the right direction than to delay the process looking for the perfect solution) will also improve outcomes. Finally, organisations must understand the differing impacts of leadership, as compared with management, capabilities and the influence these have on transaction outcomes in order to resource effectively for success.

### Three steps for successful integration

Successful integrators take three purposeful steps. First, they make cultural integration a top priority. Second, they define the elusive term ‘culture’ in concrete and actionable terms as the aggregation of employee behaviours that produce desirable business outcomes. Third, they take advantage of the pre-close period to get as much done as possible. Waiting to begin integration – or dragging it out – results in shareholders having to wait longer to realise the value of the deal.

# Cross-border transactions

**Cross-border transactions require particular attention**, given the complexities that are naturally present when dealing in different cultural, regulatory and business climates. This complexity increases when undertaking a transaction that includes more than one other country. The impact of people issues varies depending on whether the transaction is undertaken in emerging or mature markets.

Sixty percent of respondents reported giving about the same level of attention to human capital risk in cross-border transactions as they do in domestic transactions. The remaining respondents indicated that more attention was paid to human capital risk in cross-border transactions than in Australia-only transactions. Notably, no organisations reported giving significantly less attention to human capital risk in cross-border transactions.

A number of executives commented that their biggest human capital concern in cross-border transactions was the financial impact of unknown liabilities, and on the importance of having top-notch advisors when doing transactions outside their own country. Lamenting a first cross-border transaction, one chief executive commented, *'We did not know the questions to ask and we did not put enough senior people on the job'*.

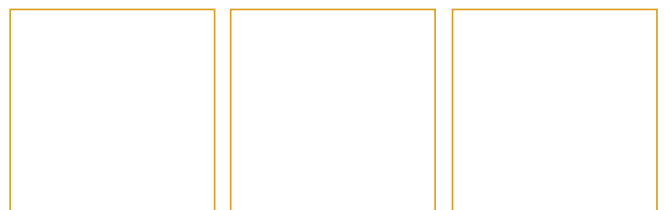
Some executives do not see human capital risks as significant when doing deals in emerging markets (as compared to mature markets) because these transactions often involve taking on a non-controlling interest or target organisations are 'bolted on' rather than fully integrated.

One executive summed up his organisation's approach to managing risk in emerging markets as follows: *'It is important to consider risk in the right order: first sovereign, then company and business proposition, and finally how to run the business, including [managing] people. There is no point in looking at the people risks if you're not past the first two hurdles'*.

Chief executives of most organisations who have undertaken cross-border transactions agree that managing human capital issues and realising full value can be more challenging than it is in single country transactions. Following are a number of comments to capture their points of view.

- *'[In cross-border transactions there are] bigger issues around culture, pay packages, long term incentives and benefits. It is important that we don't underestimate liabilities, or get the timing for dealing with cultural issues wrong'*
- *'Our experience was that the metrics were the same but we needed more time, specifically more face time, in order to build trust [in order to achieve the outcomes upon which we based the transaction]'*
- *'[Cross-border deals are] very different. People issues have a higher level of importance – and must be addressed earlier'*
- *'There are significant differences in cross-border transactions depending on whether you are doing business in an emerging market or a mature market. In emerging markets, people issues are more important given that technology transfer is usually the focus, whereas in mature markets the focus is more likely to be on cost synergies, management team and customers'*
- *'Patience is important in emerging markets. Often vendors are less experienced in doing deals; the ability to partner allows for good relationships, and this is especially important for minority owners'*
- *'Don't send inexperienced people to do deals in emerging markets!'*

Cross border transactions present particular challenges given that they involve all of the usual risks presented by local transactions plus the additional degree of difficulty that comes from different national cultures, legislative issues and market conditions. Also the practical issues around project coordination, time zones and physical distance enter the picture. And these challenges seem to increase exponentially with each country added, making deal readiness and project discipline crucial when doing a deal that involves more than one country. Finally, never underestimate the impact of national cultural differences on top of company cultural differences when considering the level of investment to make in leadership and communication.



# HR capabilities and involvement

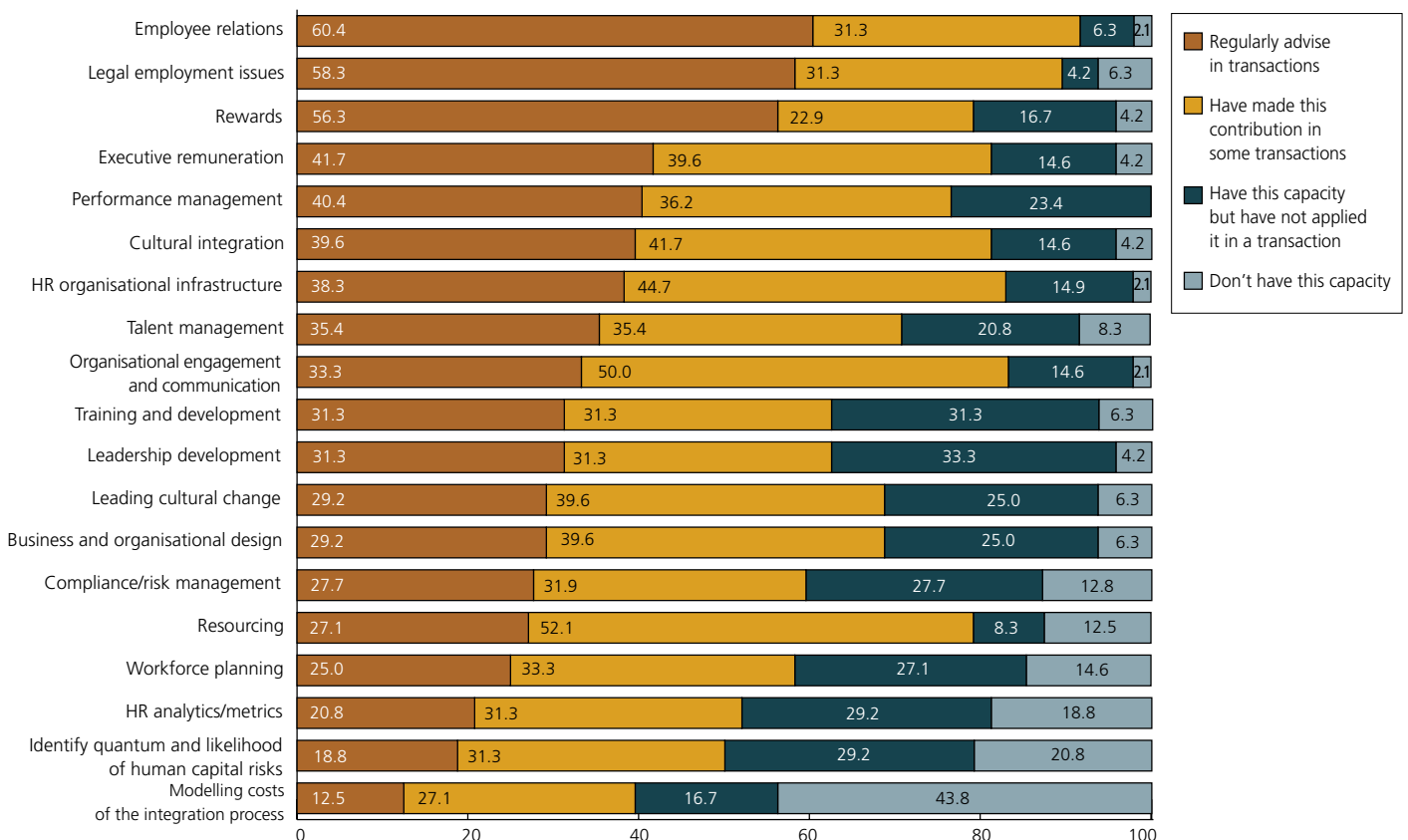
**M&A success will increasingly depend on the HR capabilities an organisation can deploy before, during and after the deal is made.** The HR function can be an important part of the transaction process and deal success, but only if it develops both the strategic understanding to drive value and the specific implementation capabilities that deliver value to the deal. The senior HR executive and the HR team must plan effectively, equip themselves with the right skills, and win the confidence of the CEO and Board. When asked about the role of HR in a M&A, chief executives and business development leaders echoed the opinions of HR leaders as to the primary reasons HR is under-utilised in transactions, specifically related to capability, focus and resourcing levels.

## HR involvement in transactions

To repeat an earlier theme: the area considered the most important for integration success and also the most difficult is addressing key employee issues. This is true whether we ask CEOs or HR professionals, whether in Australia or abroad, and over time.

What part specifically must HR play in managing human capital for successful transactions? Exhibit 9 brings together responses to a number of our questions about what HR brings to the table during M&A. Employee relations, legal employment issues, executive remuneration and employee rewards stand out, with 40 to 60 percent of respondents regularly advising on these issues.

**Exhibit 9 HR support for M&A transactions**



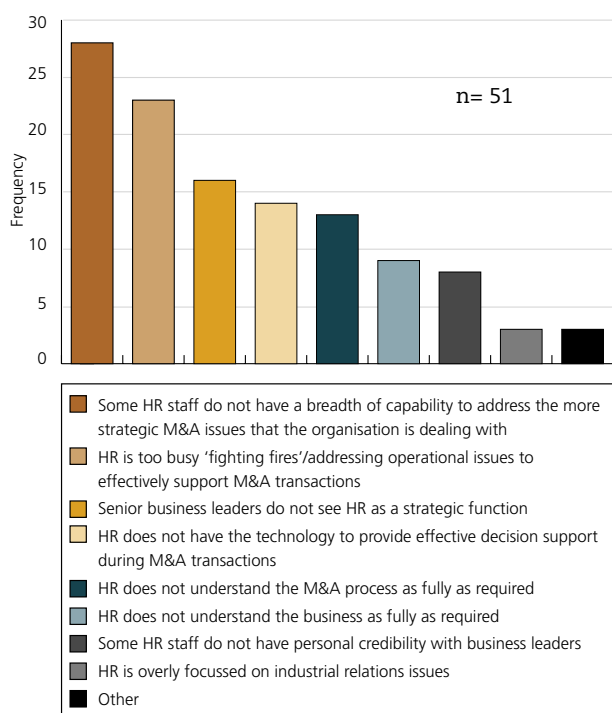
Learning what HR functions do during transactions is enlightening. Knowing what these functions don't do is equally so. The lower half of Exhibit 9 reveals areas where the HR function is less likely to be involved. We see in the bottom row that more than 43 percent of organisations lack the capability to model the costs of post-deal integration; another 16 percent have this capability but do not apply it. If business leaders are not getting this information from HR, where do they get it? It is most likely that Finance estimates the total cost (rather than value) of human capital when acquiring and integrating target enterprises. In the event that Finance does not have the full human capital picture, what opportunities could be missed?

Other important areas in which HR cannot or does not lend support include, most notably, identifying the level and likelihood of human capital risks, HR analytics and metrics and workforce planning.

Aside from a lack of capabilities in some areas, other reasons that the HR function is being under-utilised in support of transactions, even in some of the most M&A-experienced organisations, are summarised in Exhibit 10. Across the survey group, three views stand out:

- Some HR staff lack the capability to address strategic M&A issues
- HR is too busy with operational issues /‘fighting fires’
- Senior business leaders don’t see HR as a strategic function.

**Exhibit 10 Significant hurdles to HR contributions**



**Crucial human capital issues**

M&A transactions involve many people issues, some of these being more important than others. We asked our survey respondents to think back to a particular deal and answer two questions related to the list of issues in Exhibit 11:

- During that transaction, which were the three most crucial human capital issues addressed to achieve your organisation’s goals?
- Based on your experience in that transaction, which issues should have been given more attention?

**Exhibit 11 Human capital focus in transactions – most frequently named in the top three**

	Focused on	Should have focused more
Legal employment issues	57%	22%
Organisation engagement & communication	46%	41%
Model costs of integration	46%	16%
Employee relations	43%	24%
Cultural integration	35%	46%
Rewards	27%	3%
Leadership	24%	30%
Resourcing	19%	5%
Business & organisation design	16%	22%
Identify likelihood and quantify human capital risks	11%	32%
Performance management	3%	5%
HR organisation infrastructure	3%	0%

It is important to note that respondents did not say their organisations should have changed their initial focus. Rather they believed that had they focused more attention on **communication, culture and leadership**, their deals would have been more successful.

Note that three of the five most cited from the left-hand column are among the key issues in the right-hand column – namely, organisational engagement / communication, employee relations and cultural integration. Although significant focus was given to these areas, respondents believed that greater attention to them would have improved results.

In contrast, ‘identifying the likelihood and quantification of human capital related risks’ is an area that received minimal focus, and this emerged as an area requiring more focus once respondents reflected on what could have improved their deal outcomes. Similarly, ‘leadership’ did not make the top five for initial areas of focus but was the fourth most cited as requiring more focus.

Bottom line: if organisations don’t have capabilities to handle these crucial human capital issues (either within the business or by engaging external support) they will not be as successful in deals as is possible. If growth by acquisition is a significant feature of an organisation’s business strategy then it must ensure that business leaders and the HR team have or can source the capabilities to implement this strategy.

# Conclusion / future focus

Quantifying the value of and managing human capital will command greater attention in future mergers, acquisitions and other business combinations. While business combinations of the last century sought control of material commodities, many of today's deal-makers are hoping to capture the human ability to invent, design, advise and provide value-adding service. As Adrian Wooldridge told readers of a special feature in *The Economist* recently, 'Talent has become the world's most sought-after commodity'.<sup>10</sup>

## Why managing human capital is important in a deal

Many M&A deals begin with great promise but fail to deliver. The lesson from these unfortunate episodes is clear: acquirers that fail to give adequate attention to human capital in deal-making and post-deal integration do not reap the full benefits they anticipate.

Any time an organisation changes its business model – as the result of a deal, organic growth or restructuring – it must re-examine its human capital strategy. A 'new' organisation must redefine how it targets customers, the value it proposes to deliver and its profit model. So too must it look at the way work is defined, capabilities required, the employment value proposition and the required culture (i.e. individual and collective behaviours) to achieve business objectives.

Before reworking people policies, plans or programs, the new business design should be translated into a new human capital strategy. That strategy must identify the 'right' workforce and determine the drivers of desired behaviour; it also must prescribe actions to create the right workforce and shape the organisation culture that will deliver required outcomes.

Business leaders must articulate how the organisation expects to derive human capital value in the future. Only then can they begin to think about the ways in which to build and/or acquire, organise, manage, develop, motivate and retain the 'new' workforce.

## HR involvement in human capital management

Our research reveals that HR has not fulfilled its potential as an ally to deal-makers. Yes, most executives in the survey involved HR in early deal phases, but some did not. In many organisations HR did not provide the support in areas such as integrating cultures, leadership

development, communication and integration planning as required for maximum success. Scarce resources and a lack of the right skills accounted for some of these shortcomings.

If competitiveness for acquisitions continues to escalate – as it has over the past two years – organisations will have to become more proficient at extracting the benefits of mergers, acquisitions, joint ventures and other similar transactions. After paying top dollar, they cannot afford to leave value on the table.

The Australian organisations in our study are all experienced in M&A. Yet even they, by their own reckoning, have substantial room for improvement on the people side of business transactions. The good news is that HR practitioners are learning from experience and getting better at (or engaging experts to help with) the basic issues that once commanded their full attention: employee relations, legal matters, modelling integration costs, etc. Having covered these, they are prepared to turn more attention to the higher order tasks: cultural integration, communication and leadership assessment and development.

Focusing energies in these areas will have a positive impact on future outcomes and put organisations further ahead of less experienced rivals. But the fundamental question remains: *If we know that human capital risks in transactions are among the most difficult and the most important to manage, how can we do significantly more to avoid making the same mistakes we made in prior transactions?*

## The road ahead

The growing importance of human capital and this recognition by senior executives suggests several future possibilities:

- Acquirers will be successful in assessing the value of a target organisation's human capital only after they have gained an understanding and measurement of their own. New tools, including internal labour market analysis and business impact modelling, are available to make this not only essential, but practical.
- Acquirers must determine how and by whom valuation of human capital will be undertaken. If HR does not gain either the discipline or the skills to do it, Finance is the likely candidate – limiting the opportunity for HR to add required expertise and demonstrate the strategic value of the HR function. If HR loses the opportunity to provide this type of pre-deal strategic support, will it be able to claim the strategic positioning it needs to drive cultural change? And if HR doesn't own cultural change facilitation, who will?

- Acquirers must connect HR with their revenue growth and customer satisfaction initiatives. The way an organisation manages its people can influence customer behaviour. Again, the tools to link customer and employee behaviour are available for HR to use in identifying and harnessing the most important human capital practices and attributes for a winning customer experience.
- HR can (to the extent it embraces the challenge) enjoy a more strategic role in businesses, as the 'owner' of the tools, technologies and know-how to help organisations manage human capital, a strategic resource. This may require a sharper division of labour within HR departments, with one group dedicated to day-to-day operations and another dedicated to talent management and cultural implementation.

## Recommendations

Mercer offers the following recommendations for consideration by executives in acquisitive organisations.

- Get a clear understanding of the internal labour market, productive capacity and the workforce management practices that have the greatest impact on business outcomes. This understanding becomes the baseline against which to plan an integration strategy, determine the level of investment required and measure whether future human capital strategies deliver value.
- Invest heavily in communication, leadership and cultural integration at all stages of transactions. It is not possible to over invest in these cornerstones of effective engagement with the workforce.
- Develop an organisation-specific approach to evaluating the differences between the current workforce and how the ideal workforce will look. This is a critical first step towards building a workforce strategy aligned with and supporting the business strategy.
- Understand the linkages between people programs such as attraction, retention, remuneration, performance management, succession planning and development, and how these programs can drive an organisational culture that supports achievement of business goals.
- Consider how HR's own infrastructure can accelerate or impede the achievement of deal value. Too often, HR focuses only on integration of HR systems such as payroll and HRIS at the expense of finding new ways of engaging the workforce, supporting business units and building organisational capability.

- Build deal support capability into the skill profile of business leaders and HR. If deal-making is an essential part of business strategy, then HR must be 'M&A-ready'. If deal-making is more occasional or opportunistic, it may be more appropriate to buy rather than build deal support capability – but HR still needs to articulate a human capital strategy and which workforce and people practices are needed for future success.

Organisations should determine the role of HR in the context of expected growth and invest accordingly. Will HR be facilitators of leadership or implementers of technical solutions? Both are important to the success of transactions and the question of which will deliver the most value over time must be answered and acted on. Organisations must work out how to cover "the HR basics" efficiently so that resources (whether in HR or another part of the organisation) are free to add real value by focusing on future workforce requirements and engaging employees to deliver expected business outcomes.

Competition for transactions is fierce as organisations seek investment, growth, scale, access to markets, technical know-how and other strategic goals. Being able to manage human capital more effectively than others competing for deals becomes increasingly important when success or failure hinges on business leaders and HR teams having the experience and skills to not only complete the deal, but to implement effectively.

<sup>1</sup> "Mergers & Acquisitions Review"; Thomson Financial, Fourth Quarter 2006. <http://banker.thomsonib.com>.

<sup>2</sup> *Making mergers work for profitable growth: The importance of pre-deal planning about post-deal management*"; Mercer Management Consulting, Toronto, 1997.

<sup>3</sup> Matthias M. Bekier, Anna J. Bogardus, and Tim Oldman, "Why Mergers Fail: Is the belief that mergers drive revenue growth a delusion?"; The McKinsey Quarterly, Australia, 2001.

<sup>4</sup> Max M. Habeck, Fritz Kröger, and Michael R. Träm, "After the Merger: Seven rules for successful post-merger integration"; A. T. Kearney, Pearson Education Limited, Great Britain, 2000.

<sup>5</sup> "Merger Integration: Delivering on the Promise Study"; Booz Allen & Hamilton, New York, 2001.

<sup>6</sup> "2006 Global M&A Survey"; Accenture and the Economist Intelligence Unit, 2006.

<sup>7</sup> Mark McSherry, "MergerTalk: New research says merger success rate has improved"; Reuters News, 30 March 2006.

<sup>8</sup> Robert Palter, and Dev Srinivasan, "Habits of the busiest acquirers"; McKinsey on Finance, McKinsey & Company, Toronto, 2006.

<sup>9</sup> "Human Capital Management: The CFO's Perspective"; A report prepared by CFO Research Services in collaboration with Mercer Human Resource Consulting, CFO Publishing Corp, Boston, 2003.

<sup>10</sup> Adrian Wooldridge, "The Battle for Brainpower: A Survey of Talent"; The Economist, 7 October 2006.

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