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Human Capital Issues Critical to Profitable Mergers and Acquisitions

The Importance of Due Diligence and Critical Post-Acquisition Integration

by Jeremy Swan, Principal

Mergers and acquisitions offer a range of opportunities for acquirers—from expanding product lines, customer base, and geographic reach to adding new facilities and capabilities and growing market share. The catch, however, is that in order to optimize the realization of the full benefits of a merger or acquisition, the acquirer must ensure that it has uncovered the key risks in due diligence and fully developed and executed a post-merger integration plan. According to some sources, "at least 70 percent of M&As are 'considered failures from an acquiring shareholder's perspective.'"[1]

Most seasoned acquirers understand that appropriate due diligence to identify and understand the core risks of a merger or acquisition is critical to the success or failure of that transaction. Many private equity firms limit their "extensive" due diligence to finance, accounting, tax, and legal issues and will typically include only a cursory review of other areas including information technology, operations, human capital ("HC"), and environmental factors. Highly acquisitive firms are quickly learning, through their own failed or highly challenging transactions, that areas for which it used to be sufficient to conduct a cursory examination now require deeper due diligence.

The most recent research on M&A suggests that the success of an acquisition is highly contingent upon the HC compatibility of the two firms in the transaction; that high performance workplace companies correlate to higher price to book valuation than their industry peers. This correlation indicates that the organization's HC compatibility and strategy are key elements with the potential to generate financial success or failure. If this is the case, due diligence efforts should focus on the HC aspects of the transaction just as much as it does on quality of earnings, financial engineering, information technology, and the other "usual suspects" in a due diligence.

What is HC due diligence? According to Solange Charas, president of Charas Consulting, Inc. and an expert in this area, HC due diligence does not just consist of assessing the executives of the target organization, but should include examining all of the core people, processes, and technology of the HC function, including:

- HC strategy
- Infrastructure
- Competencies of the various functions in the organization
- Financial profile
- Cultural fit
- Talent
- Organizational climate

[1]Nogeste, K. 2010. Understanding Mergers and Acquisitions (M&As) from a Program Management Perspective. ***International Journal of Managing Projects in Business***, 3(1): 111-138.

J.H. Cohn's own philosophy when evaluating a target acquisition for a client is to focus on the "Three Cs: Chemistry, Career, and Compensation."

"Chemistry" refers to the overall culture of the organization—the target's ability to be able to operate successfully in the community. "Career" refers to the climate of the organization and measures its internal health including the level of employee engagement, collective intelligence, and other aspects that provides the organization a unique competitive advantage. "Compensation" is the final determination of the "economics" of the deal to ensure that the price of the deal and the planned additional investments are justified to the expected returns over time. Our goal is to make sure that our advisory services go beyond just putting "tick marks" in the expected due diligence boxes, but that we are really evaluating the current and future health of the deal to provide real value to our clients.

What makes this approach valuable is that the due diligence does not just focus on verifying the financial statements, but explores the inherent value (or lack thereof) of the organization as characterized by management talent, operating processes, relationships with clients, and the overall HC profile.

Essentially, the approach incorporates the once "un-measurable" aspects of HC to augment the easily "measured" aspects of the financial underpinnings of the organization to generate a more robust basis on which to evaluate the economics and ultimate desirability of a "deal."

Based on collaboration between Charas and J.H. Cohn, the table below provides more detail on the HC due diligence process as it aligns to the Three Cs approach and also highlights best practices that have emerged from the many due diligence engagements performed for our respective clients.

Element	Aspects Examined	Due Diligence Areas	Best Practice
Chemistry	Overall culture of the organization and fit with the acquiring company, if merger planned	■ Assessment of executive level talent ■ Articulation of guiding principles and beliefs, company objectives, quality and processes, operations management, integration, and coordination, etc. ■ Verification of strength of loyalty relationship with clients	■ Assessing executive leadership is critical in understanding how the company will be run. Deficiencies need to be addressed and planned for prior to the closing, and included in the price of the transaction (severance, recruiting costs, etc.) ■ Evaluating operating processes to identify opportunities for improved results
Career	The "climate" of the organization to engender high levels of employee engagement needed to produce required financial results to justify the transaction	■ HR programs and policies including compensation/ benefits, training/development, performance management, succession planning, communications, etc. ■ Employee engagement levels and degree of organization citizenship behavior including employee attitudes, dispositions, leader behavior and supportiveness, job satisfaction, perceptions of organizational justice, organizational commitment, personality, and task characteristics.	■ Understanding the return on investments made in HC programs is essential in determining the intrinsic value of the organization. It is critical to analyze how and where money is being spent on employees and understand if these are accretive in nature or simply a drain of resources to the company without generating measurable returns. ■ Assessing overall levels of employee engagement and organization citizenship behavior to understand and explain productivity and ultimately financial success.
Compensation	Given the above elements is the purchase/investment price too high or acceptable in relation to the expected "value" generated over time?	■ Cost/benefit analyses to capture not only the deal price, but additional investments to enhance the organization and achieve long-term transaction objectives.	■ With a full due diligence exercise, including the assessments described above, a more rational decision can be made if the deal is a "go" or "no go" based on the true economics of the transaction and not just a financial engineering exercise.

According to Charas, one of the reasons why HC analyses are not being performed is that there are few tools or methodologies available to analyze and understand the ROI of HC. In the last several years, more attention has been paid to HC metrics, to the point where approaches and methodologies are practical and useful, and when applied appropriately, can impact the overall "price tag" of the transaction and have a significant impact on post-transaction success. Charas uses a portfolio of human capital metric tools with her clients to identify and quantify the real cost of HC.

Key Takeaways

Human capital (HC) factors tend to be one of the largest expense categories (on average, between 50 percent and 75 percent of total operating expense is spent on employees) and should be included in due diligence process not only from a financial standpoint but from an integration and cultural standpoint.

HC due diligence processes are far more sophisticated than they used to be. If you're not employing these new approaches and analytical tools you are probably under-identifying the intrinsic value/risk exposure of an acquisition target.

HC metrics allow acquirers to quantify the human capital impact on transactions and generate information critical in planning the post-acquisition integration strategy—the difference between a successful or a disappointing acquisition.

As an illustration of the importance of HR due diligence, refer to the random sample of 18 S&P 500 companies (Table 1 provided by Charas) that shows on average upwards of **50 percent** of gross profit is spent on employees, and for these organizations, SGA comprises over **74 percent** of total operating expenses. According to Charas' analysis, "given that the majority of cash flow goes to HC, and 50 percent of operating profit is spent on employees, it follows that there is a need to better understand the nature and return of that significant investment." Following the closing of an acquisition the standard practice tends to be to find and cut the largest expense category—typically highly paid employees and HC programs. While this is common practice, Charas notes, however, that "without understanding the economics and return equations, we may be cutting the very assets generating the greatest financial return to the enterprise."

A further illustration of this point can be proven by looking at a recent Charas Consulting engagement where a 2,000-person organization that redesigned its

Table 1: Sample of S&P 500 Companies and Their Human Capital Exposure

Company	Industry	Gross Profit ($ 000's)	SGA ($ 000's)	SGA/Gross Profit	Total Operating Expenses ($ 000's)	SGA/Total Operating Expenses
Applied Materials	Semiconductor	4,360,000	901,000	21%	1,989,000	45%
Bemis Company	Packaging and Containers	910,196	465,709	51%	542,817	86%
Computer Science Corp	IT Services	3,117,000	965,000	31%	2,038,000	47%
Duke Energy	Electric Utility	5,614,000	704,000	13%	2,845,000	25%
Ecolan Inc.	Cleaning Products	3,322,900	2,438,100	73%	2,569,100	95%
Expedia	Lodging	2,687,737	2,165,348	81%	2,208,128	98%
Genpact Limited	Management Services	595,537	359,319	60%	379,293	95%
Hess Corporation	Oil & Gas Refining and Marketing	11,692,000	4,294,000	37%	8,253,000	52%
Intuitive Surgical	Medical Appliances & Equipment	1,273,800	438,800	34%	579,000	76%
Limited Brands	Apparel Stores	3,631,000	2,341,000	64%	2,347,000	100%
Masco Corporation	General Building Materials	1,784,000	1,585,000	89%	2,079,000	76%
Moody's Corp.	Business Services	1,597,200	629,600	39%	708,800	89%
PulteGroup, Inc.	Residential Construction	495,347	812,685	164%	812,685	100%
Robert Half International	Staffing & Outsourcing Services	1,489,602	1,240,184	83%	1,240,337	100%
Sealed Air	Packaging and Containers	1,641,200	1,034,900	63%	1,193,800	87%
Stanley Black & Decker, Inc.	Machine Tools & Accessories	3,793,500	2,813,500	74%	2,900,400	97%
Valero Energy Corp.	Oil & Gas Refining and Marketing	10,268,000	5,054,000	49%	6,588,000	77%
Whole Foods Market, Inc.	Grocery Stores	3,536,549	2,939,731	83%	2,988,929	98%
Average				50%		74%

talent identification process was able to more effectively fill open positions with internal talent. Within one year, they were able to reduce their recruiting costs by more than $3 million. That savings fell to the bottom line, and the by-product was a more engaged workforce. Restructuring existing programs can be the most effective approach to improving productivity and optimizing margin.

It is only in the due diligence phase of a transaction that these benchmarks can be identified and strategies to improve return on HC investment can be developed. The accretive value of appropriate alignment of HC to your overall business strategy can be significant. ■

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