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People Issues in Mergers and Acquisitions: Learning from Experience

CFERF Executive Research Report

February 2010

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TOWERS WATSON

Acknowledgements

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Executive Summary

According to Canadian finance executives, 44% of the M&As completed over the past five years have been "very successful." As this study shows, one factor differentiating the M&A "winners" is effectiveness at managing the people issues related to an acquisition – and the early evaluation of the potential impact of "people pitfalls" at the due diligence phase of the deal.

Although there is still nowhere near the record merger activity of recent years, Canadian companies are returning to M&As as a key part of their business strategies. As finance executives report, this not only reflects a general trend towards industry consolidation, but also shows that companies are using M&As as part of their plans to accelerate growth in new regions, to expand into new product and services areas or to acquire new technologies, processes or people. In Q1 and Q2 of 2009, M&A activity in Canada grew by 28% – with the vast majority of these deals being mid-market transactions valued under $250 million.

While M&A activity has long been a part of corporate strategy, history shows that many deals under-delivered. Their value, if any, usually came in the form of short-term efficiencies and profit improvements. It's only relatively recently that deals have started to demonstrate a real long-term benefit. A 2005 study conducted by the UK's CASS Business School in association with Towers Watson showed that, for the first time in decades, a majority of dealmakers were delivering increased shareholder value, at roughly 7% higher than the MSCI World Index[1].

The same study, repeated four years later in 2009, showed that "dealmakers" outperformed the index by an average of 6.3%, despite fears that M&As would be riskier during the downturn due to valuation challenges. While this bodes well for the M&A market, pundits continue to caution that dealmakers have yet to learn from the mistakes of the past, reminding us that traditionally, 75% of deals have failed or underperformed – often because of a lack of understanding of the people issues related to the acquisition.

With these issues in mind, in September 2009 we surveyed senior Canadian finance executives with M&A experience. We collected insights from 108 survey respondents and 17 executive forum participants on the value of incorporating people-related metrics into the financial evaluation of an acquisition, the relevance of retaining and integrating human capital, and other people-related issues at all phases of an acquisition.

We learned through the course of this research that the companies who rated their M&A activity as very successful were more effective at managing people issues during an acquisition. We also learned that there are some critical differences in how the very successful dealmakers approached their corporate transactions, suggesting better ways to make deals work.

WHAT VERY SUCCESSFUL DEALMAKERS DO DIFFERENTLY

EFFECTIVE PEOPLE RISK MANAGEMENT

Very successful dealmakers are significantly more effective at addressing people issues in the integration phase of a transaction than less successful companies. These measures of success include:

- Retaining key talent
- Aligning leadership
- Getting the right mix of skills and competencies
- Communicating and managing change with employees
- Properly estimating people-related synergies

[1]http://www.cass.city.ac.uk/media/stories/resources/PerspectivesMA%28FINAL%29.pdf

CULTURE ALIGNMENT

Although culture alignment is seen as the biggest integration challenge by the vast majority of respondents, very successful dealmakers consider their HR function significantly more effective in this area than the companies reporting less successful deals.

HR INVOLVEMENT

Very successful dealmakers tend to involve their HR counterparts earlier in the transaction, as early as the target evaluation stage, to help identify risks and challenges.

IMPROVING CORPORATE M&A KNOWLEDGE … IN HR AND FINANCE

Finally, very successful dealmakers believe that improving the capabilities of HR in M&A is a high priority, while less successful dealmakers still focus on improving the ability of finance to quantify people risks.

Data on these success factors is provided within the body of this report.

KEY SUCCESS FACTORS

COMPANIES WITH VERY SUCCESSFUL M&As ARE LIKELY TO HAVE AN EFFECTIVE TRACK RECORD IN MANAGING THE PEOPLE ISSUES RELATED TO POST-DEAL INTEGRATION:

- 71% of companies with “very successful” M&As have a “very effective” or “highly effective” track record in key talent retention, compared to 47% of companies reporting “fairly effective” deals.
- 58% of companies with “very successful” M&As have a “very effective” or “highly effective” track record in leadership alignment, compared to 36% of companies who considered their deals to be only “fairly successful.”
- 52% of companies with “very successful” M&As rate their track record in getting the right mix of skills and competencies as “very effective” or “highly effective,” versus 36% of companies reporting “fairly successful” deals.
- 46% of companies with “very successful” M&As report that they have a “very effective” or “highly effective” track record in communicating and managing change with employees, compared to 36% with only “fairly successful” M&As.
- 40% of companies with “very successful” M&As rate their company as having a “very effective” or “highly effective” track record in estimating people-related synergies, compared to 27% of companies reporting “fairly successful” deals.
- 35% of companies with “very successful” deals were also “very effective” or “highly effective” at aligning corporate cultures, compared to 24% of companies with only “fairly successful” deals.

Introduction

Over the past several years the majority of mergers and acquisitions have under-delivered on the value they promise, or have simply failed. Global M&A watchers claim that as many as 75% of mergers are disappointing: productivity drops 50% in the first four to eight months, and the stock price rises only 30% of the time when a merger is announced.[2]

While numerous variables affect the success of an acquisition, many failures are directly attributable to a poor understanding of the human capital issues involved in integrating one firm into another. Research points to culture clashes, the impact of changes in leadership, the loss of key employees, and other related factors as critical to the success of a deal. At a time when many Canadian companies are looking to acquire other organizations, either as part of an industry consolidation or as part of a newly invigorated growth strategy, the topic of how to carry out an effective M&A is again becoming top of mind.

Reports of deal activity in Canada[3] for the first half of 2009 showed a dramatic increase in the number of transactions, with the number of new deals rising by 28% between Q1 and Q2. While the total transaction value decreased over the period from $47.6 billion to $24.9 billion, due to fewer mega-deals, the transactions valued at under $250 million remained strong, accounting for 88% of all transactions over the period. This supports previous CFERF research[4] showing that industry consolidation is occurring across many key sectors of the economy, with larger firms gobbling up distressed companies, often at bargain prices. The success of these acquisitions remains to be seen.

Against this backdrop, our study seeks to explore best practices and the insights of senior finance executives who have experience in completing mergers or acquisitions. More specifically, it looks at leadership alignment, key talent retention, cultural alignment, communication, and the factoring of people-related costs and risks throughout all phases of an acquisition. It also explores the role of the finance function in improving the likelihood of deal success, and provides recommendations from experienced executives on how to address people-related issues at different stages of a transaction. In so doing, it offers a unique view on M&A integration practices in Canada from the perspective of those who are ultimately accountable for ensuring that the financial risks to the organization are properly considered and mitigated throughout the transaction.

[2]Watson Wyatt Europe. http://www.watsonwyatt.com/europe/services/oe/ma_due_diligence.asp

[3]September 2009. Crosbie & Company Inc. "Canadian M&A Activity – Second Quarter 2009 Report."

[4]CFERF 2009. "Managing the Downturn.- Key Strategies for Sustained Profitable Growth."

Research Methodology

The People Issues in Mergers and Acquisitions: Learning from Experience – CFERF Executive Research Report was prepared by the Canadian Financial Executives Research Foundation (CFERF) and was sponsored by Towers Watson. The report encompasses the results of both a survey of senior finance executives from public and private companies that have participated in M&As, and insights obtained through an executive research forum held in Toronto on October 1, 2009.

The purpose of the executive forum was to allow for a free-flowing dialogue between company experts, who were provided with specific questions in advance. A fairly broad cross-section of Canadian industry was represented, including telecommunications, technology, mining and quarries, natural gas, printing and publishing, pharmaceuticals, marketing and international professional services. All forum participants were chosen for their deep experience in carrying out M&As.

The study (including both the online survey and the executive forum) was designed to capture the insights and experience from individuals who have completed a transaction (a merger or an acquisition) in the past five years. Results reflect responses from a total of 108 finance executives who completed the online survey. Of these, 51% were from publicly accountable enterprises, while 38% were from privately held corporations. The remainder represented organizations with other ownership structures, such as Crown corporations.

In keeping with the general make-up of the Canadian economy, responses were somewhat weighted towards the views of financial executives from companies with revenues of less than $250 million (41%). The remainder of respondents were equally distributed between companies with revenues over $1 billion (28%) and those with revenues between $250 million and $1 billion (28%). The data reflects a wide cross-section of Canadian economy, and no industry sector dominates the results.

Further details on survey demographics can be found in Appendix A.

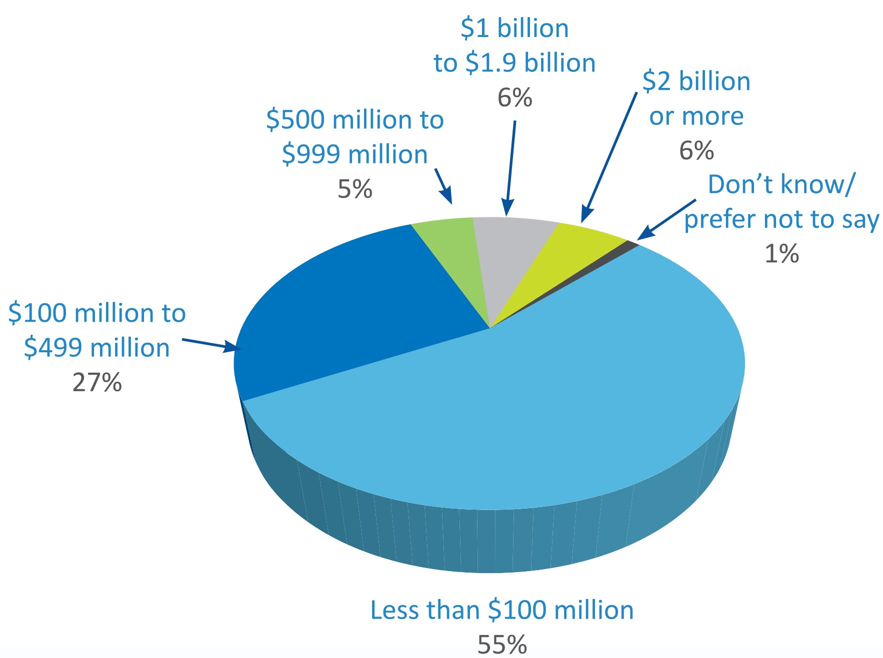
The Landscape Today: M&A Activity in Canada

- **The majority of transactions reported in the survey had a value of less than $500 million (56% of deals were under $100 million and a further 27% were in the $100 million to $499 million range).**
- **Most transactions (60%) were focused inside Canada; about 40% of respondents reported deals with operations outside Canada.**
- **Deals were conducted for both "cost" and "growth" reasons, with respondents equally split between industry consolidation or competitive response (28%) and expanding products or services (27%). The next biggest reason for M&A activity was geographic expansion, cited as the main objective by 19% of respondents.**

THE SIZE OF THE PRIZE

While the transactions in this survey represent only a subset of the deals that have occurred in Canada over the past few years, they do reflect the recent M&A landscape, with the majority, 55%, being smaller acquisitions, or deals under $100 million, that characterized the market in mid-2009. As expected, privately held companies were far more likely to be involved in smaller deals (73%) than their public company counterparts (47%).

THE SIZE OF THE PRIZE



GEOGRAPHIC FOCUS

Our results also revealed a preference for deals between Canadian companies. The tendency towards domestic purchases can be explained in part by the efficiencies of "deal proximity": the benefits of operating within known local markets, and established relationships between firms, customer groups and financial intermediaries. Six out of ten acquisitions reported by survey respondents involved the take-over of domestic companies, with the remaining 40% of deals involving operations outside Canada. This follows a general trend in the global M&A market, where the majority of recent acquisitions have been of companies within the same country.

THE WHYS BEHIND THE BUYS

Companies acquire others for various reasons, such as credit availability, international trends, asset prices and a wide array of individual strategic objectives of the acquiring firms. In our survey, industry consolidation and competitive conditions were key motivators for 28% of respondents, and a further 27% were focused on growth reasons such as the desire to increase product and service lines and expand distribution channels. Another 19% were looking to enter new market locations or to capitalize on opportunities through buying distressed assets (15%). Distressed companies were particularly open to offers by larger companies that were able to maintain relatively strong cash positions throughout the economic downturn.

Other factors driving M&A activity included liquidity for owners, defensive strategy, and compliance with a government directive. While some companies hope to achieve significant cost synergies through mergers, another advantage to mergers and acquisitions is the potential for greater revenue generation through the so-called "platform deal," which features a revenue-enhancing exchange of knowledge, skills, processes and technologies, sometimes even across industries.

Howard Johnson, Managing Director of Veracap Corporate Finance, explains how intellectual capital can be the main motivator behind certain acquisitions. Says Johnson:

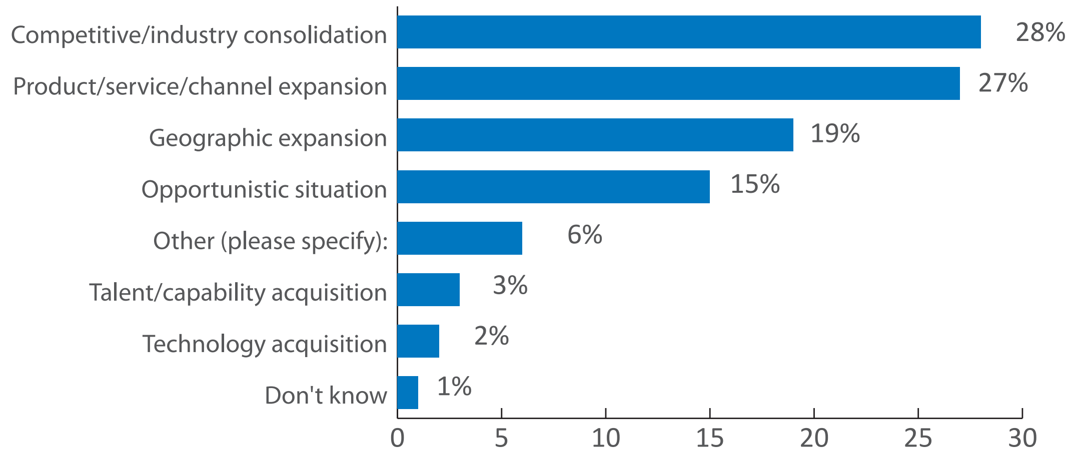
> We sold a tech company a couple of years ago that made image processing software and this software would take pictures, for example, of a cookie coming across a production line and figure out if it was the right size, right shape, right number of chocolate chips, and pass or fail it. The ultimate buyer for that company was a U.S. defense contractor who said: "This is great technology; we can use it for facial recognition." Because it was a platform deal, the buyer wasn't looking at getting rid of any people. In fact, they were looking at really leveraging those people and creating more opportunity for them. This helped to mitigate the buyer's transition risk.

M&As in the pharmaceutical industry also demonstrate the many factors driving acquisitions in Canada at this time. For the industry as a whole, explains Paul Van Damme, Chief Financial Officer at Bradmer Pharmaceuticals Inc., the reason pharmaceutical acquisitions are going to continue to increase in both size and volume is because large pharmaceutical companies are increasingly having difficulty developing drugs in-house. Says Van Damme:

> Not since Viagra was discovered accidentally by Pfizer has there been a single blockbuster drug as big. So, in order to make up for that lack of success in drug development, and the patents expiring on cholesterol drugs, which are the largest-selling drugs in the world, there's going to be an attempt by pharmaceutical companies to acquire their competitors. At the same time, pharmaceutical companies are also looking to purchase niche companies with highly specialized product lines.

As Van Damme explains, "biotech companies typically are now the research and development engines for the pharma industry." But in these transactions, Van Damme says, "smaller private companies are being acquired to reduce costs, not to grow. They'll cut out waves of sales and R&D people, since they are buying an established product."

PRIMARY TRANSACTION OBJECTIVE



GLOBAL INDUSTRY CONSOLIDATION

"As a cement company, VCNA is in the basic infrastructure business, which these days is not the nicest spot to be. We've done a number of acquisitions in the past; we basically grew the company ten-fold starting from the acquisition of St. Mary's Cement a couple of years ago. Most of our growth was in the U.S. Our industry is interesting because in Canada, it's already about 80% foreign owned. So when we talk about cultural clash, I think we have a great example when we talk about consolidation. Nowadays there are also a lot of emerging foreign players in this industry, including ourselves. Our parent company is the Votorantim Group – a Brazilian based company. So despite the financial crises, the strategy of vertical integration in our industry hasn't changed. Of course, the issue these days is capital and leverage. Whoever is in the best shape will be able to acquire companies (or parts of them) that are facing a lot of financial issues right now. What has changed is that a lot of large companies are divesting assets – being pushed by the banks because they got into financial trouble. There's a lot of M&A activity in the making as a result of those recent movements."

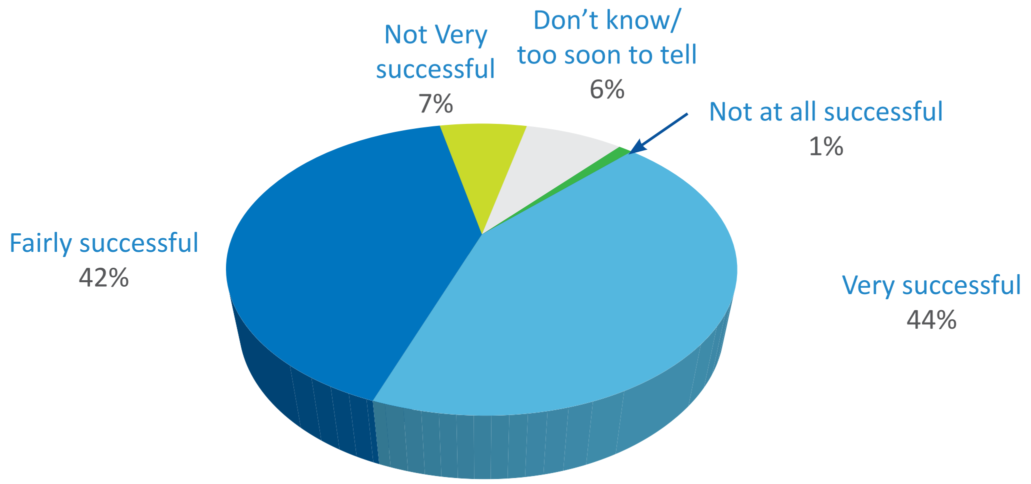
—Felipe Lima, Chief Financial Officer, VCNA – Votorantim Cement North America

Do Deals Work?

- Most deals reflected in this survey were considered either "Very Successful" or "Fairly Successful."
- Companies whose primary objective was to expand their market reach with new product and services offerings were more likely to report very successful M&As.
- Revenue growth was the most common measure of success of all deals reported. For those deals that were considered very successful, profit growth was also a key performance indicator.
- Employee engagement surveys and retention scorecards are two common tools used to measure how successful companies were in managing people issues related to an acquisition.
- Different business executives play lead roles at different phases of the transaction, starting with the CEO and CFO in the early stages of the deal with Legal playing a larger role in structuring deal terms, and then moving to Operational Management and in some cases HR in the integration planning and implementation stages.
- Finance leaders are most involved in the due diligence stage, but also play a dominant role in helping structure deal terms, in integration planning and in integration implementation.

Overall, senior finance executives report that today's deals are more successful than deals of the past. The vast majority characterized the transaction as generally successful, with 44% declaring the acquisition to be very successful and 42% stating it was fairly successful. About 7% stated the transaction was not very successful, and one respondent said the deal was not at all successful; 6% said they didn't know or it was too soon to tell.

DO DEALS WORK?



It was interesting to note that the degree of deal success varied across the range of original objectives. For example, respondents who said that their recent acquisition was very successful were more likely to cite product and service or channel expansion (31%) as the goal of the transaction, versus those who only considered the acquisition to be fairly successful (22%). Similarly, for acquisitions that were considered very successful, only 8% of respondents said that capitalizing on an opportunistic situation was the prime motivator for the deal, compared with 20% for fairly successful mergers.

MEASURING SUCCESS

For the majority of companies in this survey, cost reduction was not the key metric used to measure the outcome of the deal. The most commonly used measure of success was revenue growth (64%), followed by an evaluation of the achievement of specific synergies other than cost reduction (53%), the growth of profit margins (50%), and then cost reduction at 37%. Profit margin growth was also more likely to be considered a key metric in deals that were thought to be very successful (60%), versus those that were only reported as fairly successful (40%).

TRANSACTION SUCCESS METRICS

NON-FINANCIAL MEASURES OF SUCCESS

"On the measurement front, we did our first engagement survey shortly after we did the acquisition. We struggled with getting participation from the field the year of the acquisition, but the next year it almost doubled, so we were able to see a fairly significant shift in how the field was looking because we had improved our communication during that time. The other measure we tracked was retention, so, how many people stayed?"

—Debbie Stein, Vice President & Chief Financial Officer, AltaGas Income Trust

While senior finance executives use financial metrics as the key tools to assess the performance of a deal, they are also critically aware that financial metrics don't always capture the value add of the acquisition, nor are they the only tool for looking at how a deal meets a company's strategic objectives.

As Bill Ross, Vice President, Finance & Information Technology, at Enbridge Gas explains:

> In terms of how we measure an acquisition, we're obviously looking at long-term profitability, or the long-term growth of that organization. But we also need to look at the overall contribution of that business to the remainder of the organization. Has it filled that strategic void that you actually had at a particular point in time? In terms of people issues, we conduct employee surveys and use engagement score cards that have been developed by the major HR firms. We also measure overall retention as it's very important to succession plans. All of those are measured annually, and the improvement of those measures over time is very critical to the success of the merger.

Internal metrics are one way of gauging the success of an acquisition but, as Tim Zahavich, Chief Financial Officer of St. Joseph Communications suggests, the customer or client is the ultimate judge of how well the new relationship has gelled. Says Zahavich, "Ultimately customers are the ones who are going to determine whether the M&A deal was a good deal or not." To this end he recommends talking to customers directly:

> Go to the customers of the company you've acquired or even your own, and ask, "how are we doing?" Generally they'll tell you whether things have gotten better or worse since the acquisition, and then you can take a look and say, "okay, what are we doing right?" If we're doing worse, then you'd better start thinking about what you've done to hurt their business.

MANAGING THE DEAL

> **"It is clear that organizations today call on a wide array of both corporate functions and line management to help conduct and implement M&A transactions in order to achieve the best possible result. This suggests that "M&A readiness" could – or indeed should – become part of a company's DNA or "core capability," at least for those industries where M&A activity is likely."**
>
> **— Éric D'Amours, National M&A Practice Leader, Towers Watson**

Traditionally, business leaders identify opportunities to acquire (or divest) in the course of strategic planning, and then engage corporate functions (primarily finance and legal) to help pursue the right transaction. However, as M&A transactions move beyond the deal stage, a far wider array of organizational leaders are involved in helping implement and in some cases integrate the deal. And ultimately, the workforce as a whole is involved on both sides of a deal, in adapting to change.

KEY LEADERS ACROSS THE DEAL

In order to determine the extent to which the finance function remains involved in the acquisition after the due diligence and offer phases, we asked survey respondents to identify the critical functions that play a lead role across the entire spectrum of the deal. It's clear that while CEOs remain involved across all five phases of a typical transaction (i.e., target evaluation, due diligence, structuring deal terms, integration planning and integration implementation), their primary involvement is in the earlier stages of the deal, working hand in hand with both finance and legal on the first three of these phases.

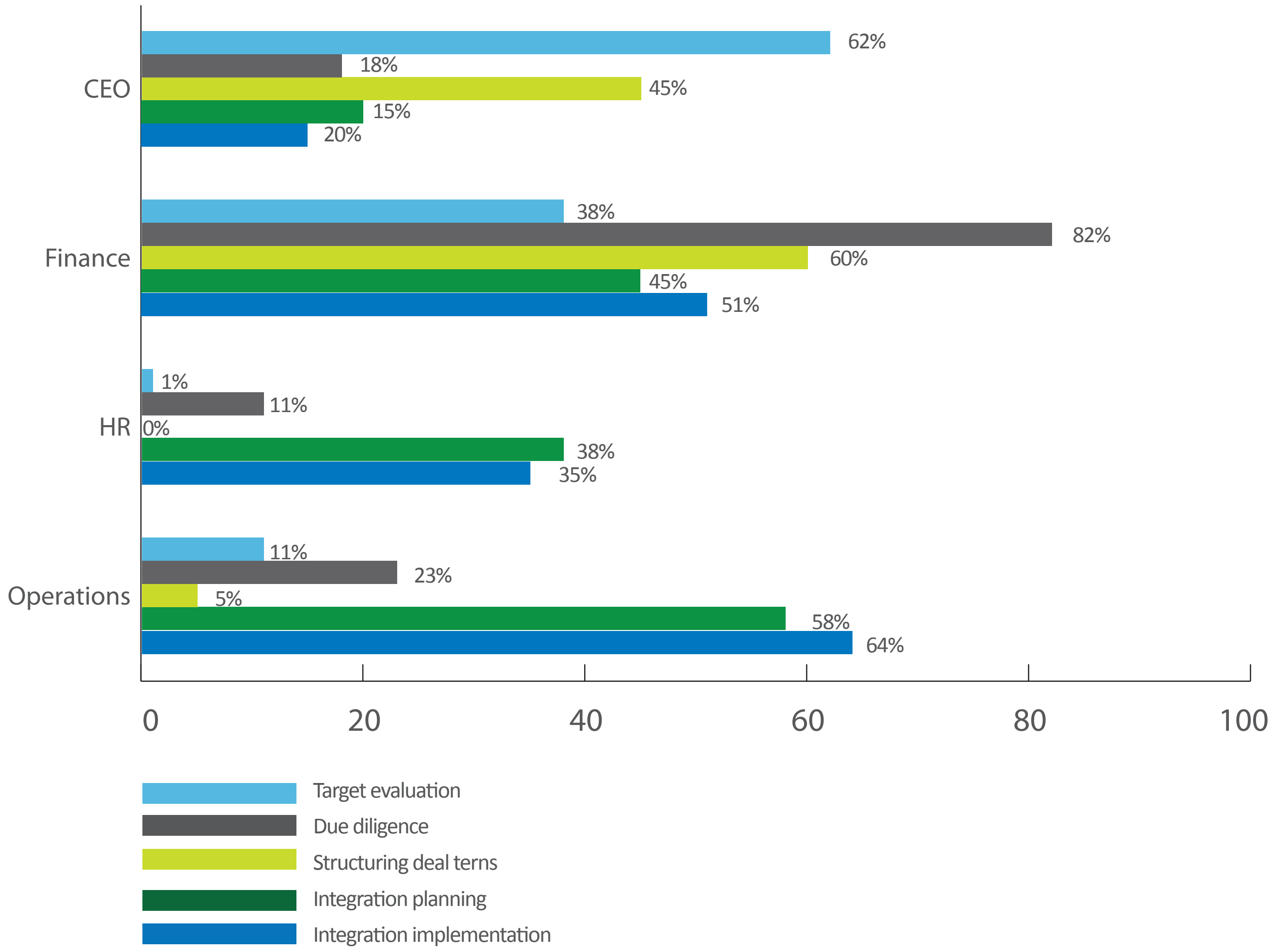
Finance leaders tend to be the most involved in the due diligence stage, with 82% of respondents saying that they lead this phase of the transaction. Finance also plays the largest role in helping structure deal terms, according to 60% of respondents.

After the deal is signed and sealed, leadership tends to transition to other parts of the organization, most notably operations; 58% of respondents indicate that their operations team handles the integration planning phase, and 64% say operations leads the integration implementation phase. However, finance is also involved on the leadership team during these phases; 45% of respondents indicate that they play a leading role in the integration planning and 52% in the implementation phase.

Fundamentally, the senior finance executive in the organization is focused on whether or not the acquisition is meeting its original financial objectives. At the same time, given the broad purview of the organization, he/she is also uniquely positioned to monitor, evaluate and communicate the people risks associated with the deal throughout the entire M&A process. As Debbie Stein, Vice President Finance and CFO of AltaGas Income Trust, explains:

> I think if you look at the role of the senior finance person involved in an M&A transaction, what it boils down to is – is this acquisition going to drive the financial results you wanted? It's therefore important that the finance executive understands all of the elements of that acquisition, including the people issues, so if the business isn't performing you know you're seeing everything that's going on with it. At the same time, the senior finance executive is probably in the best position to communicate what he/she is seeing. As a finance person, you're able to communicate most effectively whether or not the acquisition is a success, and having that people information just gives you more insight.

WHO LEADS THE TRANSACTION?

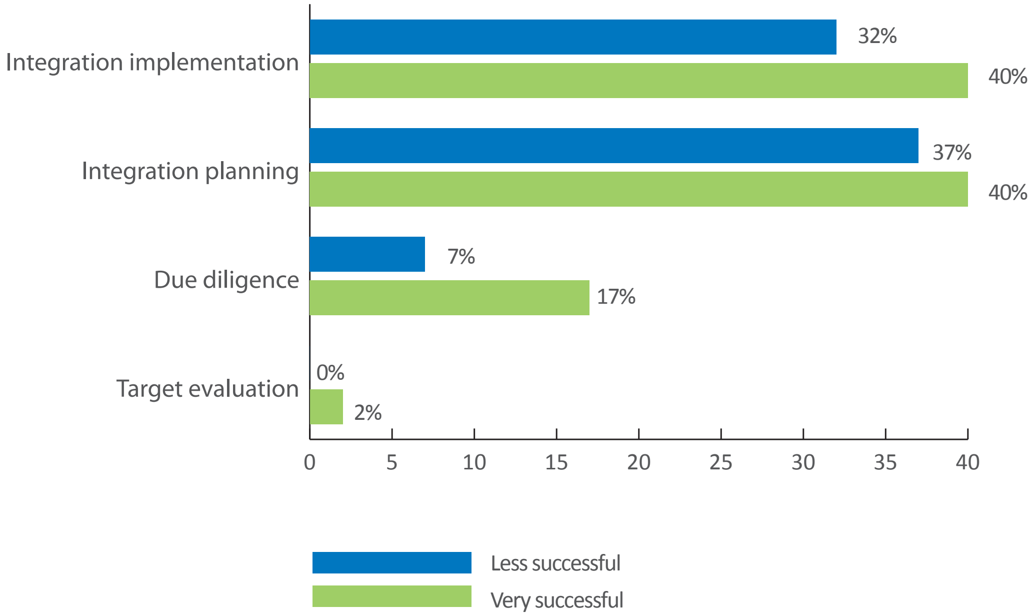


THE ROLE OF HR

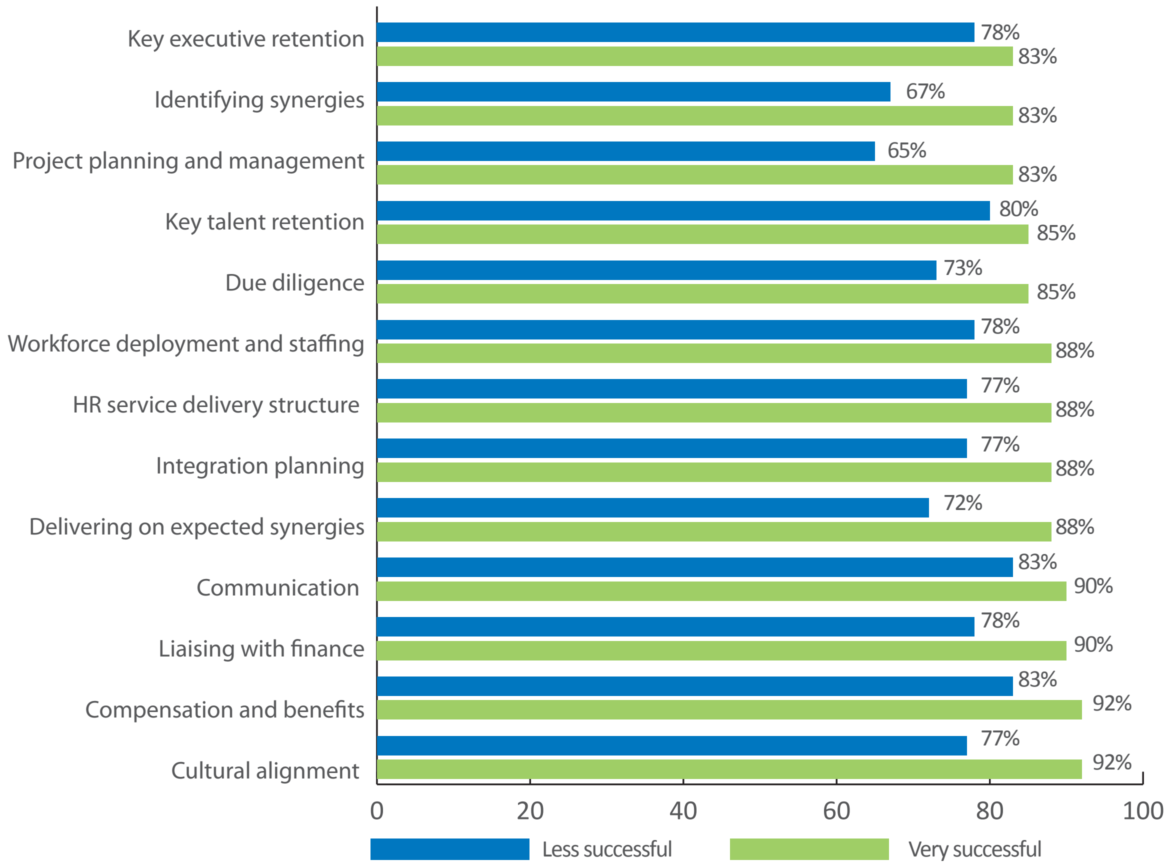
Given the increased importance of people issues in an M&A transaction, it's somewhat surprising that our survey results show that the HR function tends to be only peripherally involved in much of the M&A process. It's not until the integration planning and integration implementation phase of the acquisition that HR plays a more predominant role, with 38% of respondents saying that they're brought to the leadership team at the integration planning stage and 35% of respondents saying they have a leadership role during the integration implementation phase.

However, there is evidence to suggest that bringing HR onto the leadership team earlier in the acquisition makes sense. The data shows that a small number of very successful dealmakers chose to involve HR a lot earlier in the process. For example, 17% of very successful dealmakers involved HR in the due diligence phase (compared to only 7% for the balance of deal makers), with some also involving their HR function in the target evaluation phase. We believe this may be an appropriate response to the impact of people issues in affecting long-term deal success, provided that HR functions have the knowledge and capability to provide meaningful assistance. As well, it is interesting to note that very successful dealmakers appear to involve HR in more aspects of the deal than others.

COMPARISON OF WHERE HR IS PLAYING A LEAD ROLE IN VERY SUCCESSFUL DEALS VS. LESS SUCCESSFUL DEALS

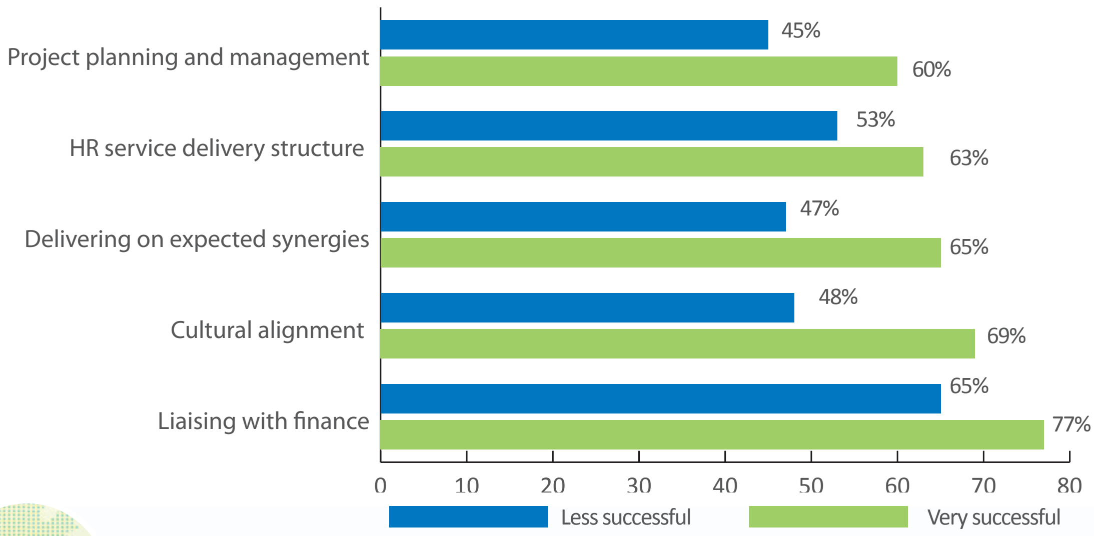


COMPARISON OF HR INVOLVEMENT IN VERY SUCCESSFUL DEALS VS. LESS SUCCESSFUL DEALS



When looking at HR's effectiveness, for companies who rated their transactions as very successful, HR played a particularly critical role in the area of cultural alignment, with 69% of companies saying that the HR function was "fairly" to "highly" effective, compared to 48% of less successful dealmakers. Very successful M&As are also more likely to have very effective HR departments when it comes to delivering on the expected synergies of the deal, project planning and management, liaising with finance and designing HR service delivery structures.

HR'S ROLE IN DEAL SUCCESS – A COMPARISON OF EFFECTIVE HR IN VERY SUCCESSFUL DEALS VS. LESS SUCCESSFUL DEALS



Doing the Deal: Examining People Risks in Due Diligence

THE TREATMENT OF PEOPLE RISKS IN DUE DILIGENCE

The majority of companies that considered their acquisitions to be very successful or fairly successful either reflected people risks in their financial assessments, or at least considered them in their initial evaluation of the future success of the transaction. However, the study also reveals that many quantifiable risks, such as future pension and benefits volatility, were often not fully evaluated, suggesting, perhaps, a need for a more methodical approach to the use of human capital metrics.

CHARACTERISTICS OF SUCCESSFUL DEALS

In order to determine how finance executives incorporated people related risks into the initial financial analysis of the transaction, respondents were asked to identify how several key risk factors were evaluated and monetized at the due diligence phase of the acquisition.

Severance costs, loss of key talent, loss of key executives and cultural incompatibility were the top four people risks that finance executives considered at due diligence. The people risks that were least likely to be considered in assessing the value of the deal at the outset were future pension and benefits volatility, workforce turnover, deterioration of labour relations, and the potential negative impact of a change in workforce demographics. The majority of companies that considered their acquisitions to be either very successful or fairly successful either reflected these people risks in their financial assessments, or at least considered them in their initial evaluation of the future success of the transaction.

However, the degree to which these variables were quantified in the assessment varied widely. While the study shows that a majority of respondents acknowledge the various people risks in a transaction, beyond severance costs, only a fraction − a third or fewer of respondents − actually reflected these risks in their financials, even when they were quantifiable. This suggests that for many acquiring organizations, there is room for improvement at due diligence in the analysis and use of data mining and metrics.

CONSIDERED RISKS AT DUE DILIGENCE

THIS TABLE REFLECTS THE PERCENTAGE OF TOTAL RESPONDENTS THAT CONSIDERED OR QUANTIFIED EACH RISK BELOW.

	Considered (Not measured)	Quantified	Total	%
Severance costs	5	77	82	76%
Loss of key talent or skill set	42	35	77	71%
Loss of key executives	36	37	73	68%
Cultural incompatibility	57	10	67	62%
Trigger of change-in-control agreements	22	32	54	50%
Decrease in engagement	39	14	53	49%
Constructive dismissal exposure (if employee program cost reduction is needed)	20	32	52	48%
Lack of experience to manage workforce integration	35	17	52	48%
Future pension and benefit cost volatility	15	30	45	42%
Unwanted workforce turnover	31	11	42	39%
Deterioration of union and labour relations	22	10	32	30%
Adverse demographic evolution of target workforce	18	5	23	21%

FOCUS ON KEY RISK FACTORS

CONSOLIDATION/BUYOUT AND SEVERANCE COSTS

In many cases, consolidating organizations can result in staff reductions and severance costs. Our study shows that in seven out of ten cases, these factors were analyzed and either reflected in the budget as an additional expense (32%), on the balance sheet (21%) or in a purchase price reduction (19%). Twenty percent of respondents did not reflect severance costs in their financial analysis of the deal, possibly because they did not anticipate any change in the workforce, or expected that severance costs would be negligible.

CONSTRUCTIVE DISMISSAL

When considering constructive dismissal exposure, 45% of the survey participants said this issue was not reflected in their analysis at the due diligence stage, and 19% said it was considered but not measured. Nearly as many, 18%, said it was accounted for with an additional expense budget; 7% said it was accounted for in an additional balance sheet provision and 6% reported a purchase price reduction. Those who had rated their transaction as very successful were more likely not to have reflected costs for constructive dismissal exposure in their financial analysis at the due diligence stage (53%) compared to 40% of the group that rated their transaction as only fairly successful, perhaps because they did not anticipate constructive dismissals.

COST OF HONOURING EXECUTIVE CONTRACTS (I.E. CHANGE OF CONTROL AGREEMENTS)

Most executives in our study indicated that they had not measured or reflected in their financial analysis the impact of the cost of buying an executive out of a contract, notably those that include change-of-control provisions. More than 20% said they had considered but not measured the potential impact of these agreements, and 38% said this issue was not reflected in the financial analysis. Nearly 14% had allowed for an additional expense budget, while 8% had reflected the issue with a purchase price deduction. Further to that, 7% had allowed for the issue on the balance sheet.

Those who had rated their transaction as very successful were again more likely not to have reflected costs for honouring executive contracts in their financial analysis at the due diligence stage (46%) compared to 31% of the group who rated their transaction as only fairly successful.

PENSION AND BENEFIT VOLATILITY

When companies undertake due diligence on people costs, certain costs can be easily projected, such as payroll. Pension and benefits, perks and other programs can be also reasonably calculated. Despite the fact that these costs might be easier to project out than other costs, many respondents (49%) said pension and benefit cost volatility was not reflected in the financial analysis at the due diligence stage. For those who did measure this factor, 17% of respondents had accounted for this with an additional expense budget. Other respondents (nearly 14%) said they had considered but not measured pension and benefit volatility as a factor. Seven percent factored it into a reduced purchase price; 5% made an additional provision on the balance sheet.

DETERIORATION OF LABOUR RELATIONS

Roughly 20% of respondents considered, but didn't measure, the financial impact of a deterioration of union/labour relations. Small minorities factored this in: 4% said it was taken into account in an additional expense budget; 3% projected lower revenues and 3% reduced the purchase price as a result.

LOSS OF KEY EXECUTIVES

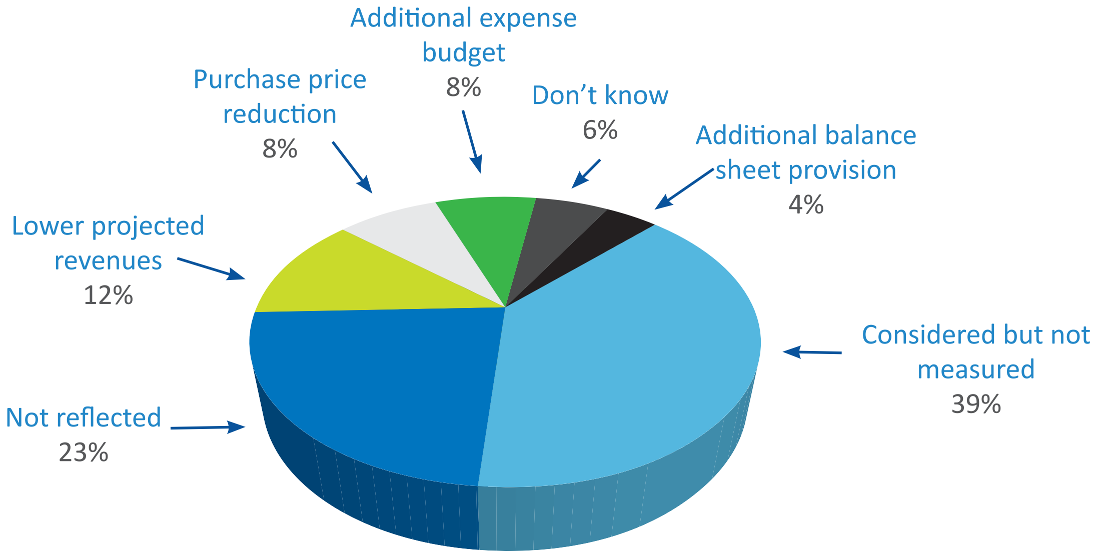
In addition, there are certain unknown future costs/losses that pose a potential risk and are harder to measure. For example, changes in staffing could alter pre-determined financial projections and, often, the loss of key senior staff cannot be reflected merely by payroll numbers. Edward Jonasson, Vice President and Corporate Controller of Open Text Corp., articulates the value of his staff this way: "When it comes to the people, in the software world, that's it – your asset walks out the door at 5 o'clock. So, we do spend a lot of time trying to make sure that the people factors are looked after."

Of all survey respondents, 30% had not measured or considered the loss of key executives at the due diligence phase of the transaction, and 33% had considered the impact but had not measured it. Eleven percent of respondents indicated that they made an additional provision on the balance sheet, 9% had accounted for this with an additional expense budget, 8% had projected lower revenue, and 6% factored it into a reduced purchase price.

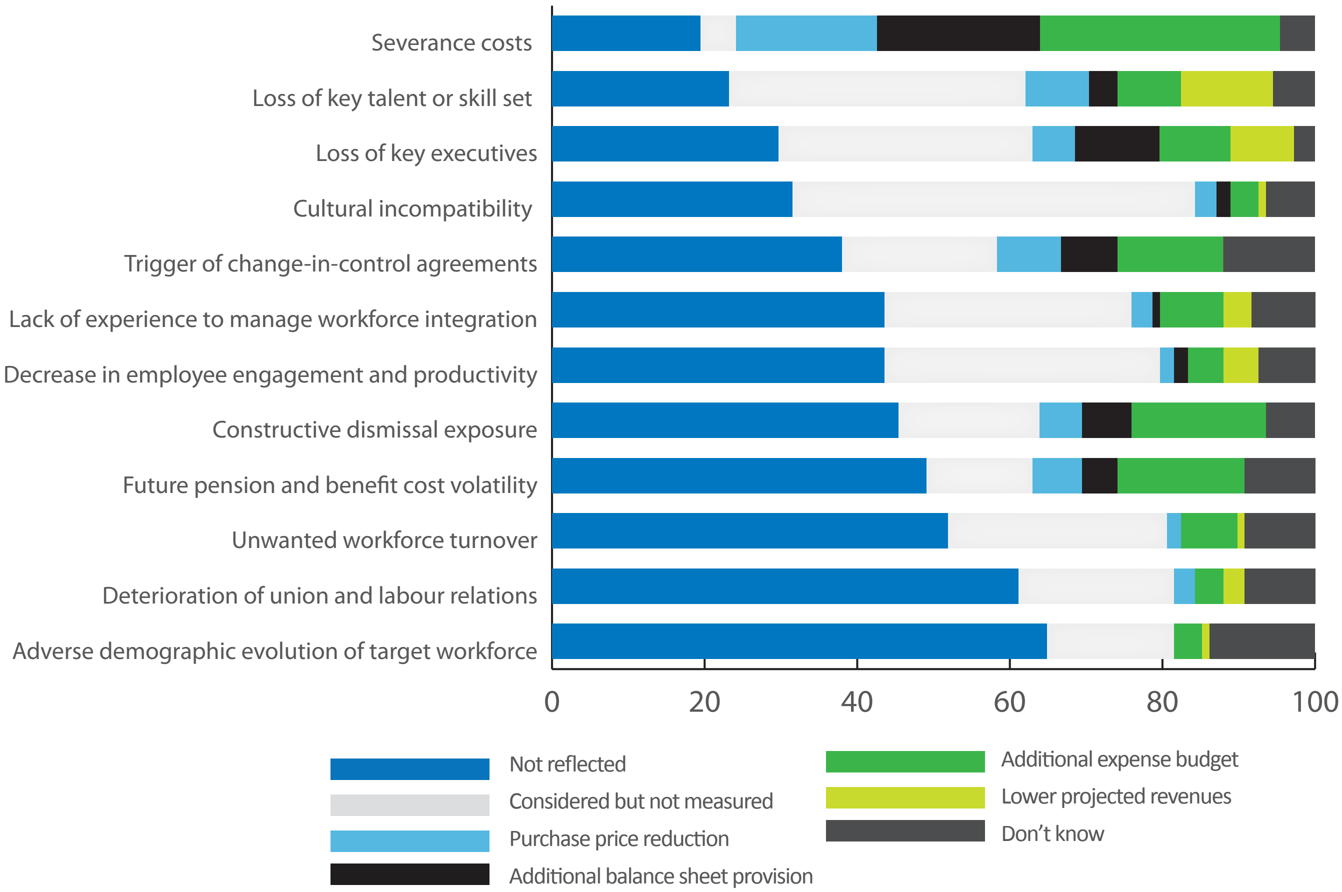
OTHER KEY TALENT AND SKILLS

The loss of key talent, while generally considered one of the most challenging aspects of an acquisition, is not necessarily always evaluated at the due diligence phase of the transaction. Our survey shows that well over one-third, or 39%, of respondents said that they had considered but not measured the impact of the potential loss of key talent or skill sets. Precisely 12% said they had accounted for lower projected revenues in the event of such of a loss; while 8% had reflected it in a purchase price reduction. An equal number, 8%, had allowed for an additional expense budget as a result and 4% of respondents made an additional provision on their balance sheets.

LOSS OF TALENT OR KEY SKILL SET



TREATMENT OF PEOPLE RISKS AT DUE DILIGENCE PHASE



RETAINING KEY TALENT IN PRIVATE COMPANY M&As

"The purchase of a private company can allow a buyer more creativity in how the funds that comprise the purchase price are allocated. Sometimes, part of the purchase price is actually deferred and allocated to some of those key people in pay-to-stay types of bonuses as a risk mitigation, whereas this method of deal structuring would not be permissible in the purchase of a public company that has to be "fully funded" at closing. In a private deal, the purchase price can be made contingent on the retention of key staff, or even the business owner, by spacing out payments over a period of time. This kind of arrangement, commonly known as a "pay-to-stay" incentive plan, requires a thorough diligence exercise in order to properly identify and offer contracts to those who may pose a flight risk. Once put in place, deals structured like this offer no guarantee against departures, but can serve as a motivator. Strategies include so-called earn-outs, to "take-back notes" (which involve regular payments of the purchase price over an extended period of time) to royalty agreements. Sometimes strategies may need to be extended to employees as opposed to sellers. These strategies can result in varying degrees of success."

— Howard Johnson, Managing Director of Veracap Corporate Finance

CULTURE CLASH

Another potential risk that is hard to quantify is culture clash. Just over half of all survey respondents (53%) considered it in their initial due diligence. However, only 4% had accounted for the problem with an additional expense budget.

Culture clash can be detrimental to M&As of all sizes and is particularly significant in international acquisitions. Culture not only extends to such things as management style, corporate structure, strategies and reporting practices, but to a much broader array of factors that define a company's environment, including legal systems and practices, workforce management traditions and of course language. These factors, while often important to making or breaking a deal, can be enigmatic when it comes to measuring their potential financial impact. For example, what is the cost of buying a company with a unionized workforce, which may have a different level of productivity than a non-unionized one? According to Edward Jonasson of Open Text, particularly when doing deals in countries like Germany, "We have to give a heavy consideration to the pro-labour culture of the society when considering the acquisition of companies there. Achieving HR goals and targets – while still possible – can simply be much more costly than in Canada or the US."

Acquisitions of smaller companies by larger organizations often results in a clash between "large company" processes and procedures – in other words, bureaucracy – and the zeal and style of a smaller, more entrepreneurial organization.

"I think one of the biggest challenges when undertaking a strategic acquisition of a small company is how you preserve their entrepreneurial culture, and, their sense of ownership, so they don't just get subsumed into a large organization with lots of functional layers and multiple layers of reporting. All this can really get in the way of the focus on their business."

— Darren Goldstein, Director, Corporate Development, TELUS

In these cases, the larger company may need to adapt to accommodate the smaller organization, especially if the skill-set held by the small company is stronger in the subject area of interest to the acquirer. As John Forester, VP Finance and Administration of NUCAP Industries, explains, "It's kind of a more humble approach. We have to recognize that the people who are in smaller niche or regional businesses tend to know what they're doing better than we do. So, in this case, it's the acquirer who has to adapt, to change their culture to maintain those pockets of intelligence that are good at what they are doing."

"I think as an acquirer, you really have to be honest with yourself, as to who you are and what your culture is. Because, what can happen is, in your fervor to pursue an acquisition target you may make promises you can't keep — or your culture doesn't allow you to keep. So, if you're going to go after a small company with people that have built up this business, and you're going to bring them under the corporate umbrella, then they need to understand what that is all about. And, if they think it's something that it's not, it can be a challenge. And, it takes a lot longer to integrate and make it work so you can see the financial benefits of the transaction... It's a challenge, because you've got to look yourself in the eye and say, "Who are we?" and "How do we make this work?"

— Debbie Stein, Vice President Finance & Chief Financial Officer, AltaGas Income Trust

Regardless of how much each side is prepared to "give" or adapt to the other, both first must develop insight and awareness of their culture before they can understand and assess the other. As Éric D'Amours of Towers Watson puts it: "Can you write down what your culture is?"

At the same time, an acquisition creates expectations among employees. As one executive explains, companies must realize this and recognize this as an opportunity to convey the upside of the merger or acquisition. For example, staff may have the opportunity for pay raises or greater career mobility. The key is to paint a realistic picture, rather than raise false hopes, which could create significant credibility problems for management post-merger.

"Right up front, tell everybody what the go-forward plan will be, because if you don't they will make up their own mind and will walk out the door and they won't come back. Our experience in managing people from the acquired company has always been better when we communicate the finance centralization plan. You can let people come to their own conclusions or you can help them and be proactive."

— Edward Jonasson, Vice President and Corporate Controller, Open Text Corporation

Creating Value: Integration and Potential Barriers to Success

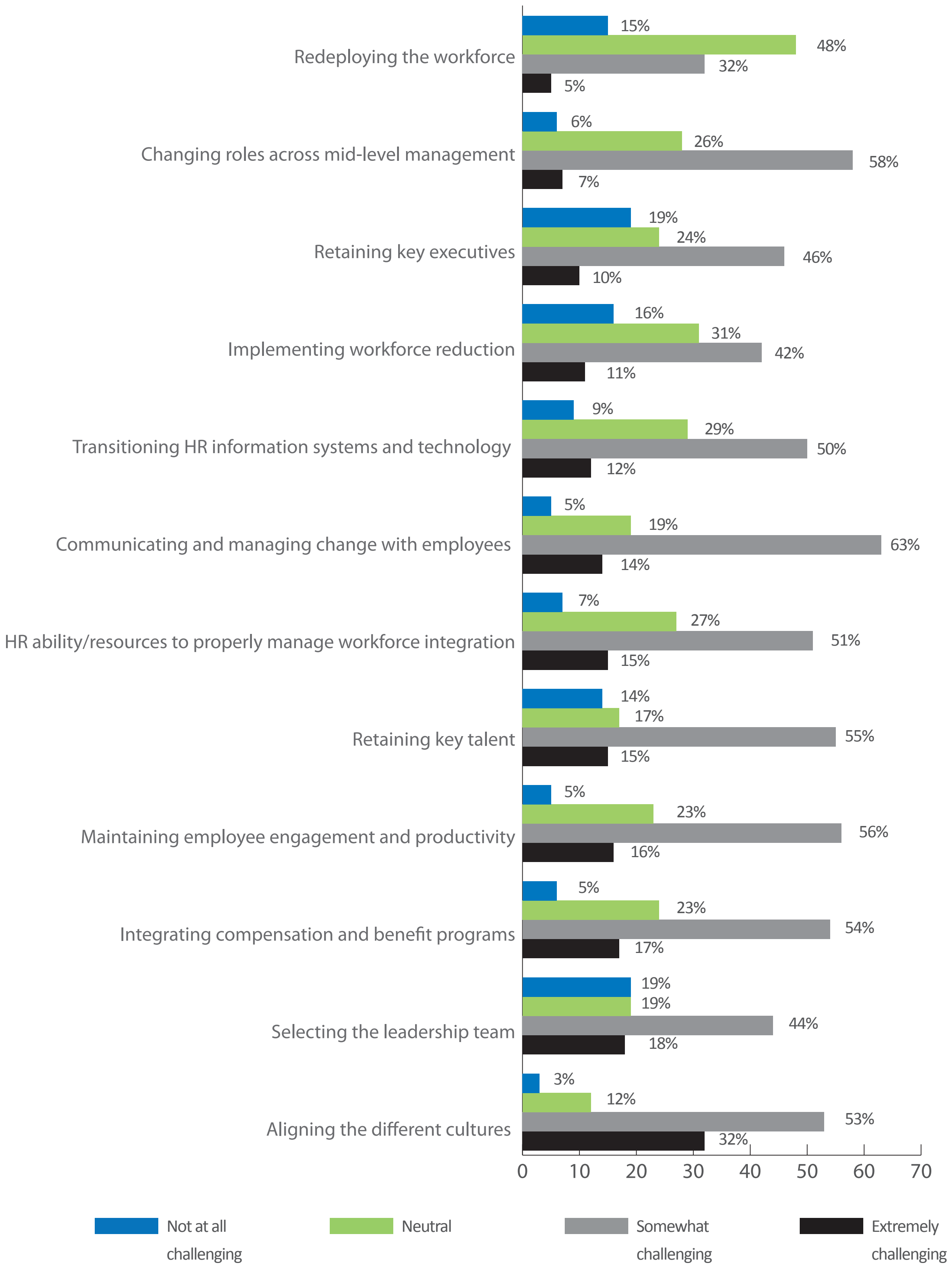
- **Integration time frames vary significantly; however, the vast majority of companies reported here are working within a one- to two-year time horizon.**
- **Cultural alignment is the most common risk to a successful integration.**
- **Executives who thought their recent acquisitions were either fairly successful or unsuccessful were more likely to point to cultural alignment as posing a barrier to M&A integration.**

The vast majority of respondents planned to fully integrate their acquisition, although time horizons differed. Most companies (56%) said they planned to fully integrate their acquisitions in less than a year, while another 32% planned to have this process done within two years. Far fewer respondents planned on a longer time-horizon; only 4% of respondents anticipated it would take two to three years and 2% said it would more than three years. A handful (7%) said there were no plans to integrate the acquired entity.

According to survey participants, the single most frequently cited integration issue was cultural alignment, followed by communicating and managing change with employees, maintaining employee engagement, integrating compensation and benefits and retaining key talent.

While more than half of the senior executives thought that these workforce issues could be challenging to the integration of their acquisitions, the views of very successful versus fairly successful or unsuccessful dealmakers differed on several fronts. Executives who thought their deals were less successful were more likely to believe that integrating compensation and benefits programs and aligning their corporate cultures posed significant barriers to the success of the integration. By comparison, finance executives who considered their deals to be very successful thought HR's ability to manage workforce integration would be a potential barrier to success, and therefore perhaps paid greater attention to the need to resource HR effectively. They were also more likely to believe that selecting the leadership team, and the changing roles of mid management, would pose barriers to the integration process.

PEOPLE CHALLENGES AT INTEGRATION PHASE



AFTER THE DEAL: REGRETS? I HAVE A FEW …

Asked how they would have done things differently, with the benefit of hindsight, executives shared a range of ideas. Among those who had rated their transaction as very successful, some said they would not have changed their approach, while others said they would have done the following:

- Conducted more detailed due diligence, including market conditions and potential barriers
- Involved management earlier in the merger process
- Increased speed of decision-making by senior managers
- Improved communication with the board of directors
- Allowed longer transition time for acquired company (e.g., to stay at original location)
- Developed a more structured integration plan
- Integrated systems faster

Those who had rated their transaction as only “fairly successful” said they would have done the following:

- Conducted more due diligence in certain areas (e.g., market share and dynamics) rather than historical performance and contractual relationships
- Improved communication
- Set targets for full-time staff reductions
- Established better pricing of deal
- Accessed more information on potential customers to be acquired
- Better, faster systems integration
- More direct, speedy integration of acquired company into new corporate culture

Track Record:
Past Performance an Indicator of Future Success

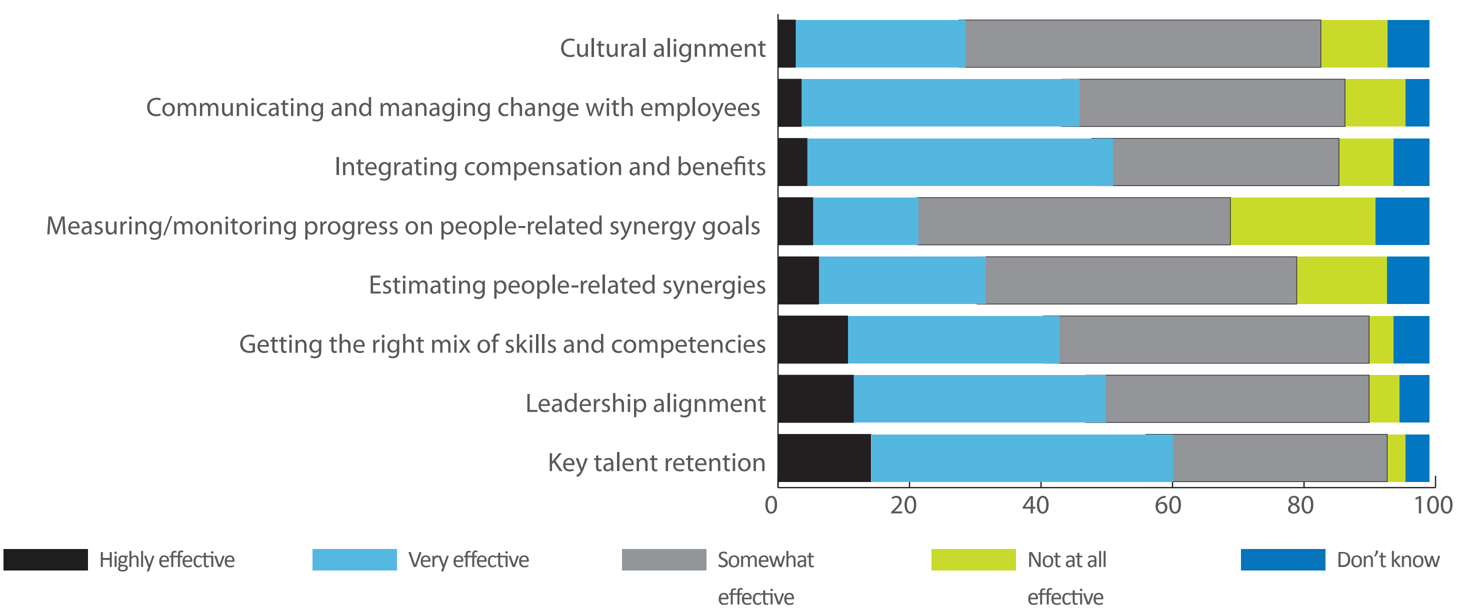
Our survey results clearly demonstrate that companies that experienced a high degree of success in acquisitions were more likely to have a strong track record in managing people-related integration issues.

ORGANIZATIONAL PERFORMANCE

An effective track record in leadership integration and key talent retention are two leading indicators for successful future transactions. The majority of companies with very successful M&As (71%) reported that they had an effective track record in key talent retention. This stands in dramatic comparison to companies with only fairly successful M&As, of whom only 47% indicated that they had been successful in holding on to key talent. More than half (58%) of respondents who considered their deals to be very successful also thought that they had a strong record in aligning leadership in past acquisitions. Again, companies that were only fairly successful dealmakers were much less likely to have had success in aligning leadership (36%).

Companies with highly successful M&As are also more likely to have learned how to effectively obtain the right mix of skills and competencies (52%) compared to those with less successful deals (36%). These same patterns hold true across the board for very successful dealmakers when it comes to integrating compensation and benefits, communicating and managing change, estimating people related synergies and aligning corporate cultures.

A COMPARISON OF HIGHLY EFFECTIVE TRACK RECORDS IN MANAGING PEOPLE-RELATED ISSUES



COMMON INTEGRATION STRATEGIES

An integration steering committee is key to the success of a merger, says one senior executive. Under the oversight of the CFO and CEO, a steering committee is formed with top people from all sectors of the business. Then working committees are formed in each area, such as HR, finance, and IT. Says Debbie Stein, CFO of AltaGas Income Trust: "For us, part of the role of the steering committee members was to sit in on some of these working committees to see how the dynamics were working so that we could try to head off any issues."

Similarly at Enbridge Gas, the CFO played a critical role in participating in the cultural change of the organization, particularly as it relates to common standards of systems and reporting. Says Bill Ross, Enbridge's VP Finance and IT:

> As a first step, leave the company intact. However, put your own finance person into place. This is one of the critical factors in maintaining control of the organization – getting good reporting in place. The CFO has a critical role to play in setting up systems and common reporting standards. There's a slow integration into culture and in some cases the culture assimilates your own.

One executive recalled a merger at a previous company in which human resources issues were handled by a change-management consultant. Employees of the acquired company were given pay increases, executives given stock options, all indicating incentives for the acquired staff to stay, recalls Paul Van Damme, of Bradmer Pharmaceuticals. However, to avoid a power struggle over leadership, the CEO was asked to retire just when the acquisition was announced. "So there was none of this butting of heads together about who's going to be the acquirer or the acquiree."

Keeping executives anchored with incentives such as options was also a strategy used by Leslie Markow, in her previous role as a CFO for SunOpta, a NASDAQ-listed company. "We had an active acquisition strategy but were not big enough to run the companies we were acquiring," says Markow. "So we tended to increase salaries, give options, and make sure that as CFO, I knew all my finance people. I visited them on a regular basis, I brought them into the crew. We had regular one-on-one and controllers' meetings." Markow notes that 10 years after the acquisitions, most of the key people remained leaders with the company.

"Some executives may be disappointed if their company is not acquired by a private equity firm. These firms have been known to use a model loaded with incentives for senior executives. It gets that management team very excited about the prospects of substantial wealth, if they work with this private equity fund, and sometimes there is a huge letdown when their company is bought by a strategic acquirer. Even after executives receive stock, there's not that direct connection because they're one small piece of a pie as opposed to being able to influence their outcomes much more directly."

— Howard Johnson, Managing Director of Veracap Corporate Finance

The finance people may also find they'll have to call upon their "softer" people skills when integrating staff. Nancy Lala, speaking of her role as CFO of an acquiring company, said she found herself on a de facto welcoming committee, helping teach the newly acquired company how to deal most effectively with the acquirers.

Another strategy common to the acquisition process is exciting people in the acquired company with new opportunities. The excitement of joining a new, larger organization can go a long way to facilitating a smooth acquisition. Says Darren Goldstein of TELUS:

> You've got technical people who work in a small organization, IT professionals and whatnot. Now, all of a sudden, they're part of a four or five thousand person group within our own internal IT team. There's now lots of opportunity for them to further their career. It's often those types of things that we try to highlight.

Conclusion

Finance executives have shown in this study that organizations can improve their chances of successfully merging firms by incorporating people-related risks into the evaluation, due diligence and deal structuring phases of M&A activity. The majority of finance executives believe that human capital issues, particularly as they relate to aligning corporate cultures, can pose serious challenges. At the same time, they also recognize that many of the people-related risk factors (such as loss of key talent) are hard to measure – and even harder to monetize. This underscores the need in any merger or acquisition for human capital metrics that are well developed and translatable into financial impacts. It also underscores the value of ensuring that HR is involved early in any prospective deal.

Our study confirms that for very successful deals, the CFO and the HR department work closely together to ensure that the people-related issues are understood and managed throughout the entire transaction. Reinforcing this view, the study also confirms that having a good track record in managing people issues during an acquisition is a clear predictor of success in subsequent transactions. Knowing how to evaluate and facilitate cultural alignment – and deliver on expected synergies – is a key skill set that HR can bring to the table. According to our survey respondents and executive forum participants, this is something that all organizations contemplating M&A activity will be well-advised to take to heart.

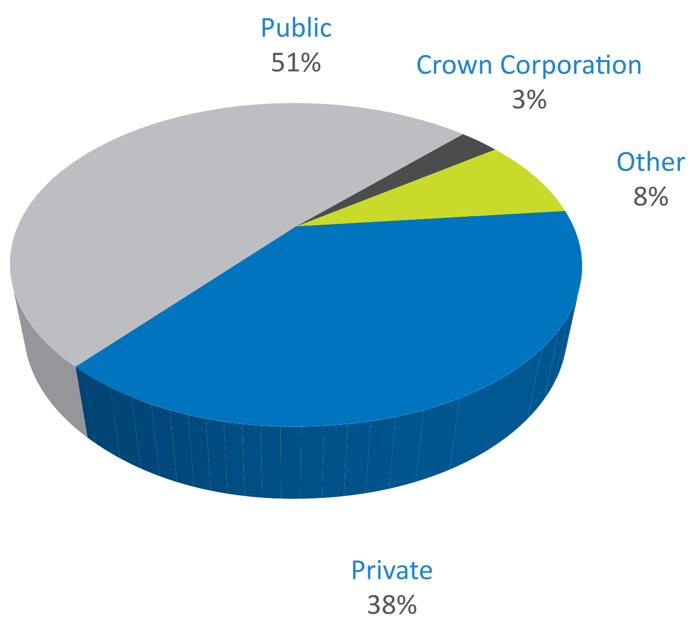
Appendix A: Survey Demographics

A total of 108 surveys were completed by finance executives who worked for companies that had completed one or more acquisitions within the last five years. Fifty-five respondents, or 51%, were from publicly accountable enterprises and 38% were privately held. The remainder represented Crown corporations and others not otherwise defined.

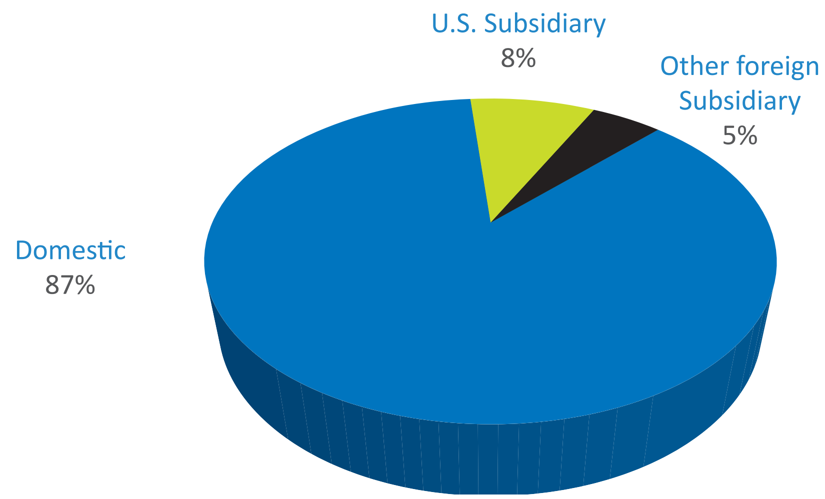
The data are somewhat weighted towards the views of CFOs from Canadian public companies with revenues of less than $250 million (41%). The remainder of respondents are equally distributed between revenue groups, with 28% from companies with revenue in the $250 million to $1 billion range, and another 28% with revenues of more than $1 billion.

A wide cross section of Canadian business is represented, and no one industry sector dominates the results. The vast majority of respondents represented Canadian domestic companies (87%), with the remaining representing subsidiaries of U.S. (8%) or other foreign corporations (5%).

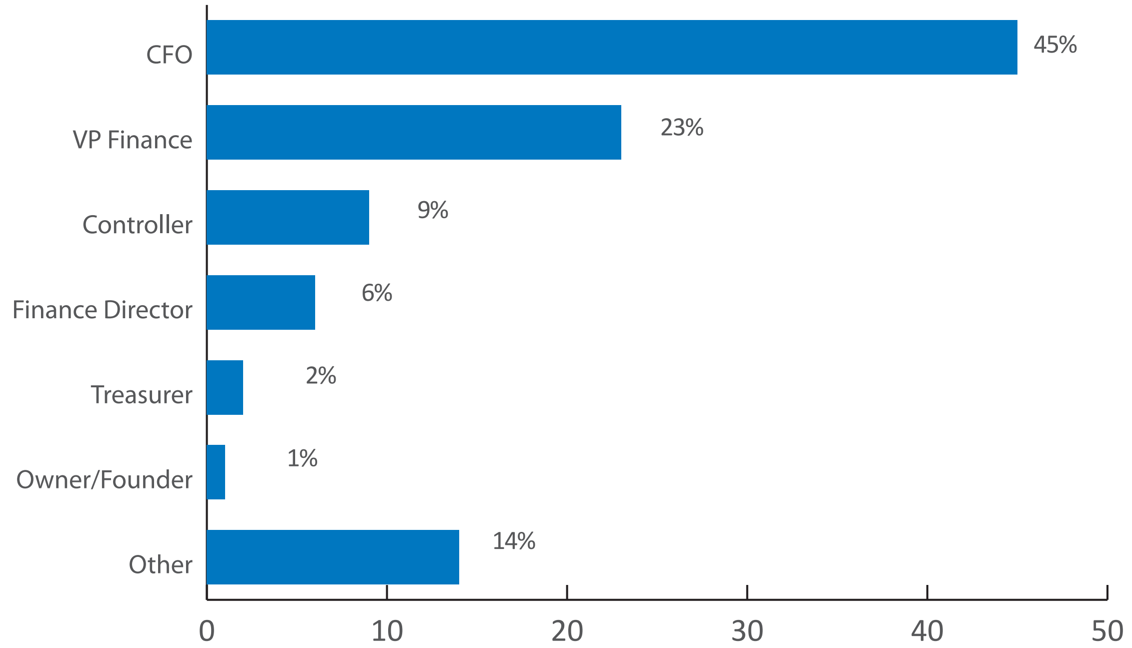
CORPORATE STRUCTURE



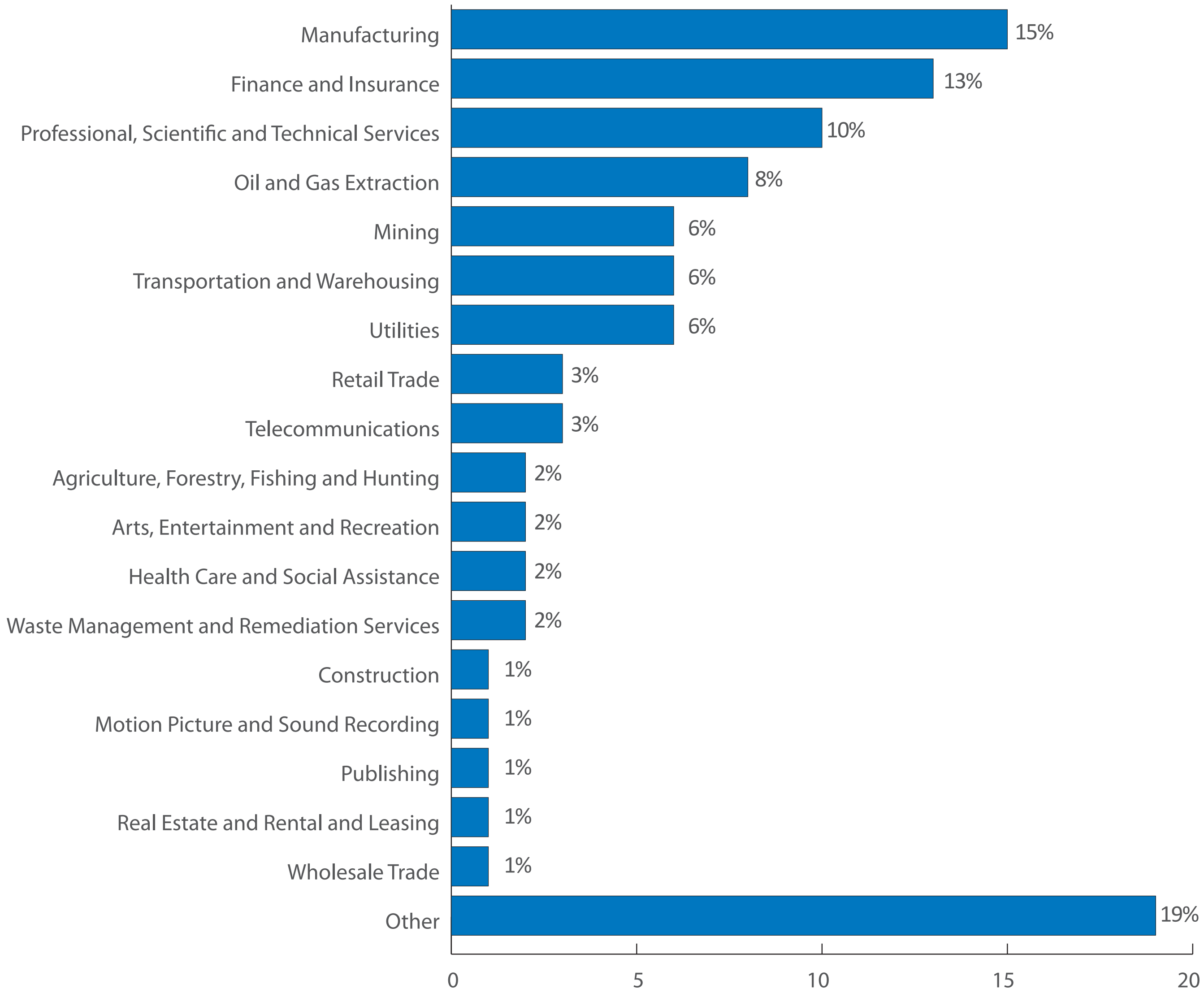
COMPANY TYPE



RESPONDENT TITLE



INDUSTRY CLASSIFICATION



Appendix B: Executive Research Forum Participants

Forum Chair:	Michael Conway – Chief Executive and National President, FEI Canada
Moderators	Éric D'Amours – National M&A Practice Leader, Towers Watson Ramona Dzinkowski – Executive Director, CFERF
Participants:	Anastasia Chodarcewicz – Chief Financial Officer, Sirit Inc. Jeff Cook – Vice-President, Finance & Accounting, CB Richard Ellis Global Corporate Services John Forester – Vice President, Finance & Administration, NUCAP Industries Inc. Pierre Gaussiran – Vice President, Finance, Transcontinental Marketing Communications Darren Goldstein – Director, Corporate Development, TELUS Robert Howard – Senior Controller, Microsoft Canada Howard Johnson – Managing Director, Veracap Corporate Finance Edward Jonasson – Vice President & Corporate Controller, Open Text Corporation Nancy Lala – CFO, About Communications Inc. Felipe Lima – Chief Financial Officer, VCNA - Votorantim Cement North America Leslie Markow – Director of Client Service, Resources Global Professionals, Inc. Bill Ross – Vice President, Finance & Information Technology, Enbridge Gas Distribution Inc. Debbie Stein – Vice President Finance & Chief Financial Officer, AltaGas Income Trust Paul Van Damme – Chief Financial Officer, Bradmer Pharmaceuticals Inc. Tim Zahavich – Chief Financial Officer, St. Joseph Communications
Observers:	Keri Alletson – Research Director, Towers Watson
FEI Canada:	Line Trudeau – Chief Financial Officer, FEI Canada Laura Bobak – Senior Writer, FEI Canada Melissa Gibson – Communications and Research Coordinator, FEI Canada

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