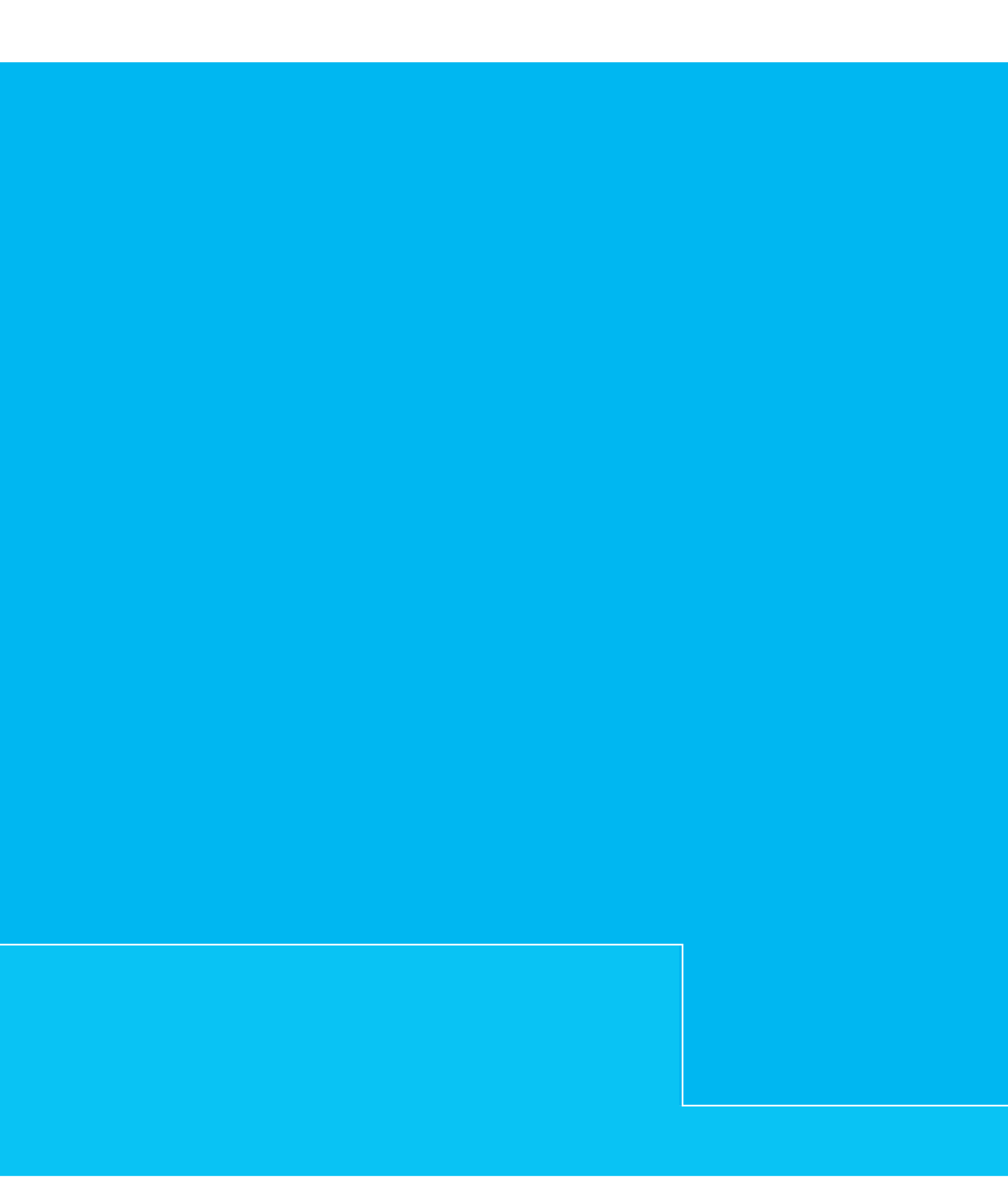


What lies beneath:

Navigating the thin line
between success & survival



With intangible capital, what you see isn't often what you get. How can you ensure the most favourable outcome for your M&A?



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Satisfaction not guaranteed

Asian dealmakers have been busy this year. According to news reports, merger and acquisition deals in Asia totaled US\$312 billion by the first half of 2011, a 28 percent increase from previous year. The bullish outlook means we can expect further consolidation among Asian industries, with companies hoping to increase market share, enhance competitiveness and improve bottom lines through inorganic growth.

Yet, the growing confidence for M&As does not negate past experiences, which warn that approximately two-third of these transactions will fail. Instead of achieving objectives that were *raison d'être* for merging in the first place, studies show

that nearly 60 percent of deals transacted between 1992 and 2006 left acquiring firms with eroded shareholder value. Clearly, the long-term value of M&As is not guaranteed.

Decoding M&A success

Most M&A veterans are familiar with the vital role of a firm's intangible capital, which can exist in different forms, with examples ranging from brand equity and client loyalty, to leadership attributes and corporate governance. We classify these under three key areas in Hay Group's Intangible Capital Model (Figure 1).

As can be seen from Figure 1, there are a total of 17 drivers of intangible capital. This is the source of challenges for all M&A exercises. Are any of these drivers more important than others, thus

requiring more attention? Or are certain drivers more critical at any particular time? Or more importantly, how can we quickly find out which ones create value?

Now you see it, now you don't

Hay Group research has put forward a revolutionary idea: that intangible capital is in a constant state of flux, oscillating back and forth from an "active" to "inert" state. Moreover, intangible capital is able to serve its value-creating purpose only when it is in an active mode.

For instance, employee engagement can vary considerably during the course of a transaction, sometimes changing the most after the deal is completed. Pro-actively managing this variable is a key source of value to any deal, since up to 30 per cent of an employee's discretionary effort (and, therefore, productivity) can be directly related to employee engagement.

Or, take the example of Apple, a company much loved for its products with user-friendly features and iconographic designs. Would the same persnickety and laser-focused attention to detail continue to exist in the post-Steve Jobs era? Would the Apple brand – an intangible capital – plunge from active to inert?

Figure 1: Hay Group's Intangible Capital Model

Hay Group's intangible capital model		
Organizational capital	Relational capital	Human capital
Cultural and market convergence	Brand	Leadership
Governance	Client intimacy	Employees
Agility	Client loyalty	Development and management
Communication and teaming	Examining networks	Engagement
Energy and clarity	Internal networks	Productivity
Organizational Structure		
Tacit 'know-how' and innovation		

“It is critical for Asian business leaders to understand the dynamic nature of intangible capital in M&A transactions,” comments Dr Andreas Raharso, director of Hay Group’s Global R&D centre for strategy execution, “because that’s going to make the difference between winning and losing.”

Indeed, in a 2011 global survey on M&As, Hay Group found that 60 percent of an organization’s EBITDA earnings and 77 percent of stock price movement was attributed to intangible capital in its *active* form.



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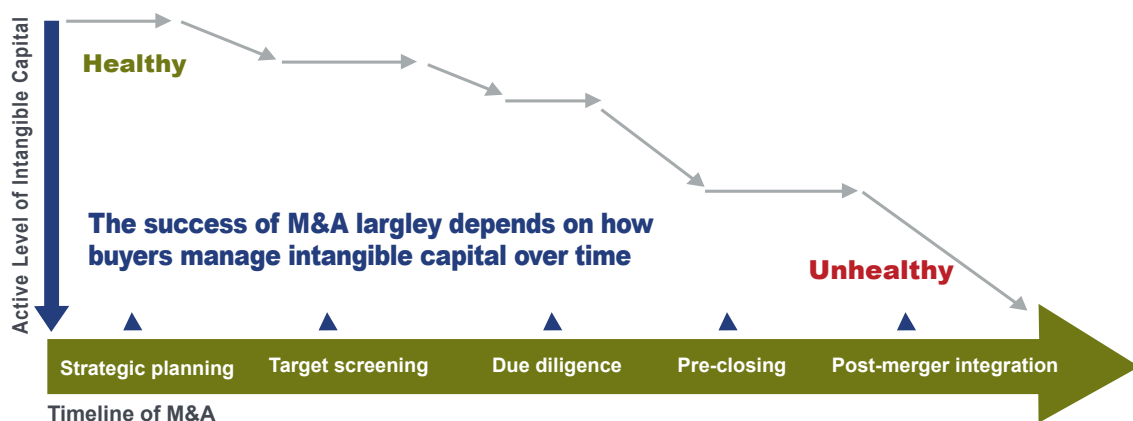
Caught in the limbo

In the rush to complete a M&A transaction, it is easy to overlook how quickly (and surreptitiously!) intangible capital switches from one state to another. Let us revisit our earlier example about employee engagement. When engagement (an active intangible capital) turns into frustration or disengagement, the intangible capital is said to be now inert. Effectively, this serves no purpose, or it is altogether detrimental to shareholder value. In our Global M&A survey, 71 percent of sales volatility was due to intangible capital reverting to its inert state.

Our consulting experience reveals that that intangible capital will become increasingly inert over the acquisition timeline – the result of internal and external changes, as well as progressively complex M&A interventions

(Figure 2). Yet, our interviews disclose that Asian leaders are still largely unsure when it comes to tackling intangible capital. Sadly, these are the ones who will pay the highest price when M&A issues begin to snowball.

Figure 2: Active intangible capital declines over the M&A timeline



Ready, set, go!

In essence, it is the state and not the valuation of intangible capital that drives a successful M&A. Sure enough, companies who make the distinction also enjoy better top and bottom lines while deriving superior value from their acquisitions.

For instance, employee engagement can vary considerably during the course of a transaction, sometimes changing the most after the deal is completed.

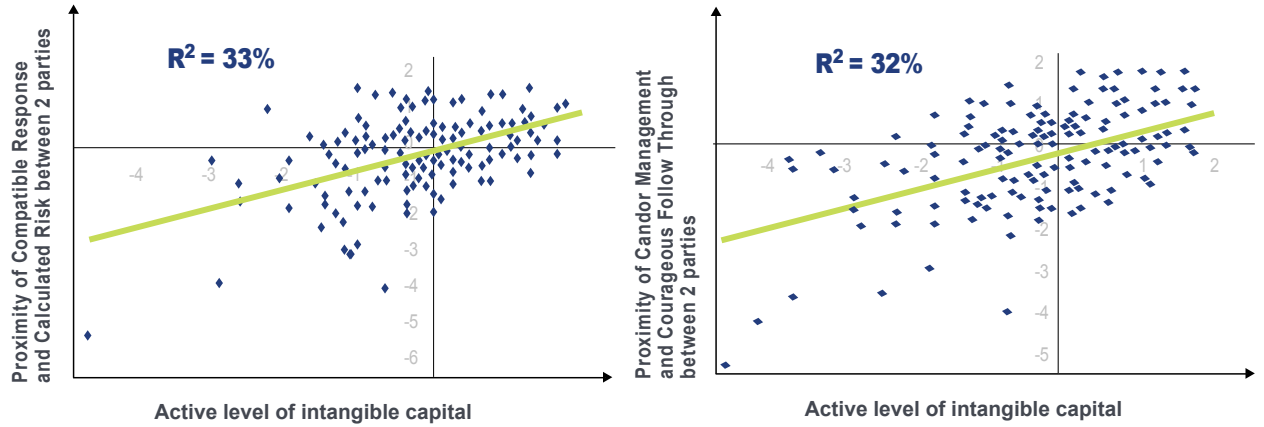
This brings us back to an earlier question: how can intangible capital be activated? In the multitude of tasks to be done during an M&A transaction, is there any catalyst that can keep intangible capital in its active, value-creating state? What are the most important drivers of intangible capital? Is there some *Deus ex machina*, so to speak?

From Hay Group's research into M&As in Asia, we identified four core drivers that are responsible for activating intangible capital:

- Candor
- Courageous follow-through
- Calculated risks
- Compatible response

Of the four, *candor* and *courageous follow-through* accounted for 33 percent of an organization's active intangible capital, while 32 percent of variation in active intangible capital was attributed to *calculated risks* and *compatible response*, as illustrated in Figure 3.

Figure 3: Relationship between the core drivers and active level of intangible capital



Candor

The uncertainties inherent during the integration phase, coupled with top management's tendency to play down negativity, can cause employees to doubt the future performance of the merged entity. However, when top management advocates communication that is honest, open, timely and accurate; they unleash the first key driver for *active* intangible capital.

By relaying information to employees – even if it means revealing negative but truthful details about the prospects of the merger and addressing immediate challenges that need to

be overcome – intangible capital is activated through the assurance that comes from managing with candor. Employees develop a greater sense of trust towards management, and are more disposed to aligning their motivation with that of the executive team's.

What does this mean for us in Asia? In Asia, where the practice of “saving face” and “giving face” sometimes run counter to frank discussions, management with candor can be difficult for both employees and management. This brings us to our next point: courageous follow-through.

A close shave: When Gillette meets Procter & Gamble

Six years ago, an impending merger between Gillette India and Procter & Gamble was leaked through the media one day before the official announcement. The information sent shockwaves through the minds of employees, who feared a massive layoff as the stock price of Gillette became adversely affected.

The CEOs of both companies acted swiftly and personally to manage the situation. They engaged employees through open communication by allowing people to voice and clarify their doubts. This mitigated the apprehensions and restored employees' trust, which helped to smooth the integration process. More importantly, the management was perceived to be approachable and accessible, and the people felt confident that the merged entity would continue to keep employees' best interest in mind.

Courageous follow-through

Change and its attendant complexities are part and parcel of mergers and acquisitions. To derive the full value, leaders from merging entities must close ranks and not retreat from making tough decisions that inevitably crop up in the course of the transaction. This might include displaying flexibility in accommodating changes, a strong ability for rallying employees to face challenges, or

making the tough call to discontinue one party's product line.

As catalysts for change in a merged entity, top management must be able to demonstrate perseverance in adapting to new circumstances, adopting a common fighting stance towards overcoming obstacles, and never taking “no” for an answer.



As shared wryly with us by an executive, “we took our courage from the motto of the Israeli Defence Force’s Engineering Corps: *The hard we shall do today, the impossible we shall do tomorrow.*”

What does this mean for companies in Asia? Fortunately, employees in Asia are more accustomed to a top-down approach. As

long as a difficult decision is sanctioned by top management, employees will usually fall in line. But this does not mean that leaders should just issue edicts and ram changes through. Some appearance of selling and explaining will still be necessary for the long-term good of the transaction.

When opposites attract: The birth of Lenovo

When Legend Holdings in China acquired the former IBM Personal Computing Division in 2005, the deal was deemed an ambitious one. Thinning profit margins, conflicting market targets, culture, language barriers and management styles were just a few of the factors that stood in the way of smooth integration.

Nevertheless, the shared attitude for dealing with challenges from both management teams ensured its success. The IBM executives enjoyed challenges and regarded them as one of the key components of their innovative “Think” culture. They advocated bold restructuring and completed renovation of their software system swiftly and effectively.

On the other hand, a deep-seated problem-solving attitude at Legend drove Lenovo towards market dominance in China within seven years of its first manufactured PC. The two parties embraced difficulties together and made a good team in achieving an ultimate goal. Their rewards: Consistent and solid performance, and a revenue surge of 234% for the merged entity.

Calculated risks

Employees in the merged entity must be prepared to take calculated risks so that action plans get implemented even in times of uncertainty, which is common in M&As. Clearly, risk appetite differs between companies and individuals – some being more aggressive and others less so.

Regardless of scenario, the secret to long-term gains and synergy in successful M&As resides in the approach. As long as both entities share similar proclivities towards calculated risks, and are prepared to commit themselves fully, it would smoothen the transition process and accelerate M&A success.

Given that the most significant M&A trend now is the move by an increasing number of Asian companies, in particular, China and India into Western markets through acquisitions, how can knowing the risk appetite profiles help both buyers and target?

One way is to use Geert Hofstede's *Uncertainty Avoidance Index* (UAI), which we believe is a useful tool in measuring a nation's or a group's tolerance for uncertainty and ambiguity – in other words, its appetite for risk.

In Hofstede's study, UAI scores can range from 0 (pure risk takers) to 100 (pure risk avoiders). At one end, Americans ranked lowest, preferring fewer rules and controls,



and greater tolerance for a variety of ideas, thoughts, and beliefs. At the other end, Japan ranked highest in its UAI score, implying high levels of control in order to eliminate or avoid the unexpected.

So in a M&A transaction, parties that prefer to “wing it” and rely on “gut feel” are going to conflict with those who demand more analysis, higher conformity and strict adherence to rules. A case in point: contrast the two different business approaches of a

US-China joint-venture company we talked to. The US stakeholders preferred to make contingency plans for possible scenarios, whereas the Chinese’s attitude was “let’s just do it and fix it as we go”. Needless to say, there was deep unhappiness on both sides.

The implication for Asian companies is this: in a deal, especially one that crosses multiple borders, the closer everyone’s UAI, the better the outcome.

It’s not about size: The perfect match between Tata and Corus

In 2007, the merger between Tata Steel and Corus took the steel industry by surprise. Tata wasn’t just acquiring a competitor four times its own size, it was taking a huge risk by forking out more than \$1 billion for a cross-border M&A – the first Indian company to do so. The deal made history by remaining the second largest M&A in the steel industry.

Thankfully, the marriage turned out extremely well for Tata, propelling it from the 56th to the 6th largest steel producer in the world. Among others, culture and a shared risk preference were cited as the main success factors for the favorable outcome.

After all, risk-taking wasn’t new to Tata. They have participated in several bold takeovers in the years leading to the acquisition of Corus. On their part, Corus braced themselves by making radical changes to the company culture, helping risk-averse employees to cope with uncertainties when faced with new challenges.

Compatible response

The amount of chemistry between merging parties is often the result of maxims governing business conduct, philosophy and decision-making. When it comes to successful M&As, employees in a merged entity must respect the need for timely and prudent response, so that decision-making does not become the Achilles heel for one party or the other.

By compatible response, we mean that both parties ought to have a similar time-frame when they enter into an execution plan. It is acceptable if both parties are quick in action, or agree to be methodical when deliberating their options. For example, we have seen conflicts arising rapidly when a bureaucratic decision-making process holds one party back, frustrating the other side, which has a flat organizational structure.

Sadly, it is common to see incompatible decision-making frameworks jeopardizing the performance of a successful M&A transaction.

Interestingly, both parties need to realize that not making any decision is a decision in itself. This puts the brakes on compatible response, leading to further compromise on timely decisions.

What does this mean for companies in Asia? Unfortunately, Asian managers have a tendency to delay making decisions in order to gather more (or better) information. If this holistic decision-making style is not shared by the other parties, then this habit will be perceived as hesitation and ultimately, backfire on the M&A transaction.

There was no getting through: Why BenQ and Siemens hung up

When BenQ decided to acquire Siemens' loss-making mobile phone unit in exchange for more than 600 patents, it was confident that the deal would increase its profit share and open-up new markets in Europe. After all, BenQ was combining its strengths in consumer markets with Siemens' reputation for high-quality products.

However, the venture failed within a year, no thanks to clashes in decision-making frameworks and the speed of execution between the two entities. BenQ's informal culture, which was flexible and entrepreneurial, collided head-on with the formality and processes at the 100-year-old Siemens, which has a culture of adhering to strict procedures. This led to critical delays in the decision to introduce a new phone model into the market – a missed opportunity that caused the venture to suffer a huge loss.



Power of the 4Cs

Turning the wheels of M&A success

Hay Group believes that the four Cs (Candor, Courageous follow-through, Calculated Risks and Compatible Response) play an integral role in augmenting organizational, relational and human capital, leading to higher levels of active intangible capital. In turn, the active state of intangible capital raises shareholder value, elevating the results of a successful merger.

“Interestingly, both parties need to realize that not making any decision is a decision in itself.”

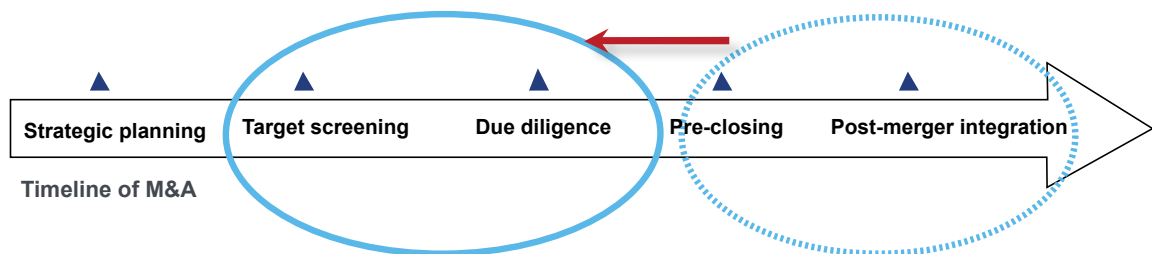
From paper to practice

The most compelling application of our research findings is the fact that firms can reduce their time and financial resources while achieving greater accuracy when dealing with the wide range of factors that drive intangible capital. More importantly, merging companies should pay attention to these drivers during the earlier stages of M&A, as opposed to resolving issues after they have escalated (Figure 4). If differences in the four core drivers – candor, courageous follow-through, calculated risks, and compatible response – between two merged companies are small, intangible capital will remain active, resulting in a more successful and rewarding M&A.

Moreover, when these drivers are identified prior to an M&A deal, high potential targets can be pinpointed earlier in the screening phase. In essence, Hay Group believes that early detection and analysis of the target's drivers can increase the probability of success.

Even if significant differences did exist in terms of organizational, relational capital and human capital, small differences in intangible capital drivers between merging firms will help to improve the chances of alleviating conflicts, creating synergy and ultimately, accelerating results.

Figure 4: Clear focus on critical drivers during the earlier stages of M&A heightens opportunities for greater success and rewards.



Overcoming cultural and geographical hurdles

Let us look at a classic example – Nissan and Renault. It was widely believed that cultural differences between the Japanese (Nissan) and the French (Renault) would destroy the merger. Moreover, the fact that Renault and Nissan targeted the same market segments sparked fears of cannibalization. Renault’s technical expertise resided in its flair for design, whereas Nissan was renowned for bland but reliable models and strong engineering skills. In short, there was a glaring difference in the intangible capital that existed in both firms.

Nonetheless, the merger turned out to be a success. This was largely due to the structural similarity between both organizations, which were bureaucratic and highly hierarchical. They shared similar approaches in “compatible response” – or general timeframe towards execution – both being highly collective organizations

where decisions were made based on general consensus. Even though Nissan and Renault had different intangible capital, their successful merger demonstrated that the right active drivers could result in better value creation, overcoming geographical and cultural differences between the two.

When strange bedfellows made good partners

Another interesting case is the purchase of Swedish carmaker Volvo by the Chinese Geely Auto in 2010. Transacted at the price of \$1.5 billion¹, it was China's largest foreign automobile acquisition deal.

In reality, however, these seemingly-odd bedfellows were being labeled by the old Chinese saying: “same bed, different dreams” *(同床异梦), for Geely had neither experience with premium automotive markets, nor the intellectual trademarks to match Volvo's exacting standards for safe designs and family-friendly cars. Yet, Geely was keen to realize its dream: re-introducing Volvo as a luxury brand in China and competing head-to-head with players like Audi, BMW and Mercedes.

Interestingly, divergences in vision and risk profiles did not keep them apart. Nor did the cautious plans and detailed budgets in Volvo's turnaround measures stop Geely from promptly setting up plants in China to catch up with global sales. In fact, the plant in Daqing took

only 12 months, after much discussion with Volvo. With abounding “tensions” between the two, it did not surprise that shares of the Hong Kong-listed Geely Auto fluctuated substantially after the conclusion of this M&A deal.

Fortunately, Geely and Volvo were open with each other and recognized their differences with respect. “We solved this very much on a one-on-one basis,” Mr Stefan Jacoby, CEO of Volvo, said in a recent interview. “We didn't want to do this in a big public setting and embarrass one or the other.” Truly, the practice of managing with candor has served them well.

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* same bed, different dreams

¹ <http://www.reuters.com/article/2010/08/02/us-geely-idUSTRE66S1TC20100802>

Although it took 10 months to sort out their differences, Geely and Volvo reconciled their visions and differing management styles to chart a course for Volvo's revival². Volvo's new design turned heads with its edgy look – a departure from the staid styles that were its hallmark. The upscale sedan has sleek curves and pale purple LEDs in its grille in a bid to plant the Swedish marque more firmly in the luxury segment.

Volvo has begun to show signs of profit recovery. However, the road remains rocky unless the two parties pay attention to the traps along the way, and the tricky outcomes caused by the underlying drivers of intangible capital.

² <http://online.wsj.com/article/SB10001424052702304563104576363041069364856.html>



A fighting chance

We all know that the M&A process is a race against time. There are many challenges to take care of, many difficult decisions to make, and often simultaneously. It is next to impossible to assess all of the various aspects of intangible capital during due diligence, as doing so could delay the transaction and destabilize the intangible capital even more.

Instead of devoting what limited resources we have to the valuation of intangible capital, companies going through M&A should focus on these core drivers outlined in this paper that ensure an active state of intangible capital, and not leave a successful outcome to chance.

Despite glaring differences, mergers can still succeed when both parties ensure that their intangible capital drivers are well aligned and kept active. By unlocking this vital component, M&A partners will discover

what keeps mergers afloat, and realize the benefits of their respective intangible capital.

M&A is intrinsically a risky business; there is no safe bet. With increasing global M&A market activity, there are good deals to be made to help companies achieve new growth. Armed with the right insights to make the best deal – a clear understanding of what you are buying and how it ‘fits’ with your existing company through intangible capital analysis – M&A can be a winning strategy for driving long-term growth for the future.

About Hay Group Global R&D Centre for Strategy Execution

Hay Group's global R&D centre for strategy execution researches best practices in strategy execution globally. Based in Singapore, the centre provides a unique East- West perspective for business leaders all over the world. Our research helps provide insightful advice to executives looking to build effective organizations for the future. The centre combines Hay Group's long-standing research

tradition with extensive client experience, database and global expertise located in 86 offices across 48 countries. We aim to nurture an eco-system for global research through open collaboration with academia and professional institutions around the world to help business leaders transform their vision into reality.

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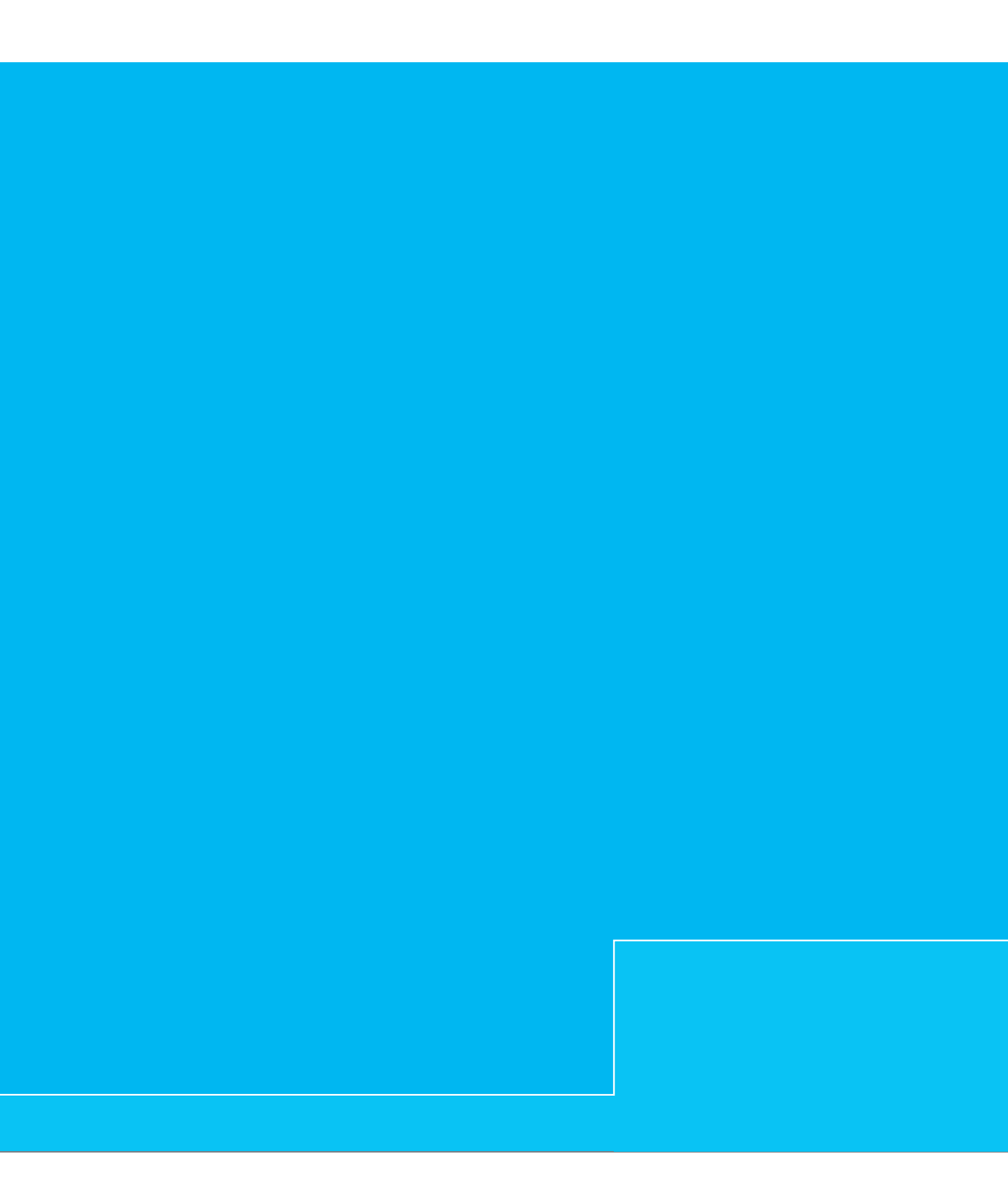
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