Before your M&A deal, do a human capital audit

Going beyond crunching the numbers, many CEOs are conducting an additional audit to assess the managerial talent in the company they are considering buying.

BY DENNIS C. CAREY AND MARC A. FEIGEN

ANY CASUAL READER of the business press now knows that many highly touted corporate takeovers have backfired — some of them spectacularly. It is hardly surprising that top executives who have staked so much on an elaborate financial due diligence process prior to the integration of two companies are stunned to find that, when the two companies integrate, it yields disappointing and unanticipated results.

These results are forcing executives, boards, and senior managers to rethink their approach to mergers and acquisitions. Instead of merely looking at potential partners who would help achieve business goals, they must select their merger partner with great care, scrutinizing every potential merger or acquisition target for problems that may not be obvious from the company's financial profile. They must ask themselves, "Is this a company whose management, employees, and approach to business I can live with?" Having answered that question affirmatively, they must then prepare themselves to integrate two businesses that might have radically different cultures.

This task is more challenging than most business leaders recognize. As executives consider possible alliances prior to a merger, they discover the limitations of traditional pre-merger due diligence exercises. In most mergers, due diligence teams led by investment bankers conduct extensive research into the value of a company's capital assets. But they pay scant attention to its human assets. Yet, often the most undervalued, underappreciated, and underdeveloped assets are the huge stores of human capital that each company brings to a marriage. These pools of talents — and how they are used — can be the key to creating a new, dynamic corporate culture, which is essential to any successful enterprise. Making sure that that new culture can be achieved may be the most important yet overlooked element of today's corporate mergers.

Recently, some acquiring companies are trying to prepare themselves. Many CEOs are going beyond crunching numbers, and are conducting an additional "human capital audit," an innovative exercise to:

— assess the managerial talent in the firm they are considering buying,

— determine whether it is possible to create a common corporate culture, and

— get a head start on making the deal work.

By thoroughly examining the state of a target company's internal culture and the strengths, weaknesses, and potential of the people who manage it and work for it, a human capital audit can provide guidance as to whether a deal is worth undertaking, and at what price. And it can help shape a game plan for steering the new corporate entity in pursuit of a unified strategy as soon as possible. Shaping the culture of a new, combined company also requires a carefully planned and executed strategy. The more knowledge company leaders have about the culture of the newly acquired company, the better positioned they are to make the post-merger integration work.

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To order a copy of the report ($35), contact DIRECTORS & BOARDS at 1-800-637-4464 or e-mail to directorsjournal@earthlink.net.

The human element

The often unspoken assumption in a merger is that one company's culture will predominate and cast strategic issues in terms of "ours" versus "theirs": whose systems, whose managers, whose products come out on top? Answering these questions and agreeing on how they will be decided largely determines how smoothly a merger integration will be.

That is why it is so surprising that little attention is paid to the human elements of mergers and acquisitions. Acquiring companies typically do not devote a sufficient amount of time to a thorough examination of the ingrained ways that a target company's executives, managers, and other employees go about getting their jobs done. Acquirers typically know little about the target executives' motivation and daily behavior, and how they relate to each other — in short, they are utterly unfamiliar with the culture of the company they are considering taking over.

At a minimum, any executive contemplating a merger should know the answers to a series of questions that can determine how well the merged company eventually will operate. These include:

— What are the skills and leadership potential of the targeted company's key employees?

— How well do they stack up against the competition?

— How would they likely tackle post-merger challenges?

— How would they handle the stresses and strains of the merger itself?

And then there is this critical question: Will key executives cash out, lose their fire, or simply fail to cope on a new management team or in a new pecking order?

Why audit human capital?

These are exactly the kinds of questions that a human capital audit can help answer. A comprehensive audit results in a balance sheet of human capital assets and liabilities — a clear picture of the leadership and key employees in place, and their strengths and weaknesses relative to the industry and the market as a whole. It helps identify potential value to be developed, and possible liabilities to be dealt with. Ideally, such a balance sheet yields benefits throughout an acquisition process, from pre-merger evaluation through merger negotiations to post-merger implementation.

In some instances, a thorough human capital audit undertaken even before a deal is announced can give an acquiring company evidence of "warning signs" that integration will be more difficult than financial analysts may realize. One of the authors was involved with a client planning to announce a merger that would create a global communications titan with unprecedented scope and resources. The investment bankers and due diligence team had given enthusiastic approval. But the human capital audit that was quietly conducted revealed that the target company was bitterly divided into two camps. Its attitude toward spending, research, and marketing was at odds with the goals of the client. The differences were enough to cause the merger plans to be shelved.

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More frequently, a human capital audit can help a buyer determine which potential acquisition to pursue, and contribute to a proper price evaluation (especially when a target is being bid on competitively). In the case of the global communications client, the human capital audit discovered through a series of interviews with industry veterans and company alumni that the target company was prepared to settle for a dollar figure far lower than the asking price.

But in the best of cases, a comprehensive human capital audit provides a running start for a successful merger. It highlights where hidden strengths may lie, and where a strategy may face significant barriers. It provides an evaluation of which key executives should take on what roles in the new company, how much integration to anticipate, and which priorities should be set in post-merger activities. An audit can also reveal whether there is fresh talent in the managerial ranks — an important signal to the firm's long-term potential — and whether the top performers intend to stay. One of the risks to an acquiring company is the threat of a post-merger brain drain. A professional audit can help plug it, by letting the buyer know which executives need to be assured of a prominent role in the new organization.

Ideally, a human capital audit will help management assess a full range of post-merger options, from completely separate operations to complete integration. By providing a clear sense of how key units function, it can help management decide what to integrate and what to keep as separate operating units. For example, merging back-office functions and product management might provide economies of scale, while integrating retail organizations would destroy more value than it created. In other cases, combining marketing operations might yield synergies, while leaving R&D autonomous could maintain intellectual collegiality and product development focus. To make these decisions, it is valuable to have a clear idea of an acquired company's human strengths and weaknesses.

Undertaking an audit

A human capital audit is an act of intelligence-gathering, which allows one company to know as much as possible about the human dynamics of a company with whom it is about to enter a partnership. Because such intelligence-gathering typically is made without the knowledge or formal cooperation of the target company, there is necessarily a low-key and confidential quality to this work.

The sources for this type of information are both obvious and obscure. Public sources, including journalistic profiles of a company, can often provide basic data about the personalities and culture of a company. Even isolated anecdotes about the idiosyncracies of management can offer clues to how a company manages its human capital. NationsBank's chief executive, Hugh McColl Jr., for example, is known to award a crystal hand grenade for achievement. One would be hard-pressed to find a more potent symbol of an aggressive corporate culture.

But a comprehensive audit requires extensive interviews with the people who know the target company best, including analysts, suppliers, and customers. Some of the most valuable sources of information and perspective on a company are its former executives and other senior managers in the industry. An established executive recruiting firm with experience in this type of human capital intelligence is able to draw on a large data bank of senior executives in the relevant sector, contacts who often yield more information about a company than a decade's worth of balance sheets. Using the skills of executive recruiting, a firm can tap into alumni of a target company, including executives who have retired or taken other jobs within the past 18 months. Interviewing these executives, without disclosing the purpose of one's clients, allows direct access to people who understand the culture of an organization.

Needless to say, great care needs to be taken in discounting information that is self-serving or biased. The possibility of receiving opinions from a disgruntled former executive must also be taken into account. But, in general, the thorough human capital audit will get an array of information about a company and how its key leaders conduct business and the goals they are pursuing. Such research can take a few days or months, depending on the scope of the acquisition. In assessing the state of a company's culture

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and human capital assets, a prospective purchaser must decide whether its priority is to "get the deal done quickly" or to get it done right.

Asking the right questions

To determine the feasibility of creating a successful new corporate culture, a human capital audit must be as rigorous as any financial analysis. It must assess the human capital assets of a target company. And it must be prepared to ask a series of tough questions about whether the internal dynamics of a company would allow it to be reshaped in a new, post-merger strategy. How successfully, for example, are new ideas generated in one department translated into increased performance across all departments? To what extent are front-line employees motivated to understand and embrace new product and service lines? Who are the key people who get things done?

The audit must also probe human capital liabilities. Are employees promoted more often on tenure than on talent? Do ideas "not made here" stand little chance of survival through corporate review? Are there powerful players who will impede change?

Through these and other unorthodox questions, a clear picture is drawn of all of the aspects of corporate culture that must be managed to allow the two companies to merge successfully. Executives from the acquiring company should insist that these types of questions can be answered satisfactorily.

Audits and integration

A new corporate culture needs to be forged by design rather than by default. When human capital management is on the agenda of the leadership team before it seeks a merger, it remains there after a deal is completed.

CEOs and boards are expected to be called upon to articulate a clear strategic vision for the merged company — and deal with bottlenecks to that vision on both sides. The audit enables the transition teams that drive the integration to do their work with a head start — armed with knowledge of what human talent must be preserved and leveraged. Instead of hearing the standard eight-word barrier to change — "That's not the way we do things here" — CEOs know who is in the vanguard and who can help get things done.

The audit helps CEOs maintain a stable corporate environment and stem an exodus of the most valuable executives, technical experts, and front-line supervisors.

And, of course, a human capital audit can determine from the outset whether it is possible to shape a new corporate culture, and how to go about it. Traditional due diligence is often compared to a chance to "kick the tires." Since top management must also decide where they want to take the new vehicle, a comprehensive human capital audit can help them chart a road map that the entire new company can follow.