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AN M&A ADVISOR FEATURE

Private Equity Reaches Major Milestones as PE Roles Continue to Shift

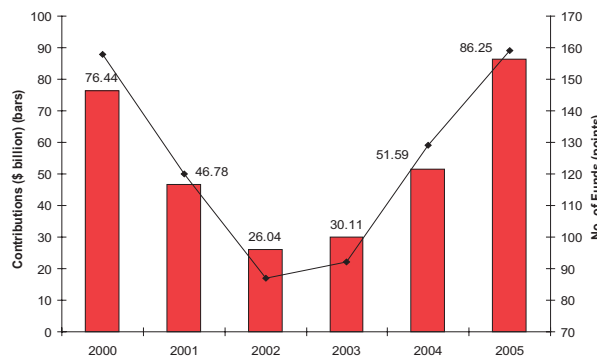
Texas Pacific Group has announced the closing of the largest single private equity investment fund in history, \$14 billion. This comes on the heels of a record year for PE fundraising in 2005, with buyout funds taking in more than \$86 billion. The TPG news signals increasing investor interest in private equity as a new vehicle for follow-on financing for companies exiting the venture capital market. We could see a \$100 billion year in 2006.

The chart in Figure 1 shows the funds' progression through the slump that followed the bursting of the dot-com bubble. As an expression of the traditional boom and bust scenario, the fact that fundraising is accelerating out of its 2002-2003 lows at a faster clip than the pace at which it fell into the pit is not startling. The soaring jump in private equity firms' acquisitions since 2003 displayed in Figure 2 is no surprise, either, since the truism "too much money chasing too few deals" is just that: a

maxim with less basis in fact than we would assume from the number of times we hear it repeated. There has been an abundance of deals out there.

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Figure 1: Investment in Private Equity Funds 2000-2005



Source: Capital IQ and The M&A Advisor

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The Impact of Cultural Due Diligence on M&A Success

Activity across virtually all business sectors indicates that M&A transactions are poised to set all-time records. But let's hope the lessons learned from the 1990s are not forgotten. Remember Quaker Oats and Snapple, Daimler Chrysler and Mercedes Benz, AOL and Time Warner? These major mergers fell well short of expected performance and results. Studies show that 75% or more of all mergers and acquisitions fail to deliver the anticipated benefits to shareholders.

Studies have shown that cultural compatibility and integration are critical to the performance and success of the combined organization

integrative integration in over 85% of failed or troubled mergers. Studies show cultural compatibility and integration as critical to the performance and success of the combined organization, yet this aspect of deal-making is rarely assessed before the transaction.

There are examples of successful combinations, however. The successful banking "merger of equals"

between Wachovia and First Union demonstrates the impact that cultural due diligence can have on mergers. Ken Thompson, President, CEO, and Chairman of Wachovia, gives credit in no small part to the due diligence efforts focused on organizational culture between the two companies as crucial to success. "While it's not enough to look only at social and human factors, such as organizational culture, it is

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Cultural Due Diligence

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easy to underestimate its impact on success. We spent a lot of time measuring the two cultures and developing integration plans that would play to the strengths of each," says Thompson.

In short, corporate culture is critical to success in any merger. Lou Gerstner, former CEO of IBM, stated that he came to realize that the greatest challenge facing leaders today is their ability to effectively reinvent corporate culture, especially during changes brought on by consolidations and mergers. Gerstner stated that culture isn't just one aspect of the integration game, "... it is the game."

Therein lies the paradox for business leaders today. In most instances, this crucial aspect of determining M&A success is typically not examined during due diligence or financial analysis of the deal. While analysts are experts at understanding a transaction's numbers, seemingly very little attention is paid to the cultural dynamics surrounding mergers.

So what exactly is organizational culture? Culture is much like an iceberg. Above the surface, the tip represents an organization's mission, organizational structure, dress code, etc. The bulk of corporate culture, however, is invisible, lying "below the surface," and includes the values and norms that dictate employee behavior.

Although culture is a vague concept, research demonstrates that it can be measured. If we can measure it, we can manage it. Because of its critical role in determining M&A success, cultural due diligence is becoming a necessary approach based on research in behavioral, social, and organizational sciences. Effectively implemented cultural due diligence provides a scientific, systematic way to measure crucial elements

of culture, identifying the "gaps" that exist between the two merging entities and providing a roadmap for aligning and integrating people and processes for long-term success.

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Cultural Due Diligence in the Energy Industry – A Case Study

Recently, two US energy companies announced a definitive "merger of equals" agreement. Company A

is a diversified energy company with assets over \$55 billion and net income of \$1.5 billion. Company B is an integrated energy company with \$15 billion in assets and \$400 million net income. The transaction, which is expected to close this year, will result in a combined company with 3.7 million retail electric customers and 1.7 million retail gas customers.

These merging energy companies faced the daunting task of integrating diverse energy-related businesses. Although they had many similarities with regard to energy solutions, customer service, and commitment to the environment, the potential for "culture clash" between the two merging organiza-

The greatest challenge facing leaders today is their ability to effectively reinvent corporate culture

tions was a consideration for accelerating the combined company. As part of a larger effort to identify the most crucial factors for M&A success, a cultural due diligence project was implemented to measure the corporate cultures of both companies. The **Organizational Orientation Index™ (OOI)** was chosen to assess the two cultures and identify synergies and "gaps." The OOI measures organizational culture at by focusing on five key elements that determine organizational performance: Leadership, Norms, Values, Beliefs, and Performance Measurement. These five elements of culture are measured based on two dimensions: Attention (Internal or External) and Agility (Stable or Flexible.) A four-quadrant model of culture emerges, with the following organizational culture classifications: **Create** (External Focus and Flexible), **Cooperate** (Internal Focus and Flexible), **Control** (External Focus and Stable), and **Compete** (Internal Focus and Stable.) The profile results for the two companies follow.

Company A has a more external focus which results in a **Create** culture, while Company B is more internally focused which leads to a **Cooperate** culture. This analysis quickly gained face validity as both parties realized that Company A had, in fact, initiated the merger discussions between the two organizations. Upon further reflection, members of the transition team recounted the perception that Company A was more formal and strategic while Company B was more informal and maintained a "small town" atmosphere.

Using the information from the diagnostic framework of the **OOI**, the team was able to determine

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QUICK GLANCE

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buildings currently occupied by the unit. Serologicals employs a total of approximately 1,000 people worldwide in three companies: **Chemicon International**, headquartered in Temecula, Cal., **Upstate Group, LLC**, headquartered in Charlottesville, Va., and **Celliance Corporation**, headquartered in Atlanta. Contact: Bill Davis, Serologicals Corporation, (678) 728-2018.

Electronics design and manufacturing service provider **Sparton Corp.** (NYSE: SPA) has signed a letter of intent to acquire **Astro Instrumentation LLC**, a privately owned company located in Strongsville, Oh., which designs, manufactures, and sells a variety of specialized medical products, generally involving high-quality medical laboratory test equipment. Sparton intends to continue to operate the business as a wholly-owned subsidiary at its present location and with the current management and staff. Sparton, now in its 106th year, provides design engineering and electronics contract manufacturing services utilizing seven manufacturing locations encompassing nearly 855,000 sq. ft in North America and Vietnam. In addition to strong core competencies including surface mount technology, plated through-hole, printed circuit board assembly, and complete assembly manufacturing capabilities, Sparton offers a complete range of pre-manufacturing, post-manufacturing, and engineering services. Contact: Rhonda Aldrich, Sparton Corporation, (517) 787-8600.

Industrial

An affiliate of **Performance Fibers Holdings, Inc.**, itself an affiliate of **Sun Capital Partners, Inc.**, has signed a letter of intent to acquire **INVISTA Resins & Fibers GmbH's** German polyester yarn business. The acquisition would include both commercial and manufacturing operations in Germany. It is expected that the definitive purchase agreement will be signed in the coming weeks. This acquisition would represent the third major expansion of the Performance Fibers' business in the past year and is a key component of the company's growth strategy. In August, 2005, Performance

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Fibers announced the acquisition of the North American business of **Diolen Industrial Fibers, Inc.**, a leading producer of high-tenacity polyester yarns used in a wide variety of technical applications and tire reinforcement, and in January 2005, announced a greenfield expansion of its existing manufacturing operations in China, strengthening Performance Fibers' position as a leading supplier of industrial fibers in China. **Sun European Partners, LLP** advised Sun Capital on this transaction. Sun European Partners, LLP is the European advisor to Sun Capital Partners, Inc., a U.S.-based private investment firm focused on leveraged buyouts, equity, debt, and other investments in market-leading companies. Sun Capital has offices in Boca Raton, Los Angeles, New York, London, and Shenzhen. Contact: Sandy Frinton, (845) 454-3895; sandy@mallen.com.

First Reserve, a US-based private equity firm that specializes in the energy industry with \$4.7 billion under management, has agreed to acquire **Industrial Power Generating Corp.** ("INGENCO"), a company that designs, builds and operates distributed power generation facilities, including traditional oil and gas-fired peaking facilities, industrial cogeneration facilities and landfill gas-fired ("LFG") renewable energy ("LFGE") facilities. As part of this transaction, **First Reserve Fund X** will acquire a 90 percent stake in INGENCO, while current owners and management will retain the balance. Detailed financial terms of this transaction were not disclosed. INGENCO's current business includes six diesel and natural gas-fired generating facilities, and five LFGE generating facilities. INGENCO has also entered into agreements for the development of five additional LFG projects in the next year. While LFG contains methane (effectively natural gas) it is present in a lower concentration than natural gas and so is not suitable for many industrial users or electric generators, but INGENCO has developed a low cost solution to convert low value LFG energy into high value electricity for sale to the wholesale market. Contact: Alan Katz,

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the distinct set of behaviors, and more importantly, values and norms that underlay them, which could potentially lead to roadblocks and resistance during the integration efforts. The cultural due diligence process allowed the transition team members to highlight the best practices of both companies while identifying areas for improving the culture. For example, the transition teams recommended that Company A maintain its strategic orientation but establish processes for more bottom-up decision making in order to improve employee engagement. Likewise, Company B should maintain its exemplary record of customer service but integrate their service systems with improved technology capabilities in order to improve efficiency.

Based on the results of the cultural due diligence effort, both companies now have a valid model for understanding differences in organizational dynamics and leadership style. Moreover, the integration teams now have a systematic, universal framework for identifying and addressing cultural "gaps" during the integration process and to accelerate the alignment of the merging cultures for the combined organization.


The Future of Cultural Due Diligence

Looking ahead to another recently announced "merger of equals" between Jefferson Pilot (JP) and Lincoln Financial (LF), what can we expect? The first clue is the careful, deliberate attention being paid to describe this as a "merger of equals." Although the statement alone means little, the actions behind it communicate a powerful mes-

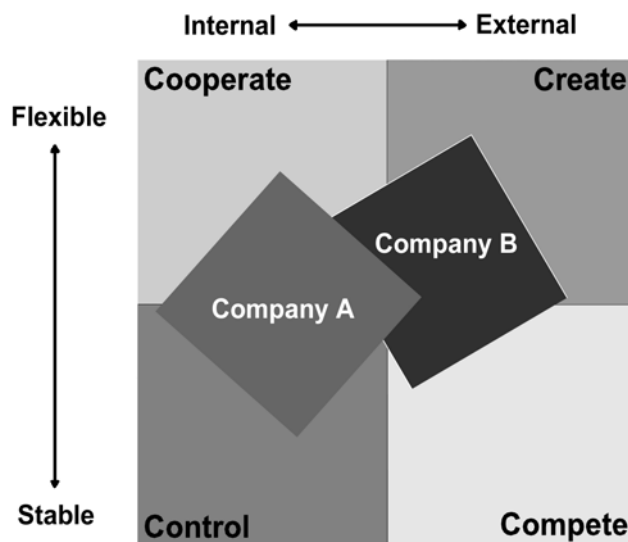
sage to employees, customers, and Wall Street. Dennis Glass, who will serve as President and Chief Operating Officer of the combined organization, is focused not only on the shareholders, but all "stakeholders." The new Board of Directors will be split roughly 50/50 between JP and LF members, and Glass has committed to maintaining the high level of commitment and charitable giving to greater Greensboro, North Carolina, community, including raising the profile of the Chrysler Classic Golf Tournament.

Other indicators point to strong cultures of JP and LF with potential synergies to tap into. For example, JP recently celebrated a "Century of Excellence" and is recognized as a leader in providing high quality insurance and financial services. On the other side of the transaction table, LF is well-known as an employer who leverages diversity in its workforce. Examples of LF's commitment to diversity

include its focused effort to attract and retain mature workers ages 55 and over from the "baby boomer" generation and its recent recognition by the Human Rights Campaign Foundation for creating a corporate culture of inclusion.

As M&A activity continues within today's market, cultural integration will evolve and become a more solid cornerstone in due diligence activities. Financial interests, market share, and shareholder value associated with M&A activities will always play critical roles in these evaluations. Going forward, however, successful integration will require organizations to pay just as much attention to cultural dynamics as play as to the transaction's numbers. 

Company Culture Profile Comparison



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