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Human Capital Issues Critical to Profitable Mergers and Acquisitions

The Importance of Due Diligence and Critical Post-Acquisition Integration

by Jeremy Swan, Principal

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

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

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

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

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

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

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

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

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

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

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

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

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

Key Takeaways

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

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

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

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

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

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

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

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

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

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Early Stage SBIC Regulations Issued

by Guergana Rangatcheva, CPA, Manager

Our View of the News

The new SBA regulations make the Early Stage SBIC debenture program more compatible with the unique characteristics of early stage funds, which typically cannot support regular interest payments in their earlier years. The SBA addressed this issue by easing the regulations for the first five years during which Early Stage SBICs will have the option to either maintain a five-year interest reserve, which may be held as unfunded capital commitments, or structure the interest due as an original issue discount.

The Small Business Administration ("SBA") issued final regulations for the Early Stage Small Business Investment Companies (SBICs) initiative on April 27, 2012, nearly a year after President Obama's "Start-up America" legislation was passed creating the $1 billion, five-year program. This initiative is intended to promote American innovation and job-creating by encouraging private sector investments in job-creating early stage small businesses. Under the initiative, the SBA will provide leverage in the form of 10-year debentures as a one-to-one match to private sector investments in promising high-growth companies. The leverage will be deployed up to $150 million in 2012, followed by up to $200 million per year from 2013 to 2015 and up to $250 million in 2016.

Highlighted below are the major provisions of the new regulations and their impact on fund managers who would consider participating in the Early Stage SBIC program. The SBA created the Early Stage SBIC program with three major differences from the traditional SBIC program:

- Applications for the Early Stage SBIC program can only be made annually at specified periods of time.
- There are two application tracks in order to speed up the licensing process. Track 1 was created for applicants with capital and Track 2 was created for all others.
- At least 50 percent of the fund's capital must be deployed in early stage companies, which are defined by the regulations as companies that never achieved positive cash flow from operations prior to the SBIC investment. Those managers interested in applying for a subsequent Early Stage SBIC license will have to pay close attention to their cash management, especially if they have a lot of leverage outstanding in their previous fund as it may deter them from obtaining a second license.

On May 1, 2012, the SBA made its first annual call under the Early Stage SBIC program and announced the deadlines for the 2012 application process. For Track 1 applicants, the management assessment questionnaire ("MAQ") must be submitted by May 25, 2012 followed by a formal license application no later than July 30, 2012. For Track 2, the deadline to submit the MAQ is May 19, 2012 and for the formal license application is May 15, 2013. The anticipated licensing dates are September 28, 2012 for Track 1 and September 30, 2013 for Track 2. Those funds that intend to file a license application must achieve at least $20 million in regulatory capital by the time they submit their formal applications.

The SBA did not relax its licensing standards in connection with the Early Stage SBIC program. Early Stage SBIC applicants will still have to demonstrate top quality manager qualifications, track record, proposed investment strategy, and proposed organizational structure and fund economics. In addition, the SBA announced that it has reserved the right to diversify the licensing geographically and across vintage years in order to mitigate some of the program risks. The SBA also reserved the right not to license any SBIC if no applicant meets the qualifications. ■

For more information on the SBIC program, please contact Guergana Rangatcheva, CPA, manager, at grangatcheva@jhcohn.com or 860-368-5275.

Inventory: Is It Really an Asset?

by David Rubin, Principal

While accounting rules define inventory as an asset, the broader definition of "an asset" is an advantage or resource. Yet, as many organizations struggle to optimize associated costs and customer service levels, operations and financial managers may often question whether inventory is indeed an asset. Keeping too little inventory often results in both lost sales and lost customers, while too much inventory increases costs, and adversely affects cash flow.

Excess inventory is a significant issue for many U.S. businesses right now—particularly in the manufacturing and distribution sector. According to the U.S. Department of Commerce, the average investment in all U.S. business inventories in 2011 increased eight percent over 2010 to their highest point since the third quarter of 2008.

Within the overall increase in inventories, manufacturer and distributor inventories increased significantly while retail inventories remained relatively flat. *(See Figure 1 – Private Business Inventories.)*

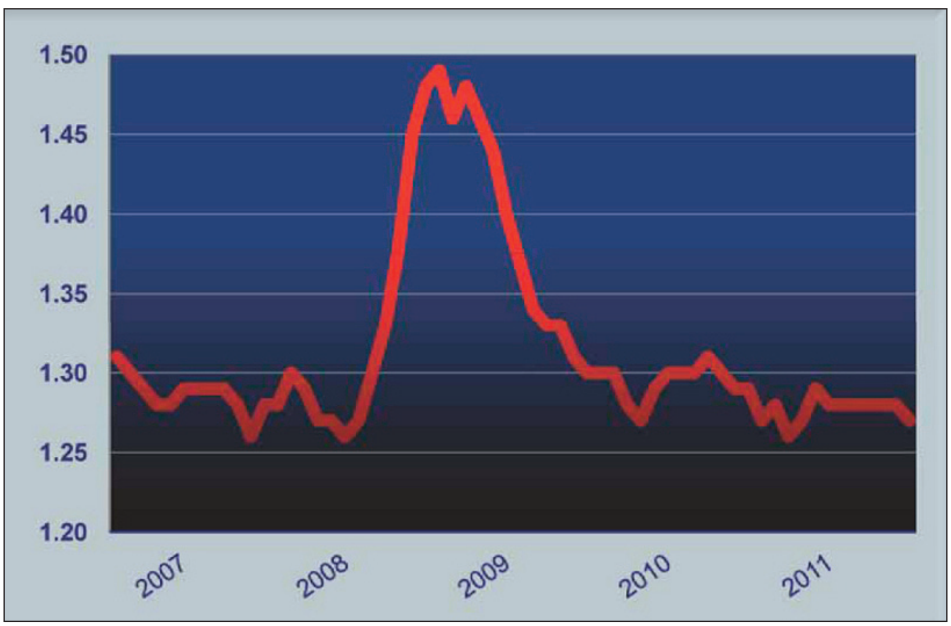
The slight overall increase in retail inventories during the last five years, demonstrated in Figure 2, can be attributed to nominal strengthening of retail sales, as the retail inventory to sales ratio was relatively flat during 2011. *(See Figure 2 – Retail Inventory to Sales Ratio.)*

After a spike in 2009, retailers leaned their own inventory levels. Essentially, many manufacturing and distribution companies are challenged as their retail customers have reduced or eliminated their safety stocks while pressuring their suppliers to maintain service levels. For companies in the manufacturing and distribution sector, the ability to maintain service while leaning their own supply chains may differentiate EBITDA leaders and laggards across industry groups.

Figure 1: Private Business Inventories

Source: CSCMP 2011 Annual State of Logistics Report/U.S. Department of Commerce/Census Bureau

Figure 2: Retail Inventory to Sales Ratio



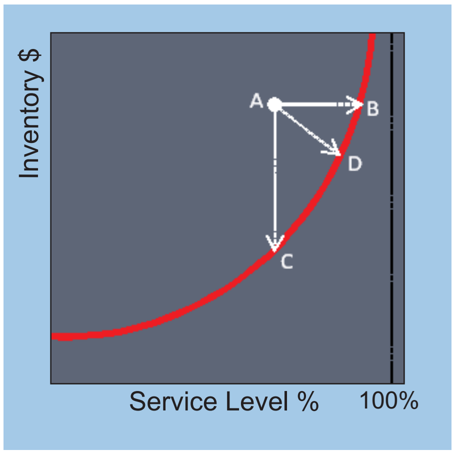
Source: CSCMP 2011 Annual State of Logistics Report/U.S. Department of Commerce/Census Bureau

Customer Service vs. Cost

The single most important component of customer service for a manufacturer or distributor is inventory availability: is the product available when the customer needs it? An essential part of managing a business that sells tangible products is determining when and how much inventory to stock; this determination seeks to balance customer service with cost.

The relationship between inventory investment and service level is often expressed in terms of a theoretical inventory curve. *(See Figure 3 – Inventory Investment vs. Service Level.)* A ready observation about the inventory curve is that it represents incremental investments in inventory improving service levels—sometimes significant increments, and sometimes, as service approaches 100 percent, by very small increments.

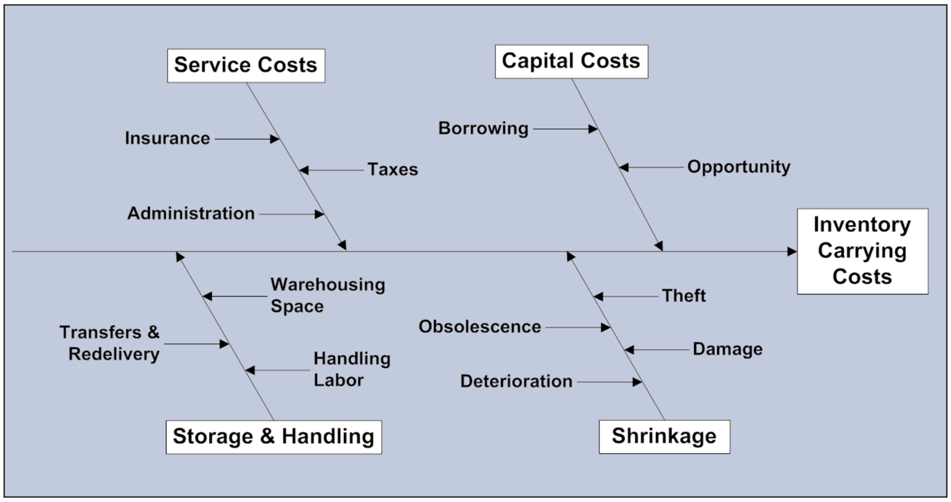
Figure 3: Inventory Investment vs. Service Level



Operations and financial managers know that often significant investment in the wrong inventory is made, yielding little or no service improvement which leads to the belief that the company needs to operate "inside the curve." At Point A in Figure 3, for example, this case investment in inventory has not yielded the expected level of service. The negative impacts on earnings include lost revenue via substandard service levels coupled with the higher costs associated with slow moving inventory.

The benefits for the company in moving toward the curve include improving service levels with the same level of investment (Point B), offering the same service level at a lower inventory level (Point C), or simultaneously improving service while reducing investment (Point D).

Figure 4: Inventory Carrying Costs



Measuring Inventory Performance

As with all business activities, performance measurements provide a fact-based, data-driven analytical framework. Inventory performance measures focus on availability and cost. A standard measure of availability is order fill rate (percentage shipped versus ordered). Large retail customers also often directly measure and report their supplier's product availability to them via fill rate or in-stock scorecard metrics.

Objective measurements of company's inventory management efficacy typically include asset, liquidity, and ROI ratios. The benefits of utilizing these performance ratios include:

- The underlying data can be accessed directly from balance sheets and income statements.
- The impact on earnings can be readily understood.
- They may be readily benchmarked to assess both performance and improvement potential.

The downside of relying on financial ratios is that they assume inventory value as the cost basis. Beyond the actual cost of the inventory, the costs to carry inventory are significant and often not measured or managed. Carrying cost is actually an amalgamation of a number of different expense items. *(See Figure 4 – Inventory Carrying Costs.)*

Carrying costs are typically expressed as a percentage of the average value of inventory held on an annual basis. For most companies, these costs range from 25 to 40 percent of average inventory value.

Typical Areas of Opportunity

Service and cost measurements provide the means to point toward areas where costs and earnings are particularly impacted. Evaluating the associated processes, tools, and policies provides the ready means to devise improvement strategies.

Based on our experience working with client companies of all sizes across many industry groups, following are some of the typical contributors to lagging inventory performance:

- Performance Measurement: Inventory carrying costs are not measured or managed. Financial ratios are not tracked or benchmarked. Likewise, service performance isn't measured or managed effectively.
- Strategy: The company's supply chain management strategy has not evolved to adequately address the needs of the business or to external factors.
- Process: Processes for managing demand and inventory either have not been clearly established or optimized to support business requirements.

- Coordination and Collaboration: The company does not take advantage of opportunities to coordinate supply planning activities internally or with suppliers and customers.
- Information Technology: The systems used to plan, forecast, and manage inventory do not adequately support business requirements. For many companies, the ability to track, monitor, and synchronize supply chain processes with trading partners is also vitally important; lack of supply chain visibility is readily associated with higher inventory levels. ■

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Key Takeaways

- **Inventory is often a company's single largest asset, while inventory availability is often the single most important component of customer service.**
- **Inventory is a significant issue for many U.S. businesses right now—particularly for manufacturing and distribution companies as they hold higher levels of inventory which pressures their cash flows and earnings.**
- **For companies in the manufacturing and distribution sector, the ability to maintain service while leaning their own supply chains may clearly differentiate EBITDA leaders and laggards.**
- **Inventory cost and service performance may be readily measured and benchmarked to provide a fact-based, data-driven analytical framework for improvement. Carrying costs are an important means to evaluating and managing inventory investment.**
- **Opportunities for optimizing inventory for earnings improvement often hinge on supply chain strategy, planning processes, coordinating internal operations, collaborating with trading partners, and insuring that information management systems support the needs of the business.**

Case Study

Client Industry	Medical Products Manufacturing
Functional Areas	Demand Planning, Forecasting, Inventory Management, Production Strategy
Challenges	The company's private equity owner sought assistance to turn around the operations of a medical products manufacturing company. Our immediate objectives included addressing high inventory levels and low order fill rates.
Our Approach and Findings	We gathered relevant cost and volume information, reviewed processes and tools, interviewed staff, and prepared our findings, which included: ■ The client's enterprise resource planning system provided poor demand forecasting support. ■ Product proliferation, long lead times, and minimum order quantities, together with poor forecasting functionality, all contributed to low inventory turnover and low fill rates.
Actions Taken	■ We identified a demand forecasting application and assisted the Planning Group in implementation. While increasing forecast accuracy significantly, a benchmark against the existing method indicated a $500,000 lower investment in inventory in the first month. ■ We implemented a means to compress lead times by planning components on a group basis and postponing the final decision of finished goods built until final assembly. While reducing lead times from two months to one week, we were able to significantly lower safety stock levels of finished goods. ■ We developed a strategy and assisted in implementation of a packaging process within the distribution center to allow the client to finish low-demand products to order. This resulted in the ability to pack slow moving items to order, allowing drawdown and elimination of inventories of approximately 200 slow-moving items. ■ We worked with the Design, Marketing, Planning, and Production teams to review the product program and identify opportunities to reduce SKU proliferation. Our analyses resulted in identifying product differentiations which impacted costs, but were not valued by customers. A single component standardization reduced manufacturing set-up requirements, lowered lead time overall, and permitted a 20 percent reduction in finished goods SKUs within a single product line.

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