



Wilson Perumal
& Company

A Strategy consulting
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in operations



Chief Strategy Officer Summit

Scalable M&A: Stripping the complexity out of integration

December 2, 2014

Agenda

- Current trends in M&A
- Why M&A has such a high failure rate
- Three companies that buck the trend
- 3 steps you can take to ensure your M&A is successful

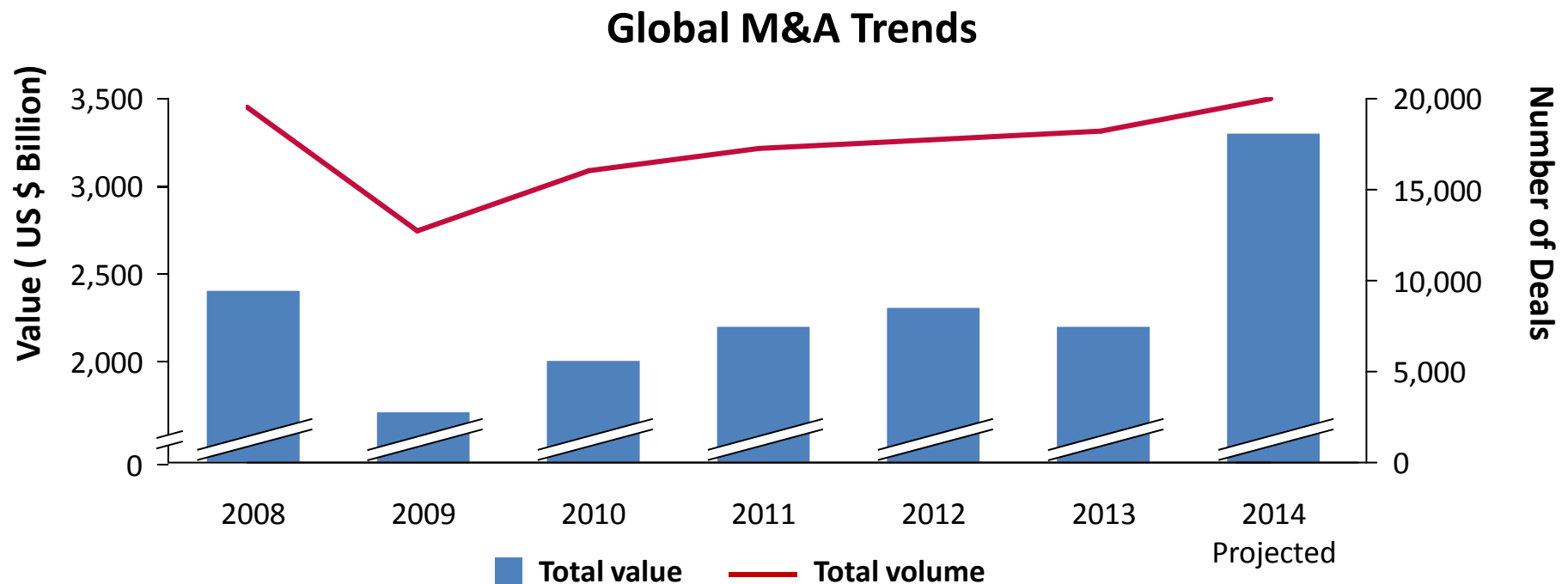
2014 global M&A activity will be the highest since the recession

Favorable conditions have increased the demand for good deals...

- Low cost of capital may increase soon
- Economic recovery
- Less fear of double dip recession
- Large excess cash reserves

along with increasing supply

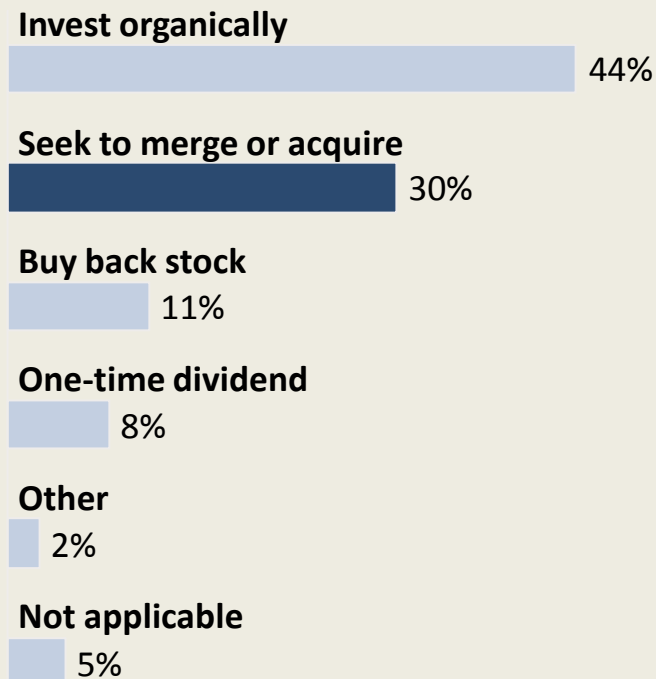
- Opportunity to reduce tax basis
- Large inventory of companies available for sale



Executives continue to see M&A as a key component of their growth strategy

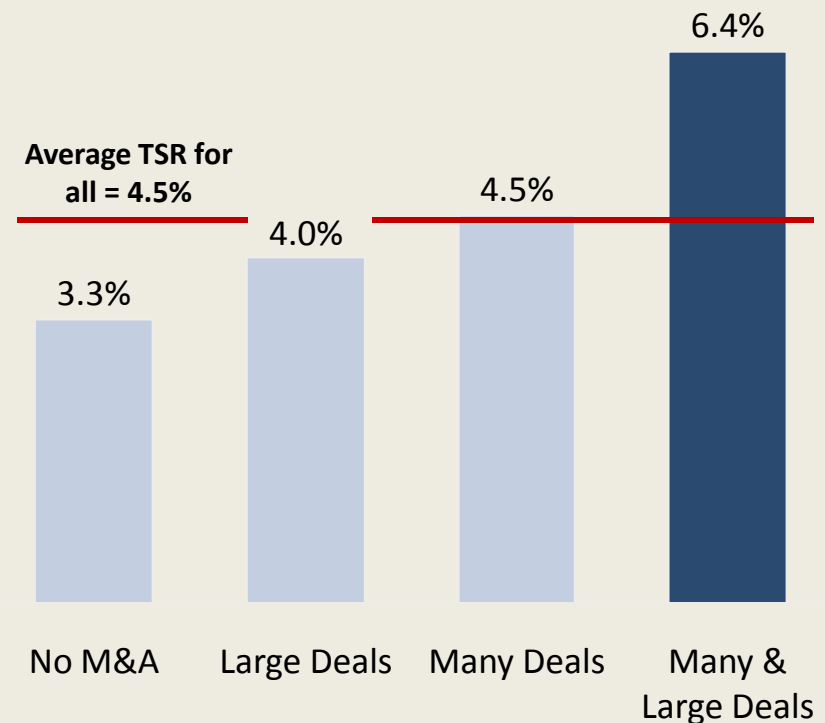
M&A is the primary intended use of excess cash for 30% of corporations¹

Primary intended use for excess cash, 2014



Because those who do it right significantly outperform their peers²

Annual total shareholder returns (CAGR 2000-2010)



Source 1: Deloitte "M&A Trends Report 2014"; 2: Bain & Co Brief, "The renaissance in mergers and acquisitions: a lesson from the 2000s"

Yet the majority of M&A deals fail

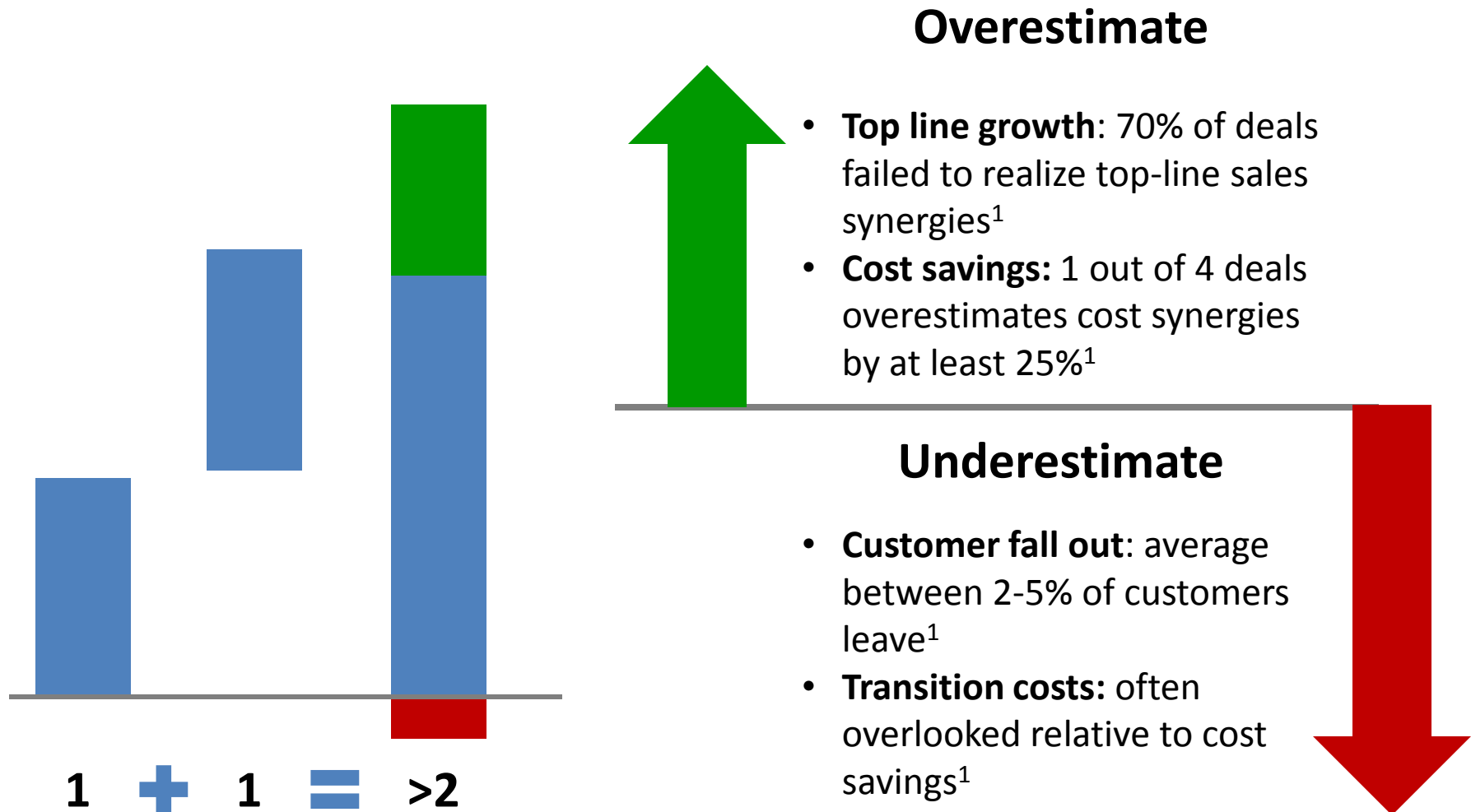
**50 – 80%¹
failure rate**

With so many deals, you would expect higher success rates

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Most reasons provided for failure focus on the analytical process of due diligence



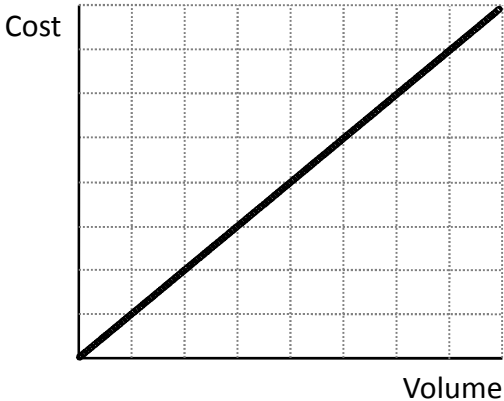
We believe most of these assessments are missing the key reason for failure of M&A

Complexity

The world has changed

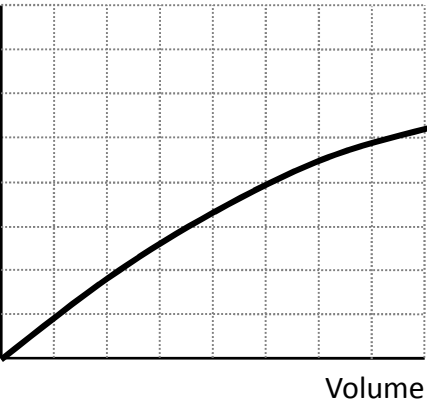
Pre-Industrial Age

“Individual productivity”



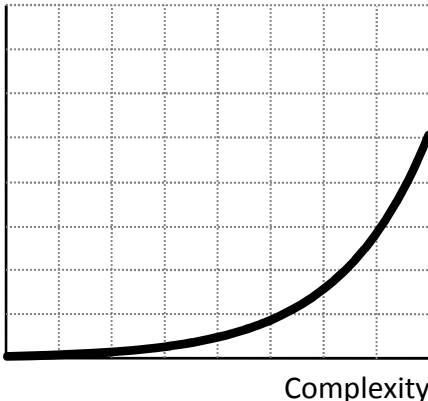
Industrial Age

“Economies of Scale”



Post-Industrial Age

“Complexity Costs”



Key competitive advantage = controlling complexity

Complexity is stretching the capabilities of most companies

TECHNOLOGY IS MORE COMPLEX

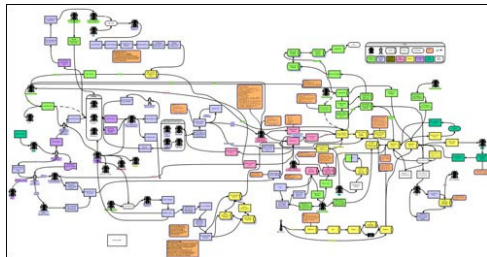


PRODUCTS AND SERVICES MORE COMPLEX

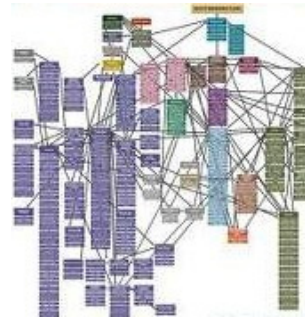


X

PROCESSES MORE COMPLEX



ORGANIZATIONS MORE COMPLEX



X

X

MARKETS MORE COMPLEX

X



REGULATIONS MORE COMPLEX

X

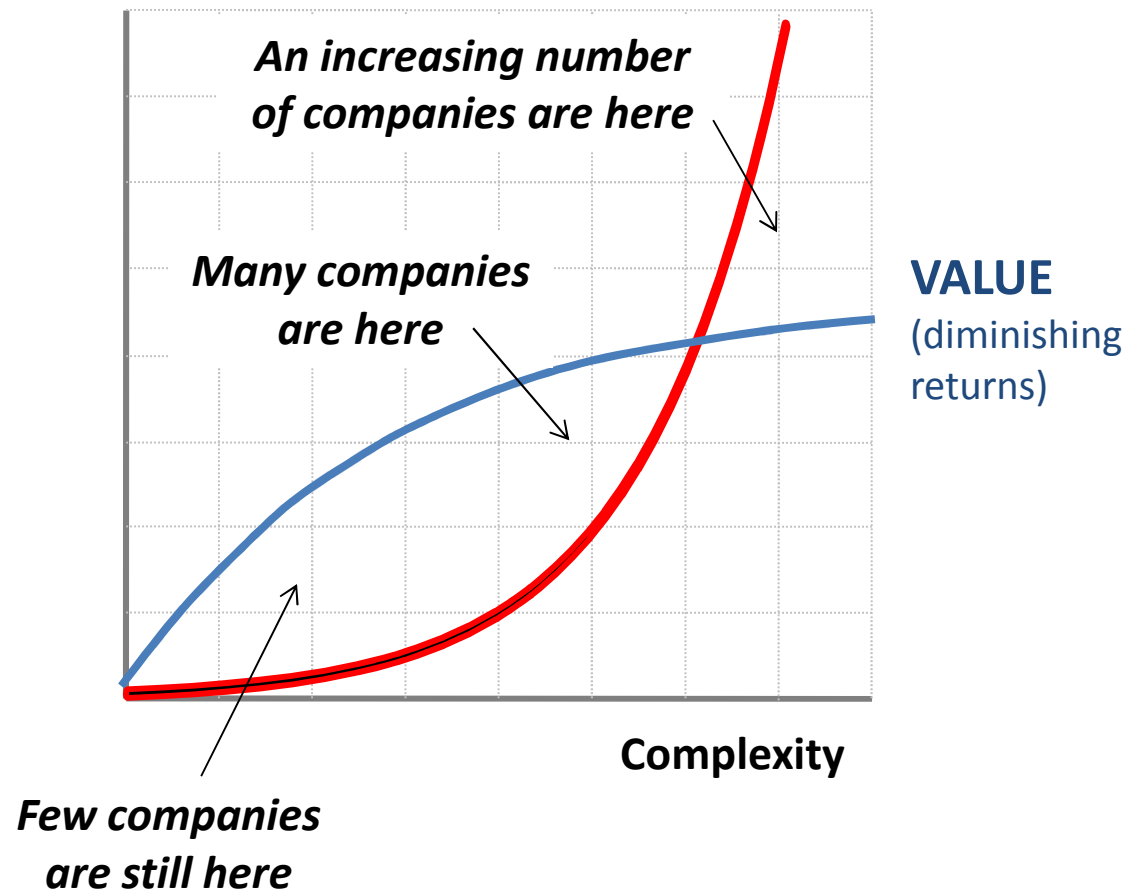


Many companies are passing a threshold where additional complexity erodes expected value

Operational risk grows exponentially with complexity

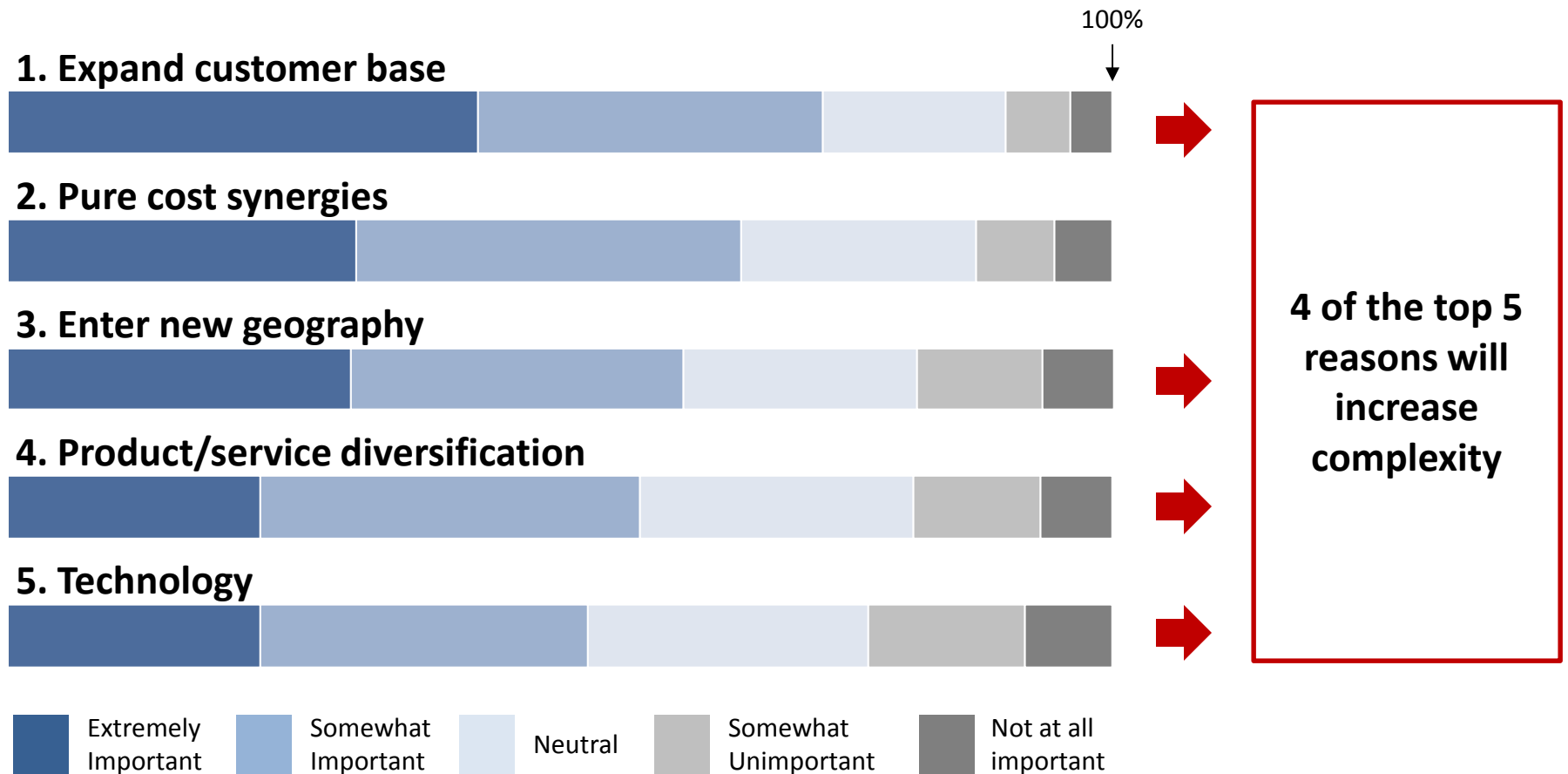
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COST & RISK
(exponential growth)



By definition most M&A activity introduces additional complexity to an already complex system

Top 5 reasons corporations seek to merge or acquire



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Eaton Corporation strives to be an efficient, safe and sustainable energy provider

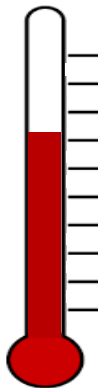


- **Industrial products** manufacturer
- \$22.0B revenue in 2013
- 103,000 employees

Business Diversity: High

Major Divisions:

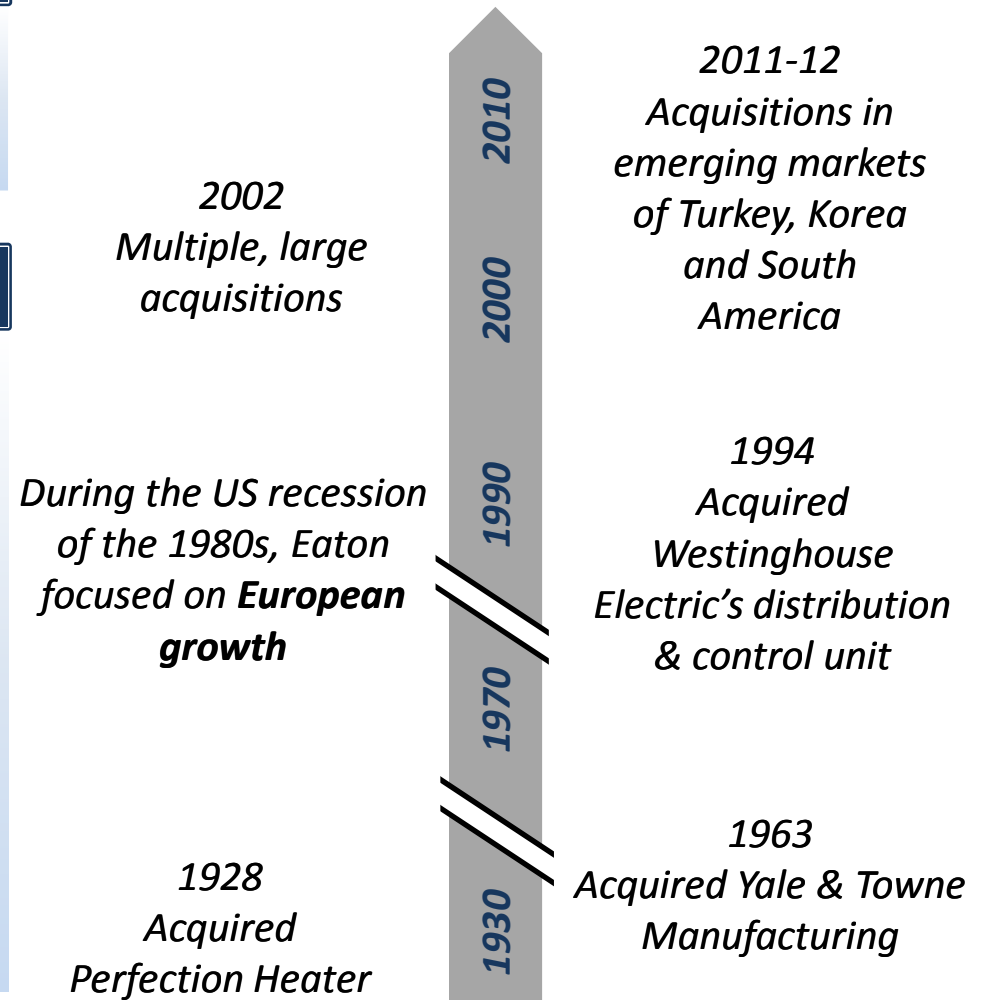
- Aerospace
- Electrical
- Filtration
- Hydraulics
- Vehicle
- Industrial Clutches & Bakes
- Plastics Extrusion



Global presence:

Sales to **175+ countries**

M&A Activity

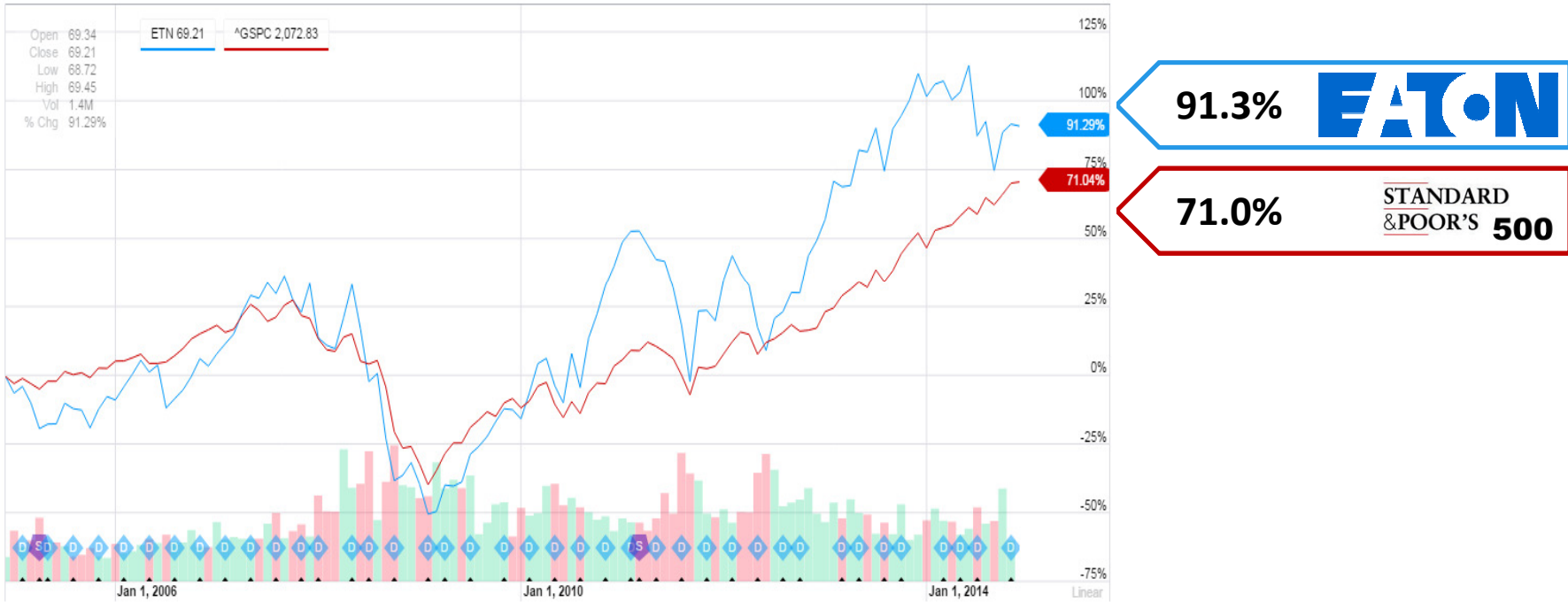


Sources: Eaton Corporation website, Nov 2014

Notes: M&A Activities are samples of activity that occur in nearly every year, See appendix for detail

Eaton outperformed the S&P 500 over the past 10 years

Financial performance for Eaton vs. S&P 500 over 10 yrs



Danaher endeavors to improve quality of life through serial acquisitions



- Global science and technology innovator
- \$19.1B revenue in 2013
- 66,000 employees

Business Diversity: High

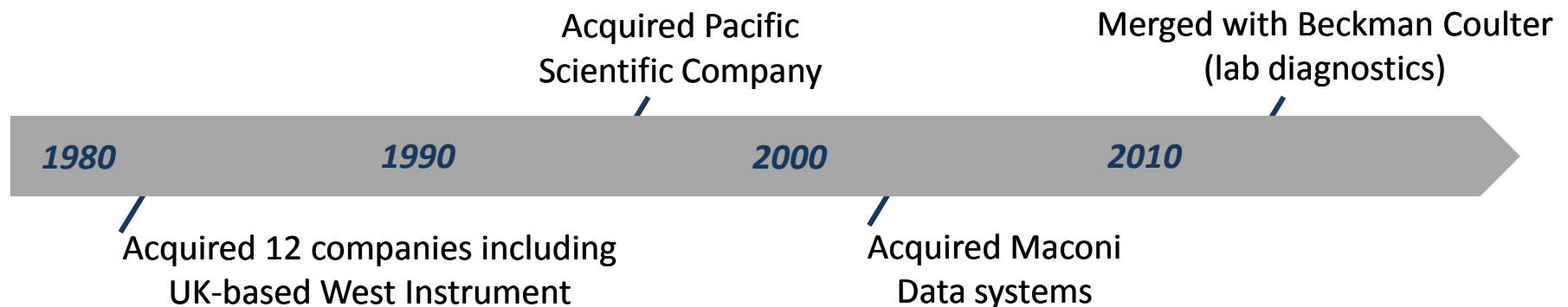
Reporting Segments:

- Environmental
- Test & Measurement
- Dental
- Life Sciences & Diagnostics
- Industrial Technologies



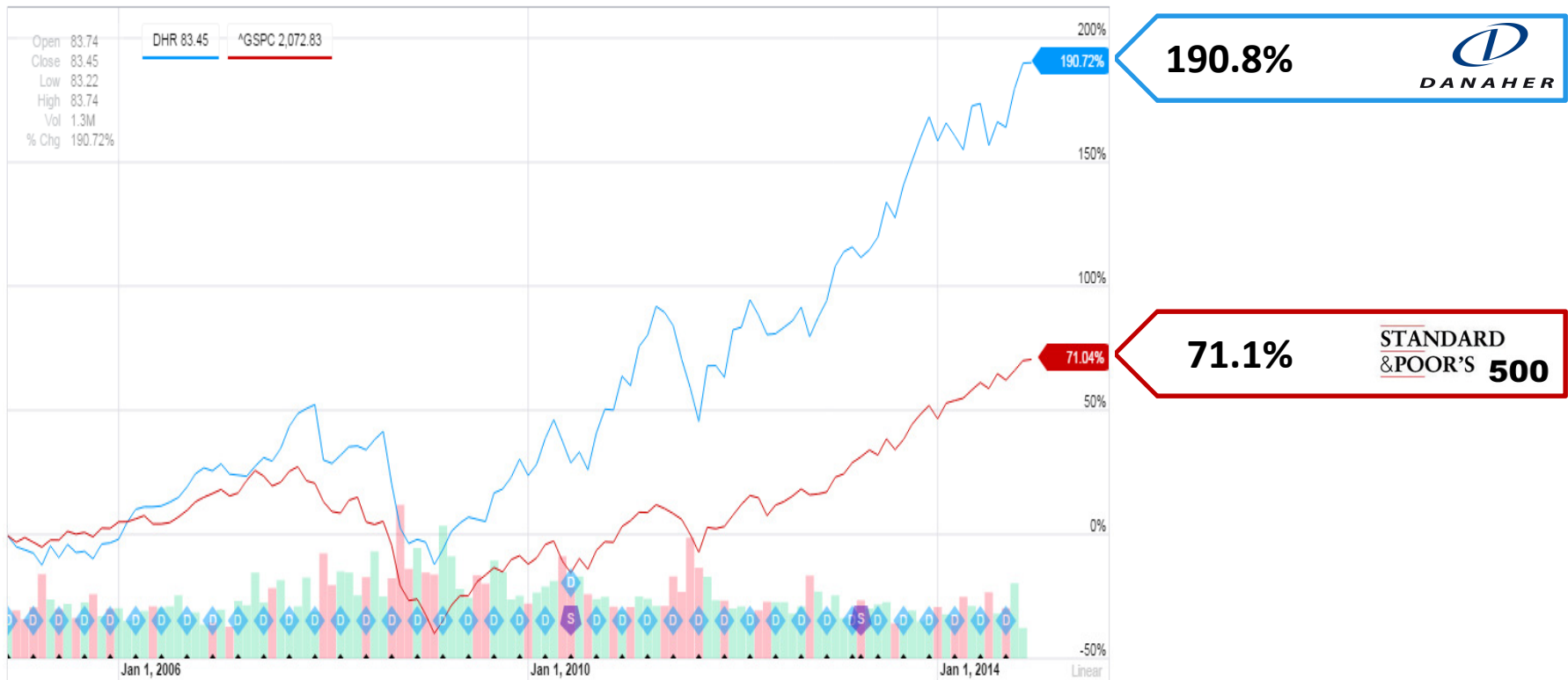
M&A Activity

Since 1984 Danaher has acquired more than 400 companies.



Danaher outperformed the market by 2.7X

Financial performance for Danaher vs. S&P 500 over 10 yrs



Koch Industries continuously absorbs immense levels of complexity with new products and processes



- 2nd largest private company in the US
- \$115B annual revenue
- Over 100K employees

Business Diversity: Very High

Major businesses:



- Chemicals
- Refining & Fluid Transport
- Consumer Goods
- Dry Bulk Goods, Electronics
- Ranching, Agricultural Products
- Environmental Processes
- Commodities Trading

Global presence:

Active in at least **50 countries**

M&A Activity

Koch reinvests up to 90% of its annual earnings

2011:
acquires **UK-based fertilizer producer**

1995: established **venture capital firm**

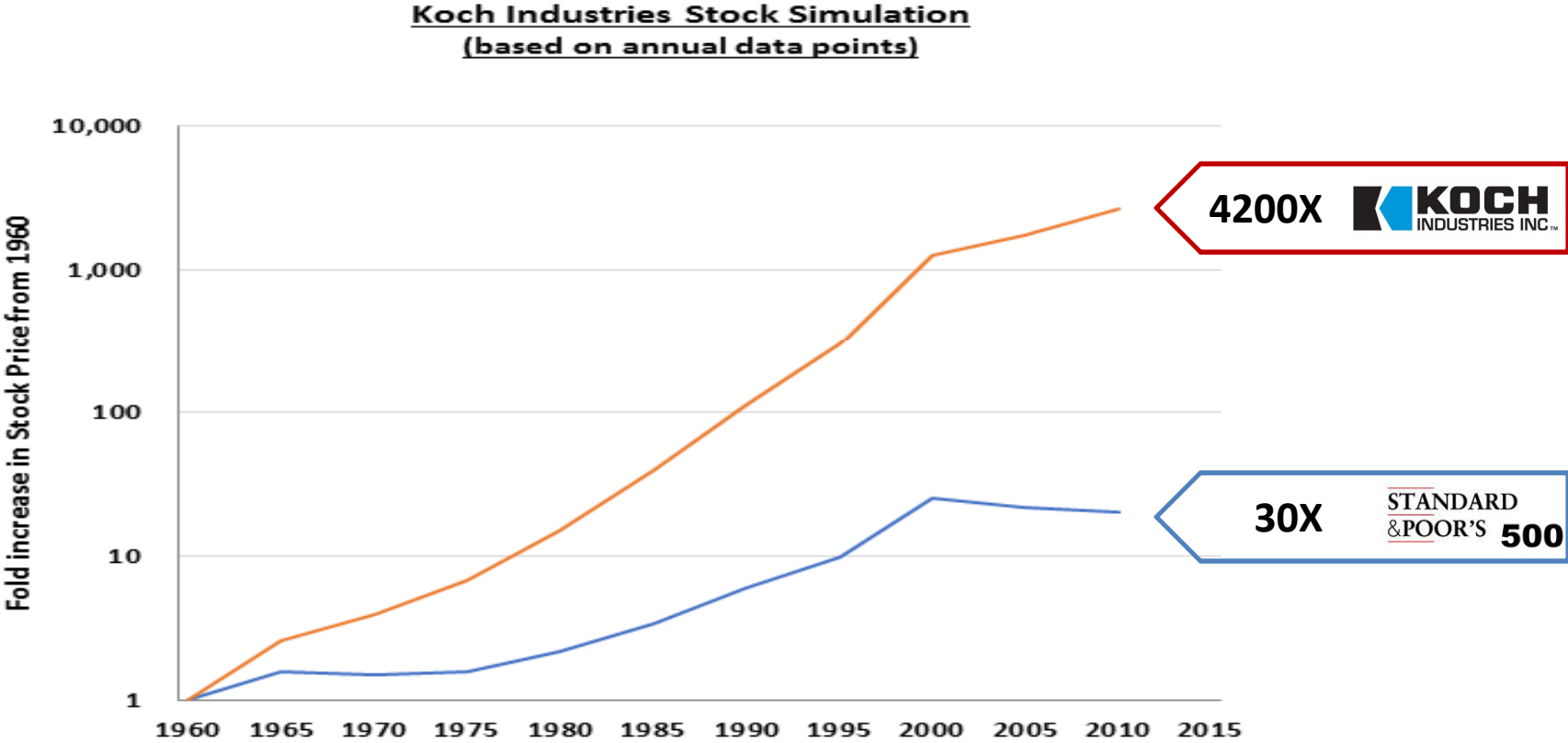
1981-82:
acquires **refineries**

1976: purchase of **Chrysler Realty**

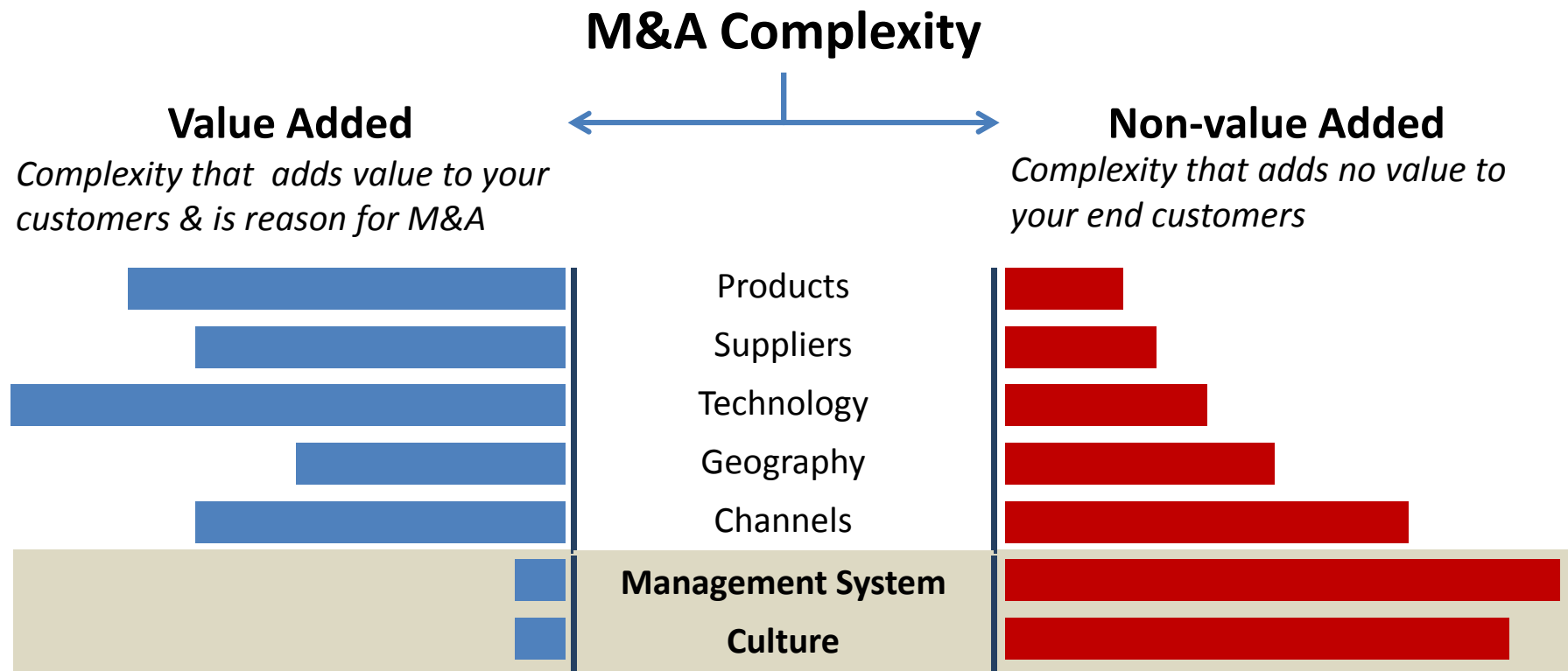
1952: formation of **Matador Cattle**



Koch Industries increased 4200X in value over a 50 year period



These 3 companies are so successful because they eliminate non-value added complexity






1. **Management System** and **Culture** always add almost exclusively NVA Complexity
2. Most difficult to assess through due diligence
3. Most commonly ignored factors
4. Unlike other complexity, far more difficult to remove

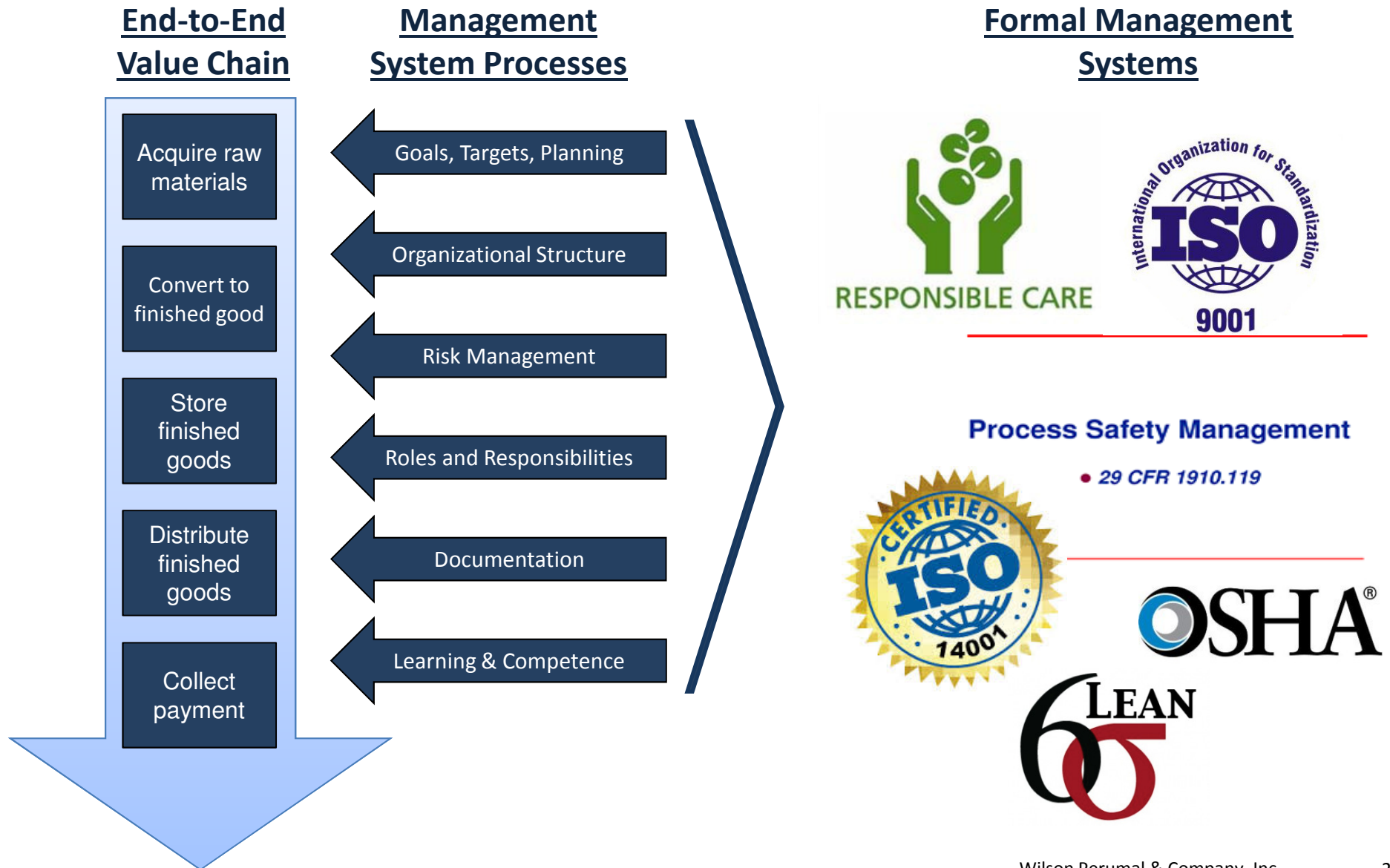
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3 steps to eliminate non-value added complexity that arises from your Management System and Culture

- 1 Implement a single Management System and require your acquisitions to adopt it
- 2 Create a well defined culture and purposefully manage it
- 3 Take a top-down approach to integration

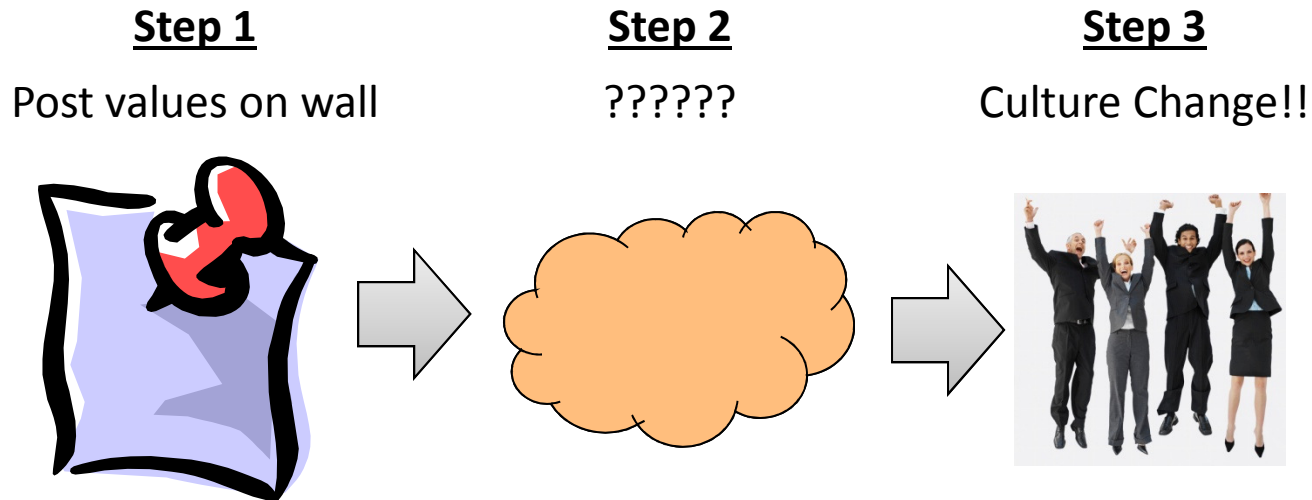
Whether formally defined or not, all companies have a management system



Similarly, every company has a culture, whether formally defined or not

"A pattern of shared basic assumptions that the group learned as it solved its problems that has worked well enough to be considered valid and is passed on to new members as the correct way to perceive, think, and feel in relation to those problems." – Edgar Schein

How some companies view culture change:



Danaher, Eaton and Koch all require their acquisitions to adopt their management system and culture

1 Overarching Management System and Corporate Culture



Danaher Business System

“DBS provides us with the tools and resources we need to shape strategy, focus execution and create value for both our customers and shareholders.”
- Danaher website



Eaton Business System

“The Eaton Business System is our source of competitive advantage and, when effectively deployed, leads to superior performance.”



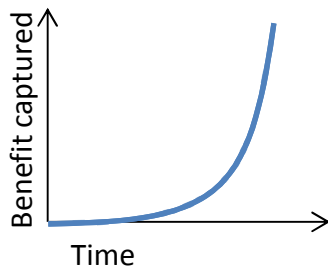
Koch Market-Based Management

A key attribute for acquisition candidates is a culture consistent with **Koch’s Market-Based Management® business philosophy** which encourages employees to think like owners

A Top-Down approach yields results faster, and has a higher probability for success

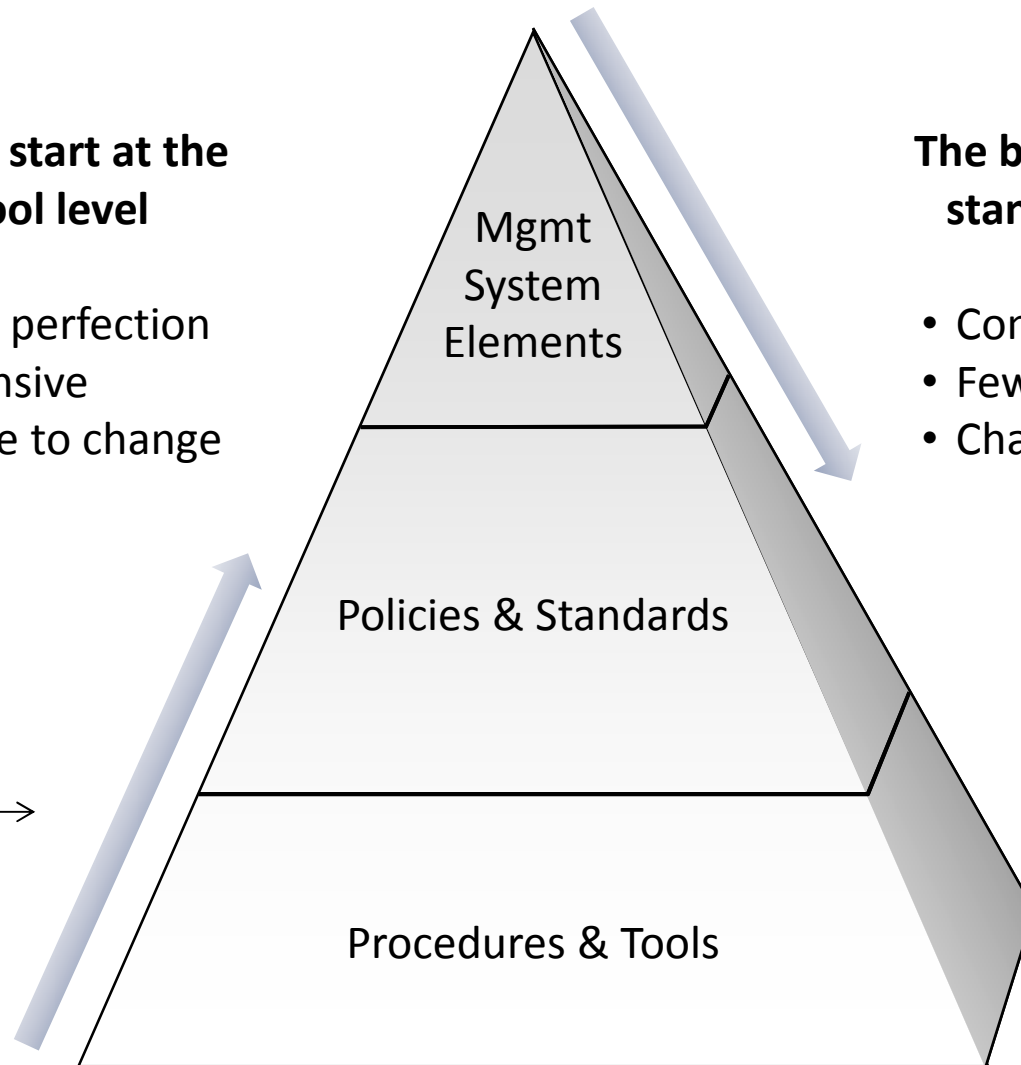
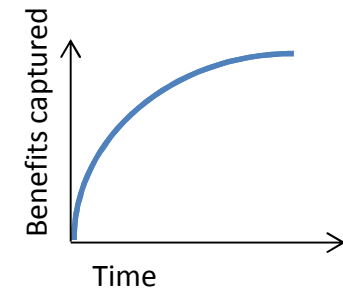
Many companies start at the procedure/tool level

- Instantaneous perfection
- Resource intensive
- High resistance to change



The best acquirers start by standardizing Elements

- Continuous improvement
- Fewer resources required
- Change in chunks



We have seen these same principles pay dividends for our clients

Integrated Energy is the product of the merger between two large oil & gas companies. After their merger, complexity increased dramatically, and their performance suffered.

What they did

Merged management systems, attempting to keep best of both



What that caused

Overlapping processes with unclear ownership and expectations



How we helped

Simplified management system to reduce redundant effort

Talked about culture in broad generalities



Little effort to change employee's beliefs or values



Designed culture based on principles of High Reliability Organization

Took a Bottom-Up approach to implementation



\$30MM annually in implementation costs with little progress



Took Top-Down approach, reducing cost >90% and accelerating progress

Key takeaways

- M&A is likely to be critical part of your company's strategy
- M&A have a high failure rate and the root cause is complexity
- To be successful, M&A must take on value added complexity, while avoiding non-value added complexity
- The most successful companies avoid non-value added complexity by:
 - Standardizing their Management System
 - Standardizing their culture
 - Taking a top-down approach