Making Acquisitions Work

by Kenneth W. Freeman

The continuing enthusiasm for mergers and acquisitions appears to be the triumph of hope over experience. Will the combinations of Procter & Gamble and Gillette, SBC and AT&T, Sears and Kmart — and other megamergers that are sure to transpire — flourish? Success won't come easily. About two-thirds of mergers and acquisitions fail to live up to expectations. My experiences at Quest Diagnostics Inc. show that successful acquisitions are distinguished by three strategic principles that apply before the acquisition, and four operational principles that apply afterward.

Quest Diagnostics, the nation's leading medical testing company, was founded as MetPath in the late 1960s. In 1982, the company was acquired by Corning Glass, and subsequently renamed Corning Clinical Laboratories. At the end of 1996, it was spun off to the public as Quest Diagnostics. Throughout its iterations, Quest Diagnostics has been largely built through hundreds of acquisitions. Some, like that of SmithKline Beecham Clinical Labs in 1999, have been triumphs. Many prior to that were not.

What's the difference? There are some general rules of thumb that can in most cases separate good from bad acquisitions. Don't do the deal for the deal's sake. Dreams of headlines in the *Wall Street Journal* and the unstinting attention of the business press for one day are an insufficient basis for an acquisition. Never make more deals than your company can fully digest or integrate at one time. And be certain that you can create shareholder value from the acquisition within the first year.

When I arrived at Corning Clinical Laboratories in 1995, the company had grown from $150 million to $1.6 billion in revenues in 13 years, primarily through acquisitions. But the result of all of these deals — including four major acquisitions in the prior 18 months — was that Corning Clinical had become a loose confederation of operations with very limited central oversight. The mantra was "do a deal, squeeze out the synergies ASAP, do the next deal, repeat."

Unfortunately, the singular pursuit of synergy, which often meant eliminating staff (or the ongoing threat of eliminations) and cutting costs regardless of the impact on the ability to serve customers, led to widespread customer and employee dissatisfaction. And with so many moving parts at the company — each of them operating semi-autonomously — there was very little information at the top to oversee the performance of the company as a whole. The response to the question, "How many employees do we have?" was "We don't know. Give us a week or so, we'll call around to the business units and come back with a number."

Although I knew that major acquisitions were the only way for Quest to eventually take leadership

in a service industry with thousands of local competitors, I froze acquisitions. Only after we had completed the hard work of fully integrating and learning to run the businesses we had already acquired did we again test the waters.

In 1997, we were ready to try again. We set three ground rules — our strategic principles — for all acquisitions. First, the company had to have a record of full regulatory and legal compliance. Second, it had to be reasonably well run — you can't change a company's condition simply by changing its name. Third, it had to add to earnings per share within a year. Armed with these ground rules, in 1999, we were ready to pursue the acquisition of the biggest company in the industry, SmithKline Beecham Clinical Laboratories (SBCL).

After the purchase of SBCL was completed, the real work began: integration. We applied four simple operational principles of integration that we could rely upon in subsequent acquisitions:

• **Serve all customers without disruption.** Typically, when a lab company was purchased, some 15 to 20 percent of revenues from the acquired company would disappear within the first year because the buyer treated the acquisition's customers poorly. Labs would be consolidated and systems and courier routes would be changed in an already logistically complex business. Customers, upset at the disarray and the poor service, quickly got fed up. With the SBCL purchase, though, we made customer satisfaction our primary responsibility. Instead of sending thousands of customers, mostly physicians, an impersonal letter announcing changes in how we would work with them, we communicated with practices individually, face-to-face. And we solicited their advice. Of course this took time, but the payoff in customer retention was significant: Continued sales growth from the acquisition throughout the integration process versus the industry norm of double-digit losses in revenues.

Instead of sending acquired customers an impersonal letter, we asked their advice face-to-face.

• **Treat every employee with fairness, dignity, and respect.** In most lab acquisitions, redundant testing facilities had been closed and about half of the people fired — most of them from the acquired company. Such tactics erased the connections that customers had with the acquired company, embittered the remaining employees, and impeded integration. Under our new operational principles, we maintained open and frequent communication during integration and involved employees in developing strategic plans and timetables. This dramatically reduced the fear of the unknown and created a forum for widespread engagement among employees. There were no mass dismissals; we let voluntary attrition take its course, and offered "stay bonuses" to rank-and-file employees of both companies to retain them at least through the transition. For

Kenneth W. Freeman
(freemank@kkr.com) is managing director at the private equity firm Kohlberg Kravis Roberts & Co., where he focuses on health-care investments. Formerly, he was chairman and chief executive of Quest Diagnostics Incorporated.

Edward Landry
(landry_edward@bah.com) is a vice president with Booz Allen Hamilton in New York. He focuses on strategy and sales and marketing effectiveness for consumer packaged-goods and health-care companies.

Jaya Pandrangi
(pandrangi_jaya@bah.com) is a senior associate with Booz Allen Hamilton in Cleveland. Her work focuses on strategy and sales and marketing effectiveness for consumer packaged-goods companies.

Gordon Cook
(cook@cookreport.com) is the editor and publisher of the *COOK Report on the Internet Protocol: Technology, Economics and Policy*, an online newsletter (www.cookreport.com) founded in 1992 and devoted to telecommunication and Internet strategies.

Doug Hardman
(hardman_doug@bah.com) is a vice president in Booz Allen Hamilton's Chicago office. He specializes in operations strategy, organization productivity, and supply chain management for consumer products and retail companies.

David Messinger
(messinger_david@bah.com) is a principal with Booz Allen Hamilton in New York. He focuses on supply chain and consumer channel strategies primarily for packaged-goods and retail companies.

Sara Bergson
(bergson_sara@bah.com) is an associate with Booz Allen Hamilton in New York. She works with consumer products companies on value chain strategies.

those who were ultimately released, we provided comprehensive severance and outplacement services.

- **Move with deliberate speed.** Go too slowly and you sink into torpor as employees wait interminably — and unproductively — for the ax to fall or things to change. But if you go too fast in, say, converting the computer systems or assimilating the two cultures, you're likely to botch the acquisition. Ironically, undue haste delays the benefits of the acquisition. Usually, companies go too fast. Wall Street wants immediate results, the hard work of integration often bores executives, and many CEOs seek the glamour of the next deal. At Quest Diagnostics, by emphasizing customer and employee satisfaction, and moving at a pace that enabled customers and employees to keep up and feel comfortable with the changes we were making, we achieved our projected performance gains and improved morale at the same time. Remember, synergies are realized only once, whereas satisfied customers and employees are a recurring long-term source of value.

- **Learn from each other.** When we acquired SBCL, we could have been tempted to say we won and they lost. The SmithKline people could have replied that they could just as easily have bought us. To forestall these attitudes, we established integration teams, with members of equal standing from both companies. We staffed the senior leadership through a methodical process based on past performance and an assessment of whether managers met the standards that we set for top executives. We set the stage for mutual learning in the difficult job of integrating systems, laboratories, and sales forces.

By following these four operational principles, we more than doubled the size of Quest Diagnostics and created tremendous shareholder value. Between Quest Diagnostics' 1996 spin-off and the end of 2004, market capitalization increased from $350 million to more than $9 billion, and the SBCL acquisition was the linchpin.

Ultimately, the hard work of acquisitions is a bit like romance: It's not the courtship that's important, but the continuing relationship called marriage. In acquisitions, what follows courtship too often looks more like divorce. It doesn't have to. +

Getting the Most from the "Feet on the Street"

by Edward Landry and Jaya Pandrangi

Since the early 1990s, the world has grown much more challenging for consumer products manufacturers. Consumers no longer respond as readily as they once did to conventional advertising and marketing; research shows that they make more and more decisions at the point of sale, while facing a retailer's shelf. Needing to keep the price of their goods at the lowest possible level and burdened by the rising expenses of promoting and marketing their brands, many sales managers have turned to field merchandising as a place to cut costs.

Field merchandising refers to the marketing done by the "feet on the street" — sales force members who travel to individual stores to place products and to negotiate for better display presence. Many consumer products companies have outsourced most or all of their merchandising force — a cost-cutting move that often reduces merchandising costs by 50 percent right off the bat. But frequently this initial benefit is frittered away, because these manufacturers do not manage their new merchandising forces strategically.

When companies do not take a strategic approach to the decision of whether and when to outsource, they pay outsourcing vendors more than they need to pay and they fail to build the capabilities needed — in both themselves and their vendors — to support high standards of retail marketing effectiveness. As a result, they lose marketing wars to competitors. In contrast, the more adaptive, responsive, and intelligently deployed the sales force, the lower the costs and the higher the sales and profitability the company can achieve.

The optimal sales force mix depends on the company's unique combination of retail channels and product categories; a company selling large numbers of cigarettes through convenience outlets would merchandise them differently from a company producing detergents for supermarkets or shampoos for boutiques. Some manufacturers will do best with a merchandising model based entirely on outsourcing; others with an in-house merchandising operation; and many with an ap-

proach that integrates in-house "hands" with outsourced "feet." There are three steps to creating an optimal sales force mix:

1. Develop a thorough understanding of the requirements of each retail channel. Typically, the allocation of field merchandising resources depends not only on an account's strategic importance, but also on its control structure (i.e., the degree to which the retailer's decision making is centralized) and shelf execution (how attentively the product is restocked and how effectively pricing and promotions are communicated).

Industry dynamics or channel characteristics often enable companies to separate selling from sales execution, creating a two-tier sales structure that maximizes the time available for in-depth sales calls by highly skilled salespeople, while allowing less-skilled salespeople to conduct basic merchandising and audit activities. One successful consumer products company, for example, divided its merchandising force between a highly paid "selling" group and an outsourced "execution" group. The selling group targeted independent accounts, going to mom-and-pop convenience stores and independent community-based stores. The execution group focused on more rote selling activities at chains.

2. Choose wisely from among three outsourcing models. The three principal outsourcing approaches are:

- **Syndicated or "continuity" coverage:** A manufacturer hires a single outsourcing vendor, one that handles services for many manufacturers, for multiple projects.
- **Project or retail coverage:** A manufacturer purchases the vendor's

services for one project at a time.

• **Dedicated or exclusive resource coverage:** A manufacturer contracts with an outsourcer to manage merchandising solely for that manufacturer, which increases focus and flexibility but comes at a higher cost.

One consumer company built a powerful and highly efficient merchandising force by combining "dedicated" coverage in the mass-merchandiser channel, "syndicated" coverage in the grocery channel, and "project" coverage in lower-impact channels such as drugstores.

3. Build outsourcing management capability. Many outsourcing vendors have invested heavily in technology and can customize how they report the costs of every promotion and visit, with capabilities that are often better than those of in-house merchandising departments. But this data only benefits manufacturers with a management team that can work with vendors in a disciplined fashion to support high standards of retail effectiveness. In our experience, a sustainable vendor management capability is based on four building blocks:

• **Processes:** Manufacturers must build advanced retail cycle-planning processes, which manage the scheduling and mix of merchandising resources, a process that serves the needs of vendors and manufacturers alike.

• **Organization:** Typically, the retail merchandising organization shrinks to reflect its new role, organizes by channel (or geography) to parallel the outsourcer's organizational alignment, and rebalances its staff to include a planning coordinator and analyst resources.

• **Analytics:** High standards of retail effectiveness require in-depth assessments of segmentation, deployment modeling, and target setting.

• **Systems:** The data collected by merchandisers during store visits feeds the analytical engine that supports the cycle-planning process and enables the measurement of vendor performance.

For most organizations, building all of these capabilities means transforming the current sales organization model. Some manufacturers might fear that they are investing to build the capabilities of a third-party contractor who could someday use those capabilities on behalf of competitors. But the most important capabilities are those of the manufacturers themselves: to choose vendors effectively, synchronize processes, garner the loyalty of vendors, track their results, and manage the whole process. Once developed and internalized, these are capabilities that no competitor can borrow or steal. +

Skype's Choice

by Gordon Cook

It was one of those little-noticed incidents that in hindsight turn out to be a significant hint of something big to come. In February 2004, Daiwa Securities analyst James Enck wrote in the Web log EuroTelcoblog (www.eurotelcoblog.blogspot.com) that project teams at the consulting firm Accenture were bypassing their usual mode of communication — mobile phones equipped with GSM (Global System for Mobile Communications), a widely used protocol for enhanced privacy and security — during a shared job between Madrid and Pakistan. The teams had become frustrated with the erratic connections and dropped lines. Instead, according to Mr. Enck, they used Skype, a renegade Internet-based telephone service. They took this route "for obvious cost reasons," said Mr. Enck, "but also because of the superior" voice quality.

Skype? Who? Skype is a "softphone" — a software-based telephone that uses a computer, cell phone, PDA, or any other equipment connected to the Web to deliver voice with simultaneous file transfer and instant messages over the Internet. Unlike the growing number of "voice over Internet protocol" (VoIP) networks offered by phone and cable companies, Skype is a peer-to-peer system. This means that it creates ad hoc computer-to-computer links over the Internet any time Skype users want to reach one another. With this approach, no central networks mediate or manage the connection.

Because Skype eliminates the middleman, calls between its users are free. The company generates revenue by selling services that allow subscribers to make calls to people who haven't downloaded the software. A connection from a Skype-loaded device to a traditional telephone in most places generally costs about two cents per minute. And, according to the company (and some of its subscribers), Skype's sound quality is better than typical telephone reception, primarily because it is not limited to the standard telephone transmission spectrum of 300 Hz to 3 kHz, a relatively narrow bandwidth.

In the peer-to-peer sector, Skype boasts an unmatched pedigree. It was launched in August 2003 by Niklas Zennström and Janus Friis, the Swedish entrepreneurs who founded Kazaa, the file-swapping, music- and video-sharing network that at one time was the most downloaded software on the Internet. Messrs. Zennström and Friis, who run Skype out of Luxembourg, claim that it costs their company about a penny to acquire a customer. That compares with about $150 for Vonage, a leader in traditional VoIP.

Since its debut, Skype has signed up 35 million users and, at any one time, well over 3 million people are logged into its network. One of Skype's most high-powered adherents is former Federal Communications Commission chairman Michael Powell, who said in January 2004 at a telecommunications conference at the University of California, San Diego: "I knew [the traditional telephone system] was over when I downloaded Skype…. The world will change now inevitably."

With all this going for it, Skype would seem to be on a smooth trajectory, but that's not quite the case. In fact, Accenture's use of Skype instead of GSM was significant because its project teams were bucking the prevailing bias among corporations. Most corporate IT and telecom managers are trying to avoid Skype at all costs.

Skype is an IT manager's nightmare. For one thing, Skype encrypts all its traffic, which makes it impossible to monitor what employees are doing, sending, or saying when they use this communications tool. In addition, Skype doesn't follow the path of most VoIP services. It enters the corporate network as an application embedded in a mobile device; it is activated whenever a user accesses the Internet from within the corporate network to make a call. In this way, Skype could theoretically open holes in a corporate firewall from the inside. The fear is that Skype users could expose corporate networks to hackers, viruses, and malicious software ("malware") — or shield the activities of malicious employees.

Peer-to-peer telephony will level the telecom playing field for small companies and those in developing nations.

For the immediate future, these conditions make it risky for most large companies to embrace or even consider adopting Skype. And employees can expect memos like those issued at many companies these days warning against using peer-to-peer networks for any form of communication. But as the Accenture scenario illustrated, that won't stop employees who are dissatisfied with the quality of other forms of communication from accessing Skype anyway. Which means that, before long, management will have to address the potential of Skype or Skype-like technologies — and determine the peer-to-peer applications whose benefits outweigh their risks — rather than simply outlaw the technology and hope it goes away.

Until then, most large companies will avoid Skype, but the technology can level the playing field for small and midsized companies or for companies in developing nations for which a global, inexpensive, and dependable telecommunications infrastructure is a dream come true. With Skype, the Internet becomes a virtually cost-free private telephone-and-voicemail network, a feature-rich system for remote real-time collaboration. This will become even more obvious as Skype's capabilities increase. The company recently signed an agreement with Motorola to co-market Skype-ready equipment for cell phones, and it completed a deal with Broadreach, the largest provider of Wi-Fi hotspots in the U.K., that will let all users with Skype-capable devices make and receive calls without paying for Internet connection time. In June 2005, a video version of Skype was released that permits teleconferences with up to 200 people.

Soon it will become imperative for larger companies to take Skype seriously, if for no other reason than that peer-to-peer architecture is one of the most efficient, most direct, and least wasteful systems of digital interaction. The eventual answer will probably be software fixes that smooth over Skype's rough spots. These could come in the form of licensed versions of Skype customized to match a company's security requirements — a development that could bring additional revenue to Skype.

But perhaps the most lasting influence of Skype will be that it will force management and IT executives to consider how to structure a

network that exists both inside and outside the corporate firewall. To improve innovation and their own productivity, employees will gravitate to the most advanced collaboration and communication tools with the most reliable levels of quality, no matter what price is paid in weakened security. Companies will have the task of figuring out how to integrate new technologies like Skype into their businesses — and how to get the most out of them. Or, they could take the opposite course: keep such technologies out by banning cell phones, PDAs, and laptops in the workplace. +

Virtual Scale: Alliances for Leverage

by Doug Hardman, David Messinger, and Sara Bergson

Only a few companies — giants such as Procter & Gamble, Wal-Mart, Dell, and Toyota — are in the enviable position of being able to leverage their size into operational scale that consistently drives down per-unit costs and increases efficiency, creating sustainable competitive advantages. And as these companies enhance their lead, the rest of the pack faces a disturbing prospect: Lacking a dominant market position or funds to acquire other businesses, smaller companies are finding that achieving the level of scale required to catch up to industry behemoths is fast becoming a futile pursuit. To make matters worse, "predators" are coming from all sides — that is, predators are now not just traditional competitors in the same industry, but also customers and suppliers, who are dead set on taking a bigger bite out of the margins earned by manufacturers.

It sounds dire, but it needn't be. There's a strategy that could solve this dilemma. Through carefully structured alliances, organizations can combine mutual assets and capabilities to gain the benefits of scale that they would be unable to achieve alone. For instance, a mid-market consumer goods company whose factories frequently operate at much less than capacity could share its plants with smaller competitors or private-label companies. Manufacturing and labor costs per unit would be reduced for both the mid-market company and the companies using its facilities. And more frequent full truckloads carrying products from all of the manufacturers involved in this arrangement — instead of separate shipments from each of these companies — could be dispatched to big retailers like Wal-Mart. In turn, Wal-Mart would be more eager to purchase from these companies because fewer trucks to unload translates into less expensive and more efficient operations.

We call this "Virtual Scale" — a customer-centric pooling of resources that is mutually beneficial, and a paradigm shift that goes beyond simple transactional relationships to build long-term capabilities through alliances that drive corporate growth and value. Besides manufacturing and logistics, Virtual Scale can be applied to such areas as procurement, research and development, marketing, promotion, and even media buying. We estimate that companies adopting Virtual Scale partnerships can increase annual revenues by as much as 14 percent and cut costs by as much as 7 percent — a performance improvement that will allow mid-sized companies to punch well above their weight class and compete more effectively with their largest rivals.

To implement Virtual Scale, begin by identifying where scale matters the most within the organization. Some companies in highly innovative fields need to leverage R&D; shared research networks or modular designs that could be used by many enterprises might be a solution. Other companies seek to cut procurement or marketing costs; co-locating suppliers or cosponsoring focus groups could be the best options.

Often, a Virtual Scale arrangement is most beneficial when an organization is making a significant structural change or capital investment, such as building a new factory. In those cases, Virtual Scale can greatly amplify the value generated by the project. For example, a company could build a plant with 60,000 tons of capacity to meet its own needs. However, by constructing a factory with 90,000 tons of capacity, filling the additional capacity with a partner's manufacturing operations and leveraging third-party operators, the combined alliance can reduce operating costs by 10 to 20 percent and significantly improve the return on the capital invested by all participants.

Keep in mind, though, that pursuit of scale without a clear

understanding of immediate and future corporate strategies can lead to futility rather than dominance. Placing the wrong bet can lock your company into long-term obligations that destroy rather than create value. For these reasons, it's important to balance complexity and value by assessing the trade-offs between the added costs associated with multiple partners — such as more complicated operations management — and the strategic advantages that these partnerships bring.

After determining the specific ways that Virtual Scale can benefit your company, compile a list of potential partners from organizations involved in businesses that in some fashion overlap the areas where scale is most needed. Some companies can be quickly eliminated; among them should be large organizations that already enjoy significant operational scale and small companies lacking enough volume to create any appreciable scale even in a partnership.

Whether to ally with a competitor is a trickier question. Companies need to make a clearheaded identification of their real hard-bitten predators and exclude them from Virtual Scale relationships. But at the same time, it's essential to take a fluid approach to alliances. For example, it may make good business sense — and pose almost no risk — to share with a direct rival high-volume procurement of a commodity part when the component has no bearing on differentiating one product from another. In our experience, the failure to realistically analyze the competition and determine which companies are truly a threat to your business strategies and business model and which are prospective partners can significantly narrow the potential value from Virtual Scale.

Next, evaluate the relative merits of each potential partner by answering these questions:

- What is the value in partnering? Will there be benefits in terms of improved margins and market share, increased return on investments, and enhanced capabilities?
- Why is my company interested in forming this alliance?
- What would be the other company's gain from this alliance and what would the company bring to the partnership?
- Can these two companies work together successfully? Is there a cultural and regional fit?
- What other external factors need to be considered, including safety, regulatory, environmental, and sociopolitical issues?

The final implementation step involves negotiating the Virtual Scale partnership. Before contacting potential allies, companies should prepare draft contracts that include specific rules of engagement and working joint-venture guidelines, including production prioritization, intellectual capital usage, and performance targets.

Only alliances designed to close the gap with larger competitors will be worth undertaking.

Considering that Virtual Scale offers the hope of turning companies that are under competitive pressure into virtual giants, it's surprising that more companies have not yet adopted this strategy. The hesitance seems to stem from the fear of losing control in an alliance. Small companies sharing trucks with midmarket ones, for instance, might be concerned that large retailers would blame them — and even cancel their orders — if a shipment were late, even though the small companies would have had little sway over the distribution center. Or a midsized company might be wary that confidential marketing data could be leaked to a competitor by its smaller partner.

These are certainly legitimate worries, but they imply that strategies like Virtual Scale require abdication of good business judgment. Issues of control, supervision, and oversight should be covered in detail in the working agreement, and none of the partners in a Virtual Scale arrangement should relinquish their responsibility to closely manage activities, including joint ventures that could affect the future of their organizations.

The larger reality is that before long, Virtual Scale may not be simply an option; it may be a requirement. Without it, many companies could fall further and further behind their larger scaled competitors — and risk being swallowed up by them. Indeed, for these companies, Virtual Scale's true value could be as the sole criterion for prejudging the success of alliances. Those ventures that are specifically designed to close the distance between a midsized company and its larger competition will be the only ones that are strategically worth undertaking. +