The human capital audit:
The missing element of merger strategy

BY DENNIS C. CAREY AND MARC A. FEIGEN
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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 companies have begun 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.

**The high expectations of mergers**

The overwhelming majority of mergers and acquisitions are aimed not at cutting costs but at adding strengths and enhancing the corporation's ability to execute a new strategy in the marketplace. Indeed, savings anticipated through streamlining, consolidation, systems integration, and other operational efficiencies or balance-sheet savings do not generally justify a typical acquisition premium. Since January 1996, the average premium paid by an acquiring company has been 26% while the average book value for a Fortune 500 company is only 22% of its market value. The goal of a successful merger cannot be to slash and burn, but to change and grow.

Executives who capture merger deals often overlook a crucial factor: They are not just merging plants and technologies— they are combining people. Whether a merger succeeds or fails depends largely on how well the management team creates a new strategic direction and shapes a corporate culture to support it. The history of corporate mergers throughout the 1990s, however, is filled with examples of mergers that undermined shareholder value due to a failure to recognize the importance of shaping an appropriate corporate culture to support a new strategic direction. The consolidations that looked good on paper from a financial perspective suddenly became far more unwieldy and unpredictable when it came time to unite people behind common corporate goals.

AT&T's hostile takeover of NCR in 1991 and Wells Fargo's equally aggressive 1995 takeover of First Interstate (see page 4) both brought together companies on entirely different paths, and led to nothing but the loss of market value or market share. The M&A wave of 1998 has witnessed similar results. In October, the pharmaceutical giants Monsanto and American Home Products suddenly aborted plans for a merger that had been widely praised just five months earlier. Apparently the burden of two contra-

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 ac-
quition 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.

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 a human capital 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 idiosyncrasies 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

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— Dennis C. Carey

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Let's call the whole thing off...

Sorry, wrong number

The Deal: AT&T acquires NCR
Date: May 6, 1991
Deal Size: $7.4 billion

The Potential: AT&T Chairman Robert E. Allen could barely contain his excitement upon completing the unfriendly takeover of NCR, forecasting “a level of growth and success that we could not achieve separately.” Much of the business media agreed, noting that the merger would greatly enlarge NCR’s customer base, provide marketing and sales support, and add R&D resources. AT&T would gain the critical mass needed for a leadership position in networked computing applications. NCR’s expertise in electronic transactions would be joined with AT&T’s networking and systems integration capability.

The Problems: It was like trying to mix oil and water. NCR’s conservative, centralized management culture was turned inside out by AT&T’s reengineering efforts. Scientists at both companies found few ways of working together. AT&T’s unionized employees could not manage the arrangements to work in the same building as NCR’s non-union staff. Those who had initially made NCR profitable bailed out in droves; by 1997, only four of the top 30 pre-merger NCR managers still worked for the company.

The Result: When AT&T finally sold NCR, the inability of the executives and employees to make the deal work had cost AT&T over $3 billion, and NCR about half of its market value. In the words of University of Denver professor Bob McGowan, a specialist in telecommunications issues: “It looked good on paper, but NCR’s culture and brand could not survive.”

Not the right prescription

The Deal: Merger of Monsanto and American Home Products
Date: June 1, 1998
deal canceled on Oct. 13, 1998
Deal Size: $33.6 billion

The Potential: The pairing of pharmaceuticals-driven American Home Products and the chemicals and biotechnology-driven Monsanto had the makings of a leading-edge corporation that could set a new pace in the life sciences business, an emerging industry that combines human and animal health with plant science. Both partners brought a lot to the table. American Home offered a formidable marketing infrastructure, with a sales force of 10,000, to launch products emerging from Monsanto’s promising drug pipeline. Monsanto brought R&D expertise and an aggressive growth strategy, which American Home’s financial resources could support. The two companies were expecting to save $1.5 billion over three years by closing overlapping facilities and eliminating overlapping R&D.

The Problems: As one pharmaceuticals analyst put it, the merger was fraught with “incompatibilities at the top.” Trying to merge a frugal, rigidly run company like American Home with a high-spending, risk-taking firm like Monsanto was not an easy fit. The two sides couldn’t agree on who was going to run the company, or how. Disagreements ranged from the proportion of funding for pharmaceutical versus agribiotech products, to how many employees would be laid off (and which company would take the biggest layoff hit), to who should be assigned to corporate headquarters.

The Result: The original merger announcement had hardly sent a tremor in the markets, unusual in an industry as exuberant as biopharmaceuticals. But when the deal was called off on Oct. 13, shareholders in both companies took a big hit. Monsanto shares dropped 27% from $50 to $37 (it had been trading in the $54 range prior to the merger announcement). American Home fell 10%, from $50 to $45 (it had traded in the $49 range prior to news of the deal).

A merger they couldn’t bank on

The Deal: Wells Fargo acquires First Interstate
Date: November 18, 1995
Deal Size: $10.9 billion

The Potential: Wells Fargo’s hostile takeover of First Interstate, at an acquisition premium of $3 billion (27%), created the nation’s eighth-largest bank, with a strong base throughout the nation’s largest state. Combining Wells’ high-tech delivery systems with First Interstate’s vaunted customer care would not be easy. But it offered the opportunity to create a bank with the capacity to please a wide range of customers while staying ahead of the technological race, and operating from the largest regional base in the country. President and COO William Zuentz saw potential for huge cost-cutting, mincing no words as he promised to slash $800 million in operating expenses.

The Problems: The technology-focused Wells cut its work force by 26% in the first 15 months, replacing traditional bank branch-es with supermarket kiosks and telephone banking services. Several senior First Interstate executives had already left, resigning before Wells even had a chance to make its plans clear. Michael Abrahams, analyst for Sutro & Co., noted that Wells “lost a lot of the people who keep customers happy.” Competitor banks took advantage of the situation, running ads specifically targeting former First Interstate customers unhappy with declines in service levels. Deposits fell by 11.8% within the first 15 months of the merger, with $5 billion removed in the first three months of 1997 alone. It was as if Kmart did a hostile takeover of Nordstrom and eliminated stores, made merchandise more uniform, cut highly trained sales staff, and asked customers to stand in line.

The Result: Wells Fargo had once been the most profitable bank in the U.S., measured by return on equity. But from the time of the merger to August 1998, Wells shares rose 47%, less than half the 95% rise for the Standard & Poor’s Major Regional Banks Index. As Wells and First Interstate suffered merger meltdown, Zuentz resigned. Wells Fargo was ultimately forced to merge with a stronger bank, Norwest Corp.
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 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 before integration**

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 frontline 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 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 be answered satisfactorily and should look at the target company for the following critical components:

**Work force composition.** A potential acquirer must obtain a clear understanding of the work force that is already in place and the hiring and promotion policies that have shaped it. It is necessary to determine what kinds of employees are recruited and promoted at each relevant level of the company, including their credentials, background, experience, and work traits. What criteria determines who fails, who succeeds, and who advances within the organization? To what extent are employees who do not match the organizational mold accepted or rejected by their colleagues? Comparing the company's current work force with the kinds of employees needed in the merged company will make it possible to develop an effective approach to hiring and promotion.

**Power and decisionmaking authority.** Perhaps the most important elements of human capital management — power and decisionmaking — are also the thorniest and most complicated to shape. It's necessary to determine who truly has influence within the organization. What processes are used to reach decisions, and what factors have the most impact? How do official corporate policies and procedures compare with the way things actually get done? A new strategy will require new kinds of decisions to be made at all levels. Will the right people come together to make wise decisions efficiently — and be able to translate decisions into results?

**Organization and communication.** Dramatically more important than any organizational chart is an understanding of who in fact talks to whom and who works with whom to make things happen. A potential acquirer needs a clear map of the informal organization. How effectively do people work together, across the organization and up and down the corporate hierarchy? How do people find out what they need to know to get things done?

**Motivation.** To ensure an effective performance culture, key employees will need to be persuaded to realign their commitment to the new corporate strategy. It is important to provide the right incentives — tangible and intangible — for individual and collective performance. What do employees at each relevant level of the company see as their overall mission and their day-to-day mandate? What incentives actually drive individual and team performance? In what ways does the current informal work regime create barriers to increased performance?

**Skills and information.** Beyond integrating systems it is also necessary to plan for the building and sharing of intellectual capital. What gaps in skills and information could potentially undermine the new business strategy? What skills and information are valued within the organization, and actually drawn on to drive performance? How well are skills aligned with the new strategic vision? What are the missing skills? Are they present but not exploited? How difficult is it to access skills and information within the organization? What kind of feedback do executives, managers, and front-line employees receive to improve their performance?

**Investment in people.** Companies must give executives, managers, and employees the opportunity to build skills and knowledge, and give them access to the tools and expertise that help them get their jobs done. A potential acquirer will want to understand to what extent employees' skills and knowledge are valued and invested in. Do key leaders tolerate outside ideas and expertise? What analytical and informational tools are used to support individual and collective performance? What resources can be drawn on? Will these need to change in light of the new strategic direction? Successful management of human capital requires constant attention to the renewal of people and ideas consistent with the new business goals.

**Audits and integration**

A pre-merger human capital audit can be an early warning system for a company prior to proceeding with a merger. It can also help shape a strategy for how to structure a transition period so that the merger comes off smoothly. But once the merger has been accomplished, there remains much to be done to shape corporate culture going forward.
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.

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**Commit to the cultural integration...or go!**

In June 1997, 3Com Corp. and U.S. Robotics Corp. completed a merger agreement that was, at the time, the second-largest corporate merger in the history of high technology. As president and chief operating officer of U.S. Robotics, John McCartney helped negotiate that deal and continued to work as president of the Client Access Business Unit of 3Com until March 1998. In a recent interview, he discussed the importance and challenge of creating a new corporate culture integrating two companies.

Q. Tell us about what you saw when U.S. Robotics merged with 3Com.

I think that in most large mergers, the integration process is extremely difficult and often underestimated, even by the most talented executives. Bridging the differences in culture between two organizations is not easily done. That’s a fair description of what we faced with 3Com and U.S. Robotics. In the year following the merger, my company struggled — in part because of external factors in the market, but in part because of the challenges posed by cultural integration. These problems occurred even though I believed then and continue to believe now that the underlying strategy of the merger was sound.

Q. What made it difficult to bridge the two corporate cultures?

The two companies were very different. U.S. Robotics was a more aggressive, rambunctious, fast-moving organization that was extremely competitive inside and outside of the company. We were very market-driven. 3Com, on the other hand, was a more deliberate, planning- and process-oriented, technology-driven company.

Q. Did those differences surprise you?

No. Both sides were aware of the culture differences. Each saw in the other elements that it would like to emulate. We thought of moving toward a new corporate culture that reflected the best of both cultures.

Q. How much time was spent in preparing to bridge those cultural differences?

In hindsight, not nearly enough. It was an issue that was addressed, but not subjected to nearly the degree of scrutiny that technology, market, and financial issues were. From my experience in mergers and acquisitions, that’s quite typical.

Q. What were the results of that insufficient attention?

The most direct manifestation was that nearly all of the senior U.S. Robotics team left in the first year after the merger. Some of those departures were a natural outgrowth of a large merger, of course. But some of them were a direct result of people not enjoying the new environment. It’s not that it was necessarily better or worse. It simply did not match their personalities and business attitudes.

Q. What do you now wish you had done differently?

We would have been able to move faster and avoid a difficult transition if the leadership had spent more time during the negotiations and immediately afterward in defining the elements of what we wanted the new culture to be — and then defining the steps to achieve that culture. I now realize that in any big merger, focusing on the common culture is as important as focusing on product integration, strategy, or technology.

Q. How important is leadership in that process?

It’s essential. From the outset, the collective leadership has to show a united front and a tenacious commitment to that. Merger integration is a real leadership challenge, and it needs that commitment. Looking back, I believe it is essential that members of the senior management team who don’t share a commitment to the new cultural outcome simply need to go.

Q. What advice would you give to executives now involved in a merger or on the brink of one?

Identify the key elements of the culture you want the company to have. Understand the types of behavior you’ll need to create that culture. And then be absolutely ruthless about ensuring that those behaviors are adopted. What I learned is that the behavior and attitude of managers are much more important in determining how a company is going to behave than deciding which person is in which box.