

# Extending Due Diligence to Improve Mergers and Acquisitions

By Steve McGrady

*The track record of merger and acquisition deals points to shortcomings in the traditional due-diligence approach.*

The \$47 billion acquisition of Fleet Bank by Bank of America in April 2004 created the number 3 bank in the United States. With assets estimated at \$966 billion, it is exceeded only by Citigroup and the combined Bank One Corp. and J.P. Morgan Chase (another recent merger).

While Bank of America and Fleet may have been 2004's high-profile banking mergers and acquisitions (M&A) deal, it was not the only one. For example, during the first 10 days of November 2004, Wachovia acquired SouthTrust in a \$14 billion deal, Valley National Bancorp's \$141 million acquisition of Nor-Crown was announced

and Riverview Bancorp continued its expansion by absorbing American Pacific Bank in a \$34 million transaction. There were also the acquisitions of First Washington Financial Corp. by Fulton Financial Corporation, FSF Financial Corp. by MidCountry Financial Corp. and Snake River Bancorp Inc. by Intermountain Community Bancorp. While many of these are community banks, it is still virtually one merger or acquisition deal every working day.

You can even gamble on future bank acquisitions: Ryan Beck & Co. recently launched the "Select Bank Merger Portfolio," a unit investment trust consisting of bank stocks selected because of their potential for consolidation. This is not a recent phenomenon. Thousands of bank mergers and acquisitions have taken place in the United States alone in the last hundred years.

The volume has fluctuated, but the trend has been broadly upwards, with various authors throughout

the 20th century reporting increases in consolidation activity compared to the past. For example, a sharp rise in bank merger activity was recorded in the early 1950s when compared to the preceding decade.<sup>1</sup> Almost 900 commercial banks were absorbed between 1960 and 1965.<sup>2</sup> Contemporary opinion does not always recognize this longevity though: "The banking industry is consolidating at an

accelerating pace, yet no conclusive results have emerged on the benefits of mergers and acquisitions ... technological innovations and a thorough-going deregulation have prompted a wave of mergers in the bank-

ing industry throughout the world, starting in the United States in the eighties and reaching Europe in the nineties."<sup>3</sup> How can consolidation take place on this scale for so long without reaching an end? At least part of the answer lies in the vigorous growth of new banks, which is revealed by the fact that large banks (which are responsible for the bulk of acquisitions) grow more slowly than the banking sector in total. Research conducted on 600 commercial banks between 1960 and 1971 confirmed this and also found that medium-sized banks grew at a faster rate than they were absorbed, which resulted, perhaps surprisingly, in a net deconsolidation within the industry.<sup>4</sup>

The increasing availability of potential acquisition targets must have an influence on the larger banks'

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*Steve McGrady is Managing Director at Meridian 1 Ltd., Dunmow, United Kingdom. He can be reached at [steve.mcgrady@meridian1.ltd.uk](mailto:steve.mcgrady@meridian1.ltd.uk).*

propensity to merge and acquire, but the reasons behind these deals have changed in response to external strategic drivers, such as changes in the social or macroeconomic environment. For example, in the 1920s, banking consolidation was driven by a wave of mergers throughout the economy. In the 1930s, the trend shifted toward defensive behavior following the Great Depression. Current activity is explained by global competition and the resulting need for global reach, a growing client base and economies of scale.

This article considers what success is likely to be achieved by the continuing series of bank M&A, what lessons have been learned from the thousands of deals during the preceding decades and what practical steps might be taken to improve.

### The Current Position

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Ten years ago, Tom Peters challenged the logic behind large bank mergers in typically humorous style, wondering why anybody thinks they can join two “clumsy, rotten, bureaucratic” companies and produce a gazelle.<sup>5</sup>

Customers and investors might expect that with the cumulative experience of M&A within the banking industry, the success of any new deal should be virtually guaranteed. In this ideal world, a streamlined process would deliver assured success for both the premerger due diligence and postmerger integration phases. At this point, the article should have a neat graph illustrating how deal profitability has progressed “up and to the right” as the years progress, but the data tells a different story.

The value of worldwide M&A in 1998 hit almost \$2.5 trillion before peaking in 1999. Following the dot-com bubble burst, this level reduced, but activity has been increasing again recently. Looking at the situation across all industries, there is 30 years of evidence that the majority of acquisitions do not create value for shareholders in the acquiring company. In October 2002, *BUSINESS WEEK* magazine reported that 61 percent of U.S. mergers destroy shareholder value. Recent research shows that acquisitions in the 1990s had just as poor a record as those that took place 20 years before.<sup>6</sup>

The specific evidence for banking is inconsistent, with some claims for success balanced by evidence of

failure, but the situation is summarized by research published last year that concluded, “[O]n average, bank mergers do not create value.”<sup>7</sup> This situation is certainly paradoxical. The record of accomplishment is poor, but almost in spite of the evidence, M&A have continued within the banking sector at the community, state and national level.

### Due Diligence

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The dictionaries define “diligence” in terms such as “careful,” “persistent,” “earnest” and “painstaking.” It is also defined as “the opposite of negligence.” This implies that any premerger or preacquisition audit should make every effort to identify all the factors that indicate whether the target organization will produce a successful outcome.

The guidelines and best practice vary widely, but they do appear to be comprehensive. A typical example is contained in Exhibit 1. These headings are usually backed up by exhaustive lists of specific items that should be checked. For example, the intellectual property area might typically include copyrights, patents, service marks, trade secrets and trade names, each of which would employ specialist expertise to analyze rights, applications, registrations, proceedings, license agreements and other documents.

Until recently, this list might have consisted exclusively of financial and legal issues. Maybe the inclusion of employees, benefits, environment and intellectual property are signs of a broadening of scope in the due-diligence process.

A recent European survey revealed, however, that human resources (HR) is the lowest priority area in due diligence, with less than 10 percent of management time being spent on HR issues.<sup>8</sup> However, the guidelines referred to in Exhibit 1 specifically refer to HR issues as follows:

Purchasing companies often anticipate firing workers to cut costs. However, based on existing employment contracts and union contracts, these cuts may not be possible, or could result in costly litigation and/or severance packages. Policies on pay, benefits, perquisites, holidays, vacation time, salary ranges, and employee handbooks are all ripe for litigation if appropriate due diligence is not undertaken. There could

also be outstanding workers' compensation claims, unfair labor practice charges, civil rights claims, and other labor disputes that may result in additional costs.

Buyers must review all employee benefit plans, including liabilities for underfunded or unfunded pension plans, and past filings with the Department of Labor and IRS to ensure the business has complied with all governmental rules and regulations.

Each type of plan will have its own set of issues to address. Obviously, all elements pertaining to health and medical benefit plans should also be analyzed to make sure they comply with regulatory requirements. An analysis of insurance and relationship to the employee benefit plan is also required to make sure that the company gets all the insurance it paid for.<sup>9</sup>

So, is the European research wrong, or are these guidelines atypical? Careful analysis of the guidelines shows that although the subject areas might be employees and benefits, the process is essentially financial and legal, concerned with realizing intended cost savings and avoiding litigation. The survey also found that respondents identified core HR issues, including cultural fit, decision making, alignment of compensation and benefits and organizational structure as the most critical and difficult areas to resolve during integration, with cultural fit being highlighted as the area that would be given more attention during both due diligence and integration. Jean-Luc Santerre, senior vice-president of corporate social development at Schneider Electric, one of the survey participants, said, "It is crucial that companies address the issues of cultural fit, organization design and change management early on in the merger and acquisition cycle—ideally at due diligence—so that we can help make, not break, the deal."<sup>10</sup>

Another perspective is provided by looking at businesses where the success or failure has been largely determined by cultural issues and the quality of the people. For example, interviews with managing partners in a number of accounting firms identified culture as the most significant aspect in response to

### *Exhibit 1 Typical Due-Diligence Areas for Consideration*

- Corporate organization and structure
- Accounting and financial matters
- Tax matters
- Real property
- Furniture, fixtures and equipment
- Insurance
- Intellectual property
- Contracts and commitments
- Environmental matters
- Employees
- Employee benefit plans
- Litigation

*Source: G. DeLong, Does Long-Term Performance of Mergers Match Expectations? Evidence from the US Banking Industry, 32 FINANCIAL MANAGEMENT 2 (2003), at 5–26.*

the question, "How do you conduct diligence?" For example, Bob Bunting, CEO with Moss Adams in Seattle (a firm with 1,200 staff members in 23 offices), said, "We tend to focus on the values and ethics of the people." David Krajanowski, comanaging partner with Singer Lewak Greenbaum & Goldstein in Los Angeles (150 staff members), says, "We just had a firm talking to us and one of the questions we asked was, 'Tell us about your culture.' They said, 'That has nothing to do with what we're talking about.'

It's *all* about culture."<sup>11</sup> These views are increasingly supported by empirical evidence, both generally and specifically within the banking sector.<sup>12</sup>

### What Can Be Done to Improve Things?

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Research into the 117 most significant deals closed between January 1994 and July 1996 analyzed a number of factors to isolate those that correlated with subsequent success as determined by performance relative to industry peers.<sup>13</sup> It failed to identify any statistically significant factor that could predict success or failure, but it did produce some surprising findings:

- There is no link between purchase premium and success.
- The relative size of acquirer and target is not significant.
- Vertical (different industry) and horizontal (similar industry) mergers demonstrated no significant difference.
- The researchers did, however, isolate a number of activities that were used by the successful companies:
  - A clear, agreed vision shared by both parties
  - A detailed, prioritized architecture for change
  - An architecture for the new company based on the strengths of the two parties focused on maximizing value
  - A new leadership team chosen and communicated quickly
  - An explicit plan to address cultural issues

There seems to be a pattern emerging from both research and experience that intangible issues such as culture and change are critical to success. Some research even identifies "irrational" influences on postmerger integration.<sup>14</sup> However, the predominant focus of due diligence remains financial and legal.

The track record of M&A deals points to shortcomings in the traditional due-diligence approach. Despite thorough examination of financial and legal aspects before entering into a deal, the critical measures, such as subsequent performance relative to industry peers, do not indicate success. Maybe more focus on the less tangible factors such as culture, leadership and change might increase the chances of success.

### How Do You Include Intangibles in Due Diligence and Integration?

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The evidence that both due diligence and integration need to be improved is compelling. Research and experience indicate that intangible areas might hold the key to improve, so why has nothing happened to incorporate these elements within most due-diligence exercises? Unfortunately, the probable answer is that, by definition, intangibles cannot easily be defined; therefore, they cannot be assessed, measured or managed.

Fortunately, some models and tools might provide a basis for extending the process. A brief article such as this does not permit an exhaustive analysis of the field, but a selection might illustrate how intangibles could begin to be included in the process.

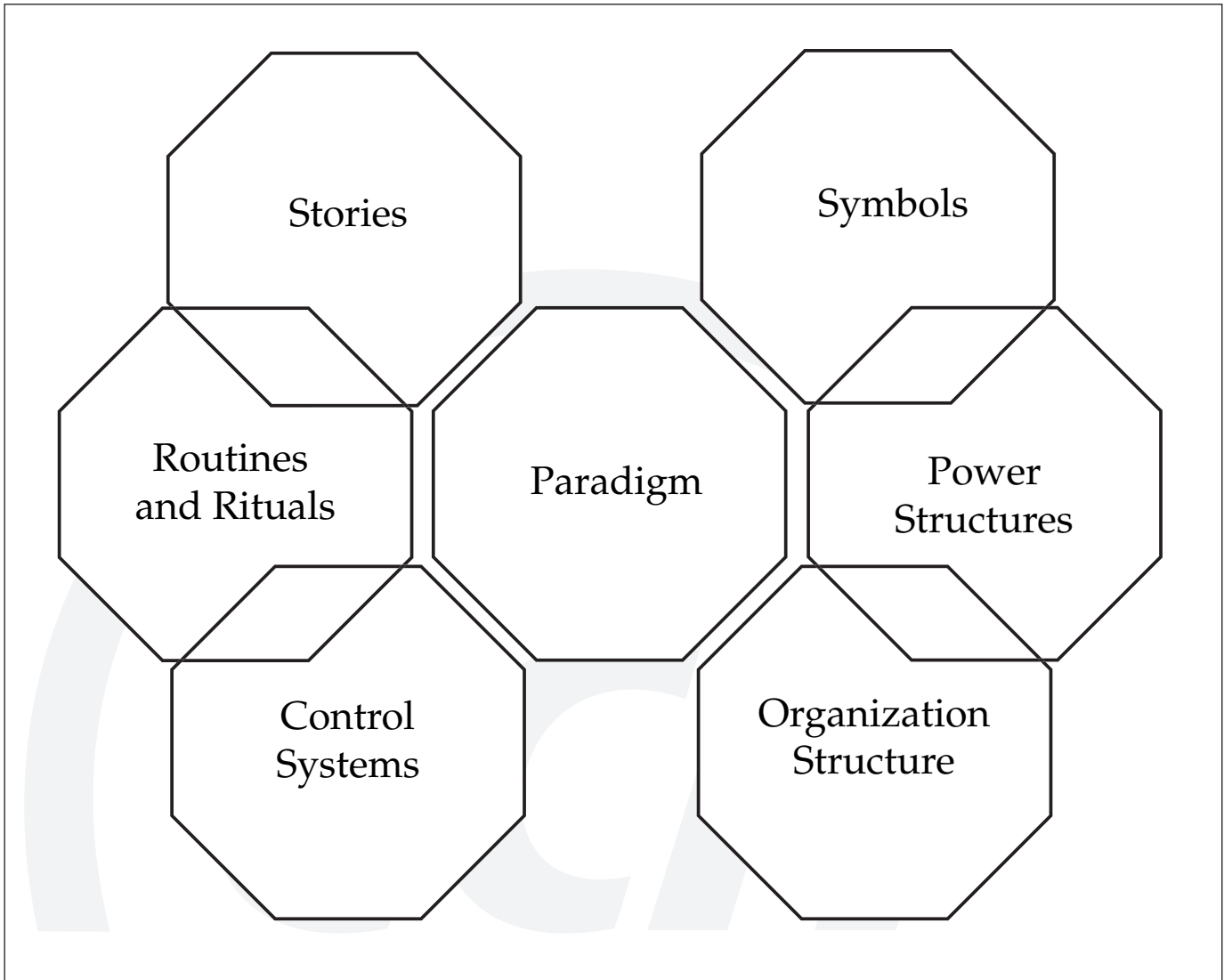
### The Balanced Scorecard

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One of the best-known management frameworks that addresses more than just financially derived measures is the concept of the strategy-focused organization, which developed from the balanced scorecard and strategy maps.<sup>15</sup> The basis of these tools is a belief that the predominance of financial management tools that characterized the industrial era is no longer appropriate in whatever age we are now in (information, creativity, entrepreneurial, leadership, postindustrial, *etc.*), because leverage of capital assets is no longer the sole determinant of competitive advantage. In recent years, banks and other financial institutions have invested in enabling cross selling of products, customer relationship management and affinity programs as ways of increasing revenue and profits. These initiatives require organizational and cultural shifts in order to deliver success. The winners are those organizations that are best able to capture the hearts and minds of their people to embrace change, not those necessarily with the largest reserves or strongest balance sheet.

Therefore, this framework might provide some insights if we consider translating its principles from running the business to running the M&A process. For example, the original balanced scorecard proposed that performance should be measured by financial, customer, internal business process and learning and

Exhibit 2  
The Cultural Web



growth measures. Each category comprises a mixture of traditional, retrospective (lag) measures and new, predictive, strategic (lead) indicators. Where both parties use balanced scorecards, the lag measures can be included in due diligence, and the lead indicators (or performance drivers) can be used as a skeleton for integration planning, as well as an indicator of cultural fit. However, what happens if only one party has a balanced scorecard? In the case of the target company not having a scorecard, the development of, at least, the performance drivers using strategy maps could be a powerful and effective exercise. Not only would it give the acquirer rich insights into the strategy and

culture of the target company, but also it would lay the foundation for developing an integration plan.

In the opposite situation, where the target is the only company with a balanced scorecard, it is more difficult. The experience to date suggests that the acquiring party typically identifies the use of the balanced scorecard as a cost saving to be made postacquisition by scrapping it. This may not be easy to change, because the balanced scorecard approach is more suited to a growth-oriented management style. When the management team driving the deal is primarily adept at cost cutting and enhancing productivity, it tends not to understand the potential of the framework.

### Exhibit 3 The Cultural Web: Some Useful Questions

#### *Stories*

- Do stories relate to strengths or weaknesses? Successes or failures? Conformity or mavericks?
- Who are the heroes and villains?

#### *Routines and rituals*

- What are the key rituals?
- Which routines are emphasized?
- What do training programs emphasize?

#### *Organizational structures*

- How flat/hierarchical are the structures?
- How formal/informal are the structures?
- Do structures encourage collaboration or competition?

#### *Control systems*

- What is most closely monitored/controlled?
- Are controls related to history or current strategies?

#### *Power structures*

- What are the core beliefs of the leadership?
- Where are the main blockages to change?

#### *Symbols*

- What aspects of strategy are highlighted in publicity?
- What status symbols are there?

Source: G. Johnson, *Managing Strategic Change: Strategy, Culture and Action*, 25 LONG RANGE PLANNING 1 (1992), at 28–36.

## The Cultural Web

This cultural web (Exhibit 2) was developed specifically to analyze organizational culture.<sup>16</sup> It arose from the belief that understanding and characterizing both the culture and the subcultures within an organization could help predict how easy or difficult it would be to adopt new strategies. The concept defines organizational culture as layers of values, beliefs and taken-for-granted assumptions.

The cultural web represents the unquestioned assumptions or philosophical framework of an organization and the physical manifestations of organizational culture. Like the balanced scorecard, this tool was not developed for use with M&A but can similarly be adapted.

The elements of the cultural web follow:

- **Routines** are seen in the behaviors that members of the organization use with each other and those outside the organization. They make up “the way we do things around here.”
- **Rituals** are special events through which the organization emphasizes what is important and reinforces “the way we do things around here.”
- **Stories** told by members of the organization to each other, to outsiders, to new recruits, *etc.*, embed the present in its organizational history and highlight important events and personalities.
- **Symbols** such as logos, offices, clothes and titles or the type of language and terminology commonly used become a shorthand representation of the nature of the organization.
- **Power structures** are the most powerful groupings within the organization and are usually associated with this set of core assumptions and beliefs.
- **Control systems**, measurements, recognition and reward systems emphasize what it is important to measure in the organization and to focus attention and activity upon.
- **Organizational structure** is likely to reflect power structures and to describe key relationships emphasizing what is important in the organization.
- **The paradigm** (philosophical framework) of the organization encapsulates and reinforces the behaviors observed in the other elements of the cultural web. It represents the un-

questioned assumptions that exist within an organization.

Clearly, the requirements for confidentiality make it difficult to undertake this type of analysis in a target company. However, by incorporating a tool such as this into the due-diligence process and ensuring that everyone involved in the process is aware of the tool and understands how it works, the qualitative information can be gained through observation and questioning during almost every other phase of due diligence. Provided that responsibility for collating the information rests with one of the team, and he or she possesses the appropriate facilitation skills to encourage other team members to recall and provide the information, maybe in a daily meeting, a rich cultural picture can be developed without explicitly analyzing the culture. Exhibit 3 lists questions to ask when using this tool. By comparing the resulting cultural web to that of the acquirer, the analysts can identify and assess potential matches and gaps. As with the balanced scorecard, the results can contribute to a cultural assessment during due diligence and may also provide information for the integration plan.

## Conclusion

The popularity of bank M&A does not appear to take account of their relatively poor success rate. By focusing on this area sufficiently to increase its success rate, a financial institution could tap in to a unique and valuable source of competitive advantage.

Assessing intangibles during due diligence and using the information that results to inform the development of an integration plan could be a significant source of improvement. The opportunity exists to change decades of underperformance by developing an M&A process that can deliver real value to stockholders and customers.

## Endnotes

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- <sup>4</sup> S.A. Rhoades and A.J. Yeats, *Growth, Consolidation and Mergers in Banking*, 29 J. FINANCE 5 (1974), at 1397–1406.
- <sup>5</sup> T. Peters, *Corporate Culture & the Challenge of the Single European Market*, MANAGEMENT PERSPECTIVES (London: Just Results, 1993).
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- <sup>7</sup> G. DeLong, *Does Long-Term Performance of Mergers Match Expectations? Evidence from the US Banking Industry*, 32 FINANCIAL MANAGEMENT 2 (2003), at 5–26.
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- <sup>9</sup> A.J. Goldberg, *Mergers & Acquisitions Due Diligence: Buyer Beware*, CORPORATE BOARD, 1999.
- <sup>10</sup> *Supra* note 8.
- <sup>11</sup> *MPs Share Merger Due Diligence Secrets*, CPA MANAGING PARTNER REPORT, Sept. 2003, at 3.
- <sup>12</sup> G. Yen and N.N.H. Liao, *On Acculturation in Business Mergers: Empirical Findings from a Commercial Bank's Opinion Survey in Taiwan*, 6 REV. PACIFIC BASIN FINANCIAL MARKETS & POLICIES 2 (2003), at 141–66.
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- <sup>15</sup> R.S. KAPLAN AND D.P. NORTON, *THE STRATEGY-FOCUSED ORGANIZATION: HOW BALANCED SCORECARD COMPANIES THRIVE IN THE NEW BUSINESS ENVIRONMENT* (Boston: Harvard Business School Press, 2001), at x, 400.
- <sup>16</sup> G. Johnson *Managing Strategic Change: Strategy, Culture and Action*, 25 LONG RANGE PLANNING 1 (1992), at 28–36.

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