Key Success Factors for Successful Merger Integration

Even though the commercial aerospace sector is expected to grow significantly over the next couple of years, defense-sector budgets are under pressure. As a result, suppliers face the twin challenges of finding cash for new technology and production capacities on the commercial side and cutting costs on the defense side. Given those competitive and supply chain pressures, we expect heightened industry consolidation in the near term.

However, finding the right partner for mergers and acquisitions (M&A) is only the first step to achieving success. Once the deal is signed, management must immediately begin focusing on the complex process of integrating the merger while also running the day-to-day operations. Planning in advance and appointing a chief integration officer to lead the process are two major elements in ensuring an integration marked by more speed, less turmoil, and better results.

Heightened M&A Activity Expected

In 2012, M&A activity in the aerospace and defense industry centered mostly on the aerospace and maintenance, repair, and overhaul (MRO) sectors, which together accounted for 61% of deal volume and 75% of deal value. Despite a relatively high level of activity, however, the industry’s total deal value of $19.5 billion in 2012 was 15% below the average level of $22.9 billion for each of the prior 10 years. And defense saw another drastic decrease in M&A volume, with that sector accounting for only 8% of total deal volume last year compared with 37% in 2011 and 57% in 2010. However, given the challenges in both commercial aerospace and defense, we expect to see heightened M&A activity in the years ahead, especially among smaller-size deals and mainly in the following four sectors.

- **MRO.** This will be driven in part by thin margins linked to overcapacity; a fragmented landscape of players, especially in airframe MRO; the evolution of original equipment manufacturers’ (OEMs’) business models to bundle services at the aircraft point of sales; strong fundamentals that attract private-equity investors, with a doubling of commercial aircraft fleet every 15 years; and the benefits from rapid growth in emerging economies with lower labor costs.

- **Structural components.** OEMs need suppliers with broader and deeper capabilities, and many small companies fill the bill in this sector.

- **Jet engine components.** The aftermarket business provides another revenue stream that can be scaled up, and many small companies with specific expertise may be attractive targets.

- **Space.** Many companies are seeking to gain exposure to commercial satellite communications amid ongoing sector fragmentation and increasing competition.

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2 Ibid.
In addition to those more-defensive moves, we expect to see selective offensive M&A activities, such as deals that would enable companies to build new offerings (complete work packages) or to prepare for future technology (such as electrical aircraft). Those more-strategic mergers in particular will require careful integration to adapt an organization to a new commercial offering or a different industrial footprint.

A third stream of M&A, which already exists but is expected to continue, comes from major defense contractors, particularly in the United States, which have to compensate for their declining defense equipment programs. Among alternative options are mergers between the primes, spin-offs of noncore entities, or gaining through M&A more exposure to attractive and growing market segments such as information technology (IT) and cybersecurity on the defense side and equipment and aftermarket on the commercial side.

**Merger Integration: Key Success Factors**

For many companies, a merger is a once-in-a-lifetime—or at least a once-in-a-decade—situation, and it’s crucial that the postmerger integration succeed. Success is about the fast, deep analysis and rigorous opportunity and risk prioritization that cause savings to be realized immediately after the transaction closes and throughout the course of the integration life cycle. Thorough, advance planning is necessary so that the integration can begin immediately, on Day One (closing day), while business continuity remains the top priority. The most-successful merger integrations are marked by:

- **More speed:** Divide and conquer
- **Less turmoil:** More-focused analysis, better judgment, and faster implementation
- **Better results:** Fewer but more-senior professionals involved

### More speed: Divide and conquer

Merger integration work should begin, at the latest, at signing. Transactions are in their most sensitive phase between signing and closing. The combined entity must be ready to immediately defend its current revenue against the real threat of attrition. Therefore, companies must minimize potential damage by analyzing and prioritizing potential at-risk accounts and pricing situations and proactively communicating to those business partners. In parallel to business retention, management retention, too, must be addressed early in the transaction process to ensure critical talent is retained. Action plans should be developed so that on Day One, management can deploy teams of dedicated, senior resources in two key areas:

- **Enabler teams:** To manage the legal and technical sides of the integration, such as finance, IT integration, and human resources integration. Also, the new organizational structure for the top three levels should be established before Day One in order to mitigate risk and avoid unrest in the organization.

- **Synergy teams:** To identify and detail specific cost and growth synergy initiatives. These include bottom-line-oriented areas such as purchasing, overhead, supply chain, and manufacturing, as well as top-line revenue improvement and expansion into new markets. In the short term, cross-selling and up-selling opportunities might drive some growth. In the middle to long term, growth is driven by shaping next-generation technologies, systems, and solutions that build on complementary strengths. Prior to the close, synergy teams should work in a clean-room setting to analyze, identify, and prepare action plans around information-sensitive areas such as purchasing and sales and marketing. Such actions can help accelerate the realization of synergies and minimize risk.

### Asset Deals in Aerospace Magnify the Challenge

Asset deals and asset carve-outs are not uncommon in aerospace, and they require the management of additional risks. In such cases, only the business assets (e.g., plants, intellectual property, facilities) are sold or purchased, and depending on the specifics of the contract, the deal may or may not include employees or customer and supplier contracts, each of which must be carefully transferred to enable business continuity. Some aspects of the business may need to be rebuilt or provided as transfer-of-service agreements (TSAs) from the previous owner.

### Considerations for aerospace asset carve-outs include:

- **MRO/customers:** Many aerospace equipment and component suppliers derive a significant portion of their revenues and an even greater portion of their profits from after-sales services in competition with other service providers. After a merger, the business must continue operating, which often requires rebuilding either in part or in full certain key processes (in case only some of the assets are transferred but not complete sites). Additionally, on Day One the business connected with the transferring assets could immediately become engaged in competition with its previous owner. Customers are critical to the business and need to be managed as such: it is therefore imperative to
INSIGHT | Key Success Factors for Successful Merger Integration

preserve not only continuity of customer service throughout the transition but also all customer communication channels. All changes—including those made to Web interfaces, ordering and invoicing processes, and customer service contact centers must be carefully communicated.

- **TSAs:** In many cases, it will not be possible for the carved-out assets to be operated fully independently of their previous owner from Day One. While new capabilities are being created or the new owner’s systems and processes are being adopted, business continuity will depend on TSAs. It is crucial that such instruments be robust and well negotiated, especially when future entities will be potential competitors. For example, it is important to ensure that all services required be well defined, that services not required not be paid for, and that the service provider be incentivized to operate efficiently (e.g., paid based on outputs rather than time and materials).

- **IT:** Experience shows that IT is one of the most common areas of complexity and disruption risks. Thus, the importance of first-rate negotiation of IT TSAs cannot be overemphasized. IT TSAs should be handled the same way as the outsourcing of a business’s entire in-house IT function to a third-party service provider is. There must be a specific focus on costs, service-level definition, and knowledge transfer so as to ensure capability is transitioned over a defined time period and that confidentiality requirements are satisfied. The IT project should distinguish clearly between Day One priorities and the actual carve-out and integration project. The former is critical to the availability and reliability of IT systems on closing day, and the latter is a real project—including a technology strategy—that ensures the right decisions get made around investment and technical solutions. Day One should be the priority focus, but the end solution must also be prepared up front, with an eye toward the interdependencies between the two and toward operations during the transition phase.

- **HR:** At the most basic level, it is important to make sure everyone gets paid on time during the transition. It is also fundamentally important to focus on addressing individuals’ broader concerns. People and benefits packages have to be transferred individually. There may be significant changes in pension terms in particular if moving from a defined-benefit plan to a defined-contribution plan, as is often the case in present-day deals. This matter needs to be managed with sensitivity. It is imperative to identify the people in key functions relevant for business continuity and to ensure they are incentivized not to leave during the transition—and especially during periods of uncertainty. Careful planning and continued communication are essential during such periods.

- **Finance:** The integration of the company’s main business processes and works instructions is vital to success (e.g., to support MRO). It is crucial to identify the role of transactional processes within the work flows and the potential accounting compliance limitations (e.g., what is and is not compliant within workaround solutions).

- **Aerospace regulatory:** In the creation of new legal entities and in the establishment of new systems and processes, additional risks to business continuity arise from industry-specific regulatory requirements. These must be anticipated and planned for at the earliest opportunity in the project. They include time scales to obtain airworthiness approvals to supply parts for use on aircraft, capability to manage import/export licenses to ensure compliance, and management of relationships and compliance with antitrust agencies in all markets in which the parts are sold or used.

**Less Turmoil: Head, Hands, Heart**

A content-heavy program management office should be established to manage the integration and to propel a smooth and efficient process. This office enables the development of a consolidated, coherent, big-picture integration guideline; a thorough 100-day plan; and a detailed Day One action agenda. Because existing management teams often lack the time and expertise needed for dedicating focus on merger integration efforts in addition to running the company’s day-to-day operations, management usually nominates a chief integration officer to act as the head, to make decisions quickly, and to provide stakeholders with confidence and security.

To maintain momentum, the program management office also needs to use its hands, through the use of a regular, content-driven review process and a reporting and tracking tool that is linked to operative budgets. These hands can maintain a clear and actionable work plan for the various teams to execute. In a fast-paced project with tight deadlines, an integrated milestone plan—with common dates across all work streams—is effective in maintaining common focus. With a content-heavy program management office, this approach helps zero in on and resolve obstacles to reaching the next milestone. Simplified reporting and a disciplined drumbeat also enable steering groups to resolve issues and remove roadblocks more effectively.

Finally—and equally important yet often underestimated for merger success—is the heart dimension. Cultural integration should be considered a top priority, and strong central and operational change management should be integrated into daily work rather than approached as a separate process. Senior
management should lead by example and demonstrate authenticity by living up the core values it promotes. There can never be enough communication both upstream and downstream; however, it is vital that the core message always be credible and consistent. As in real life, there is no standard approach for the heart dimension. Here, strong functional and operational know-how, social skills, and cultural sensitivity are necessities.

Better Results: Follow the Money

Most transactions fail because of poor execution, not because of poor choice of merger partner. When integration execution fails or falls short, transaction value is lost. That’s why the entire integration process must focus on the strategic rationale and financial value levers of the transaction.

In most cases, mergers are based on bottom-line and top-line synergies, whereas the realization of revenue synergies is typically much lower than cost; in only very few cases are the targeted synergies cash focused. In certain situations, such as the booming commercial aerospace sector, wherein cash and liquidity can facilitate further growth, it is important to focus from Day One not only on earnings before interest and taxes (EBIT) but also on cash improvements. Synergy teams that are organized not only around EBIT and revenue targets but also around very tangible cash targets for capital expenditure and net working capital are typically more successful.

Conclusion

As cost-cutting and repositioning become imperatives in the defense sector and as volume and complexity continue to increase in the commercial aerospace sector, we expect to see more and more companies look to M&A as they chart paths forward. Careful, well-planned, and well-executed postmerger execution is essential to the long-term success of both the transactions and the combined entities.

Six Key Lessons Learned

1. Identify and respond to problems quickly. Decisions must be made quickly and pragmatically and must focus sharply on the relevant levers. Rapidly defining and rapidly implementing effective solutions are more important than conducting an overly detailed analysis of root causes.

2. Prioritize business continuity and customers. Attrition is a real risk, so it’s important to mitigate any attrition risks the deal may present. This becomes even more vital in an asset deal in which business continuity is a real operational challenge.

3. Reorient management teams and if necessary quickly change them. Resist the temptation to delay difficult decisions and to protect so-called sacred cows among the management team.

4. Integrate operational management and change management into daily business activities rather than approaching them as separate projects.

5. Company management must demonstrate strong leadership. Only when the top tier leads by example can the necessary changes be inculcated throughout the entire organization via middle management.

6. Don’t look for cookie-cutter solutions. The ultimate keys to success are (1) the rapid deployment of solutions tailored to specific situations and (2) the courage to act decisively when crunch time comes.
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