ELECTRIC LIGHT & POWER

INDUSTRY REPORT

ON DEREGULATION AND COMPETITION

Reaching for the gold ring: Mergermania in the utility business

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Recently on CNBC's business program, "Power Lunch," a stock market pundit proclaimed that the frenetic merger market was beginning to slow down. At the end of his interview, he added one caveat: "Except for utilities." Mergers in the utility industry, he said, will be the hot spots of merger activity in 1998 and perhaps beyond.

More than 57 percent of mergers fail to reach intended goals

Indeed, American utility companies are facing the most aggressive merger boom in history and this activity shows no sign of letting up. As the forces of deregulation continue to push the industry toward open-market competition, utilities see mergers as their best opportunity for gaining competitive advantage.

Expectations aside, the true and final measure of a merger's success is the bottom line. And while mergers may seem to offer greater profitability, the reality is that a merger can also expose a company to dangerous vulnerability. The failure rate is high. The facts are sobering. Conservatively, more than 57 percent of all mergers fail to reach the goals management had hoped to achieve. Even worse, this sizable failure rate also reflects the number of companies that, after merging, fall behind their own industries in terms of return to their shareholders.

Photo by Hasi Vogel

Myron J. Beard

Additional data supports this dismal record. Three years after a major acquisition, the average shareholder value isn't upæit's down 16 percent. Even worse, in three out of four cases, the earnings of firms that had merged were less than the sum of the earnings of the two firms separately. It's no wonder that the stock prices of an acquiring company typically fall immediately after the deal is announced. Utility mergers are somewhat more successful.

These failures have prompted utilities to become more sophisticated in their planning. In order to provide data to assist in this planning, RHR International surveyed a sampling of utility industry leaders nationwide about their own mergers. Preliminary results of the survey indicated some good news as well as some bad news for utility mergers. On the positive side, survey respondents pointed to four improved outcomes from completed utility mergers. First, respondents felt that the merger had improved the reputation of their company within the industry. Second, they felt the merger had increased their company's competitiveness. In addition, respondents also believed they had achieved some consolidation of operating processes and that by merging their company had increased its market share.

Unfortunately, the financial results these utility leaders reported were not positive. Not surprisingly, merging did nothing to improve the debt of the utility and that, in itself, reduced their financial leverage—the capital they would need for future transactions, new technology and growth. Stock value of the merged companies remained flat or actually decreased. In addition, respondents felt that the mergers had decreased their speed to market for products and services—a slow-down that also resulted in lost value.

In short, a full 47 percent of surveyed utilities reported that they had failed to realize the financial targets they had counted on. This news is encouraging only in comparison to the 57 percent failure rate seen in mergers in general.

Seeking out the cause

Many merger experts claim that because acquisitions are so often aggressive, the resulting hostility keeps the newly merged entities from being able to work together—a situation that ultimately leads to failure. But hostility was not a factor in the utility mergers reported to RHR. In fact, the majority of respondents to the survey said that their mergers were cooperative. So the question remains: if utility mergers are so frequently mutual and cooperative, then why do they fail to reach their financial goals?

The answer is that a company's increased value following an acquisition hinges on the success of the company—how well it functions—after the merger. Increased value is directly related to how well the two companies can integrate their people and their processes. Even so, 85 percent of the managers of failed mergers from the general merger population reported that the cause of their company's failure was the "unresolved post-merger differences in management style and practices." It would seem, then, that planning how to manage these differences should be one of the most critical elements for setting the stage for a smooth and successful merger integration. But the fact is that only one company out of every five spends adequate time creating a strategy for implementing integration.

Despite their somewhat improved rate of success, even utility companies aren't immune to this neglect. Utility leaders who responded to our survey indicated that they, too, had failed to plan sufficiently for the effective integration of the two companies.

The race

After you sign the papers, it's a race for your company's life.

Why is planning for the integration of the merger so critical to its success? Because once the papers are signed, everything happens at break-neck speed. A merger doesn't gradually increase the pressure on existing systems. It sends the company into shock. In the initial aftermath of signing the purchase papers, roles become blurred. Confusion and miscommunication run rampant. There's fear and anxiety at all levels of the company. Policies and personalities clash, and in the ensuing chaos, productivity and customer service inevitably suffer. Key employees who are vital to the success of companies often leave. If companies are not lucky, they can unwittingly offer severance packages to some of their most impressive talent.

That's why it is the early transitional stage—the first 100 days after signing the deal—that is most critical to the later success of the company. Leaders must act quickly and decisively to protect the value of the company or resign themselves to losing value. But with a staff overburdened with the effort of running the new company, no one really has the time (or the expertise) to make the merger work.

This isn't a worst-case scenario. Based on RHR's work in helping companies manage their integration process, it is a typical scenario. All the problems the two companies had before the merger will be augmented by the new problems that have developed because of the merger. The longer it takes to handle those problems, the worse they will get.

A blueprint for success

The survey uncovered several key barriers to a successful integration. To make these discoveries more meaningful, a look at the processes that must be undertaken in a successful merger should be made clear. Having assisted in the implementations of numerous mergers, RHR views integration as an ongoing process that involves four general areas of activity. Refer to the figure for a pictorial explanation of these activities.

The first general area is pre-acquisition. Before the transaction is consummated, the purpose and strategy behind the merger or acquisition should constantly be kept in perspective. The risk is always there, especially in a hostile situation, that egos will come into play. When that happens, the decision to continue in a merger can become more an issue of emotion than analysis and solid judgment. When companies can maintain their perspective and stay grounded in business strategy even in the face of momentum they will be better able to know when to walk away from a deal.

As indicated earlier, as much planning as possible should be done before the merger is an accomplished fact. It's also important to develop an action plan that envisions what the strategy driving the acquisition will look like when it's played out three to five years down the roadæin short, a merger "road map." One benefit of the road map is that it should describe not only the company's capabilities but management and leadership competencies as well.

To be prepared for the merger, the acquiring company should designate two teamsæan executive team and a transition teamæwhose function is to spearhead the most important and immediate challenges the merged company will face. The transition team will be called upon to implement changes immediately following the merger. The executive team, on the other hand, must make immediate decisions about leadership changes within its own company. These should be based on the company's strategies, goals and expectations.

When RHR assists a company in selecting its leadership during a merger, the company first helps the executive team clarify what the new company must look like (how it must function) if it's going to meet the company's strategy. Based on that strategy, a "Profile of Success" is formulated. This profile is a picture of the traits and characteristics the new leaders and managers should have if they are going to be able to effectively support that strategy. When this profile has been completed, RHR (or the company itself) can evaluate managers and leaders against the needs of the new company. The Profile of Success is a potent tool for helping the company make rapid, informed decisions about executive potential and capability. Other evaluations should also be undertaken. Whenever possible, the cultures of the two companies should be assessed before the merger in order to evaluate their compatibility and identify future obstacles to the integration. The infrastructure should be also be evaluated. It's essential to know if the existing systems for information services, operating and finance can adequately meet the demands of the larger organization.

One company out of every five spends adequate time creating a strategy for implementing integration.

The turbulent transition

The second general area of integration activity is the transition phase. After the merger, the integration will move into a transitional phase. The goal in this turbulent time should be to protect productivity by capitalizing on the energy and momentum created by the transaction. Decisions should be made quickly. Leaders should be put into place rapidly. In addition, the company should look for ways to make "quick hits" that inspire confidence. Remember that the acquired company is always going to be skeptical. Its managers will be wondering about the competency and future of the new company.

That's why it's always up to the acquiring company to make some positive rapid changes. The acquiring company should look for "low hanging fruit" that will let it demonstrate that this is a merger that is going to work.

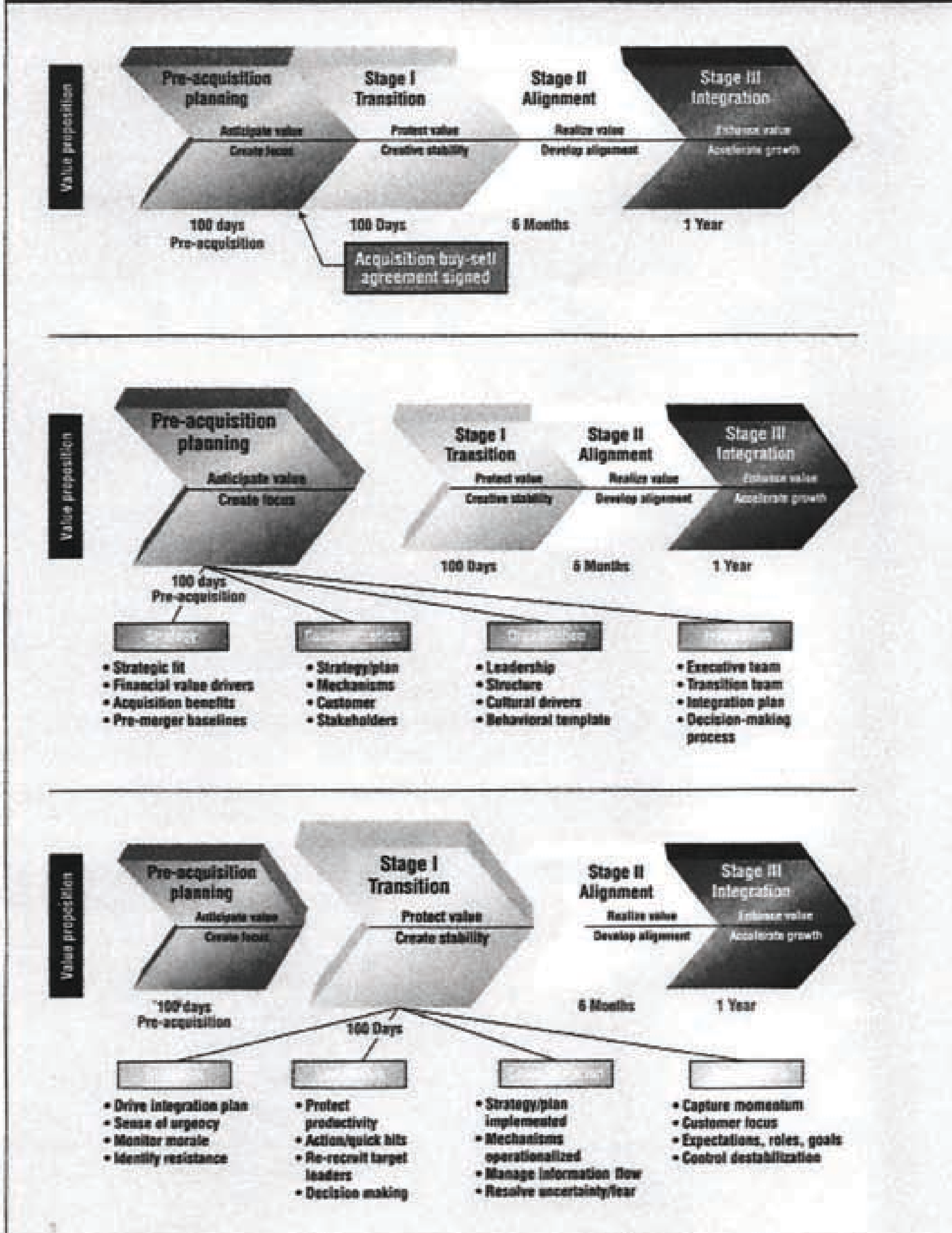
The importance of quickly establishing a clear direction for the company cannot be overstated. Understanding direction is not only necessary for the executives who are steering the ship; it's essential to allay the fears and confusion of everyone in the company. The longer people worry about who is going to be fired, the more distracted they will become and the more they will lose productivity. In the same way that the acquiring company evaluated its leaders before the merger, the merged company should now evaluate leaders from the acquired company. The measurement tool should again be the Profile of Success. Once the evaluation has been accomplished, leaders and operations people from the acquired company should be added to the existing executive and transition teams. At this point, it's also important to evaluate gaps in the company's work force through a formal talent gap analysis. This will not only detail the capabilities the new company is lacking, it will provide a much-needed blueprint for hiring.

A brief word on downsizing is appropriate at this point. Does capitalizing on talent from both companies mean that a merged company shouldn't downsize? No. Efficiencies of scale almost always demand it. But downsizing alone can never save a company unless it is handled in ways that support the corporate strategy.

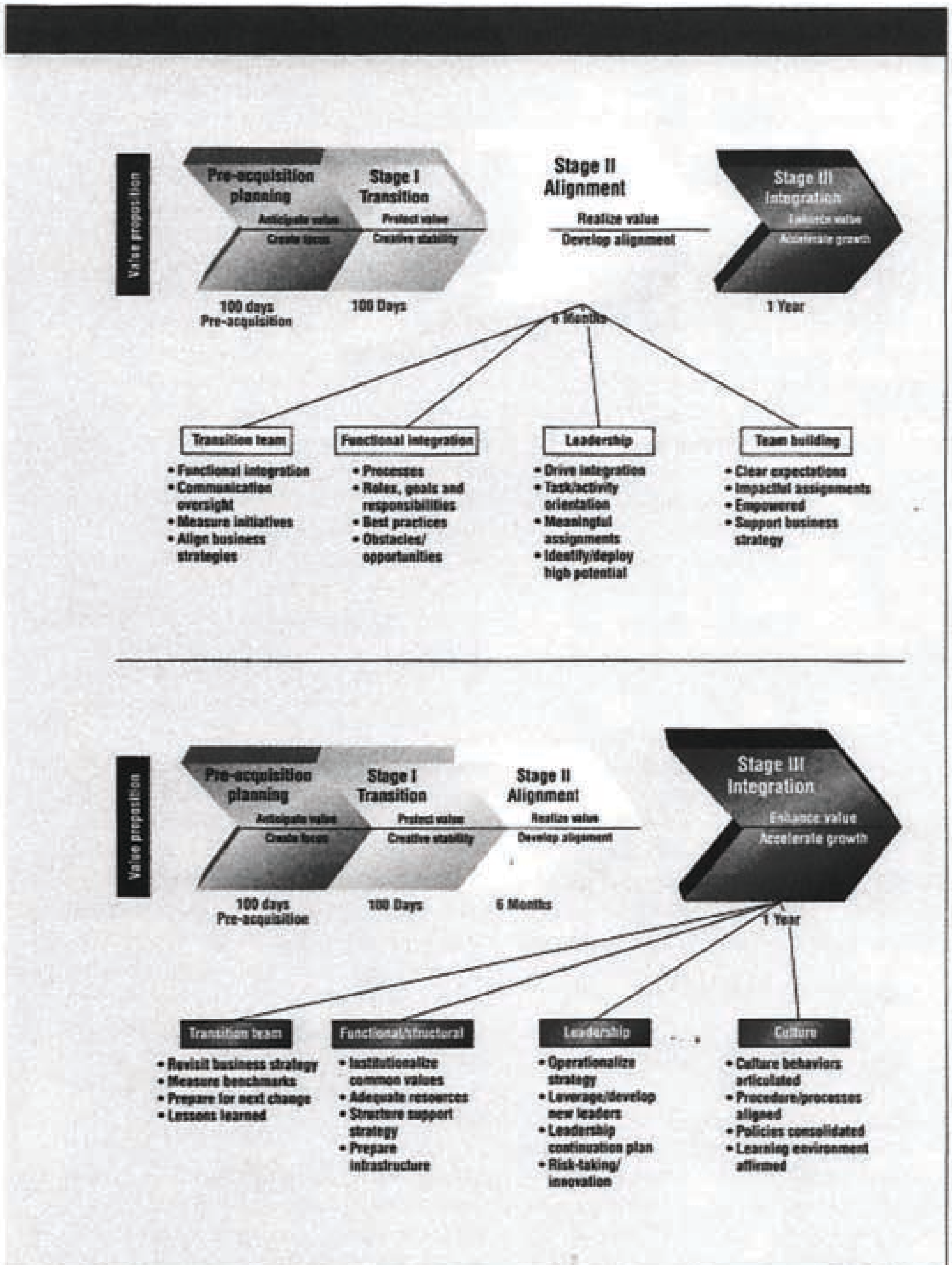
Instead, companies often downsize by simply firing managers and employees in the acquired company. This practice is based on the notion that "since we bought them, our people must be better than theirs." But it is usually a serious mistake and it keeps a company from realizing synergy. In fact, it's essential that the newly merged company retain key people from the target organization who are familiar with the processes that made that company desirable for acquisition in the first place.

The third general area consists of the alignment phase, which should occur within the third and sixth months following the merger. It is in this phase that companies can realize the value of their acquisition by aligning the processes, systems and people of the two companies.

The Merger Integration Advantage™—A simplified view



In this phase, focus groups and task teams should identify the best practices in the merged company and enhance them. The reason the transition team should be made up of operations people from both companies is to ensure that the company is able to identify and incorporate the culture and processes from the target company. The purpose of this work should be to cut costs, eliminate or reduce redundancies in the company's processes, and look for synergistic practices. It is an important task that will give representatives from both firms a chance to reevaluate the way they have been doing business and improve their effectiveness. It should not be forgotten that the participants in these teams are also busy with other work. To keep implementation from being delayed,



the teams should be monitored. Deadlines, goals and incentives should be used to drive the process forward.

In this period, problems will begin to crop up, too. Often companies merge with the goal of consolidating functions and decreasing the number of managers. The result is that managers who were competent in their old jobs are now faced with greater responsibility and larger numbers of direct reports. For many, it's a set-up for failure—and those failures negatively impact the company. Executive coaching can be very effective in helping these managers move into their new jobs. It can help them learn to delegate; move from tactical to strategic thinking; broaden their focus from detail to big-picture thinking; and make decisions rapidly with less data. The value of executive coaching is that it lets managers expand their skills more quickly than if they were merely learning from experience. In addition, coaching can help the executives and leaders that are now running the new company develop the traits and behaviors that will help the company meet its strategic goals.

The fourth general area of integration activity is the integration phase. After the first six months, the company should begin to look like an integrated whole. In the early phases of merger integration, leaders are, figuratively speaking, removing the rocks from the mine. Here, they can brace and widen the shaft for greater capabilities. If growth is the company's strategy, the company should prepare management and its infrastructure systems for rapid future growth. Computer systems, for example, should be evaluated as to whether they can take on additional growth. Managers and the next generation of managers must be prepared to effectively accommodate new growth activities. At this point, leaders should also revisit their original strategy to incorporate changes based on the present reality of the business. This evaluation should dictate whether it's appropriate to take on new acquisitions and growth.

Barriers to success

When utility executives were asked to reflect on their mergers, they identified four significant barriers to successful integration of their company.

1. **Resources.** Utility leaders said they had grossly underestimated the load that merger activities would put on their functions. As a result, necessary resource allocations were not made, and members of functional areas found themselves working long and hard without clearly understanding why. By overburdening areas such as sales, marketing and finance, the speed of the integration was slowed, employee morale was damaged and value was lost.
2. **Leadership.** Although top management was in place early on, the merging utilities in RHR's survey did not deploy people to manage all aspects of the transition. This failing may have been caused by a lack of familiarity with all the many tasks that are necessary for a good integration. Most managers have never worked through a

merger; in fact, they may never go through that process again. If they have vague notions about what has to happen, it's difficult for them to assign specific jobs. Another leadership problem was that transition teams made up of representatives from both the acquiring and the target organizations were usually not appointed in a timely fashion. This omission made managing the integration of operations much more difficult. Nor did the companies perform formal talent gap analyses, which are essential for describing the skills missing in the new organization. The result was that managers were forced to hire blindly, hoping for a talent fit, but unable to know definitively if they had found one.

3. **Regulatory issues.** Surveyed utility leaders often said they had had unrealistic notions regarding regulatory and legal issues. They underestimated the complexity of the demands of regulatory agencies and overestimated the speed at which their mergers would be approved. Typically, they were unprepared for the lawsuits and appeals that can block or slow the merger.
4. **Cultural differences.** Cultural differences in these mergers were a particularly difficult barrier to overcome. The survey reflected a critical area of neglectaethe companies did not do cultural due diligence. That is, they did not assess the two cultures and evaluate their compatibility. This was a significant and glaring omission considering that one of the primary reasons for convergence mergers is to take advantage of the synchronicity of the different approaches to running regulated and competitive businesses.

The corporate culture

"Organizational culture," according to organizational theorists Warner Burke and George Litwin, is "the way we do things around here." Even though this definition is a simplification, it's a hard one for many industry leaders to grasp. "We don't have a culture," they often say. "We just see what needs to be done and we do it." But the fact is that every organization does have a culture. Culture is simply the broad term for the behaviors that employees use to accomplish their work and the expectations that they have about the company's response to them.

Clearly the behavioral characteristics that lead to success in a traditional electric utility are very different from the success characteristics of a deregulated gas marketing company. Leaders and employees of an electric utility, for example, are responsive to regulations. They have an incremental approach to solving problems and tend to be satisfied with the status quo. They avoid risk, think tactically and are respectful of hierarchy and tenure. Note that these are not negative traits. They are simply the approaches to work that are effective in a regulated environment. On the other hand, leaders and employees of a contemporary gas marketing company are market driven. They approach problem solving with an entrepreneurial attitude. They take risks, think strategically and are respectful of impact.

These conflicting approaches to business lie at the core of a typical convergence merger scenario. Traditional utilities want to develop a culture that encourages competition because they want to be successful in a deregulated industry. Entrepreneurial

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utilities seek the customer base and the image of stability and permanence that traditional utilities bring to the table. The assumption is that the two cultures will rub off on each other. Theoretically, it seems like a marriage made in heaven. But in reality, the clash can lead to impatience, discontent and loss of productivity.

Since mergers are infrequent, it's hard for company people to have expertise in making them work. In most mergers, key integration processes—particularly those involving "people issues"—simply aren't done. Perhaps it's because they seem "too soft" to worry about. Perhaps it's because people are overworked in their newly expanded jobs and no one in the company has the time to do them. Certainly it is also because most people don't know how to do them.

Mergers, after all, are infrequent events. For most people involved, it is the first time ever. Even when companies have acquisition as a strategy for growth, mergers are not done on a regular basis. By the time the next merger takes place, experienced people have left or have simply forgotten what they learned before. Companies can speed the integration process by using consultants who are schooled in facilitating interpersonal issues, enhancing teamwork effectiveness and executive coaching. Using consultants to assist with important merger events may also be cost effective. At the conclusion of one integration handled by RHR, the vice president of human relations calculated that his company had realized a 40-to-1 return on its investment in consulting services.

The implementation of a merger is critical and it is also difficult to do it well. At the very least, merging companies should make sure that they are adequately resourced in terms of people and technology and that they have adequate merger integration infrastructure (teams, etc.) in place. And, if an electric utility is merging with an unregulated gas company, the companies should be sure to focus on people issues. If people are not focused on, all of the financial support and systems in the world won't make a newly merged company run the way it should.

Editor's Note: Myron J. Beard, Ph.D. is RHR International's merger and integration practice leader and senior consultant. RHR is a business consulting firm comprised of organizational psychologists. For more information about the data contained in this report, the results of RHR's utility survey or merger/implementation case studies, please contact Dr. Beard at [illegible]