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Human Capital Due Diligence

The Failure

The cross-border merger of Daimler Benz and Chrysler in 1998 was to be the perfect union of carmakers, where financial and structural examinations of the companies showed that successful synergies were a matter of course. The public was informed about how the new German-American organization DaimlerChrysler would benefit from the compatible technical solutions, wide product portfolios, and geographically covered markets resulting from the merger. From the consolidated annual report of 1998, it says that the mission was to "integrate two great companies to become a world enterprise that by 2001 is the most successful and respected automotive and transportation products and services provider". This was to be accomplished by "constantly delighting our customers with the quality and innovation of our products and services, resulting from the excellence of our processes, our people and our unique portfolio of strong brands".

As probably understood by the overly promising build up, it did not fold out exactly as it was planned. In fact, the merger did not only fail to live up to its optimistic mission, it actually ended up becoming a public failure. The reason was the false promise by Jürger Schrempp, Chairman at the time, saying that it was a "merger of equals". In reality, it was a collision of two incompatible cultures, and a deal that would never have taken place if all information was known, according to Schrempp himself a couple of years later.

What was found specifically was that the companies had completely different views on how the people of the merging companies should be integrated. In addition, both companies lacked the willingness to sacrifice their deeply embedded habits, for the well-functioning of the combined corporation. Klein, former manager of corporate communication at DaimlerChrystler, had a few things to say about these differences.

Firstly, he pointed towards the problem-solving processes, where the detail-oriented and structured process of the Germans at Daimler Benz clashed with the unstructured, thought-to-be creative process of the Americans at Chrysler. Secondly, he brought up the way the two parties made decisions. At Chrysler, the presentation of ideas was done informally, and the managers' decisions did not require much explanation nor involvement of other colleagues. The German approach, however, was slower and more controlled, where you were bound to prepare thought-through reports and present them at formal meetings. Thirdly, the people of the merging companies had different views on work ethic. Some German managers argued that the Americans did not devote the time necessary to finish the projects, while the Americans pointed at the bureaucracy of the Germans making their working time less efficient.

It is safe to say that many un-thought problems rose post-merger when these differences became evident for the managers. Not only did this lead to misunderstandings, but it also contributed to a growing frustration. The Germans became irritated by the Americans' lack of structure and uncontrolled processes, while the Americans thought that the stiffness and overly formal way of working of the Germans was restricting and unproductive. The naïve mindset of executives assuming natural synergies and integration of processes led to the realization that these differences had to be accepted. As a result, the two sides started to organize separately, just like the situation pre-merger. The promising words in the annual report of 1998 did not get lived up to, and the merger was in the books as a massive failure.

The neglected focus on people-related issues in M&A activities and its underestimated consequences has not only hurt DaimlerChystler. This phenomenon is not explicitly a reality of merging carmakers. Nor global corporations. Nor companies with completely different cultures. Hiding in the shadow behind cases like this one are thousands and thousands of deals which main reason for failure is related to the integration of different people and cultures. Understanding the human aspect should not only be a recommendation, but an entry barrier, in company transactions.

Soft Factors, Hot Topic

During a due diligence process, essential legal and business aspects of the companies on the target list are considered. In general, the financial and commercial parts are evaluated in-depth, while the human aspect is far too often not emphasized to the same extent. David Harding and Ted Rouse, Advisory Partners at Bain & Company, point at the loss of great talent, culture clashes, and operational difficulties, as examples of the dreadful consequences arising from this. What is positive is that these effects can be mitigated by qualitative human capital due diligence procedures.

This aspect of due diligence is crucial for uncovering issues of one or more target companies, laying the foundation for a successful merger and a smooth integration. By other things, human capital due diligence will help identify gaps between capabilities and performance of teams and individuals in the target companies, points of friction within the organizations, and crucial differences between the merging companies in terms of things like communication and decision-making. These findings will help the acquirer make informed people-related decisions pre- and post-merger about the deal per se and operational actions to take when the deal is done.

The people issue in mergers and acquisitions is an increasingly hot topic and its importance has really risen to the surface in recent years. Still though, acquiring companies miss crucial focal areas which often lead to failures. According to studies, cultural integration was the second most common direct reason for failed mergers (Aon Hewitt, 2011). Also, the results showed that people-related issues are moderating factors on most other common issues causing failure. Hence, it is safe to say that these soft factors are worth dealing with.

Insights:

M&A and human capital

90% of companies loose market share by the third quarter following a merger

It is **40%** more likely to capture favorable revenue- and cost synergies if involving integration teams early in the M&A process

Cultural intregration is the **2nd** most common direct reason for failed mergers

Successful acquirers are **3x** more likely to identify key talent to target for retention in comparison with unsuccessful acquirers

Sources:
PwC (2020) *PwC's 2020 M&A Integration Survey*
Harding D., Rouse T. (Bain & Company, 2007)
Aon Hewitt (2011) *Culture Integration in M&A*

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Cohr's Core Reasons

For Performing a Human Capital Due Diligence

As concluded, people-related issues are crucial to take into consideration for maximizing the chance of successful mergers - and there is a lot of value waiting to be unlocked in the human capital due diligence process. The vision and purpose of an acquisition will heavily determine what specific aspects that should be the focus points. Regardless, there are always critical reasons for prioritizing this matter when looking to do mergers or acquire new companies - we have listed our main ones.

Managerial Structure

Looking at an organization from the outside, it is often quite difficult to fully understand which people are key drivers for a positive development. A thorough examination of the employees provides in-depth knowledge about direct and indirect leadership and who does and does not contribute with value to the organization in alignment with its long-term strategy. Identifying these parameters in the human capital due diligence process helps executives determine who should stay, who should go, and who should take on new roles. Hence, it guides the strategy for the managerial structure of the combined business.

Retention of Talent

Loss of talent as a consequence of the uncertainty and organizational changes arising during the merger and in the integration phase, is one of the most critical problems in merger- and acquisition situations. Building upon the point above, it is as important to identify the key players as it is to retain them in the organization. Further, the talent that is considered critical for the future of the combined business needs special treatment early on. During the human capital due diligence process, personal information about internal motivational drivers, responses to incentives, and future ambitions, lays the foundation for a successful long-term talent retention strategy.

Aviodance of Conflicts

Merging two or more organizations with different ways of coordinating work is almost meant to create points of friction resulting in a decline in productivity. To mitigate this problem, executives need to understand how decisions are made and how communication takes place, in more depth than the simplified picture given by organizational charts. To find the real and practical information of potential merging companies, it requires analytical human capital assessments. For example, authoritarian vs democratic decision-making, professional vs personal communication, and individual agendas/political ambitions, are areas where identified differences are of highest essence when setting the plan for a smooth integration.

Deep Knowledge

The core of human capital due diligence is to get insights of the people behind the companies. Deep knowledge about personality profiles and competencies enables informed evaluations when finding and creating optimal teams. Also, details about personalities and group dynamics will guide the appointed managers to deal with situations on a micro level. Preferably, the information should be gathered from multiple sources and tackled from different angles. To get a complete picture of the key people that will be dealt with, a combination of measures should be used on an individual, team-based, and organizational level.

Identification of Red Flags

A consistent focus area of the human capital due diligence process is to find and identify potential red flags. Details about individuals, group dynamics, and the general condition of the company might give rise to unavoidable measures. For example, there might be conflicts within a management team that need to be addressed. Another scenario could be that illegal or unethical behavior takes place within the organization, having to be brought up to the surface. Finally, red flags could be about the general state of operations and the overall outlook for the future of business, undisclosed earlier in the process.

Act of Professionalism

Performing a human capital due diligence is really an investment in both the people of the target company and the combined business in case of a merger. In addition to the reasons mentioned above, this investment establishes the foundation for a strong and trustful upcoming partnership. By showing this sense of seriousness when making decisions in the merger and acquisition process, it also sends out a message of professionalism to additional stakeholders.

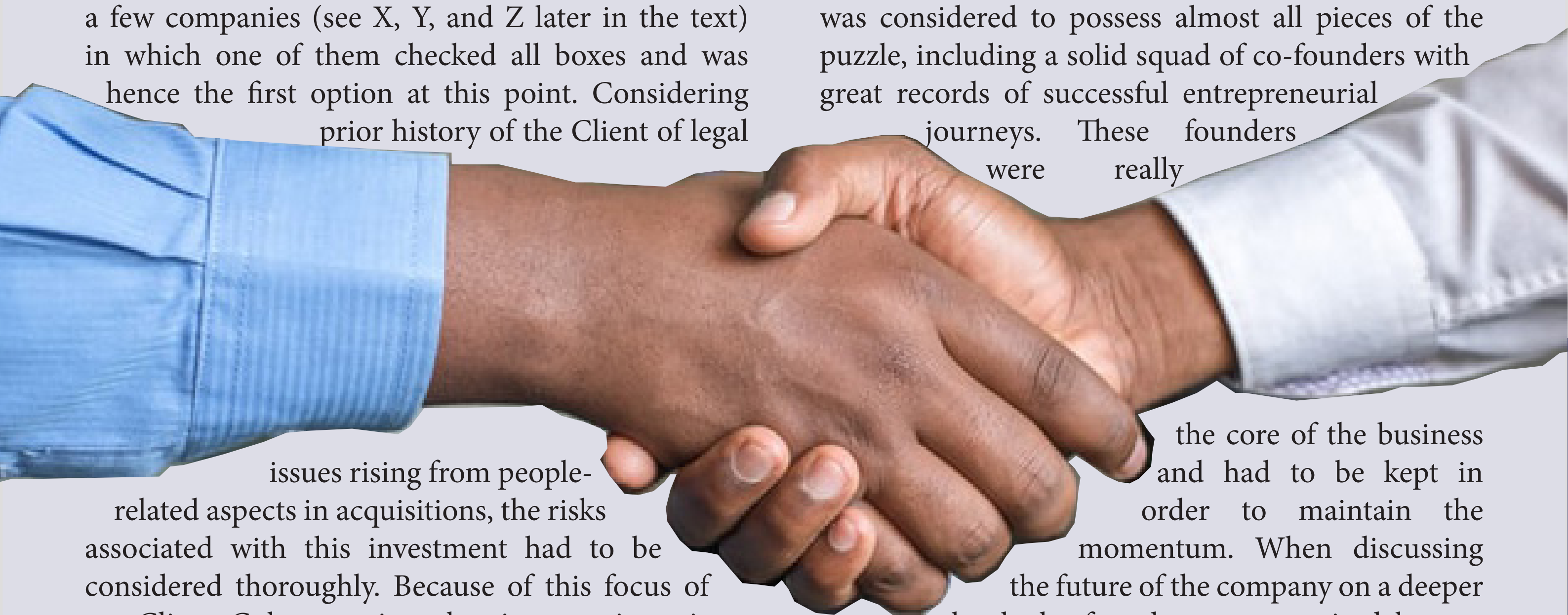
Expertise is Needed

Understanding the pillars of human due diligence helps structuring the thoughts related to people issues in merger and acquisition situations. When dealing with people-related due diligence processes, however, there is no fit-all procedure since organizations are complex and individuals are willing to share information to different extents. Here, there are many business-relevant topics that easily get forgotten or remain undisclosed, but which must be covered in order to make fully informed decisions. With that in mind, there is a need for a structured and well-functioning method of human capital due diligence that managers use to dive into the deeper questions that only the people of the organization knows the answers to. In addition, system-critical information about the management team and its members is lost if not analyzed from a psychological expert's point of view. For example, addressing neurobiologically constructed patterns reveals the true expected behavior – when executives are experiencing control, but more importantly, when they are experiencing pressure. The aftermath of a deal most often means considerable changes to governance, operations, and in many cases, the management constellation. These are circumstances where no one involved can predict the exact outcome, not least the company executives. As such, the data gathered when performing a psychological investigation provides insights that will enable the foreseeing of how the new conditions will be met and ultimately handled, bringing to light how well matched the company management is with the strategic goals of the acquisition or merger.

One of Cohr's Cases

A few years ago, Cohr Group helped a large European client seeking to acquire specialized expertise and technological solutions with the purpose of entering a new market. From research performed by its internal M&A team, a couple of smaller entrepreneurially driven companies were put on the target list as potential central actors. All of these had interesting technical solutions which from the outside seemed fitting with the strategic vision of this new initiative.

With help from external consultancy firms, a due diligence process began starting with the focus on the technical and financial aspects of the targets. From thorough analyses, the list was narrowed down to a few companies (see X, Y, and Z later in the text) in which one of them checked all boxes and was hence the first option at this point. Considering prior history of the Client of legal issues rising from people-related aspects in acquisitions, the risks associated with this investment had to be considered thoroughly. Because of this focus of our Client, Cohr came into the picture to investigate the human capital dimension of the targets. Our findings later turned out to shift the whole situation and end up being the driving factors for the outcome of this M&A process.



Our approach in a situation like this is to look beyond the actual target companies. First of course, we ensure that we get an understanding of how the target companies work today from a holistic perspective. More importantly, however, we investigate how the integration of potential acquired companies into the organization of the client would function under one roof. In this particular case, the key aspects were shown to include the personal risks and conflicts of interest within the targets' management teams, the internal motivation of its managers, and the companies' attitude toward a potential merger with a large corporation such as our Client.

Prior to Cohr's involvement, company X seemed like the optimal option for our Client to acquire and the one to be centrally responsible for the acceleration of the initiative. Unfortunately, a major issue arose during the due diligence. This problem was grounded in managers having interpersonal engagements outside of the company and being involved in external assignments, that were not suitable for the particular industry. In this case, it implied a massive legal risk for the Client that could not be overlooked.

Next on the list was Y. This was a company that was considered to possess almost all pieces of the puzzle, including a solid squad of co-founders with great records of successful entrepreneurial journeys. These founders were really the core of the business and had to be kept in order to maintain the momentum. When discussing the future of the company on a deeper level, the founders got surprised by our comprehensive assessment and analysis during the due diligence process. What we managed to uncover about these business journeys was the inherent drive to continue along a pattern of quick exits with the founders leaving quickly post-transaction. These insights were complemented by qualitative tests and more interviews – indicating a high probability of the history repeating itself even in this case. Since our Client needed loyalty and expertise in this area to drive the product field forward, this was seen as too big of a risk.

During the human capital due diligence, company Z displayed people-related risks on a more acceptable level than the other targets. More importantly, we found great potential for a successful integration with our Client. Z's employees at the development team were extremely motivated to make the product perfect but didn't have the resources necessary to go all the way. The passion for the product and the need of assistance from a larger partner, together with the cultural match when considering the identified underlying emotional preferences and patterns, reduced the risk of friction in case of a merger. In addition, Z had a passionate founder who was knowledgeable in all different areas of the business. Moreover, he had a well-developed emotional intelligence and an understanding of the behavioural patterns in his organization. This added the potential for a highly successful integration since he could be a critical asset in the acceleration of this new product area for our Client. Largely influenced by the findings from the human capital due diligence, the M&A process ended with our Client deciding to go through with the acquisition of Z.

Since the acquisition, the initiative has accelerated at a high pace. Not only did this happen just because of the choice of the "right" target, but just as much because of the preparation for the integration. The collected information of the target and the transparent communication between the merging parties made it smooth and efficient. When Cohr entered the due diligence room, nuances were added that otherwise would have been overlooked. This resulted in an added crucial focus on soft values beside the numbers. In addition, it drove the integration process to become characterized by transparency, genuine relationship-building and grounded motivation in the way forward.

While all parts of the evaluations that take place during M&A processes are important, the human aspect is often one that determines whether or not the excecution will live up to the ambitions of the deal. We take pride in being part of this important area of business and look forward to providing valuable advice to many other clients in the future.

> "Cohr has the professional psychological knowledge without losing the business side of the assessment. This ability is crucial when making pinpointed evaluations on critical executives in due diligence-processes and in that aspect Cohr is the leading company on the market and the reason why we use them.
>
> - Managing Director of a client

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Since 2002, Cohr Group has acted as a strategic partner for Investment Organizations and Corporations in their M&A activities with a track record of 160+ deal involvements. Our well-proven due diligence process of in-depth analysis of the human capital enables smooth and successful acquisitions and integrations. The services include assessments on Individual, Team, and Organizational levels that investigate leadership capability, team cohesiveness, organizational maturity, and potential red flags, providing valuable data before making decisions. For Cohr, successful M&A processes of our clients are of the highest essence. Therefore, we work in close partnership before, during, and after the merger, often including additional advisory on certain matters during the holding period, such as the selection of critical recruitments, management development, team alignment, crisis management, culture integration, and engagement & transformation programs.

We act at the intersection of business performance and neurobiology, holding niched expertise about psychology in combination with business acumen, where our teams consist of experts in Psychology and Business to Statistics and Behavioural science.

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