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Mergers & Acquisitions…

Believe It or Not, Opportunities Still Exist

Can mergers or acquisitions be successful in today's market? Certainly, with the right combination of due diligence and precise assessment and matching of each party's resources and capabilities. The only way to address today's many challenges is through a strong strategic vision, and the ability to foster positive change through communication.

BY TOM WAJNERT AND STEVE SHERMAN

Compared to the acquisition frenzy of late 1990s, the past year's leasing industry merger and acquisition activity is marked by fewer transactions and a spirit of caution and conservatism. The prevailing economic climate has been a factor: capital equipment investment has been sluggish; in turn, overall lease volume has declined. Much of the recent activity has been of the "trading" variety with "parents" offloading leasing units due to changed strategies or distressed circumstances. In addition, there are fewer independent lessors to be counted among the Monitor 100 than there have been in the past.

It's a good time to be a buyer — if you can find a motivated seller. Valuations are down for leasing companies. Prices ran from a discount to 100 percent of net receivables or 135 percent of book value as compared to the multiples of two times book or more in the past. Many investors have been cautious, taking a hard look at opportunities in the market, and demanding terms that protect buyers from potential risk, demanding high return for their money. Companies are buying lease portfolios rather than entire organizations or divisions to minimize downside.

Does this portend negatively for the industry? We don't think so. Consider the current climate to be an investment, not a trading, environment. Companies are much more realistic in evaluating opportunities, managing their prospects and rationalizing their cost structures. In this period of pragmatism, people are focused on having the flexibility to maintain viability while the economy recovers, so they can target building share in areas where they have a strategic advantage.

There is always opportunity for new entrants and a place for strategic sales and acquisitions. Consolidation is occurring outside the Monitor 100 — so you're seeing the Monitor 100 companies of the future gathering momentum now. Independents are raising capital from private equity firms and other sources to fuel organic growth as well as consolidating smaller players to posture for strength in their targeted niches as the economy recovers. Exit plans are being delayed by several years.

Among the Monitor 100, specialty lenders, banks and thrifts (including leasing companies held by banks and foreign leasing companies) were the predominant buyers in 2002's M&A market; with reported values of these transactions ranging from $5 million to $2.3 billion. During the year, there has been an up tick in investment by private equity firms in this sector — a reaction, perhaps, to counter the results of some of the riskier technology and healthcare plays in their portfolios. Sellers include: strategic lessors focusing their businesses on their most attractive segments; captives and finance companies which are focusing their capital investments on their core businesses.

Some of you reading this article today may be part of a merger by the time the next Monitor 100 issue is published. You may be the merger's initiator, its architect or change leader in the new organization. With this potential in mind, it is helpful to consider some of the reasons why companies merge, some of the road hazards involved in integrating two organizations, and above all, the criticality of managing change effectively.

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Why Merge?

Let's first consider the sell side. A lessor may seek to be acquired to meet increasing needs for equity and debt capital. Or the company's owner may seek to monetize his or her equity stake. Many companies may be forced to divest a leasing company in order to ration limited capital and focus on their core business.

While all buyers acquire leasing companies in order to grow profitably, they may employ either or both of the following strategies to achieve this goal. First, they may simply add assets by executing a portfolio purchase. In the second strategy, the buyer seeks synergies with the new company that can add value to the overall entity. A synergistic buyer looks for a complementary business; one that creates new opportunities for growth and/or that create economies of scale through operational integration.

Integration Issues

It's worth a reminder that the leasing industry is a hands-on business with multiple functions contributing in concert to the business' success. Not all acquiring companies (especially if they are outside of

the industry) understand how important all of these functions are and how they need to work together. We may be tempted to integrate leasing companies into a larger, diversified "umbrella" organization where they fail to flourish — no matter what level of financial, HR, technological resources — the acquiring company may offer. Perhaps a year or two down the road the acquirer has a change in direction or corporate mood and decides the leasing business is no longer a strategic fit. Corporate goals may over shadow the needs of the leasing organization. The distraction may cause disruption between the sales, credit, asset management, treasury and corporate management organizations of the lessor. This causes internal issues and eventually has a negative impact on operations and customer relationships. In today's competitive environment, the functions within a leasing organization must work together seamlessly within hours to book a new lease and continue to coordinate through the life of the lease. Disruption of this unified focus can lead to loss of customers, or increased risk for the business.

The reasons to merge may look good on paper, but beyond the numbers and "vision," a host of integration issues must be addressed. Here are some operational issues to consider when aligning two companies with one vision.

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Human Resources

Cultural integration is never easy. There's always the challenge — whether it's through reduced headcounts or increased workloads — of having to do more with less. The transition needs to be managed by the head of the organization and coordinated and communicated throughout the business. People need to embrace the fact they are now one organization. Ideally, this process begins during the acquisition process, before the transaction is consummated. During the transition, it is more important than ever to clearly outline and communicate the organization's goals and objectives. Departmental communication channels need to be established to ensure that business issues are resolved quickly with no cost to customer service or employee goodwill. Selection, performance appraisal, compensation, and training and development programs all need to be aligned. Formal activities that demonstrate support for the new organization without favoring one group of employees or another can be important to the process of melding a strong common bond. In the merger of CIT and Newcourt, for example, each company agreed not to simply bolt-on either company's policies and procedures without analyzing the appropriateness and viability of such action. Policies and procedures were analyzed in light of the total company and mutual changes were made with the result being somewhere in the middle of the two cultures.

Planning

Planning begins before the initial talks, not after the deal is complete. While sellers will retain counsel (legal, investment advisor, tax, etc.) buyers are less inclined to seek advice. This may be unwise. This is especially true if the buyer is outside of the leasing industry or new to a specific market niche but also true for seasoned lessors with a good understanding of the niche. All transactions generate issues. Buyers need impartial advice not only on the technicalities of the transaction detail, but also on alternative ways that transaction issues might be approached. Many buyers within the industry will conduct their own due diligence in an effort to save money; but cutting corners can be painfully expensive in the long run.

Information Technology

This is another area where the "doing more with less" mantra will resonate. IT costs have been cut, yet adding a new business requires additional work and potentially additional capacity. A strong transition plan is critical. Most companies will map records from the system to the permanent system, then run both systems in parallel until the transition is complete. Some businesses will continue to operate multiple systems especially for remote and international entities. Accommodation will need to be made for management, accounting, tax, marketing, treasury, funder, investor, customer and other constituent needs for information from the system.

Sales and Marketing

The challenge of combining sales organizations is to provide consistent customer/ vendor service at an acceptable level of cost. To deliver on this objective can be difficult while combining sales and their support organizations. Customer communication must be clear that the change is going to bring additional benefits and no disruption to the service quality. All reasonable efforts should be made to deliver on that promise. Beyond the customer service issue, the goal is to increase revenue while maintaining, or lowering the cost of sales. If the products of the two companies are the same, but the customers or the vendors are different, then lowering the cost of sales without hurting customer service is the goal. If the acquisition brings new geographic coverage to the firm then the goal is to grow revenues by offering your company's full line of services to the customers in the new geographic areas of expansion.

Accounting & Reporting

The trend towards more conservative accounting conventions is prevailing, with gain on sale especially affected. While gain on sale treatment is not disappearing entirely, its use is being significantly reduced. Relatively new requirements governing goodwill are also driving change in the way acquisitions are being evaluated.

Treasury

The availability of capital is the life blood of this business. Transactions are being scrutinized by sources of capital as well as by rating agencies to determine both the availability and the eventual cost of capital. The current capital constrained environment favors transactions that open new sources of capital to the acquirer with potential to enjoy a lower cost of funds.

Regulatory Issues

Folding an independent into a regulated entity (such as a bank) requires not only additional operational support to ensure compliance but may present challenges in the way business is done or drive a cultural shift for employees of the lessor.

Credit Policies

Changes in underwriting standards and requirements may be frustrating for the acquired company's employees, vendors and customers. Acquirers need to be clear in communicating their expectations of portfolio performance, as well as consider how a shift in risk appetite may affect future customer and vendor relationships and volume.

Cultural Integration:
The Ultimate Deal Maker or Deal Breaker

Managing change is probably the most fundamental issue for the success of any given merger or acquisition. Most acquisitions that fail do so because of people related issues, not because of the business model. Wells Fargo Leasing CEO Jim Renner, interviewed for a fall 2001 white paper authored by The Alta Group says, “If we can’t integrate the people then we will pass on the entity. We have to be comfortable with those already in place.” According to Renner, a pattern occurs in most acquisitions. Getting through the phases described below is key to success, and is, perhaps, the greatest organizational challenge.

- A honeymoon period in which everyone works together, and tries to determine the direction of the culture.
- A period of frustration with the changes that are occurring creating the potential for resentment to appear.
- A time of questioning: people start to ask whether they fit within the new organization in months six through 12. Their psychological contract with the old company has been broken so they either have to make a new contract with the new culture, or leave the organization.
- Eventual normalization: the new culture has generally taken over. Those that have adapted stay on and those that have not adapted generally have left. The new hires view the culture not as a new culture but as the existing culture.

Effective communication is probably the most important catalyst for facilitating successful change. In order to quell employee concern about change, the challenges of integration and their livelihood, communication by all levels of management must be immediate and frequent, and focus on the real business issues resulting from the acquisition. Some effective methods of change communication include:

- Group and “one on one” meetings by all levels of management.
- Demonstration that the integration issues are being handled quickly and in a fair and equitable manner that places the business, customers and employees first.
- Articles in employee newsletters, intranets, e-bulletins.
- Stewardship of sensitive information — maintaining a proactive approach to media relations on the outside, squashing rumor mills on the inside.
- Encouraging active participation by those affected — focus groups and transition teams, matching employees with their counterparts as soon as possible and providing, as much as possible a collegial environment to foster productivity and a positive attitude.
- Events — town meetings, in which the new culture and organization are explained, can give focus to efforts and allowed people to voice concerns over various facets of the change.

One notable example cited in The Alta Group’s white paper was the acquisition of U.S.-based Tokai Financial Services by Dutch finance company De Lage Landen (DLL). DLL’s strategic motivation was to become a truly international commercial finance company. DLL’s vision included fully integrating the business lines throughout the world, thereby creating additional synergies. To facilitate the TFS integration DLL flew 250 people from the U.S. to the Netherlands for a week-long meeting including numerous familiarization activities, corporate events and dinners. “Could the TFS integration and information dissemination have been handled in other ways?” Authors John Deane, Shawn Halladay and John Nachbin say, “Certainly, but the process left no doubt in the minds of the employees that every effort was going to be made to integrate them into the clearly international DLL organization.”

Can mergers or acquisitions be successful in today’s market? Certainly, with the right combination of due diligence and precise assessment and matching of each party’s resources, capabilities and expectations. Each scenario presents new challenges due to a plethora of strategic, financial and operational issues, all of which are colored by the philosophies of two different cultures. The only way to address these many issues is through a strong strategic vision, and the ability to foster positive change through communication. *m*

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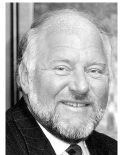

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RESOURCES:

“Integrating Disparate Entities: Organizational Aspects of Mergers and Acquisitions,” Shawn Halladay, John Deane and Joe Nachbin, December 2001. Available at www.thealtagroup.com.