Untangling Product Complexity in M&A

Addressing complexity before it strikes

M&A is a powerful instrument. Acquiring another company is often the fastest way to gain access to complementary technology, channels and other critical assets without the risks or travails of organic growth. However, only 50 percent of mergers actually increase shareholder value. Why? Often, one of the culprits is product complexity. Companies that manage the complexity of a newly combined product portfolio can capture value, smooth the overall merger process—and deliver the full promise of M&A.

M&A is a well-known avenue for improving competitive position. Consider the acquisition of PeopleSoft by Oracle to gain access to customers and channels; the buyout of Organon by Schering-Plough to increase its large-molecule R&D capabilities and increase its product pipeline; and the merger of the Burlington Northern Railroad with the Santa Fe Pacific to realize scale-based operational efficiencies. Mergers and acquisitions are likely to increase in the current economic climate, as companies that weather the downturn will be on the prowl to acquire weaker companies on attractive terms.

In theory, M&A achieves value through top-line and bottom-line synergies. Top-line opportunities include cross-selling, product line extensions and gaining access to new channels and customers. Bottom-line synergies include rationalizing assets and capital, improving productivity, and improving sales, general and administrative (SG&A) costs.

However, numerous studies suggest that mergers only have a 50 percent likelihood of achieving a sustained increase in shareholder value. We believe that a key and often overlooked culprit is increased product complexity, the result of combining two companies' products and services and the processes necessary to manufacture and deliver them *(see sidebar: Why It's So Tough to Manage Product Complexity)*. Effective complexity management, challenging enough under normal circumstances, becomes both more crucial and more difficult during a merger or acquisition.

Managing Product Complexity Can Pay Off

Addressing the underlying complexity of the combined product (and process) portfolio is at the core of M&A success. Cost savings is one reason: A company can cut costs by up to 30 percent as a result of complexity management *(see figure 1 on the following page)*. Let's

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FIGURE 1: Potential complexity management savings

Segment	Automotive and industrial products	Chemicals and process industries	Consumer goods	Financial services
Product development	10%-30%	3%-10%	3%-10%	5%-15%
Purchasing	5%-15%	3%-5%	4%-7%	5%-10%
Production	10%-20%	3%-5%	3%-5%	10%-20%
Logistics	5%-20%	3%-5%	3%-5%	
Sales and marketing	3%-5%	3%-5%	4%-7%	4%-7%

Source: A.T. Kearney

examine the advantages of properly managed product complexity:

From a bottom-line perspective, well-integrated product portfolios result in better-utilized manufacturing facilities, consolidated sourcing of raw materials and components, and streamlined production processes. An infrastructure that supports multiple products and variants also benefits other functions. For example, since the company does not require more sophisticated control and reporting systems, it needs fewer IT investments. Maintaining an integrated manufacturing footprint is less costly, and supporting fewer technologies or standards also requires fewer investments.

From a top-line perspective, the impact is more subtle but equally important. For example, a simpler combined product range creates less confusion among salespeople. Confused salespeople often sell the products they know instead of those that increase the value of the new combined company.

Why It's So Tough to Manage Product Complexity

Why is managing product complexity so difficult during the M&A process? There are three main reasons:

Product complexity is often overlooked even before an acquisition is decided. Few companies preemptively manage their product portfolio on a sustained basis, either because they lack the tools to understand their true product costs, or for fear of hurting profitability by retiring older products.

Mergers exacerbate the complexity challenge, by amalgamating new products, services, assets and processes in a daunting mix. Managers are fearful of making rushed decisions to simplify this mix that may harm future performance.

Management lacks incentives to tackle portfolio complexity early on in the merger process. To show rapid value creation, the executive leadership generally focuses on low-hanging fruit with a proven track record of synergy, such as procurement or SG&A rationalization. At the same time, leaders are generally careful to show respect for the products of the acquired company as a sign of goodwill, thus delaying product rationalization.

A clear plan for product integration across companies also makes customers less nervous: Will our product continue to be supported? Will we have to change dealers? What about the upgrades we were counting on? When these issues are resolved, customers are less likely to switch to a competitor (trading performance for predictability).

Moreover, properly managing product complexity offers benefits for the broader M&A integration. When product complexity is contained, companies experience fewer quality issues, manufacturing delays and customer complaints. Management can focus on accelerating returns from the new combined business, rather than the squabbles that often occur when two companies struggle to integrate.

Don't Wait for Day One

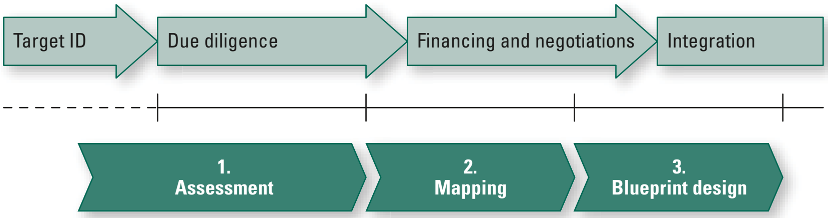
Creating a product complexity management blueprint *before* M&A officially begins is vital. Armed with the blueprint, leadership can be ready before the post-close integration, when a flurry of tactical and emergency matters tend to engulf most companies.

Before developing the blueprint, it is a good idea for the company to assign ownership for the complexity management effort to an individual leader from the acquiring company, supported by a small team.

Once this team is assembled, the company is ready to begin the M&A complexity management process *(see figure 2)*. This approach helps both companies exchange information and prepare integration opportunities, while also remaining compliant with legislation before the deal is officially closed. Even companies that are restricted from

FIGURE 2: Complexity management timeline

M&A planning timeline



Source: A.T. Kearney

interacting in the pre-merger phase can use a "clean room" to strengthen and accelerate their integration planning. Integration teams may wish to host a series of synergy summits to build relationships and plot product portfolio integration strategies.

The following offers more details of the three-step process:

Mapping. The M&A team develops a map of product complexity for the acquiring company and the target company, simultaneously. This map creates a picture of the universe of product variations, options and subcomponents for each firm.

Although mapping may seem easy, we find that only a few best-practice companies, even in manufacturing, maintain a complete and current view of their product and component variants and combinations *(see sidebar: What the Leaders Do Right)*. A detailed map ensures that these companies don't underestimate the complexity of their product portfolio—a widespread problem in manufacturing, and even more so in service industries where there are no SKUs to identify a particular service.

The map also accounts for future product changes and new products in various stages of development.

Assessment. Once the product universe is mapped for each company, product variants are assessed to create a database of "product profiles" that is used to identify best-of-breed products, components, functionalities and cost elements. The database also captures the consumer view of products, based on customer switching history, price sensitivity and category growth projections, which helps determine which products are must-have instead of merely nice-to-have.

The assessment allows the organization to see the end-to-end "cost picture" of any product. This picture cuts across P&L and reporting lines and is often the first time the organization can assess the true cost of complexity.

Blueprint design. The product profiles are the foundation of the integration blueprint. For all products

What the Leaders Do Right

Managing product complexity, difficult enough under normal circumstances, becomes even more challenging during the turbulent M&A process. Yet, best-practice companies are able to handle these issues effectively. There are four traits that the leaders share:

Address common M&A issues early. Leading companies anticipate and plan for M&A risks such as lack of M&A experience; entrenched resistance to rationalization on either side; or the acquirer's reluctance to quickly launch a critical product review for fear of destroying goodwill toward the acquired company. Ideally such risks are considered when creating the original business case for the deal.

Understand reasons for complexity and its impact. Best-practice companies are fully aware of the complexity of their products or services and employ complexity management initiatives that usually uncover many more product or service variations than the company was aware of. In fact, variant trees designed to graphically represent products or services variations never fail to astonish executives who thought they knew the extent of their product portfolio inside-out.

Increase transparency. Lack of information and data transparency at the enterprise level hinders executives' ability to measure the firm's product and service complexity. The best firms uncover buried data from across the IT systems of different departments and use it to create a platform for effective data synthesis and analysis. Enterprise-wide transparency provides a thorough view of the complexity landscape.

Own the complexity management process. Product complexity often has many masters, with little perspective on their interplay. A best-practice company makes a point to assign owner(s) to the complexity management process. In so doing, complexity never slips through the cracks of the due diligence process.

planned to be part of the combined portfolio, this blueprint defines the optimal combination of components and features, and corresponding cost-to-serve.

The blueprint has an *outward focus*, factoring in market coverage, product substitution and customer preferences; and an *inward focus*, accounting for cost and performance data on the product portfolio. Finally, a detailed scenario analysis is used to quantify the impact of the blueprint as it relates to the merger's value-creation objectives.

A key advantage of this approach is that it develops an objective, comprehensive view of product complexity and its associated costs and performance impact across both organizations. This avoids cultural and perception biases, and the preferential treatment of the acquiring company's products, which are all too common in M&A.

Losing Complexity, Gaining M&A Value

Managing product complexity adds tremendous value to a merger or acquisition. Companies that engage in this process early will see multiple benefits: cost savings from well-integrated production processes, increased revenues and profit potential from the product portfolio, and in-depth collaboration between the acquirer and the acquired. Ultimately, successfully managing complexity will ease the integration process and increase the odds of a successful merger.

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