

**SWP 54/91 "INCREASING THE EFFECTIVENESS OF
MERGERS AND ACQUISITIONS WITHIN THE
MANAGEMENT CONSULTING INDUSTRY"**

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ABSTRACT

Considerable activity in M&A within management consulting firms has occurred recently. Consulting firms pursuing rapid growth, expanding their services, and increasing their international activities are exposed to a number of key growth options. This paper provides an overview of these options and explores how management should plan their acquisitions strategically.

INTRODUCTION

An avalanche of mergers and acquisitions has swept across the management consulting industry during the last five years. The intensity of this activity has been driven by rapid pursuit of growth not available through organic means. This has reflected the general M&A trend across all industries, with the decade of the 1980's having the highest level of merger activity in history.

However the overall general record of industrial companies' acquisition success has been disappointing and the rate of divestment has dramatically increased. The depth of this problem is illustrated by a recent study on the diversification record of 33 very large US companies over the period 1950-1986 (Porter, 1987). The study found most of these companies had divested more acquisitions than they had kept and the corporate strategies of most of the companies had dissipated instead of increased share-holder value. Evidence of the poor record of acquisition success is wide-spread (eg Asquith, 1983).

Further support is provided (Hunt, 1990) that "takeovers are at best an each way bet". In a sample of 40 cases 55% were very successful or successful, while 45% were either disappointing or very unsuccessful as assessed several years later by people involved. Other M&A experts believe that one-third of all corporate marriages are outright financial failures and three-quarters fail to fulfil the desired objective (Reed, 1989). In a recent study by McKinsey of cross-border M&A (Bleeke et al, 1990) 16 cases out of 28 were described as successes. Although this was a poor result it represented a higher success rate than expected. It points out that success was mainly achieved where the cross-border acquirer purchased targets in its core business. Another study suggests that investments involving diversification into unrelated business are perceived as being more risky (Kitching, 1973). This supports the view that acquisition in closely related businesses is most likely to succeed.

In a study by Hitt, Hoskisson and Ireland (1990) the trade-off between growth by acquisitions and managerial commitment to innovation is discussed. They point out that if acquisition serves as a substitute for innovation, the energy and attention spent on the activity may effect managers' time and risk orientation. Because of these effects, managers may reduce their commitment to innovation which can, in the long run, represent a significant threat to the firm.

Management consulting firms form part of the professional service sector. This sector is one that merits special attention because it represents the confluence of two of the most important trends in the economy: the growth of the services sector and the emergence of the 'knowledge worker' (Doorley et al, 1988).

Disappointing performance from firms acquiring within the professional services sector, including management consultants, has paralleled the industrial experience. For example Cresap, McCormack & Paget which was originally purchased by Citibank was later sold. In legal services 80% of mergers do not measure up to the expectations of the partners (Cobb and Garrett, 1988). After the merger mania which swept through the Swedish accountancy sector in the 1980's, Sveiby & Lloyd (1987) describe the 'morning after' effect and note that several firms had to call in consultants to assist them in getting the firms running smoothly again.

On the other hand Marsh & McLennan (an insurance broker firm) have successfully acquired a range of consulting firms including William M. Mercer, Temple, Barker & Sloane and Strategic Planning Associates and have now become one of the world's largest consulting firms. Even 'one-firm firms' such as McKinsey & Co., who have traditionally grown solely through organic growth, have entered the acquisition race through the acquisition of ICG (Information Consulting Group) from Saatchi & Saatchi).

In the light of these mixed results from M&A activities both in general and with respect to professional services firms this paper examines the role of M&A in consulting firms. As professional services firms have much in common, experiences from other professions as well as consultancy are included where appropriate. The paper commences by exploring growth options within professional services firms and proceeds by exploring the strategic role of M&A. It develops a framework by which consulting firms can strategically manage their acquisition activities in order to gain enhanced economic value from them.

GROWTH STRATEGIES AND M&A

In the 1980's the British advertising agency, Saatchi & Saatchi, initiated a major campaign to build a global consulting conglomerate. Saatchi diversified into management consulting initially by hiring Victor Millar, the highly respected head of Arthur Andersen's consulting practice. He then embarked on a strategy, by acquisition, to 'create the world's pre-eminent business services company'. By 1989 Saatchi shares had fallen from £7.00 in 1987 to £2.60 and the empire's acquisition campaign was coming apart faster than it had been assembled. This included the divestiture of the Hay Group through a management buy-out.

A number of explanations for the fall of the Saatchi empire have been put forward. Doorley (1990) claims that Saatchi did not obtain scale economies because scale benefits do not accrue so readily to professional services firms. While unit costs do decline early on as office size increases, at a very low scale threshold costs no longer continue this scale-related pattern. This is evident in a number of the larger consulting firms. Another explanation for the missing success of the Saatchi strategy is their service and marketing concept. The full-service concept 'one stop shopping' has a certain logic. However, practice shows that most clients want the best. These clients do not believe that they will get the best, across all services, from any one firm and they are prepared to purchase services from different providers. In addition, a very large company has many individual "clients" who will buy management services in accordance with their specific needs and knowledge of the consulting markets. These 'clients' often have considerable freedom in choosing consultants. A third explanation given is that the price level of the acquired firms was too high. The resulting borrowings may have placed too great a pressure on the firm thus not allowing time for the strategy to work.

The ambitious growth plans of Saatchi's Millar conceived consulting as a \$70 billion industry providing a wide range of professional advice and assistance. Millar's vision of consulting may be more important and enduring than Saatchi's ambitions (Pringle, 1990) as it represented a sea-change in how consulting is perceived. The definition of consulting has undergone change. It has been transformed from a narrow definition of 'management consultants offering independent advice in a number of identifiable and discrete areas' to a much broader definition of 'consultants to management' who include a wide range of

professional service firms. The latter definition has now been adopted by the Council of Consulting Organisation. The information technology business is a case in point. Initially viewed as a business totally separate to mainstream consulting, its growth rate has consistently outstripped all other sectors of the consulting industry and it now represents an estimated 25% or more of the consulting sector.

It is undoubtedly the growth prospects accompanying the broader definition of management consulting which have fuelled the ambition of so many firms to look beyond internal organic growth and consider the acquisition path. It is not only rapid growth sectors such as information technology which have attracted firms' attention. A number of developments are changing the global perspective for consulting. With the advent of Europe 1992, representing a total a market of more than \$5 billion, and potential developments in Eastern Europe, Russia and China, many firms are looking to achieve growth through capitalizing on opportunities in these markets. Merger or acquisition has frequently been the path advocated to enable fast penetration of multinational markets. The area of greatest activity will be Europe where the stage is set for considerable further merger activity. A recent poll by KPMG Peat Marwick found 62% of companies surveyed indicated they are actively considering merging or acquiring another European company (Kirkland, 1988). The increasing M&A activity by companies generally will present considerable opportunities for many consulting firms.

When looking at the 20 largest management consultancies in the US and the UK in 1990 it is notable that almost all the firms have obtained their growth - in a predominantly flat market - from M&A activities.

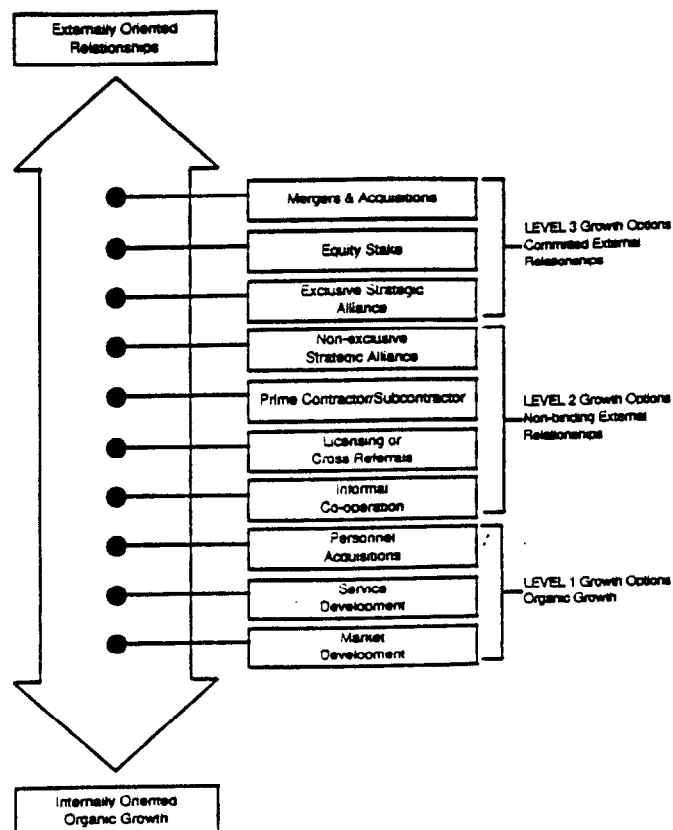
The intensity of professional service firm merger activity has led many firms to view M&A as a key strategy for their firms. However merger is not a strategy. Mergers and acquisitions are tools to implement growth strategies, global expansion in key markets and product lines to meet client needs (Management Consultant International, 1990). Consulting firms need to review fundamental business strategy issues before leaping head-long into a possibly regretted merger. For example, one view of the failed Arthur Andersen and Price Waterhouse merger is that they may have done themselves (and their clients) a big favour by avoiding a sized-obsessed firm which might have resulted in inefficiency, escalating costs, lower morale and client defection.

Amongst the reasons for not obtaining the benefits of M&A are the differences in culture between firms. Frequently conflicts between different cultures are unavoidable, even when the two groups are members of the same profession. Sveiby & Lloyd (1987) argue that it is surprisingly how often the managers are caught by controversies that blow up after a merger. This may well be because they rely too much on the rationale of synergy for mergers. It should be realised that personal chemistry between the two groups of most senior professionals in the acquirer and acquired firms is of major importance.

GROWTH OPTIONS

A decision to grow by M&A, or otherwise, should be predicated around a sound business strategy not the pursuit of economies of scale which may not materialise. A consulting firm should carefully review the growth rate appropriate to its strategy. Having identified the required target growth, the firm must review the strategic growth options, and decide on which are the most appropriate. Figure 1 shows a continuum of growth options available to a consulting firm consisting of three broad levels.

Figure 1: Growth Options for a Consulting Firm



Level 1 growth options are organic ones and include market development, either in terms of entering new market segments or geographic regions through internal growth, or service development through their introduction of either service extensions or new services, or a combination of both. Personnel acquisition of a team or individuals from other firms is a further option to provide organic growth.

Level 2 growth options involve some form of non-binding relationship. At the most modest level these include informal cooperation with other firms in areas such as staff rotation and sharing training facilities or ad-hoc joint marketing. A more developed version of this is a cross-referral programme where work is referred to another firm on the basis on the referring firm not having the geographic presence, skills, or capacity, to undertake a particular assignment. Further development of such relationships can lead to a prime contractor/subcontractor relationship on an on-going basis or a non-exclusive strategic alliance to attack a particular market or unlike complimentary skills, systems or expertise.

Level 3 growth options include formal strategic alliances where firms contract to work exclusively with one another to perform specific activities on an exclusive basis, undertake a minority equity stake in a firm (Bott 1990), or at the furthest point from organic growth, acquire or merge with another firm.

Should a consulting firm pursue market or service development and organic growth, perhaps through progressive acquisition of individuals and teams from other firms, or should it pursue some form of non-exclusive alliance? Should it merge, acquire, take an equity stake or enter some form of exclusive long term arrangement? A firm pursuing growth should carefully analyse the pros and cons of each option as part of its corporate strategy before proceeding.

CONSULTING FIRM ACQUISITION FRAMEWORK

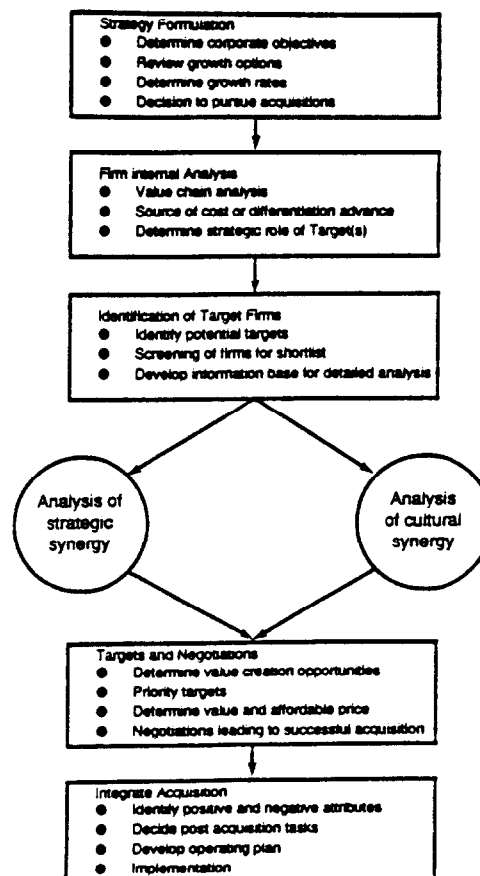
It is notable that the literature of M&A has almost rivalled the level of acquisition activity itself. However despite this large body of literature, relatively little of it has focused on M&A from a strategic stance. Of the acquisition literature that deals with strategy most of it focuses on specific aspects rather than providing an overall strategic framework for the whole acquisition process (eg Mallernee & Kirby, 1985; Pekar, 1985; Newton, 1981; Guiniven, 1985; Sveiby & Lloyd, 1987).

To guide M&A activity in professional service firms development of a strategic framework is appropriate to help improve success. In developing a framework a distinction between three levels of possible M&A activity is needed:

- 1) A 'traditional' merger where two firms join together as more or less equal partners
- 2) An 'investment' acquisition where the acquired firm is left with maximum independence and there is no requirement for integration with the acquirer
- 3) An 'integrative' acquisition where it is essential to gain synergistic benefits between the two firms

In Figure 2 a strategic framework for undertaking an integrative acquisition is shown. This form of acquisition is the most complex of the three levels of M&A because of the need, to integrate on a cultural and managerial, as well as a strategic basis. The framework to be followed for a traditional merger will be similar, but for an investment acquisition there will not usually be the emphasis on a strategic and cultural match between the two firms. Each of the major stages in the framework in Figure 2 is now examined.

Figure 2: Strategic Framework for a Consulting Firm 'Integrative' Acquisition



Strategy Formulation

For a professional service firm formulating and implementing a strategy Hodgart (1989) suggests four principal steps:

- 1) Identifying where the firm wishes to compete.
- 2) Defining how to gain competitive advantage in its chosen market position.
- 3) Implementing development programmes which endow the firm with the capability to execute this strategy.
- 4) Evaluating the result of its strategy and modifying it and its implementation in the light of changes in the firm's competitive environment.

A consulting firm should start by reviewing where it wants to compete and identifying its corporate objectives which may involve considering the following questions:

- What are its growth ambitions?
- What clients does it want to serve?
- What range of services does it wish to supply to them?
- Does it want to pursue clients on a local, transnational or global basis?

Growth is an essential element of a consulting firm strategy. Target growth rates must be identified and should relate closely to the staffing levels, organisational structure and promotion incentives. The required growth may be substantial. In an illustrative example, Maister (1982) points out that the firm considered must double in size every four years in order to preserve its promotion incentives. If it grows more slowly than this either the firm's incentive will be eliminated or the firm will grow into an 'unbalanced factory' (too many seniors and not enough juniors) - a situation into which many small and medium sized consulting firms have fallen.

A consulting firm needs to carefully consider all the growth options above as a path to growth. For an acquisition such care is particularly important as it is becoming increasingly difficult to locate firms which have a successful record and prospects and at the same time are financially attractive to purchase. Thus if

acquisition is the strategic option which the consulting firm decides to pursue it is essential to ensure economic value is achieved from it.

Similar considerations have to be taken when mergers are in focus. The basic question is whether it is possible to stimulate value creation through a merger - a point emphasized by Doorley (1989): "Merge for value creation - never for convenience". However, in looking at M&A in the consulting business it seems as if more firms should have had this statement in mind.

From a strategic perspective it should also be recognised that the traditional wisdom regarding competitive advantage that has been developed for manufacturing firms does not always hold for professional service firms. The demonstrable link postulated by Henderson (1979) between profitability and market share and scale effects does not seem to follow for professional service firms. A study by Doorley et al (1988) suggests that many professional service firms develop large scale-oriented activities as if the same principles apply to their firms. Their study shows that size seems to have less inherent value in professional services. Industry concentration rates in professional services such as management consulting, advertising, legal services and executive placement tend to be very low, and in their study of the advertising and legal service sector no evidence was found of a systematic relationship between size and profitability. This is supported by *The American Lawyer* in an analysis of the country's top 50 firms (Sveiby & Lloyd, 1987) which reported a conspicuous lack of correlation between profitability and size.

It is also clear the successful merger and acquisition should not be based on the follow-the-leader mentality apparent in many professional service firms. Rather M&A requires a careful assessment within the broader context of the overall strategy of the firm. This implies a thorough understanding of the firm and its context, including value chain economics and where competitive advantage can be gained through cost or differentiation drivers.

Despite potential problems associated with M&A in professional service firms, if rapid growth is sought acquisition is often the most attractive means of achieving it. However, M&A in consulting as a high risk approach (Doorley, 1990) and considerable care needs to be examined in undertaking it.

Therefore, five specific considerations must be addressed if the potential acquisition can be expected to produce lasting value (Singer, 1988):

- 1) Will the acquisition strengthen competitive position, adding skills necessary to penetration and segmentation within a medium-attractive to high growth professional services market?
- 2) Will managerial philosophies and human resource values produce a compatible and synergistic reorganizational climate?
- 3) Will the proposed acquisition be legally and financially feasible including enhancement to earnings, profitability or taxation benefits?
- 4) Will the acquisition result in opportunities to develop the firm's technical capabilities, build a new technology and experimental base or contribute under-utilized resources to sustain acquisition success and provide future business growth?
- 5) Will the acquisition contribute to the firm's risk management framework, lowering overall risk exposure, insurance premiums and justify returns per unit of risk?

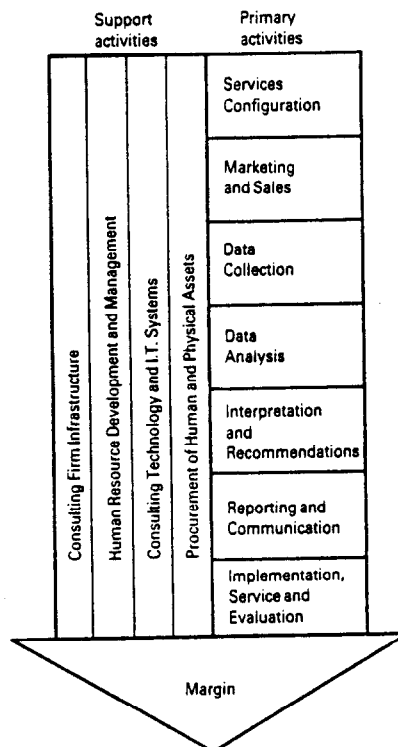
Firm Internal Analysis

Once the firm has considered the basic elements of strategy formulation in terms of growth, and made a decision to pursue an acquisition strategy it needs to review its existing business activities. An appropriate start for any organisation wishing to achieve sustainable competitive advantage is for it to clearly identify its activities which create value. These "value activities" are the building blocks of competitive advantage. The value chain concept (Porter 1985) provides a means of depicting an organisation as a collection of activities that are undertaken to design, produce, deliver and support the creation of a product or service. To achieve competitive advantage over its rivals an organisation has two choices. It must either produce comparable value to the buyer but do it more cheaply - a lower cost strategy; or perform the activities in a unique way that produce greater value to the customer at a premium price - a differentiation strategy (Porter, 1990).

Whilst the general value chain provides a useful framework for manufacturing firms it requires further

development in the context of the professional service organisation such as a management consulting firm. Based on examination of activities in a wide range of consulting firms, a value chain for management consultancy firms was developed and is shown in Figure 3. Each element of the value chain represents an area which should be investigated thoroughly to identify existing or potential means through which the firm can achieve cost advantage or differentiation advantage as a result of acquisition. Each area of the value chain should be reviewed to identify skills which may be transferable to (or from) an acquired company.

Figure 3: Consulting Firm Value Chain



The value chain concept may be used in several ways by a consulting firm:

- 1) The firm can use it to gain a clear understanding of its own value chain and where it seeks to gain sources of differentiation or cost advantage.
- 2) It can use it to understand where it fits in the value chain of its clients. If the client is a typical manufacturing company its value chain will be similar to that of the generic value chain described above. However, if it is a service business the firm will benefit from considering how the value chain for this services company differs from the generic value chain.

- 3) The value chain can be used to help identify the strategic synergy match between itself and the acquisition prospect.

Once the value chain and sources of competitive advantage are established the firm should determine the desired strategic role for the proposed acquisition. Reed (1989) suggests a general model for deciding the specific strategic perspective of the potential M&A. The model suggests six roles: service extension, market extension, free-form diversification, horizontal integration, vertical forward integration, and vertical backward integration. Most M&A activities in management consulting firms concern either their core business or related activities.

Identification of Target Firms

The process of identifying target firms includes a search and a screen process. This includes assembling a list of the potential players as well as conducting a preliminary analysis of the different firms. The key issue is whether the candidates on the list represent a good match with the corporate objectives of the acquirer. Sloane (1987) argues that too many of the mergers which have taken place within the consulting industry have been between weak firms. He further emphasized that a merger is not a cure to recover weak firms.

Experience suggests that many M&As have been triggered through personal relationships. However such relationships are not the pre-conditions for success. In the preliminary analysis, emphasis should be on the immediate strengths and weaknesses among the potential candidates. An important source in developing an information base for the first screen, and the later detailed analysis, is the informal network of the partners. Surveys should also be conducted and it is surprising how much information can be gained from a relatively few interviews. The data gathered about different candidates is the first step in the acquirer's due diligence process leading to an information base for detailed analysis.

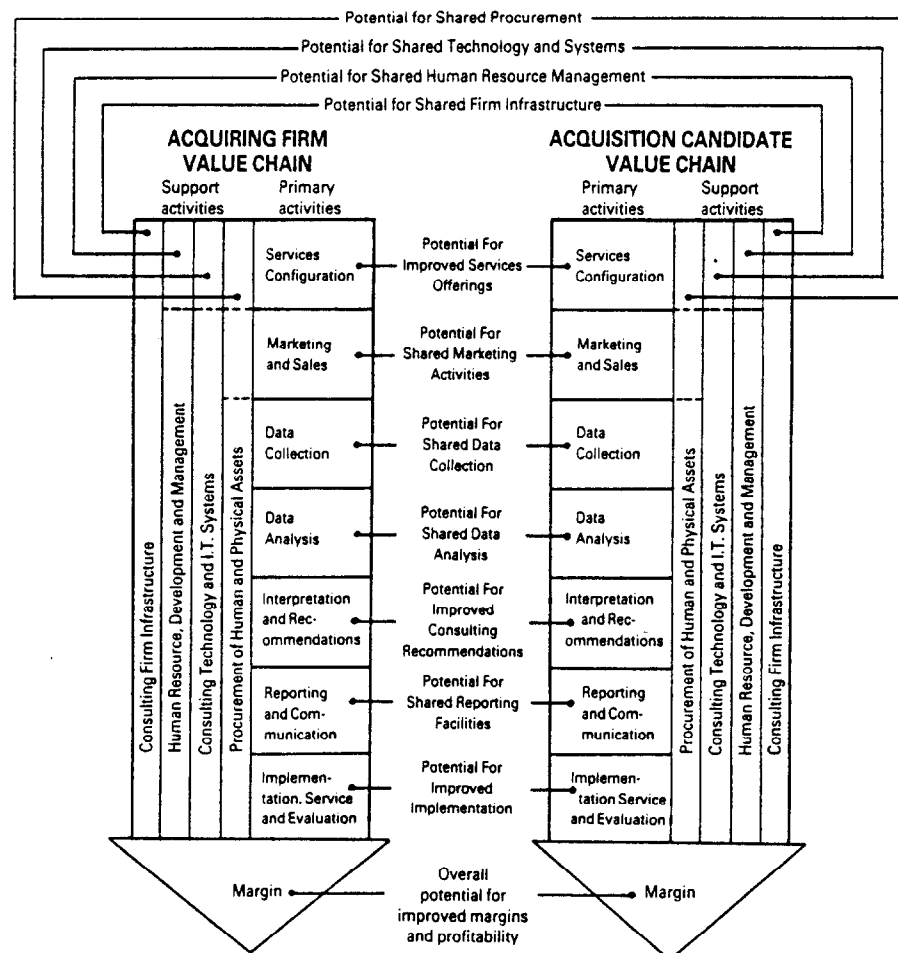
Strategic and Cultural Synergy

In evaluating a potential acquisition prospect it is necessary to consider both the strategic and the cultural aspect of fit with the acquisition prospect. We term these two areas **acquisition synergy** and

cultural synergy. Although recognising cultural fit could well be considered as part of strategic synergy we believe by identifying this as a separate and distinct issue to consider, greater focus and attention will be directed towards this. Justification for this is given by a recent study by Braxton Associates (1989-90) which showed over three quarters of the effort in making an acquisition goes into the 'front end' and only a quarter of the effort is expended on the integration and cultural aspects.

As discussed above the value chain concept can be utilised to explore the strategic synergy between two firms. Figure 4 shows the value chain for the acquiring and acquisition candidate consulting firms. The figure illustrates the potential for sharing and improving both primary activities such as the services offerings to clients and data collection, as well as support activities such as recruitment, training and firm infrastructure.

Figure 4: Identifying Strategic Synergy Between Acquirer and Acquisition Candidate Firms



Acquisitions which are strategically valid are those which strengthen the competitive posture of a firm in either a specific business or for their overall portfolio. It should follow that the firm's managers should have a clear understanding of both the potential of their own firm and the one to be acquired.

It should be emphasized that the strategic fit must be accompanied by a match in culture. The clash between cultures in merging firms is a major cause of high merger failure rate (Mitchell, 1990). A perfect congruence between the cultures of two firms is very seldom. One potential tool to map the profile of different companies is the cultural map (Clarke, 1987). The cultural map is used to portray key cultural dimensions relevant to a specific acquisition situation. Each dimension forms an axis of a spider-like web. The number of axes are determined by judgement as to which are the critical dimensions that need to be compared between the two firms. A quantitative or relative measure is then used to compare the profile of the acquirer and acquisition candidate, and the completed map shows visually the degree of fit between them. In successful mergers the culture web for both parts should have a profile that is complimentary, or at least not too contradictory.

Another model which can be used in order to determine the degree of cultural fit is the McKinsey 'Seven S' framework. This is a useful model for considering both the strategic elements (or hard S's) of strategy, structure and systems, and the cultural elements (or Soft S's) of shared values, style, skills and staff. The 'Seven S' framework is a powerful device for considering any change program within a firm and is especially relevant in considering cultural fit in a professional service firm. A careful comparison of all the 'Seven S's' can help to both identify the degree of existing match between firms and assist in the identification of change that may be necessary in both the acquired firm and the acquirer (Waterman et al, 1980).

Targets and Negotiations

Based upon the specific analysis outlined above a platform is established for making a priority judgement between the candidates as well as a preliminary valuation estimate. In this phase a key question is whether or not the M&A is financially feasible including an estimate of the potential profitability. Based upon a number of studies, Doorley (1989) points out that synergy is a word that is overused and under

utilised. Very often the expected profitability of M&A's is based on a too optimistic forecast and budget.

In this part of the process the more active negotiations can begin. Hunt (1990) notes that the tone (friendly, hostile) of those negotiations may be the most important influence on subsequent success and failure because of its effect on the negotiations. In addition expectations by both buyers and sellers are formed. The climate of the negotiations is also effected by what the dominant motive is behind the M&A. In a discussion of "why mergers do occur?", Trautwein (1990) emphasises motives of an empire building nature and are frequently dominant ones.

Finally, following a consideration of the above elements the strategic decision can be made regarding the desired acquisition target and negotiation entered into which lead, hopefully, to the desired acquisition being consummated.

Integrate Acquisition

It is suggested (Reed, 1989) that most merger implementation programmes fail because: no strategy to achieve synergy was developed; the merger was hotly contested; the parties then failed to manage the implementation transition; they failed to merge management skills; they failed to plan for organisational relationship such as integration mechanisms and rewards and incentives; or they lacked a supporting culture. Sveiby & Lloyd (1987) argue along the same line: "It is likely that the urge to merge in the agency industry will turn out badly. The mergers are handled by managers who are, for the most part, totally ignorant of the basics of know-how management". They add that "since merging knowhow companies is a paramount to merging people, the question such as growth strategy begs is to what extent it is possible to 'acquire' human being".

Malekzadeh & Nahavandi (1987) contend that a successful merger not only involves a thorough financial and strategic analysis and planning, but also planning regarding the two firms preferences regarding the implementation strategy of the merger. They suggest an acculturative model of merger implementation which encourages focus on the processes within the acquired and the acquiring firm. They also claim that conflicts are inevitable and that they should be managed.

The importance of developing an integration and implementation plan cannot be under-stressed. This includes various steps: identifying negative and positive attributes of both firms and how these will be addressed or built on; determining post-acquisition tasks; developing an operating plan for post-acquisition activity; and finally, implementation and continuous review. In addition to being comprehensive the plan has to be realised and managed. In too many cases the efforts, which have been put into the post M&A activities in consulting firms, have not been sufficient. Also it often turns out that too many key issues have actually not been clarified before the final decision and M&A agreement.

The structured approach outlined above should enhance, but will not guarantee, the chance of a successfully selected and implemented acquisition.

CONCLUSIONS

Management consultancies are professional service firms. Among their key characteristics are that they are knowhow-oriented, personnel and professional intensive, and often poorly managed. Further their senior partners sometimes behave like 'leading ladies' in a play, exhibiting prima donna behaviour rather than professional management. In general, the degree of strategic capability in professional service firms is much less well developed than it is in a traditional manufacturing company and their strategic direction is often weak because it depends on wide-spread rewards and sanctions (Greenwood et al, 1990).

Historically, many consulting firms have pursued expansion which relied solely on internally generated organic growth. However, in order to keep pace and expand faster, many consultancies have chosen M&A activities to capitalise on an expanded definition of what constitutes management consulting. However, the M&A process in many consulting firms has not been strategically managed with regard both to the pre and post M&A activities. Given this, it is important to recognise potential problems which can impede successful progress.

Whilst most M&A research is based on industrial companies, this paper proposes an acquisition framework by which a consulting firm may approach an acquisition strategically. 'Integrative' acquisitions

have been the area of principal focus as they represent the greatest challenge in terms of attempting to gain synergistic benefits from both strategic and cultural perspectives. The framework developed takes into account the essentially different characteristics of consulting firms.

With little research done to date on M&A in consulting and other professional service firms, a number of specific areas for possible exploration are suggested.

The high levels of M&A activity in consulting and other professional firms provide a large potential database for case study research on factors influencing M&A success and failure. Opportunities for research also exist in the area of international acquisition. There has been remarkably little attention paid to broader strategic issues and questions of international acquisition methodology. Harris & Nicholls (1988) raise several important questions including the philosophies, acquisition and country selection criteria, and categories of acquisition. These should be addressed in terms of professional services firms. The issues associated with partnership, where partners own the business, raises interesting problems. The dynamics of integrating an acquisition with many owners who are involved in both running the business and in the development and delivery of its services merits attention. Finally, the topic of developing a framework to help assess cultural match, especially in the international context, is worthy of examination. The cultural web described earlier represents an initial start in this but the development of more sophisticated and robust profiles and frameworks are needed.

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