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**Financial  
Institutions  
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*Creating Value in Post-Acquisition  
Integration Processes*

by  
**Harbir Singh  
Maurizio Zollo**

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*The Working Paper Series is made possible by a generous  
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# CREATING VALUE IN POST-ACQUISITION

## INTEGRATION PROCESSES

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After the Citigroup, the BankAmerica/Nationsbank and the Wells Fargo/ Norwest announcements earlier this year, there is very little that can surprise an observer of the US bank merger arena. Already this year, \$813 billion of deals have been announced in the US only, compared with \$920 billion during all 1997 (source: Financial Times, June 29). Banking is obviously taking the lion's share with close to 30% of the volume. Eight of the largest fifteen deals in history (worldwide) have been completed in the US banking industry, including the largest two. In spite of all this determination in pursuing acquisitive growth, however, the drivers for value creation in acquisition processes are far from being established. The CEO who looks around for advice is typically welcomed with truisms such as 'don't pay too much' or 'pay attention to integration'. Although the literature has

shown no value creation to the acquiring firm *on average*, the performance distribution has a very large, and largely unexplained, *variance*. This study focuses on post-acquisition integration decisions and on the mechanisms behind the creation of an organizational capability specialized in the management of integration processes. We believe, and the data confirm this belief to a large extent, that these two sets of explanations can supply the key to interpret the variance between successful and unsuccessful acquisitions, and thus to understand *how* value is created and *under what conditions* this might or might not happen. What you have in your hands now is a summary of the most important results of the study. We hope you find it as interesting as the study itself has been for us.

*Prof. Harbir Singh, Wharton*  
*Prof. Maurizio Zollo, INSEAD*

# Results

The research project focused the attention on three classes of explanations for the variation in acquisition performance<sup>1</sup>. Let's examine each in turn, detailing their effects (both direct and indirect) on performance.

## CHARACTERISTICS OF THE TARGET

Starting with the characteristics of the target firm, the two critical issues are the *quality of the target* (measured through the pre-acquisition performance level), and the *relatedness of resources between target and acquiring firm*. Relatedness in this study is measured through the geographical overlap of the markets served by the two firms (i.e. we distinguished between in-market and out-market acquisitions).

Somewhat surprisingly, resource relatedness does not seem to have any direct effect on acquisition performance. Both in-market and out-market acquisitions exhibit similar

chances of success, in spite of the fact that the primary mechanisms for value creation are different (cost efficiencies for in-market, revenue enhancement for out-market deals).

- **Relatedness of resources between target and acquirer does not affect performance.**
- **Quality of the target has a negative effect on performance**
- **Relatedness encourages replacement and integration, while quality discourages both.**

Geographic overlap, however, does encourage acquirers to both replace the top management of the target company, and to reach for a higher level of integration between the two institutions. We will see below that this has significant, albeit indirect, implications for acquisition performance.

The quality of the target has a negative effect on performance: it is easier to create value through the acquisition of poorly performing firms than it is by acquiring a good performer.

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<sup>1</sup> For this study acquisition performance was measured through the change in the acquiring firm's ROA between one year before the acquisition and three years after. The average ROA in the acquirer's geographical area is deducted at both points in time.

## POST-ACQUISITION STRATEGIES

The second class of determinants of acquisition performance refers to post-acquisition decisions. The attention here is focussed on two dimensions: (1) the level of *integration* of the acquired institution within their own organizational structure, and (2) the degree of *replacement* of existing resources within the target (in particular, its top management team).

The extent to which the target's top management team is replaced (a good proxy for overall resource replacement) negatively impacts performance. This result seems to indicate that the improvements that a new management team can introduce are more than offset by the disruptions in processes, routines and personal motivation that a change in leadership inevitably causes.

- **Replacement of leadership has a negative effect on performance**
- **Integration has a positive effect on performance**

The level of integration, on the contrary, affects performance positively: the value

creation potential inherent in acquisitions of the kind considered (essentially horizontal and market extension) can only materialize through the complete integration of the target within the acquirer's structure. Interestingly, the value created through the integration of the two organizations seems sufficient to offset the hidden costs and disruptions generated by the integration process, controlling for all the other factors (replacement, relatedness and quality).

## LEARNING MECHANISMS

Finally, learning mechanisms play an important role in our efforts to discriminate between superior and inferior performance. More precisely, companies can learn from past acquisitions through the tacit accumulation of *experience* (number and similarity of previous acquisitions) and through a more explicit process of articulation and *codification* of the lessons learned from acquisitions completed in the past. Knowledge codification manifests in this context in the creation of ad-hoc tools,

such as post-mortem documents, manuals, blueprints or decision support systems specialized in the various sub-tasks of the integration process and in monitoring their performance.

Both experience and codification have a positive effect on performance, but only under specific conditions. Experience improves performance only if it comes from very homogeneous tasks: in our case, experience proved valuable only if accumulated through in-market acquisitions. Buying banks in diverse geographic areas might help market expansion goals: it does not however facilitate the creation and fine-tuning of a well-oiled integration procedure, which is what matters for achieving consistent results from acquisitions.

Knowledge codification, on the other hand, has a very strong effect on performance when coupled with appropriate degrees of complexity of the task, i.e. appropriate levels of post-acquisition integration. For each level of integration implemented, there is a corresponding optimal degree of development of ad-hoc post-acquisition

integration tools. This result suggests that acquirers should align their post-acquisitions decisions with the degree of development of their integration practice. If they plan to achieve high levels of integration, then they should make sure they develop all the tools necessary to effectively manage the integration process.

- **Experience has a positive effect on performance, but only if built on homogeneous acquisitions**
- **The fit between codification and integration has a very strong positive effect on performance**
- **Both experience and codification encourage acquirers to achieve higher levels of integration and replacement**

Experience and codification have a strong influence also on the type of post-acquisition decisions made by the acquirers. The higher the experience and the codification of lessons learned, the higher the degree of both integration and replacement.

All the results are summarized in Figure 1.

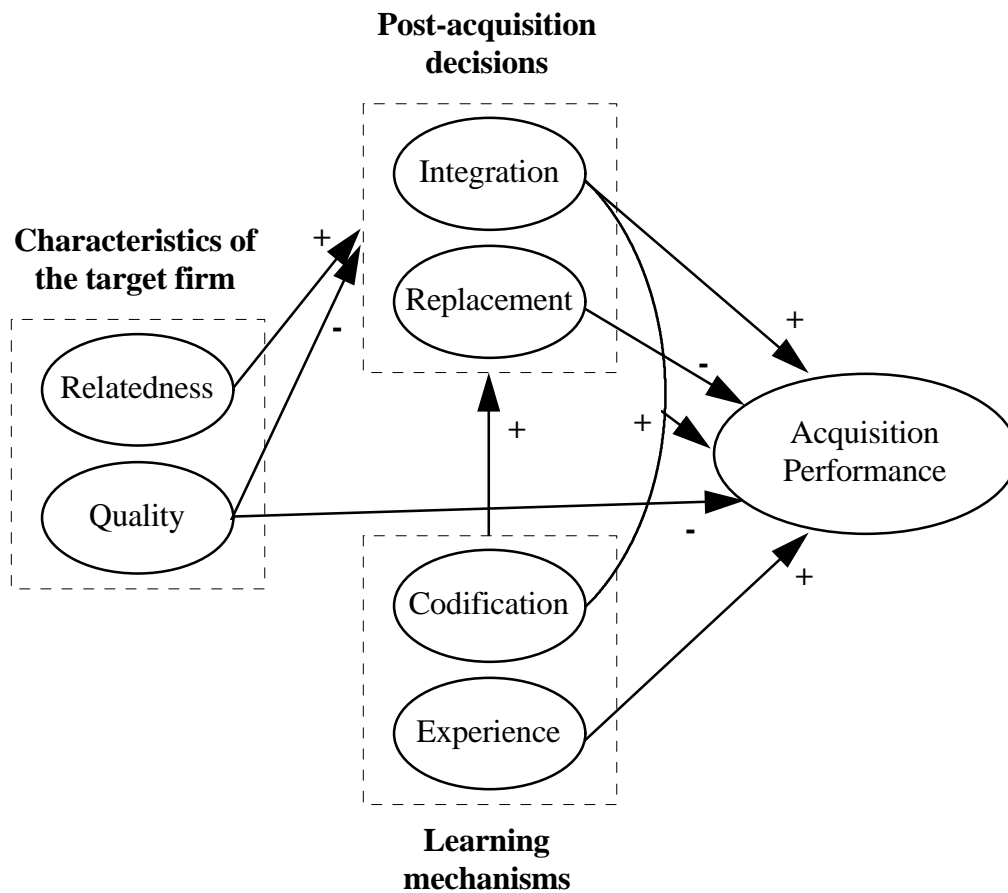


Figure 1: Research results

## Implications

What implications can we draw from these results? Though the data supports the literature conclusion that *on average* acquisitions do not create value to the acquirer's shareholders, it is also very clear that the difference between successful and unsuccessful acquisitions lies to a large extent on the specific post-acquisition strategy acquirers decide to adopt.

For example, what we called convergence

strategies (implying low degree of replacement and high levels of integration) outperform all other combinations of levels of replacement and integration. Based on the results of the analysis described above, we estimated the magnitude of change in the acquirer's earnings three years after the acquisition (deducted the variation of its competitors in the same geographic area) in all the combinations of high/low levels of

integration and or replacement. Figure 2 reports on the results of this analysis.

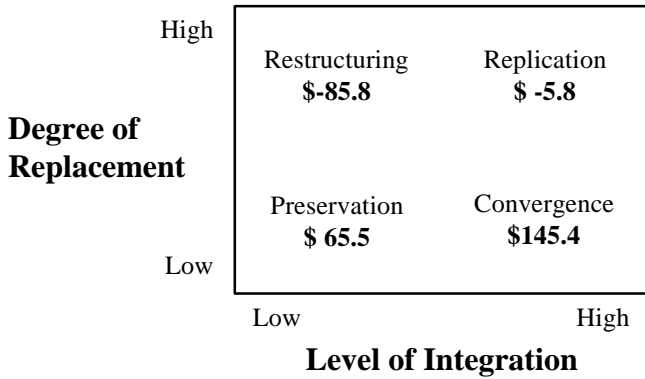


Figure 2: Value creation and post-acquisition strategies.

The selection of a convergence strategy by the average bank in the sample, with \$26.4 billion in assets and managing the average acquisition (\$2.14 billion in assets), improves the bank's net earnings by \$145.4 million more than its competitors over the three year period. This translates into the creation of competitive value totaling 58.9% of the average purchase price of \$ 246.7 million. At the opposite extreme, managing an acquisition by using a restructuring approach (total replacement and incomplete integration) results in a \$85.8 million loss, compared with the earnings variation of competitors.

A similar exercise performed using the combinations of the two learning

mechanisms (tacit learning-by-doing and explicit codification) reveals that the acquirer with ten in-market acquisitions completed which has selected a combination of high integration and high level of codification of its acquisition process creates competitive value of \$129.6 million over the three year period on average (Figure 3).

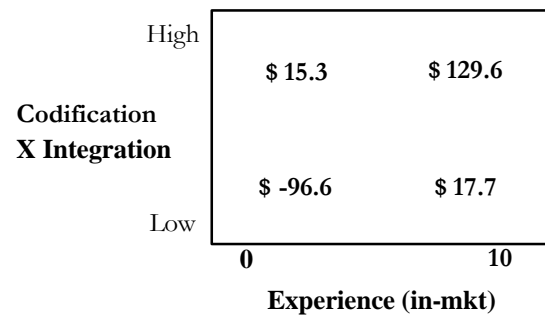


Figure 3: Value creation and learning mechanisms

By comparison, an acquirer at its first in-market experience who opts for a low integration/low codification strategy loses \$96.6 million with respect to its competitors. Note, however, that the same inexperienced acquirer who selects a more opportune combination of high integration/high codification is able to exceed break-even with its competitors, by creating \$15.3 million of value from its acquisition.

A focused (i.e. homogeneous) acquisition experience, then, while an important

ingredient of the success formula, is not the only one, and not even the most important. In order to create and develop an effective post-acquisition integration practice the acquiring firm has to invest time and efforts in the attempt to extract all the relevant lessons to be learned from previous experiences, codify those lessons into paper-based or electronic support tools and then constantly update these tools after every new experience. Learning from rare, heterogeneous and complex experiences such as mergers and acquisitions does not happen automatically, through a learning-by-doing process, you have to work hard at it.

Finally, we believe that this study has helped to shake some long-standing beliefs in bank mergers, such as: (1) in-market acquisitions are more profitable than out-market ones,

(2) the higher the quality of the target, the more value can be created from the acquisition, (3) an accurate target selection and rigorous negotiation is all that is really needed in order to create value in acquisitions.

Indeed, the results seem to indicate that what you decide to do with the firms you acquire, and how well you can do it, are the key drivers of success in the M&A game.

- **Post-acquisition strategies make the difference in value creation.**
- **Acquisition experience is important but not sufficient to create value. Learning by codifying the integration process is essential at high levels of integration.**
- **It is not so much what you buy, but what you do after you bought it and how well you do it that matters in distinguishing failure from success.**