Building a better working world

Does your integration playbook tackle tomorrow's M&A challenges?

Advanced manufacturing

The better the question. The better the answer. The better the world works.

Mastering integration when combining machines and megabytes

Traditional manufacturing businesses in the industrial sector are in the midst of deep and fundamental change. Instead of products, their attention is now turning to solutions, such as Rockwell Automation's Connected Enterprise approach. Everything is being rebuilt, from operating models to mindsets. How can businesses that are used to selling machines in a very established manner use M&A as a strategic lever to create value in this brave new world?

Many companies in the sector have acquired new capabilities, and many are looking to adopt emerging tools in everything from automation to artificial intelligence (AI), big data and analytics. Companies are using M&A to bring these capabilities on board ahead of the competition.

M&A activity in the sector has continued strong over the past several years, with an average of 7,715 deals annually from 2013 to 2017 and an average value of US$611b, according to Dealogic, and 2018 has already seen close to 4,000 deals valued at US$464b through July 18.

Cross-sector deals are increasing as executives venture out of the sector's traditional comfort zone and look further afield for new capabilities. We also see cross-border M&A in the sector, as executives try to mitigate the risk of restrictive international trade policies or to bring manufacturing capabilities closer to their customers.

The £1.2bn purchase of UK industrial solutions company Fenner by the French group Michelin in 2017 is one such example, with the latter business targeting its British counterpart's technologies. Sun Hydraulics' US$500m acquisition of Faster Group of Spain is another: the US company sees Faster as an accelerated route to strengthen its portfolio and deepen its penetration of industrial goods and agricultural markets. Still, most of the sector has grown via traditional consolidation and adopted old-school cost-cutting or efficiency exercises. Breaking into new territory and buying businesses from outside the sector does not come easily — but that is precisely how to build future growth.

About this report

This report is part of the EY *Buy & Integrate* series of sector-specific reports that encourage CFOs, CDOs and transaction leaders to take a fresh look at how they identify and capture synergies during M&A. In the reports we suggest leading strategies to improve your M&A and integration playbook.

For more EY *Buy & Integrate* perspectives, see the reports at **ey.com/synergies**:

- Consumer products and retail
- Health care
- Life sciences
- Technology, media and entertainment, and telecommunications

Prepare for a solutions-based future

Businesses in the sector are being pushed toward packaged solutions in their search for growth, rather than focusing on products. Caterpillar, for example — well known for machinery, engines and traditional plant manufacturing equipment — is embracing a services strategy built on data and analytics capabilities. This includes everything from geospatial mapping of job sites using drones to measuring productivity through analytics and benchmark assessments. Underpinning its transformation are the company's "Age of Smart Iron" and Cat Connect Technology programs. The focus of this transformation is the customer experience through the integration of digital capabilities that enable connection of entire fleets; data analytics; and creation of services that help customers run, grow and innovate their businesses. Caterpillar's acquisitions of M2M Data Corporation and ESRG Technologies are representative examples of the strategy to find transactional opportunities to further integrate products, services and technology.

Rockwell Automation is another example. The company offers automated technology solutions for manufacturing businesses via a connected enterprise approach, noting on its corporate website that "connected smart devices open new windows of visibility into processes. Data and analytics enable better and faster decision making. Seamless connectivity spurs new collaboration." The company is using M&A to "fill the product gaps" and develop packaged solutions, most recently acquiring Scottish tech firm Odos Imaging, which produces 3D "time-of-flight" sensing systems for industrial imaging applications.

Most companies in the sector are integrating and capitalizing on new capabilities. But synergy and integration plans need to take into account that the business models of the target are likely to be very different than the buyer's.

Given the premiums involved, companies need to understand key integration challenges earlier in the transaction life cycle:

- **Plan for integration at the same time you conduct front-end due diligence so that you can design the target operating model and increase the likelihood of enhancing deal value.** The typical playbook of integrating and optimizing plants or inventory, for example, will need to be revisited when designing solutions instead of products. Companies that are looking to change their business models need to spend the time up front to truly understand how the operating model will need to transition as well.
- **Identify, quantify and execute revenue synergies.** Asset-intensive manufacturing businesses tend to focus on cost synergies in potential deals, but the sector needs to shift its mindset to also focus on substantial revenue synergies, if deals are to create value. Expanding the product portfolio or capturing more of the value chain (such as with downstream services) are two examples.
- **Be prepared to refresh product offerings more frequently, especially after a cross-sector acquisition.** Large manufacturers may refresh product ranges in five-year cycles, while tech firms may introduce software updates every year, if not constantly and continuously doing so, in the case of as-a-service models.
- **Find reverse integration opportunities.** Best practices used by the target should be evaluated and potentially adopted into the combined entity. In our experience, advanced manufacturing businesses that have long prided themselves on an assumed competitive advantage when it comes to capabilities, such as procurement or working capital management, are increasingly receptive to adopting the target's processes, people or technology.

Prioritize people as much as processes or products

We expect collaboration between industrial manufacturers and consumer-facing companies to rise, as will deals with technology firms that bring specific capabilities. Transformation built on technologies will necessitate new skills. When companies try to bring in these skills through an acquisition, they may need to adopt new approaches to integration.

Embrace new skills or risk destroying value. Early in the deal process, identify key talent at the target business who will drive business success, particularly in the technology or software space:

- Establish organization design principles that align with the target operating model. The organization needs to be aligned to design, sell, and deliver services and solutions with a higher degree of customer centricity. Your operating model needs to transition from manufacturing and selling what customers buy to a more proactive engagement with the customers to identify their needs and design customized solutions for them. This is enabled by moving from a process-driven operating model to a knowledge-based operating model that creates value for the customer by using differentiated capabilities and tools. In our experience, businesses often defer the tough management discussions for how the organization will support a potentially new operating model.
- Evaluate how new addressable markets or customers may require changes in skill sets, roles or responsibilities. In a product culture, sales relationships are highly focused and sometimes short-term. In a solutions environment, there is a sustained partnership with the customer focused on the problem

you are trying to solve — each solution has to be tailored for the customer in which your product and service elements are building blocks of the solution. Elements of the sales force will have to be realigned to sell the solutions.

- Recognize staff transition concerns early so they can be addressed through integration planning, and implement a structured and centralized communications approach to support a consistent and repeatable message to impacted employees. In the case of capability acquisitions, it is critical that personnel on both sides of the transaction clearly understand how the target creates value, how the business will fit in with the long-term solutions strategy and how employee contributions (specifically in development, sales and service) will add value. Employee retention is a key goal as the capability you buy resides within the employee base.
- Consider the needs of both sales teams. Conflicts may arise in the integration stage, particularly as a business shifts from product provider to solutions provider. It is not just a matter of integrating the acquired sales team into the buyer's business. If you're buying a business to build a solution that adds services to the products you already sell, how will your traditional sales teams adjust, and how can you avoid creating conflicts within the channel?
- In our recent experience supporting two large manufacturers with the integration of their sales teams, the companies focused first on defining the new market model and the associated skills required to support a new customer and business model. They took an objective and data-driven approach to change the historical ways of supporting accounts and geographies, stepping back to define what geographies were relevant markets and what skills were needed to be effective. Rather than trying to fit into the current sales framework for either company's team, it took a best-of-breed approach to establish a new sales model, rethinking incentives and customer engagement behaviors in order to best go to market not only with today's products and services, but those to be developed in the future.

Concentrate on cultural fit, especially in cross-sector deals. Slower internal systems, longer project timelines and the somewhat less flexible working practices found in large advanced manufacturing companies can drive away talent used to a more nimble, entrepreneurial approach. Acquirers need to:

- Conduct a cultural assessment — ideally using an independent party to avoid bias — to understand any associated risks and use this as the basis for the integration plan.
- Make sure that leaders agree on the vision, deal objectives, priorities and the desired ways of working needed for the integration and long-term growth strategy, and communicate that strategy widely.
- Deploy a formal culture and change management road map, including culture survey tools for employees and action plans.
- Establish regular monitoring, evaluation and recalibration processes — companies must continue to focus on implementing cultural change or risk reverting to a legacy environment.

Case study: Finding additional synergies by breaking tasks into smaller components

Challenge

A multinational original equipment manufacturer (OEM) was identifying strategic acquisition opportunities. The sector was rapidly undergoing consolidation and many companies were looking to keep pace with the trend while at the same time build out services capabilities underpinning their own product base. As a result, the client was focused on expanding beyond making and selling products through a recent acquisition of an aftermarket services company. Given potentially overlapping front- and back-office capabilities, supply chain processes, and customers, it was critical for the company to identify and realize synergy opportunities.

The company needed a detailed synergy plan and a practical framework to validate and achieve targets.

Approach

During diligence, the company developed an initial summary view of synergy initiatives. The initiatives included cost savings related to headcount and vendor spend rationalization, as well as revenue synergies related to customer cross-selling opportunities. EY advised the company on breaking down the initial synergy targets into specific and measurable opportunities. First, a synergy assessment framework was developed and applied to all synergy initiatives to facilitate consistency in realization planning and cost-to-achieve assumptions. A structured data analysis approach also drove a bottom-up analysis of people and non-people costs to validate top-down assumptions and also stretch initial targets.

Result

The company was able to accelerate the identification of measurable value and facilitate a consistent approach across all accountable functions. Additionally, the company was able to quantify and track synergy targets through an online reporting platform. The platform also enabled cross-functional collaboration on data, process, interdependencies and risk mitigation, because all data and status updates were in one central repository. As a result, the company was able to identify more value opportunities than were previously contemplated and helped accelerate the identification of functional tasks related to synergy realization. Its executives also had a repeatable synergy capture framework that could be applied to other transactions.

Don't let old-fashioned approaches kill the deal

Advanced manufacturing companies can be deeply mired in old working habits even as they bring on new technologies. Businesses in the sector need to ask themselves some hard questions before proceeding with a deal:

- **Am I over-promising or under-delivering?** Deals are being made today where the buyer expects to achieve 100% or more of blue-sky, poorly defined synergies. But deals where synergies have not been properly identified and quantified, and where there is no clear vision for integration, may destroy shareholder value. This can especially be the case for old-line manufacturing companies adding new technologies. For example, when we advised a global industrials conglomerate with its synergy case for an industrial power solutions acquisition, there was a need to redefine the basis for capturing value. The company had been anchored to historical internal benchmarks and sales force biases that failed to provide a baseline for how to realize value through a new solutions business model. By taking a more forward-looking approach beyond benchmarking and digging into specific market segments, they were able to develop more targeted analyses of market trends and their impact on future demand. The company's more targeted data was able to pinpoint specific geographies where the company could generate stronger product demand.
- **Are my value creation targets realistic?** Acquisition synergies vary widely by subsector. According to an EY analysis of transactions from 2010 to 2017, deals in the traditional manufacturing arena produced an average realized cost synergy of 6% of target revenue, while that figure was 3.7% in aerospace and defense and 7% in chemicals. While these targets can help companies gauge where typical savings opportunities can be found, they must rethink the broader value-creation agenda. For example, as companies stand up new solutions to sell to their customer base, the priority then becomes incremental revenue synergy opportunities.
- **Am I planning for the end state as well as ensuring a successful close?** As some companies acquire products in their pursuit of integrated customer solutions, they defer post-merger integration planning and focus on simply getting to a transaction close. But articulating and planning for how the solution will be integrated into the business and drive revenue growth should be a key planning activity pre-close. If not done properly or early enough, companies can leave value on the table.

Conclusion

Manufacturing executives will need to consider a host of new integration issues as the business model changes. The shift to a solutions-led business can mean developing more of a focus on growing revenue than is encapsulated in the traditional integration models. Accurately quantifying potential synergies and hurdles ahead of time is difficult; however, those executives who don't do so risk suffering surprises when a deal is done.

Contacts

David Gale
EY Global Advanced Manufacturing Transaction Leader
david.gale@ey.com

Neil S. Desai
Executive Director, Transaction Advisory Services,
Ernst & Young LLP
neil.desai1@ey.com

Brian S. Salsberg
EY Global Buy & Integrate Leader
brian.salsberg@ey.com

EYG no: 011138-18Gbl
BSC no. 1807-2827628

ED None