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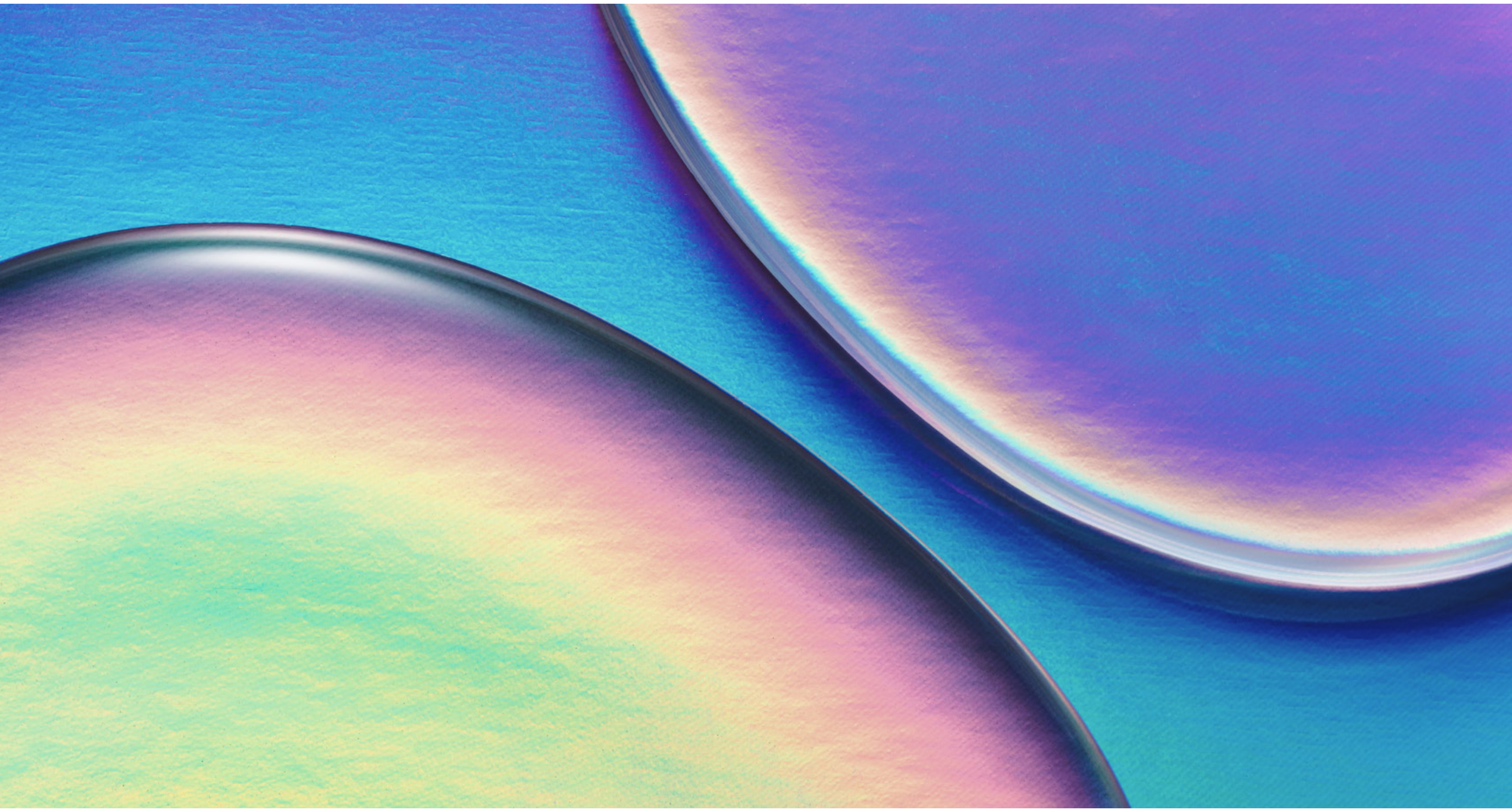
Winning at portfolio-company integrations

Private-equity firms use add-ons to scale portfolio companies, but poor integrations impact results. Five practices can ensure that deals flourish.

This article is a collaborative effort by Oliver Engert, Ali Korotana, James McLetchie, Sean O'Connell, Yves Slachmuylders, and Patryk Strojny, representing views from McKinsey's Private Equity & Principal Investors Practice.



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One increasingly popular strategy for private equity (PE) firms in recent years is to "buy and build." In that approach, existing portfolio companies create platforms and pursue add-on acquisitions to achieve rapid growth and scale. In 2004, add-on transactions accounted for roughly 43 percent of PE companies' deal volume, but the share increased to approximately 71 percent as of the end of 2020.[1]

While buy and build can be a winning strategy, mediocre integrations turn deals that might have been transformative into slow-growing add-ons. At worst, poorly managed integrations can erode investor returns. Unfortunately, in our experience, that isn't a rare outcome. A large group of PE owners and portfolio companies will likely have inconsistent integrations for many reasons, including lack of expertise, slow decision making, and poorly defined roles for both platform companies and PE firms' deal teams.

PE-company teams and platform-company managers can, however, capture maximum value from their integrations. In this article, we examine four key, often-overlooked principles that the most successful companies make central to their integration efforts. We then propose five practices that PE sponsors can pursue in their next add-on deals. Activating these best practices will help deliver successful integrations, maximize the potential of the add-on strategy, and capture full value from deals.

Four underestimated themes in an integration

Leading PE firms approach integration planning with the same discipline and rigor that they use in deal sourcing and diligence. They understand the material value that can be derived by successfully integrating acquisitions and the extent to which great integrations build confidence in the platform company's valuation. We have observed four key themes that lead to success.

The value of integration

After the intense focus required to advance a deal to signing, companies often call on management teams that lack merger-management experience to execute the integration. Although the leaders of such teams may be experienced in running private companies with great success, they often realize too late that an integration is different and that it requires highly specific expertise. In such situations, the integration falters and is managed only intermittently. To create full value, successful merger-management teams must operate at a much faster rhythm. They are required to make many more

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[1] Rebecca Springer, *Q2 2021 Analyst Note: Exploring trends in add-on acquisitions: US PE sees the buy-and-build escalate, innovate, and sophisticate*, Pitchbook Data, April 12, 2021, pitchbook.com.

decisions, in a much shorter period, than during business as usual.

The benefits of broader, faster action

During due diligence, companies consider how quickly cost synergies can be realized and the potential for future revenue growth. This, plus any additional value that can be created, is the basis on which financing and decision making occur. However, it has been our experience that a lot more value—well beyond the estimates made before the deal—can be unlocked once ownership is assumed.

Successful integrators revisit the drivers of value for the merging companies. They look more aggressively at what's possible through at-scale cost reductions and rapidly move on to consider broader, transformational shifts in productivity to accelerate growth (for example, through professionalization of the sales force and adoption of agile techniques). Transformational capital efficiencies, such as those that can be achieved through the choice of technology infrastructure or platform, may also present substantial upside.

The division of labor

In an integration, the PE firm's deal team (or for some, operations team) and the portfolio company have essential but different roles to play in making the integration work. While collaborating on the big picture, they can each take on the primary roles for which they are best positioned.

The PE company's team oversees responsibilities that include the following:

— identifying the primary opportunity areas for synergies as well as sources of risk

— finding and installing the best possible management team (which might be the current leaders) for the newly acquired company

— developing and continuously monitoring the performance requirements (both financial and operational, including the expected synergies) for the newly acquired company

The portfolio company's management team focuses on the following:

— delivering on the deal thesis by capturing opportunities, mitigating risks, and putting plans in place to capture value from initiatives to reduce costs and capital usage and lift revenues

— operationalizing the newly formed company, with managers designing and establishing the operating model, organizational structure, governance and decision processes, talent-selection process, cultural initiatives to align the merged companies, and the necessary change-management program to deliver the newly formed company

— designing a "glitchless" day one, as well as making subsequent fast transitions for customers, employees, and vendors

The role of experienced integration professionals

The model for the governance, oversight, and support for a portfolio company that is pursuing an add-on strategy often resembles one used for a stand-alone acquisition. While the model can work well in some cases, many companies miss opportunities by not including individuals who have direct integration experience in company-level operating teams and on boards. When portfolio companies are run by lean leadership teams or have substantial M&A activity, adding such experts to PE firms' deal teams rather than portfolio companies' management teams likely makes more sense. It ensures that any lessons learned are shared and that M&A synergies are fully realized across the portfolios.

Five add-on practices for private-equity sponsors

Successfully executing an add-on strategy requires that both the PE firm and the portfolio company bring expertise, integration capabilities, and unique mindsets to the table. Five practices help ensure that the integration extracts the maximum value from the deal.

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Align goals

A shared mission focused on a deal's full potential is the glue that will make partnerships sustainable across the PE firm and the portfolio company's management team. Lack of this core alignment often sits at the heart of disrupted mergers, and it manifests as lost momentum, missed targets, and talent attrition.

During an integration, portfolio-company leaders will be asked to do much more than usual, including making decisions faster than they are used to while simultaneously taking on a heavier workload. In those circumstances, some management teams may be hesitant to commit to ambitious targets or to widen the aperture on value and broaden their perspective on potential synergies and opportunities.

Accelerate decision making

Integration planning often takes a back seat during deal making. Top-performing integrators, however, invest substantial time before a deal closes in tailoring an integration approach based on the deal rationale, value, and risk and in putting in place an integration program that enables fast decision making.

In practice, that means identifying the 12 to 15 critical decisions required and ranking them on a critical-decision road map. Moreover, the most effective deal and operations teams in PE firms use a focus on value creation to overcome secondary and distracting objectives. They and management teams jointly prepare, present, and use such road maps to ensure focus, prioritization, and transparency.

Ensure rigor

One crucially important but often overlooked step after the deal closes is to establish an apples-to-apples financial and full-time-equivalent baseline to understand exactly how each company has classified its employees and functions so that they can be correctly compared. It's only by having granular insight into roles, salaries, and departments that management teams can make accurate estimates, find all the possible synergies, and eventually track the outcomes of those synergies. A baseline can ensure that near-term synergies are clearly identified and rapidly executed.

PE firms' teams can set quantified targets that top managers can buy into, insist on highly detailed planning, and prioritize execution through a series of value-capture summits. During those dedicated working sessions, sponsors and managers (properly prepared with the right fact bases and relevant data) can align on and prioritize initiatives. In our experience, a series of such summits can deliver a structured and trackable approach to overdeliver on targets. The plan is then built into the company budget.

Secure talent

PE investors are generally good at identifying and retaining critical leadership talent, typically CEOs and founders. They can take their talent-spotting skills a level deeper and assure retention of three other important types of talent:

— *Mission-critical talent.* Critical employees are essential to completing important activities and next to impossible to replace.

— *High-potential talent.* High-performing, high-potential employees can rise to more senior roles.

— *Value-creating talent.* Value creators are crucial to delivering the deal thesis and the majority of synergies. It's important to note that in relatively small companies, it doesn't take many people to move the needle—often, ten to 20 roles drive most of the economic value.

Appreciate culture

Culture is relevant not only to top teams but also to management practices, which are essential to understand when merging two companies. For example, are decisions made by the most senior, accountable executive or by building consensus in the leadership team? Creating alignment in styles and practices when combining marketing, R&D, sales, and other teams is critical to creating a united group that's focused on delivering the core deal rationale.

If not addressed properly, cultural-integration challenges inevitably lead to friction within the top team, decreased productivity, and unexpected talent attrition. Successful teams will rigorously assess top-management practices and working norms as part of diligence and head off cultural risk early.

The practices outlined in this article can quickly improve integrations, with results that can be seen in both top- and bottom-line results. Taking these factors together, it's clear that M&A integration can be a powerful driver of ROI across the ownership cycle and should be a key pillar of a portfolio alpha strategy.

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