SUCCESSFUL HORIZONTAL ACQUISITION PROCESS

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ABSTRACT: *The nature of markets is changing due the technological development, and companies are using every innovative activity and operation to maintain their positions. Some companies channel their profits back to research and development. Others invest in acquisition activities as they realise the potential of the immediate positive synergy effects of these activities. This article is focused on the complex acquisition process from the buyer's point of view. The authors examine the due diligence process and the necessity of performing an HR audit, as the key process in acquisition mainly in the case of SMEs, as part of the acquisition activities. The authors used a specific horizontal acquisition process to describe corporate cultures, the main reasons for failure of the acquisition process, and harmonisation processes in an international environment. The described process is critical to the successful operation of a newly emerging organisation.*

KEY WORDS: *Acquisition, corporate culture, Due Diligence, HR audit, processes.*

JEL CLASSIFICATIONS: *M10, G34, H83.*

1. INTRODUCTION

During the last few years, the fourth industrial revolution has been a great deal of discussion about, which will have as part of its scope an impact both on industry and the economy, while also causing social changes. The objective of each company is long-term growth and the growth of its value, a significant position on the market and a powerful brand. However, as technologies develop and digitalisation and globalisation consolidate their place in business, the nature of markets alters. All these changes epitomise the phenomenon of Industry 4.0. Companies are using all the innovative tools available for their sales and marketing activities and set their operations while considering both geographic and product growth. Global companies are currently operating on almost all markets worldwide and are competing with other global players as well as with smaller local regional companies or start-ups.

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An impact of globalisation and technological developments is an intensification of the competitive environment. Furthermore, this intensification complicates any adequate response to it. The frequency of the emergence of new companies, or rather new competitors on the market and of new products and technologies, has an exponential tendency, thus exerting significant pressure on large companies at any scale – local, regional or global. They in turn try to keep or reinforce their positions by creating their unique solutions, so they channel a high portion of profits back to internal research and development. The effects of these efforts have been very limited in the last decade as development and research initiated in reaction to the market events has enormous time limitations. That is why leaders in their segments, who dictate technological progress, mainly support their own development and research to a significant extent, and all other companies direct their other resources to acquisition activities, rather than to the costly development of new products.

Companies realise that investments in acquisition activities may have an immediate effect, and the companies may advance technologically, or even advance to other segments, thus diversifying their products or scope of operations, while also eliminating threats, such as during financial crises. Another advantage of acquisition activities is the mitigation of competition and the obtainment of competitive advantages in relation to other market players. In terms of acquisition, the current situation is characterised by two basic strategic cases – buying companies for the purpose of increasing market share or buying up small start-ups with exceptional ideas, technologies or solutions with enormous potential. In such a case, big players are willing to buy such start-ups even if there is a high level of insecurity about whether the solution under development may be ultimately capitalised on the market, or not. The reason is the high level of competition, resulting in fear that the start-up might be bought by a competitor, and also a desire to grow at a low investment cost, compared to the company turnover. A current example may be the pharma segment, with quite a limited number of large players and a lot of small start-ups which are often formed with the aim of being sold.

Acquisition as such can be described as a process of one company acquiring or the buying another. The whole process, including the pre-acquisition stage, is very sensitive. In most cases, negotiations are held behind closed door and any leaks of information can make employees and business partners feel insecure. If the companies' shares are traded on financial markets, the value of shares would change significantly. In some cases, the offer for sale is public and often demonstrative, just to cause the said effects. As the acquisition process period is quite short, it has its clearly set and defined steps to eliminate risks on both sides. In large-scale transactions, the process is managed by external companies who set the recommended price, level of risks and other important information for both buyers and sellers. The aim of the article is to describe this complex process from the buyer's perspective and to emphasise the importance of the process and of performing all of its stages. One part of the acquisition process is only rarely used and described– the HR audit. In this respect, we would like to point out in this article the importance of including this part into the standard due diligence process as a key factor of successful acquisition.

2. HORIZONTAL ACQUISITION PROCESS

The whole acquisition process will be described from the buyer's perspective. The reason for this is to highlight the strategic management of a company which has the objective of implementing its visions and objectives through acquisition activities.

The acquisition process is clearly defined and may be divided into three essential stages by (Sherman, 2010), and (Gaughan, 2017): strategic analysis and finding an acquisition target; the negotiation and due diligence process; integration of a company followed by an audit. The first stage is mostly performed internally in the company. Finding the right acquisition should be in line with the company's long-term vision and objectives, so the top management of a company is mainly involved in this stage (Soltes et al., 2015). Whatever the object might be, e.g. the consolidation of market positions, portfolio diversification, elimination of the competitors etc., the decision is made based on management consensus and appointment of an executive acquisition team, with all required competencies and responsibilities.

Other parties then become involved in the negotiation process with the purchased company. Here, the authors will focus mainly on global companies or large-scale acquisitions as they make up most of the acquisitions in terms of investments and their process is unified. Besides the company's executive team, advisors and the external company who manage the due diligence process also come into play, see (Dvoracek et al., 2014). The extent of due diligence is optional. It is possible to either check only the basic areas of interest to the buyer or to make an extensive in-depth check. It depends on the buyer's particular requirements and the size of the sold/purchased company. These requirements are usually set in the beginning; however, they may change in the process depending on the findings made.

In this respect, due diligence can be described as a series of steps characterising the purchased company in three main areas – financial, legal and operational. Although the due diligence process is divided into three main areas, remember that it is a complex process providing the buyer with a complex characterisation of the purchased company. Following the due diligence process, either the price is verified, or a new price is set. It is also the basis for the subsequent integration and other steps. Before the process, a non-disclosure agreement is signed, and the terms of cooperation are set. The result of this process is a report available to the buyer and, in some cases, to the seller as well, e.g. (Ernst and Young, 1994), and (Dvoracek et al., 2014).

Financial due diligence is agreed between the buyer and the seller in advance, and it is focused on the accounting and economic aspects of the company that the investor is considering buying. It does not concern only the buyer, and the seller should not approach it lightly. Experience shows that it may confirm the asking price as realistic to both parties or indicate another real price and all potential risks in the process of sale preparations. The most significant threats are according to (Dvoracek et al., 2014): no records of (potential) payables (such as from a court dispute); non-rotation stock; tax optimization; non-compliance with legal obligations; dependence of the target company on one (or only a few) customer(s); bad debts of high value etc.

In the case of smaller companies, data concerning the companies' real operations must be considered. As part of tax optimisation, accounting operations are performed to reduce the company's real profits, thus reducing tax payments. In most cases, such operations are one-off expenses and should be excluded from the calculations of profit/loss. Then, it is possible to determine the real value of the company. This part of due diligence uncovering the real profit/loss is absolutely essential for both parties, more in (Gleich et al., 2012), and (Howson, 2012). The buyer has a real idea of the purchased company and may then plan the integration and progress of the whole company. The seller, on the other hand, has the value of the company raised by increasing the economic parameters including EBITDA.

In terms of a financial audit, the assessment of working capital is an indispensable part of due diligence. The appreciation of the working capital is different than in the operational part. The efforts here are to quantify it as part of the purchase price. Working capital means the difference between operating current assets and operating short-term liabilities. But this is just the theory. In practice, opinions on which item should be included in and excluded from the calculation differ widely. (In most cases, account details must be considered.) It should be the main subject of agreement between the buyer and the seller. The acquisition price is often agreed on a cash-free, debt-free basis. In such case, all financial funds and credit lines are excluded from the working capital, e.g. (Gleich et al., 2012), and (Howson, 2012), and (Dvoracek et al., 2014).

It is worth noting that the efficiency of working capital management can draw the line between a successful company and a dying business. Legal due diligence must always be performed from the lawyer's perspective. A lawyer should especially review all agreements the company entered into and check whether they are correct and of significance to the prepared acquisition. In addition, all available registers or shareholder links and participations in subsidiaries are checked. In this case, too, it is important to note relevant issues where the lawyer may have a different opinion than management. The lawyer's task is to point out these issues. The final decision, however, is management's responsibility. During the operational part of due diligence, the company's operational data are collected, including, but not limited to, the list of suppliers, customers, production parameters, HR operations, etc. These data and evaluations are quite accurate and easy to characterise, except for the HR audit. In a large number of acquisitions, it is not performed at all. The significance of its absence is diminished with the size of the purchased company; however, it is absolutely fundamental for smaller acquisitions. In family-type companies or companies with a lower number of employees, dependency on individuals and individual teams is above all high. An HR audit may reveal the level of dependency and potential risks from losing such employees after acquisition. This information is so fundamental that in some cases, acquisition is subject to various competitiveness clauses, the prohibition on the executive team leaving the company, etc. The level of dependency and potential threats also changes the price of the company. When acquiring large or global companies, the HR audit loses significance as these companies are process-managed and the influence of individuals on the operation of the whole company is eliminated, more in (Rao, 2014), and (Nelson, 2015).

All the areas described above must be regarded as part of a complex. In other words, one threat (a shortcoming) may and does have an impact on other areas. For example, long-term overdue payables have a negative impact on cash flow. In terms of taxes, the company may become obliged to tax the payables in arrears. That is why in financial audits, cooperation with experts and advisors from other areas, e.g. taxation, law etc. working on the particulars of due diligence is frequent. Only in that case, will the buyer get complete information required for correct decision-making in negotiations.

If we take a closer look at the HR audit, each purchasing company tries to understand and describe each aspect of human resources of the purchased company. It includes a description of the following company parameters – organisational structure, competencies in individual positions, decision-making matrix, substitutability and dependency on individuals. An integral part is the identification of key employees and key positions and, last but not least, characteristics of its corporate culture. It is based on the above-described parameters and also defined by the management style and the style of communication regarding requirements and expectations. We can say that the corporate culture is unique in each company. Any change happens over a long period of time and with difficulty; it depends on the company management and its vision.

In the company integration process, the harmonisation of corporate cultures and processes and the centralisation of individual company sections are fundamental for the successful formation of a new merger, see (Litavcova et al., 2017), and (Hurta et al., 2017). Process unification depends on the centralisation of individual components, meaning most of all on human resources. As the whole integration process is managed in the change management system, the harmonisation of corporate cultures, branches and the selection of the right people is the initial element of success. And this important element will be described on a real example of acquisition harmonisation.

3. CORPORATE CULTURE FORMATION PROCESS AS A PART OF HORIZONTAL ACQUISITION

The horizontal acquisition process is explained by an example of a company operating in group C, the processing industry, group 11 production of beverages, based on the CZ-NACE classification of economic activities. Based on the decision of the company management and strategic analysis, a foreign holding (purchased company) was selected and an initial agreement on the merger of the companies was entered into with that holding. The strategic objective was to use significant cost and income synergies which will be attained by the companies' merger, thus intensively developing trademarks in a global scope.

An analysis of objectives, visions and individual elements indicated that the corporate cultures in the companies in question were very different. Visions and objectives were identical; however, the communication among managers of individual companies seemed problematic, complicating the acquisition process. Therefore, one of the partial objectives was to harmonise corporate cultures, implementing corporate culture into the daughter company. Based on the findings of the horizontal acquisition of its foreign businesses, Figure 1 illustrates the specific procedure of formation of a new corporate culture.

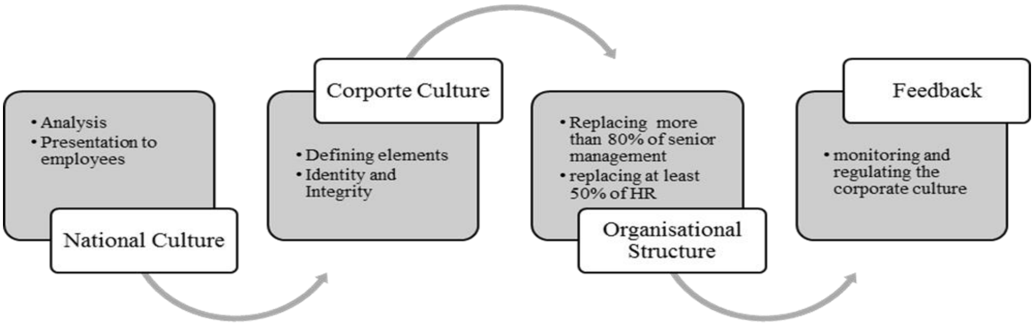

Figure 1. Corporate culture formation process

The basic step for corporate culture formation was the analysis and comparison of national cultures. The results were then presented to employees, including the planned changes. Corporate culture was determined by defining the pivotal elements which will lead to the harmonisation of employees with the vision, objectives and strategy of the organisation and to integrity. Another step, which proved to be the most time-demanding, was the formation of a new organisational structure. First, it was necessary to purchase all shares of managers in the company and then, it was possible to make extensive personal changes in senior management. By replacing more than 80% of senior management in the purchased company, it was possible to harmonise corporate cultures and begin the change process in the operation area, too. As senior management replacement was only the first stage of personal changes, in the second stage, 50% of human resources at lower positions were replaced as well. The reason was the employees' unwillingness to accept changes and the new corporate culture, including the new company management.

After introducing all the personal and process changes, the company takeover reached the final stage – monitoring and continuous supervision over introduced changes, with the efforts to improve them and react to the situations at hand immediately. In the case outlined above, the whole process took 17 months. Frequent and transparent communication with employees and the identification of problematic individuals in the purchased company proved important for the whole process. Their attitude had a negative impact on individuals who were willing to believe in the new corporate culture and who were proactively assisting the management with its introduction. These negative and problematic individuals were replaced, and this step ultimately proved essential for speeding up the companies' integration, not only for the harmonisation of corporate cultures.

4. CONCLUSION

We can say that acquisition activities are changing the situation on the market. To illustrate, based on Mergermarket (2017), the global value of the mergers and acquisitions market is estimated at USD 3.15 trillion, with 18,433 transactions implemented in 2017. Compared to 2016, there was a slight drop, from USD 3.26 trillion. 2017 was the fourth year in a row where the value of transactions exceeded USD 3 trillion. The largest transaction was Disney's acquisition of Fox at USD 68.4 billion. The whole acquisition process has a similar character across segments and individual differences may be seen in each part of the process. The most distinct and specific part is the above-discussed HR audit as part of due diligence and the HR area as part of companies' integration.

The complexity of acquisitions dictates the necessity of using external companies which have experience and a range of experts in various fields available. Only a limited number of these companies exist, and they are mainly global businesses. This allows for the sharing of information, experience, processes and experts across countries and continents, thus setting global standards in almost every country. From this perspective, the countries of Central and Eastern Europe are attractive for investors. They see huge potential in the companies operating in this region. Also, thanks to the global standard of the acquisition process managed by an external multinational company, they perceive such investment as safe. If we look at acquisitions in the Czech Republic, there were 246 transactions at almost USD 12 billion, which means 16% growth in transactions value compared to 2016. In this respect, it is important to note that the Czech Republic has been one of the leading countries of Central and South-East Europe in the number of transactions for several years now, more in (Ernst and Young, 2017).

The contrast between the stagnating acquisition development on the global market and two-digit growth of acquisitions in the Czech Republic is proof of the appeal of Central and Eastern Europe. A similar trend is expected to continue. The above-mentioned example of an acquisition mainly emphasises the HR and financial area of the due diligence process and the companies' integration. They are fundamental to a successful acquisition. As HR operations are a huge risk for the whole process and, sometimes, an unknown intangible quality, they should be one of the relevant areas. But in reality, they are not. It is one of the main reasons for the failure of a large percentage of acquisitions whose outcomes lag far behind the expectations.

Eighty-seven per cent of organisations report that the harmony of corporate cultures was important or absolutely necessary for a successful acquisition. The broad conception of corporate culture including the corporate strategy, decision-making processes and corporate management, top management's expectations and organisation values and standards are all important aspects in acquisitions. Nevertheless, 58% companies report that they were not specifically concerned about the issue of culture. Moreover, none of the surveyed companies reported that the cultural process in their organisation had been effective. According to Elizabeth Fealy responsible for Merger and Acquisition Solutions in Aon Hewitt, 2018 in the U.S., "This is very telling. The bottom-line is that, while organisations understand cultural integration is critical to deal success, they continue to struggle to implement processes that drive cultural integration forward."

What element has the largest share in the success of corporate culture and thus in the success of the acquisition process? Based on content and secondary analysis, the authors ranked these elements in the following order: Values, Attitudes, Standards of Behaviour, Fundamental Beliefs, Corporate Architecture, Habits, Rituals and Ceremonies, Organisational Language.

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