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DEVELOP AN EFFECTIVE RETENTION STRATEGY TO ENHANCE M&A DEAL SUCCESS

MARSH & McLENNAN COMPANIES

More and more companies today recognize that talent is one of the essential components in the success of M&A transactions. In many cases, achieving the promised value of a deal depends as much on the skills and experience of key executives and employees as on any other attribute. Companies are more likely to retain the best people in both legacy organizations — and therefore position themselves to succeed — when they focus not only on the financial and operational aspects of the deal, but also on talent management.

M&A DEALS CREATE SPECIAL TALENT RISKS

Even at the best of times, companies often struggle to engage and retain the talent that can help them succeed. A divestiture or an acquisition only magnifies this challenge, from increasing employees' perceptions of risk and uncertainty. Concern about the organization's future — and their own — can increase the motivation for some individuals to consider alternative employment.

Other issues — confusion about business strategy, problems with integrating the two entities' organizational cultures, a lack of role clarity, and a failure to effectively communicate with the workforce — also can undermine employee engagement and leave organizations vulnerable to losing key talent. When those at-risk employees are critical to integration or to the organization's long-term success, their potential departure poses a serious threat to anticipated deal ROI — and to the very survival of the new entity.

"By supporting retention holistically, the organization is more likely to retain critical talent without overpaying for that talent."

DEFINE A HOLISTIC TALENT STRATEGY TO ADDRESS RISKS

Providing retention bonuses for key talent is one response to this risk. Although retention bonuses are a vital component of an overall retention strategy, it is critical to first establish an effective overall talent strategy.

Long before relying on retention bonuses, organizations must support retention and engagement by ensuring that broader talent management components are in place. To ensure the commitment and high energy needed for success, companies must consider the structure of the new organization, leadership roles and responsibilities, reporting relationships, job content, and how they will reward employees going forward. In addition, for key individuals, organizations need to develop comprehensive retention plans that comprise all elements of the employment value proposition. By supporting retention holistically, the organization is more likely to retain critical talent without overpaying for that talent.

Companies involved in an M&A transaction can best support retention when they:

- *Establish an organizational structure that is aligned to the new entity's business strategy* and that will enable employees to execute on that strategy.
- *Clearly define and assign roles within the new organization* so individuals understand where they fit into the new organization.

- *Develop a cultural integration plan to mitigate the risk* of different cultures and work styles undermining success. Companies need to engage senior leaders early in the deal to define and agree on the organizational culture necessary to deliver deal success. A culture audit can both provide understanding of the differences between organizations and uncover common ground, allowing leaders to identify risks and develop an appropriate integration plan.
- *Educate the workforce* about the objectives of the deal and about the new business strategy, so each person can own and contribute to deal success.
- *Understand the needs and goals of critical employees* so retention efforts are well-aligned to those individual needs.

DESIGNING A STRATEGIC RETENTION PLAN: MERCER'S FOUR-STEP APPROACH

After evaluating the overall talent strategy, organizations will conclude that a targeted retention program is needed. They many determine additional financial incentives will be needed to promote retention. Below is Mercer's four-step methodology to program design.

STEP 1: EXAMINE WHETHER A RETENTION PLAN IS CRITICAL TO DEAL SUCCESS.

The first step is determining whether a retention plan is truly needed in order for the deal to be successful. To answer this, HR executives need to consider several questions.

How important are our people to deal success?

The organization must evaluate the importance of talent given the deal objectives. For example, if the main goal is to increase market share or acquire certain technology, talent may not be key to success. In Mercer's view, however, it is the rare transaction in which the organization's short-term or ongoing success is not dependent to a degree on retaining key individuals for some period of time.

What nonfinancial retention levers already exist?

In deciding whether to develop a retention plan, an organization must also look at the existing employment value proposition to understand the financial and nonfinancial rewards employees already receive and to identify potential gaps. Starting with the nonfinancial elements of the value proposition, companies should carefully evaluate key talent's career plans and whether the transaction has the potential to offer highly prized career opportunities. When individuals perceive a meaningful role for themselves in the new organization — one that aligns with their career aspirations — this can powerfully impact retention and engagement.

Should we offer a supplemental retention bonus?

Because the companies involved in a transaction may already offer rewards that encourage retention, a gap analysis can help them understand whether a supplemental retention bonus is also needed. In conducting a gap analysis, HR executives should review:

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- *Existing pay packages.* If current pay packages are well above market, critical talent is unlikely to leave just because of the transaction. On the other hand, if pay is low relative to the market, the organization may risk losing key individuals.
- *Existing incentives.* Existing long-term incentive programs may have a retentive effect if they are structured such that departing talent will have to forfeit substantial rewards.
- *Increased rewards due to promotion.* A high-caliber employee may be unlikely to leave if, as a result of the transaction, he or she receives a promotion that will significantly increase pay.
- *Impact of a cash windfall.* Some transactions result in windfall payouts (from accelerated equity or cash performance plans) to individuals deemed critical in the short or long term, which may encourage less-than-satisfied individuals to stay or depart.

"According to Mercer's 2012 global survey of M&A retention and transaction bonus practices, the use of retention bonuses is highly selective."

STEP 2: EVALUATE THE POPULATION FOR A STRATEGIC RETENTION PROGRAM.

Once the organization decides that a retention program is necessary to the deal's success, it must determine who should participate. According to Mercer's 2012 global survey of M&A retention and transaction bonus practices, the use of retention bonuses is highly selective. Among the 70 transactions recently completed by survey participants, almost two-thirds (62%) involved retention bonuses. Moreover, while 69% of surveyed companies provided retention bonuses to senior management and 70% to executives who are critical to long-term success, only 53% provided them to employees critical to integration and only 14% to any other employees. For more information about the survey's results on transaction bonuses, access the full survey report.

How do we take individual needs and goals into account?

By analyzing the deal objectives and the new entity's business strategy, HR executives can determine who is necessary to the integration efforts or to the execution of the strategy in the near or long term — and therefore who is critical to deal success. This analysis also enables the organization to align potential retention offerings to the relative value the individual provides to the integration and/or the business strategy. In Figure 1, the individual's impact on business success is shown on the vertical axis.

Why do we take the time to analyze an individual's needs and goals?

An understanding of the individual's needs and goals, along with the results of the cash flow analysis described above, will help the organization gauge the risk of that individual leaving the organization. This vital analysis is represented on the horizontal axis in Figure 1.

By analyzing both the individual's business impact and his or her risk of leaving the organization, HR executives can determine who should be targeted to participate in a supplemental retention program.

STEP 3: DETERMINE THE AWARD SIZES FOR RETENTION PROGRAM PARTICIPANTS.

Once it has gathered the information described in the steps above, the organization can create a multipronged retention solution for each key individual — a solution that is meaningful to the individual and that ensures the best value for the organization.

Companies should ask three questions in order to determine retention award levels:

1. What is the total cost of the retention plan?
   To get a true sense of the total cost of deal completion and integration, deal valuation should incorporate potential retention plan costs. Companies can use both a bottom-up approach (that is, determine the population targeted for retention and each respective award level, to arrive at an overall program cost), and a top-down approach (determine awards based on the total pool in the context of the deal value) to make sure talent needs are balanced with economic needs.

2. Is the retention award meaningful enough to the employee that a competitor cannot easily buy out the award?
   The award should be large enough to dissuade targeted employees from looking for other opportunities, despite the uncertainty and perceived risk to their jobs and careers. The size of the annual pay package and any change-in-control severance arrangements are also relevant — an above-market pay package or a substantial severance for termination following a change in control may indicate that a modest retention award is appropriate.

   In some situations, existing long-term incentives are cashed out upon the deal closing, resulting in a windfall payout, especially for executives. At the same time, any new long-term incentive plans will not pay out for three to five years. Flush with cash from the windfall, executives would have relatively little at-risk pay if they were to leave six to 12 months following close. Retention plans can be used to bridge this gap with shorter-term payments.

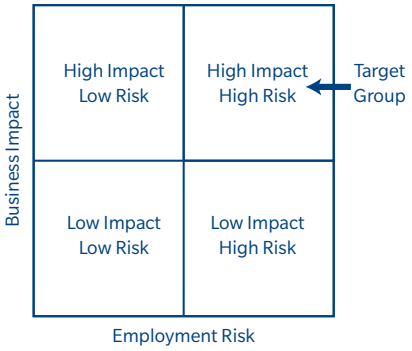
3. Should different roles have different award levels?
   Organizations can take a tiered approach to ensure that awards are meaningful to individuals at various levels but also proportionate to the risk-impact profile. Executives who are crucial to long-term success typically receive the largest awards, while professionals who are crucial to post-deal integration usually receive smaller awards.

STEP 4: CLARIFY CONDITIONS FOR PAYMENT: PAY FOR STAY OR PAY FOR PERFORMANCE?

Participants tend to discount the value of a retention award if it comes with a performance condition, as there is uncertainty associated with this type of payout. So a clear understanding of the retention plan's objective is important when an organization decides whether to include performance conditions.

FIGURE 1: TALENT RISK ASSESSMENT

Retention Program Risk Assessment



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If the objective is to retain key employees despite significant employment uncertainty, performance conditions may undermine the effectiveness of the retention plan by placing too much of the award at risk. Still, performance conditions are suitable in some situations. For example, companies might consider synergy milestones for executives leading post-merger integration work streams, or deadlines for function heads to ensure standalone capabilities in a divestiture situation.

A second issue has to do with the timing of payouts. To maximize their retentive effect, most plans pay out only after deal closing. The number and timing of payments are closely linked to the retention objective and are correlated to the size of the retention bonus. The cash flow analysis described in Step 1 is invaluable in determining the most effective approach to making such payments.

CONCLUSION

Creating the most cost-effective retention program for deal success requires HR executives to engage broad talent management strategies rather than simply rely on a retention bonus program. Companies that understand the needs and strategy of the new business entity — and the needs and goals of key individuals — can create effective financial and nonfinancial incentives to keep critical talent in place. The result: minimal retention costs and a greater likelihood of achieving the deal's full value. tablished profitability goals after 24 and 36 months.

CASE STUDY

A state-owned Middle Eastern enterprise sought to expand its geographic reach into North America and to diversify its product mix by acquiring a division of a large US-based conglomerate. The seller, one of the most prominent corporations in the world, provided its employees generous compensation and wealth-building opportunities and enjoyed a high level of employee affiliation. Following the sale, however, the company was at risk of losing critical employees concerned about the change in ownership and, in particular, the nationality of the acquirer.

Mercer helped the seller and the buyer jointly develop a two-phase approach to retention. The seller offered a time-based cash retention bonus to essential employees who stayed with the company through integration. Payments were made at the 18-month and 24-month anniversaries of the close. The buyer then offered a performance-based cash retention bonus to midlevel and senior-level executives for achieving established profitability goals after 24 and 36 months.

This dual-pronged retention program succeeded in persuading senior leadership to remain with the acquired company, which helped to persuade other critical employees to remain as well. The buyer's participation was vital to this success because it helped demonstrate the new owner's commitment to the deal, the company, and its people.

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11899-MA-0509-2013