

## Corporate Climate Change

Large, slow moving corporations will likely have to change their strategy to adapt to the new market; buyers should be ready to pounce

By Thomas Bonney

The experts theorize that 65 million years ago it was a dramatic change in climate that rendered the dinosaurs extinct. Today, the business ecosystem faces a markedly changed operating climate as the dust settles from the 2008/2009 freefall of the economy. This time around, the resultant species at risk could be the large, complex multinational company.

The large company business model was designed in the “pre-Internet” days and generally operates at the speed and service levels of 20 years ago — a characteristic particularly evident in the automotive and global banking industries. Over the past decade, easy money and inertia have masked flaws in mega-company business models.

However, more recent dynamics have pushed this model to an evolutionary crossroads similar to that of the dinosaurs. Tighter credit, rapidly changing customer preferences, a heightened, globally competitive marketplace (and the related significant revenue declines), not to mention the lack of visibility, have all contributed. The question facing many, is will certain large company species also face elimination?

Many larger organizations have passed off their problems as part of the “financial crisis” and lined up to ask Washington for help. It is clear, however, that today’s corporate dinosaurs (too big to fail, too big to exist) must ultimately transform to adapt to our new operating climate, or risk being wiped out.

For large company investors and managers, strategic metamorphic and skin-shedding measures are critical to ensure dominance and to create appeal for new holdings. For middle-market M&A professionals seeking new dealflow, the byproduct of large company

transformation — the carveout of more viable smaller companies — offers substantial opportunity.

### The great dismantling

After a decade of casual, diligence-lite adventures into new markets and products, and acquisitions driven by the lure of cheap and easy money, 2009 is shaping up to be the dawn of “The Great Dismantling” for businesses.

General Motors, for example, is undergoing a government-assisted dismantling based around core customer proposition, cost structures, brand identities, and core competencies. Executive management, arguably for the first time in a long time, is critically assessing each division’s full set of customer, financial, and competency attributes. Weaker groups are being wound down or sold off, leaving what should be a stronger, leaner, more nimble and customer-focused organization. The resulting organization, one hopes, will be able to manage through the competitive business climate in 2010 and beyond.

Furthermore, it is expected that most companies (of all sizes) will focus on core competencies to achieve sustainable, defendable revenue and profit streams to drive decision making over the next 18 months.

At some large companies, dismantling efforts can be impacted by operational “shields” — regulation, patent protection, and long-term customer contracts. These shields offer protection from the harsh realities of our changed climate. The companies may enjoy some insulation, but ultimately, regulations can change overnight, competitors can develop better patented products, and long-term customer contracts can be terminated. Survival is likely only for those that can adapt quickly to

“2009 is shaping up to be the dawn of ‘The Great Dismantling.’”

ACG

DCA

continuing changes in the business environment.

Large companies with co-existing regulated and unregulated divisions face particular challenges. Regulatory forces tend to overtake corporate culture, and unregulated entities will need to move quicker to remain competitive. Similarly, unregulated divisions within organizations with highly regulated core businesses tend to get out of control.

AIG, for example, used the goodwill and capital from its regulated groups and AAA credit rating to establish an unregulated division that ultimately caused its problems. The AIG that emerges from its government lifeline will primarily be oriented around its regulated insurance business. It's as if regulated and unregulated divisions are the equivalent of A and B blood types, and boards now know the dangers of mixing the two under one overall corporate entity. Moreover, core competency restructurings centered in enduring regulated industry strengths create deep technical knowledge of the regulations and an ability to resolve issues because of relationships and specialized knowledge of the regulator.

Another best practice as it relates to dismantling involves the ability to organize around increasingly narrow functional, geographic, and technical areas. A functional core competency focus ensures that organizations are the best at execution in their niche and therefore can fully leverage their skills to sustain and defend the revenue stream.

A geographic focus, for example, ensures that organizations are closest to a particular customer base and able to adapt more quickly to their diverse changes in need and behavior. Meanwhile, a technical focus can create intellectual property that enables an organization to go to market significantly ahead of its competitors.

### Investor considerations

Given the changed operating climate and the accompanying challenges for large companies, investors should weigh a number of factors as they evaluate the survival prospects of current and potential large company holdings.

For instance, they should look for speed and agility over size, with a focus on how quickly and appropriately a company can adapt to customer preference changes and competitive threats. Kia, for example, seemed to come out of nowhere with a focused response to a specific defined customer need in a way that GM and all of its resources could not see or adapt around.

Also, investors should seek smaller, more active boards less worried about SOX compliance and more worried about competitive positioning. They should critically review board members' backgrounds and track records, and look for those who have been operators in highly competitive industries.

Along these same lines, investors should perform more thorough due diligence on corporate culture and formalized professional development practices. Big companies tend to hire very smart professionals, but over time the "machine" culture often gradually wears them down into a mode of "just doing their job."

There is the continuing lure that "bigger is better" in business and most of our executive compensation is oriented in that direc-

tion. However, our changed climate makes it increasingly clear that the value of strategic growth initiatives (growth that enhances long-term overall competitive position in the marketplace) over questionable growth initiatives (growth that enhances shorter term overall profits, but puts longer term matters at risk) will result in significantly higher returns for the former over the latter.

### Dealflow opportunities

As "The Great Dismantling" period takes hold, and boardroom dialogue firmly moves from financial engineering and SOX to core competencies and sales, middle-market M&A professionals can expect carve-outs to be a significant source of deal flow.

With a bit of internal genetic engineering, M&A professionals can expedite the process of the large company's transformation from "Corporatus humungous dinosaurius" to "Corporatus flexibus responsibus" and ultimately gain quicker access to carve-out opportunities. These internal measures for the M&A professional can give them a leg up on the competition.

For instance, buyers should establish a vertical specialization and understand the dynamics in an industry in real time. Deals in the future will get done by those in the know and probably on the edges of specific niches.

Acquirers also need to be proactive to remove financing contingencies as best they can. They should seek to establish their financing ahead of time by going to banks, presenting a pro-forma company, and asking for underwriting feedback. The banking industry, in the face of uncertain macro economic visibility and continued tight credit, has not yet established revised concrete and widely understood underwriting parameters. Because of that, speed to complete a deal and seller confidence in the buyer's ability to get financing will continue to be a competitive advantage.

Meanwhile, buyers should actively pursue carve-outs. Large companies may have smaller divisions that are not a priority for them, but may be appealing to the middle-market deal professional. Buyers can pursue these opportunities through active inquiry, and warm introductions from intermediaries, lawyers and accountants can also prove to be beneficial.

A critical skillset for buyers in these deals is an ability to make it easy for the sellers. Large companies selling divisions often will trade off price or terms for convenience and speed. Buyers should prepare themselves to provide companies with simplified deal terms, streamlined due diligence and expedited communication through quick responses and active issue resolution.

Over 100 specific anatomical features present in today's birds are linked to similar features in the dinosaurs, suggesting that birds are the only ancestor to have survived the dramatic climate changes that occurred 65 million years ago. With the realities of our own changed business climate and our entrance into "The Great Dismantling" era, the large companies must accept that their survival, as well, will only be accomplished in a markedly altered form.

*Thomas Bonney is a Founder and Managing Director of PE consulting firm CMF Associates*