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Led by Linda Hudson, The Cardea Group brings unparalleled expertise and award-winning methodologies to our clients. Linda and her team help navigate transitions of leadership as well as multicultural and multigenerational workforces, manage the intersection of digital and traditional communications, scale businesses in rapid growth environments, and understand the evolving aerospace and national security industry. Linda also shares her coveted insight and advice as a keynote speaker, covering topics such as effective leadership and the importance of diversity and inclusion. For more information, please visit cardeagroup.com.
Smooth Landing

Successful Postmerger Integration in Aerospace and Defense

Laura Juliano, Chris Barrett, Greg Mallory, and Daniel Friedman, with industry perspective from Linda Hudson

February 2016
Changes in the global aerospace and defense (A&D) markets have led to a wave of consolidation. To make the most of deals, companies must maximize merger synergies and position the new combined company for success from the moment the deal closes.

**Evaluating Mergers in a New Defense Environment**
Defense budgets have contracted, so the government requires the industry to fund a greater share of research costs. Consequently, evaluating merger transactions has become more critical. Companies must recognize the unique challenges of combining A&D cultures, operations, and contracts to ensure that a transaction meets the expectations of management, customers, and other stakeholders.

**Six Building Blocks for Successful Integration**
For successful A&D integration, companies must do six things: focus on value-based discipline, anticipate and confront cultural challenges that may arise in the combined company, avoid customer disruptions, communicate effectively with a wide base of stakeholders, preserve the talent and knowledge that are vital to success, and properly manage data security issues.
After years of modest deal activity, the global aerospace and defense (A&D) industry has experienced a wave of consolidation. More than 140 M&As transformed the global industry in 2014, a 22 percent increase in deal activity from 2013.¹ In 2015, the pace slowed, with 19 deals in the first two quarters, compared with 31 during the same period a year earlier.² Nonetheless, 2015 was a notable year for deal making in light of Lockheed Martin’s $9 billion acquisition of Sikorsky Aircraft—the industry’s largest deal in 20 years.³

Although the U.S. Department of Defense (DoD) has said it may block some large defense-company deals, we anticipate that the M&A trend will continue, and even accelerate, for several reasons: ongoing DoD demands for affordability, buyers’ available cash, individual companies’ desire to grow faster than the industry as a whole, the overall pace of the economic recovery, and opportunities to acquire businesses at low prices.

However, the competitive environment, existing margin pressure, and customers’ high expectations emphasize the need for clear value creation when it comes to A&D mergers. Industry regulatory requirements increase the risk associated with major deals and underscore the need for careful planning and strategic thinking. In addition, as defense budgets shrink, the DoD is requiring A&D companies to shoulder a greater portion of R&D costs. As a result, A&D companies must estimate synergies accurately, design effective integration programs, and execute those programs flawlessly.

The stakes are high. Poor planning and execution can destroy a company’s shareholder value, damage its position in key programs or contracts, and divert focus from core products, undermining future growth.

Despite these risks, the potential rewards are significant. A&D M&As can increase scale and enable companies to channel cash created in the transaction into the expansion of new technologies and the development of commercial applications or other areas of the business, such as sales, business development, innovation, or engineering.

This report was created in collaboration with The Cardea Group, a consultancy that helps companies manage change in leadership, organizations, and strategies to accelerate success. Cardea’s chairman and CEO, Linda Hudson, shared her experience and perspective on merger integration in A&D with us. Hudson is also former president and CEO of BAE Systems, Inc., a global, U.S.-based defense, aerospace, and se-
curity company, wholly owned by London-based BAE Systems PLC. Hudson was involved in 19 major transactions during her A&D-leadership career and has seen integrations from both sides, as an acquirer and as an executive with a target company. The size of those deals ranged from $10 million to $4.5 billion.

The Building Blocks of a Successful A&D Integration

On the basis of our years of experience working with the A&D industry, we have identified six key issues relevant to postmerger integration (PMI), and how these issues relate to the unique aspects of A&D:

- Value-based discipline
- Cultural challenges
- Customer disruption
- Stakeholder management
- Talent and knowledge
- Data management

By focusing on these areas, companies can maximize M&A synergies and position the combined company for success from the moment the deal closes. Many of the strategies we discuss apply to both commercial and defense environments, but we have included a set of specific considerations that are critical when departments of defense are key customers.

**FOCUS ON VALUE-BASED DISCIPLINE FROM THE START**

The planning and execution of a PMI must focus on driving value for shareholders and customers. The most successful acquirers take time during the early planning stages of the transaction to lay out clear, concise principles that will govern the integration.

The first step is to define in the aggregate and also at the business, regional, and functional levels what type of integration is required: Is this an acquisition? Is it a “merger of equals”? Is it a transformational integration? Each of these deals requires different approaches for running the integration and setting objectives.

Second, with this in mind and a clear view of the synergies, acquirers can define guiding principles for the integration. These principles may include how the company will communicate, which legacy systems will remain in place for each company, and when key decisions will be made. Acquirers should define the expected synergies—both costs and revenues—of the merger early and then apply rigorous discipline to ensure that those synergies are achieved. This requires close examination of a wide range of operational and financial issues, including the following:

- **Embedded Programs.** While the structure of these programs varies, long-standing contracts are common in A&D. Driving value from these multiyear, or even
multidecade, programs can be critical for M&A success. Companies may expect cost reduction over time because of increased efficiency and learning, and a portion of the costs may be passed on to the customer. Upfront planning is critical to understanding the structures of these contracts and how they can contribute to postmerger value.

- **Coexisting Operating Models.** A&D companies often acquire targets that pull them into adjacent markets or introduce new technologies. Dissimilar business or operating models that must coexist in the combined company—such as government alongside commercial business, long-term programs alongside rapid innovations, and products alongside services—create a new set of challenges on several fronts: delivering value, designing the combined organization, and integrating cultures.

- **Pension Requirements.** Acquirers must understand the details and differences of both companies’ pensions and how the pensions affect the business case for the merger. Companies should explore these issues before the deal closes.

- **Benefit Attrition.** Understanding the target company’s legacy contracts—such as whether they use cost-plus or firm-fixed pricing models—is the first step to understanding how benefits will manifest themselves in the combined company’s postmerger finances. How quickly savings are required to be passed on to the customer, for example, is critical in understanding which contracts will affect postmerger value as well as the potential impact on future bidding for government contracts. This process should begin in the earliest stage of due diligence and business case development. Government customers typically expect that a portion of any savings will be passed on to them in 12 to 18 months. The two- to three-year time frame for savings in a commercial business must be adjusted when building business cases for defense companies.

- **Revenue Synergy Opportunities.** M&A business cases in most industries are typically built with cost synergies at the core. Often, the revenue side is left out. This is especially true in A&D given a lack of certainty about concrete opportunities. However, strategies that can unlock significant value include selling across customers, pollinating technology and engineering capabilities across products and between the commercial and defense sides of the business, and cross-training sales personnel.

**ADDRESS CULTURAL CHALLENGES HEAD ON**

Culture plays a critical role in any successful integration; its importance cannot be underestimated. This is particularly true in A&D companies, whose employees typically have long tenures and a passion for their work and for the service that they provide to customers. Cultural differences can be particularly acute in some cases: when companies that come together have different operating models that must coexist, for example, or when a large company buys a small innovator. Acquirers should use culture tools and assessments to understand the differences between their own culture and that of the target. Acquirers should also determine which culture and behaviors they wish to establish, and they should prioritize gaps that need to be closed.
A premerger culture assessment should be conducted during the planning process to identify areas that require specific attention. We often utilize a culture baseline survey that identifies 16 key behavior sets, including communications, decision rights, processes, and integration. (See the exhibit below.)

Behaviors drive culture, so understanding behaviors and their context is critical to understanding and shaping culture. Employees at each company complete the survey, and the results highlight areas of difference. The companies then develop methods for addressing these differences. We also recommend conducting interviews with leaders from both organizations to examine root causes for existing behaviors and collect input on the target behaviors for the combined company.

Companies should not underestimate the difficulty of integrating vastly different cultures. “Be very cautious and really think through the risks and opportunities in a very methodical and unbiased way,” Hudson says.

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**COMPANY POSITION**

1Company position is relative to the two diverse position statements, as indicated by survey respondents.

Source: BCG experience.

Note: The exhibit uses illustrative examples.
AVOID CUSTOMER DISRUPTION
Companies must ensure consistent delivery to customers throughout an integration. A&D-specific factors—including a large base of capital equipment, low production volumes, and long lead times for suppliers and the manufacturing process—introduce susceptibility to disruption. The risks to delivery continuity are heightened if such changes as physical moves or the consolidation of manufacturing facilities are included in the integration plan. Successful strategies for addressing these issues include production of spare parts, duplication of manufacturing or test equipment, and cross-training of manufacturing resources.

In addition to ensuring uninterrupted delivery schedules, the integration process must protect business continuity. In many cases, customer and product sales details, along with sales force alignment and services, cannot be shared before the merger closes. However, the two companies may agree to establish a “clean room”—a virtual or physical space in which data and information that both sides agree to share can be viewed securely. The “clean teams” who review this information may be third-party partners or former members of one or both companies, such as recently retired executives, who would leave the company if the deal fell through.

Companies must establish a clean-team protocol, working closely with the legal and integration leadership teams from both sides to determine what data is sensitive and what can be shared before the close. Clean teams can collect product, customer, and sales force data from both sides and use it to identify areas in which integration plans may introduce risk to customer service and delivery, as well as any customer overlap, product similarities, pricing differences, and other characteristics. Clean teams also can evaluate and accelerate procurement synergies.

MANAGE EXTERNAL STAKEHOLDERS THOUGHTFULLY
The need for early and well-planned communications is essential, not just within the company and among integration team members but also across a wide base of external stakeholders. Regulatory and other requirements governing the A&D industry create unique considerations for transactions in both commercial and defense operations:

- **Regulations.** In many countries, strict regulations govern the commercial aerospace industry. For example, the Federal Aviation Administration in the U.S. and the Civil Aviation Authority in the UK oversee civil aviation in their countries. Often, regulatory coordination, approval, and acceptance are necessary before an A&D merger can be implemented fully.

- **Government Stakeholder Engagement.** In a defense integration, internal government contacts (with the DoD and other political entities) and other customer-facing teams must be consulted early to ensure that all stakeholders that might be affected by the deal are identified and that plans are built to meet their needs. Senior leadership should conduct the necessary outreach, to emphasize the high-level focus devoted to the integration process and to ensure that stakeholders receive the proper assurances that the integration will protect or enhance their interests.

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Regulatory and other requirements governing the A&D industry create unique considerations for transactions in both commercial and defense operations.
• **Critical Defense Standards.** Defense companies in particular are governed by standards such as the International Traffic in Arms Regulations. The integration must maintain compliance with these rules. This is a particular challenge if a commercial company, which might be less familiar with these sorts of rules, acquires a defense contractor. Defense companies acquiring a commercial business must make sure that they understand the applicable rules for that side of the business as well.

**Preserve Talent and Knowledge Throughout the PMI**

Given the long program duration in the A&D industry, individual employees who have worked closely with customers to establish the specifications, design, and manufacturing of specific products often are the repositories of deep and critical knowledge, regardless of robust policies and processes to codify that knowledge.

This poses a risk during the integration process. Despite efforts to retain top talent, some departure—and therefore some loss of institutional knowledge—is inevitable. Acquirers must identify and engage key talent desired for both the long term and the integration period. The retention strategies for the two groups differ. For long-term retention, the goal is engagement in the integration effort, clarity on future roles, and financial considerations, such as bonuses, promotions, and salary increases. To retain key employees only during the integration, offers usually focus on a retention bonus that takes into account time and performance during the integration.

To identify these repositories of key institutional knowledge, acquirers should determine areas of the business that are likely to add value and then, working with HR, assemble a list of key individuals and develop retention plans for them. Departments of focus in the A&D industry often include sales and business development, technology and engineering, and key operational segments. The goal is to target individuals who hold unique knowledge, are critical to ongoing operations, or are positioned to capture synergies.

Even employees who are not designated for specific retention plans need attention in the course of the integration. For these employees, the acquirer should implement a change management program that spotlights key moves in the integration to ensure the flow of information, make employees feel that they are a part of the transition, and maintain morale and confidence in the integration. Acquirers should also gain access to the target’s design and production details and arrange to transfer that information as early in the integration as possible to preserve the talent and knowledge of the target company. (In some cases, this information may even be shared in the clean room prior to integration.)

**Maintain Data Security**

In the past, cybersecurity and data migration were issues for the IT department. However, data security is an overall business risk, one that has risen to the boardroom level. In recent years, data breaches at major companies in several different industries have cost chief executives their jobs. “The context of managing the risk of the enterprise has to include the whole IT infrastructure and IT security at a level that has not historically been the case,” Hudson says. “In an acquisition, the minute you hook their system into your system, what additional risk have you considered?”
While these concerns hold true for all companies, they are acute in A&D, in which companies often are dealing with issues of national security.

The Well-Executed A&D PMI
Managing those six issues, and taking into account other factors, such as a company’s willingness to be acquired, are key to a successful integration, Hudson says.

One of Hudson’s first acquisitions involved two weapons makers that had similar businesses: her company made munitions and military gun systems, and the target company made air-to-ground missiles. The two companies were culturally compatible, and both recognized the benefits of the deal. The deal enabled the combined company to increase its investment in R&D, which in turn enabled it to expand into new markets. The missile business generated several hundred million dollars in annual sales, but after the merger, Hudson was able to expand it into a multibillion-dollar product line that generated the highest margins she saw in her career.

The best execution often requires the CEO to make challenging decisions. Hudson recalls running a small arms business that acquired another military-gun manufacturer. Both companies’ primary manufacturing operations were located in similar small cities. Product demand had plummeted 50 percent prior to the deal, and Hudson’s company hadn’t adjusted its cost structure for the lower sales. “Our infrastructure was pretty much intact, and it was difficult to figure out how to tackle it,” she says. The acquisition enabled company leaders to rethink the manufacturing operation from scratch.

Hudson wound up shutting down her legacy company’s main manufacturing facility and transferring most of those operations to the target company’s plant. “The company that we acquired had a much lower-cost manufacturing operation than we had,” she says. “We retained a very high-tech final assembly and test capability at our primary location, and we outsourced many mechanical parts and moved more of the manufacturing, and that took 30 to 40 percent of the cost out of our product.”

While it was a difficult decision that reduced the workforce by 30 percent, it also boosted short-term profitability and revived what had been a money-losing product line. The lessons, Hudson says, are twofold: it’s important to get a handle on the cost synergies and opportunities early in the process so that all options can be considered, and it’s important to recognize the value of using an integration event to take bold steps.

Bigger Versus Smaller
Hudson cautions that an acquirer that buys a smaller company may confront more difficulty than an acquirer that buys a larger one. Larger companies tend to have more robust processes, including business standards. They also have legal teams and HR departments that help enforce those policies and processes. Smaller companies, on the other hand, may not have been held to the same standards. They haven’t encountered as much oversight and may be more likely to push boundaries that larger companies wouldn’t consider.
Additionally, integrating a relatively small company into a large one can involve significant changes to other aspects of business:

- Cultural differences are often prominent in these mergers and can affect process oversight, governance and corporate policies, standardization versus customization, and other areas.

- Speed of innovation and decision making may slow as companies grow. This can be a significant adjustment for a small company that suddenly is part of a larger one.

- The importance, and risk, of talent retention is often more pronounced, particularly if retention involves founders or visionaries who are critical to a small company’s value.

As a result, buying a smaller company may require a greater degree of due diligence to identify any hidden ethical or legal lapses that could threaten the combined company’s success. These problems, if not detected until after the merger is completed, can be extremely costly, Hudson says.

In addition, the acquirer must be careful to establish its legacy processes in a way that does not hinder the progress of the smaller acquired company.

The Road Forward
Executing successful PMI will become even more important as the anticipated industry consolidation accelerates. The constraints on defense spending and the DoD’s emphasis on having the A&D industry, rather than the government, assume more research funding increases the need for caution in evaluating merger transactions. By following the criteria we have identified, companies can help to ensure that a transaction lives up to their expectations as well as the expectations of their stakeholders.

Notes
1. According to Mergermarket, 141 deals were initiated in calendar year 2014, versus 115 initiated in calendar year 2013.
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For Further Contact

If you would like to discuss this report, please contact one of the authors.

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Enabling PMI: Building Capabilities for Effective Integration
A Focus by The Boston Consulting Group, July 2012