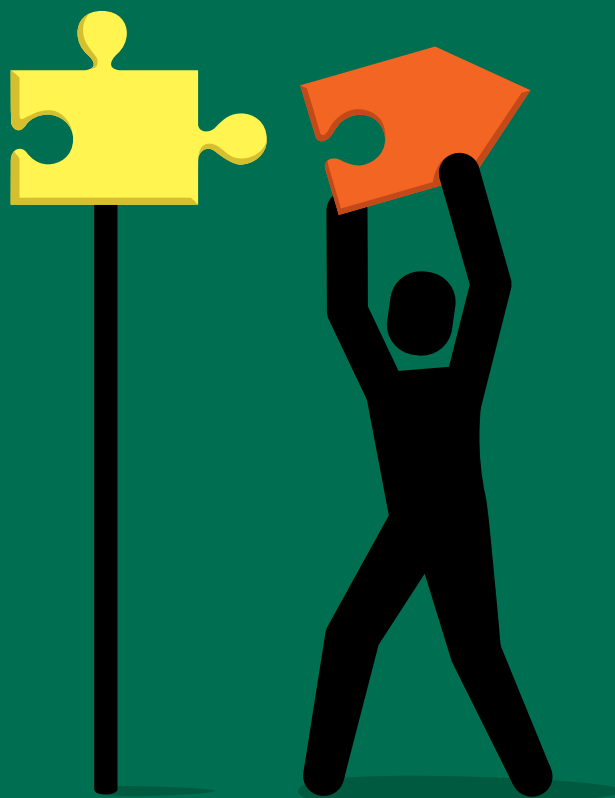


FOCUS

TRENDS IN POSTMERGER INTEGRATION V

Cross-Border PMI

Understanding and Overcoming the Challenges



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Cross-Border PMI

Understanding and Overcoming the Challenges

Cross-border mergers and acquisitions (M&A) are on the increase in virtually every sector across the globe. For example, the chemical company BASF in Germany recently acquired Ciba in Switzerland, while British Airways has agreed to team up with Iberia, and French retailer Carrefour has bought a succession of supermarket businesses in Brazil, China, Poland, and other growth markets. Other examples include the Indian vehicle manufacturer Tata Motors' acquisition of the Jaguar and Land Rover brands from Ford in the United States and the merger in the pharmaceutical sector between Japan's Takeda and North America's TAP.

There are several reasons for the upswing in cross-border M&A activity. Many companies, for example, need to find new sources of growth as their domestic markets mature. Deregulation, the globalization of consumer and business markets, and a drive for sales, cost, and process-improvement synergies also enter the equation.

However, despite their advantages, cross-border transactions pose several postmerger integration (PMI) challenges that can undermine a deal's

long-term value-creation potential. This report, the fifth in our series on PMI, addresses the five biggest challenges and suggests possible solutions, based on BCG's work on hundreds of PMIs around the world.

The following are the five biggest PMI challenges for cross-border transactions:

- ◇ Gaining a full and accurate picture of the target's business
- ◇ Navigating the political and regulatory pitfalls
- ◇ Selecting the right speed for the integration
- ◇ Bridging the cultural divide between the two companies
- ◇ Managing the "foreign fear factor"

Challenge 1—and Its Solutions: Gaining a Full and Accurate Picture of the Target's Business

Obtaining information on a foreign target is one of the most common and often overlooked challenges in cross-border M&A. Frequently, the data sources that an acquirer would normally use either differ or do not

exist in the target's country, a problem that can be compounded by dissimilar corporate-reporting requirements. Lack of reliable information can be even more pronounced in rapidly developing economies and can lull acquirers into making false assumptions about the target's financial situation, business model, organization, decision-making style, and degree of centralization or decentralization, among other issues.

Take the case of a health care company that acquired a complementary business in another country. After the deal was done, the acquirer discovered a series of less-than-ideal selling practices at the target company; these had not been spotted during the due diligence process because of the lack of information transparency and the assumption that business practices in the target's country would mirror those in the acquirer's. This problem, coupled with unfamiliar legal structures, different languages, and a large degree of decentralization of the target, eventually led to the two parties entering into dispute resolution procedures.

Often, the information differences between companies are deep-rooted, making them harder to spot. When a U.K. retailer acquired a regional re-

tailer in the United States, for example, the buyers planned to transform the business with higher-quality products and management, as well as a much bigger share of own-label products. However, the British company later discovered that the target's IT and management systems could not support the degree of centralization required to increase the own-label share. Moreover, the acquirer was unable to instill the necessary command-and-control culture. As a result, the integration never really worked, and the acquirer subsequently divested the business.

A large U.S. industrial goods company encountered a different information problem, related to real estate, when it bought a small player in China. The Chinese target had a very pragmatic approach to valuing and leasing properties—an approach that was based on de facto local practices but that sailed perilously close to the edges of what was locally permissible. When the U.S. acquirer applied its own process for valuing real estate to the target's portfolio, the differences between approaches became apparent. Eventually, the acquirer decided to exclude some of the Chinese assets from the newly acquired company's portfolio in order to avoid possible damage to the reputation of the U.S. parent company.

It is vital to recognize that information gathering in a foreign market is more difficult, more time consuming, and more complex (because of different rules, for example) than at home. Acquirers should allow additional time to collect the necessary information and to do up-front due diligence and integration planning—this is usually less costly in the end.

There is also no substitute for visiting, seeing, and experiencing the target's market. These first-hand local insights should be complemented by interviews with other players in the market—such as customers and suppliers—carried out by either external

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advisors with good local knowledge or in-house resources. The target's employees—their knowledge and experience—are another key source of information.

Challenge 2—and Its Solutions: Navigating the Political and Regulatory Pitfalls

Political and regulatory issues—including antitrust considerations and employment law—often have a pivotal impact on the effectiveness of cross-border mergers. Consequently, these issues need to be assessed at the outset.

Key questions that acquirers should consider include: How does the regulatory approval process in the target's country work? Which jurisdiction will take precedence? Which regulatory authority will predominate? How does the regulatory approval process work in that jurisdiction? What is the nature of employment laws and how rigorous are they? What is the likely degree of government influence? Systematically assessing, understanding, and answering each of these questions is

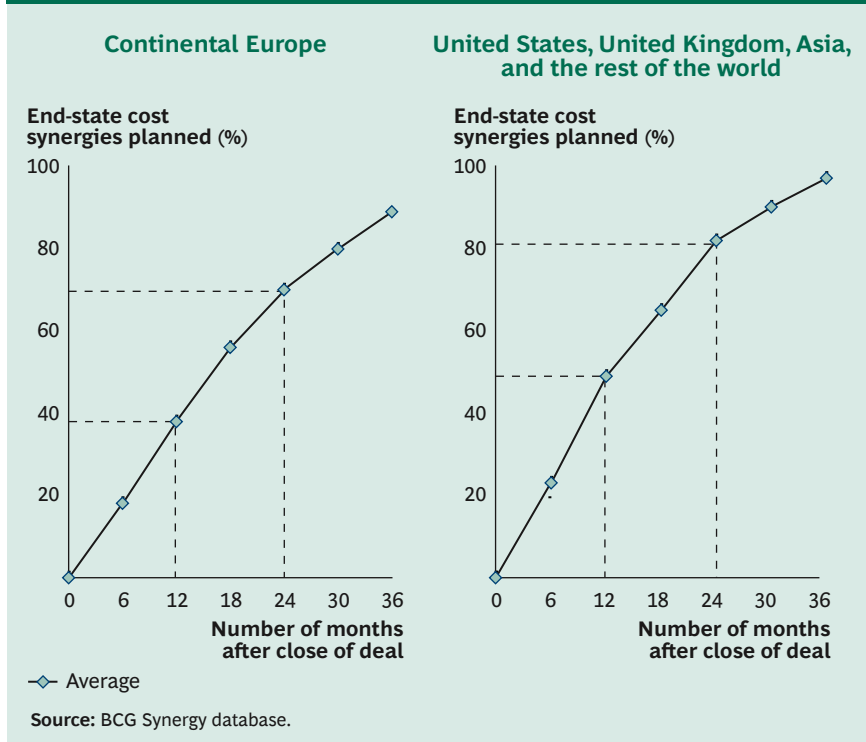
usually a prerequisite for a successful cross-border PMI.

Political Pitfalls. If the target is considered a quasinational asset in the hearts and minds of the general public and elected representatives, the acquirer's options can be severely restricted.

A large industrial goods company recently encountered this problem when it proposed closing a number of subscale manufacturing facilities of the French affiliate of a newly acquired business. Unfortunately for the acquirer, the plan was effectively vetoed by the political establishment because the plants accounted for a major proportion of local employment in a relatively underdeveloped region. To avoid the possibility of negative media attention and damage to its reputation, the company abandoned the closings—and the potential synergies they offered—in the interests of safeguarding the overall deal.

Regulatory Pitfalls. The regulatory review periods and constraints imposed on some cross-border deals can also create difficulties. When GE tried to acquire Honeywell in the 1990s, the company managed to leap the regulatory hurdles in the United States without a hitch. But the European authorities imposed significant restrictions, including requiring divestitures, which forced the GE board to abandon the deal. Over the years, BCG has found through its work with clients that synergies from European M&A deals consistently take six months longer to ramp up than M&A deals in other regions—largely because of the protective employment laws in many European countries. (See Exhibit 1.)

Exhibit 1. Synergies from M&A Deals in Continental Europe Ramp Up More Slowly than Elsewhere



For Asian and U.S. companies that are used to operating in environments with relatively little employment regulation, Europe’s labor laws can come as a surprise. These laws can have a major impact on the timing of any proposed workforce reductions, owing to the need to consult with a wide range of stakeholders—from trade unions and works councils to politicians and government agencies. Many of these companies have discovered that avoiding strikes is a delicate and time-consuming balancing act.

To negotiate the political and regulatory hurdles, acquirers must first identify the most likely political constraints and then, in view of these limitations, determine their company’s economic limits. What is nonnegotiable and what can be compro-

mised for the sake of the deal? To understand and navigate the local political landscape, it is usually wise to hire professional communicators and political advisors within the target’s country; flexibility and local knowledge are critical.

Understanding which regulatory authority will have the greatest influence on the merger will help to determine the overall integration timeline and the process that must be followed. To accelerate the integration process, the relevant regulatory authorities should be approached long before any deal closes.

Regulatory authorities typically assess the risk of an acquirer’s obtaining a “dominant position” in the market, measured by combined market shares. Before engaging in any

dialogue with regulators, acquirers should identify the assets in the merger that the authorities are likely to require them to divest. Next, they should create a lobbying plan, proactively approaching the relevant regulatory authorities to demonstrate the advantages of the deal to both customers and consumers. Acquirers need to anticipate the regulator’s likely objections and have the necessary analyses at the ready to make a robust defense. With skillful negotiation and strong, evidence-based economic arguments, acquirers can alleviate many regulatory concerns, avoiding the need for unwanted divestitures.

If the regulatory-approval process is likely to be lengthy, using “clean teams” can accelerate the eventual integration, once approval is gained. These small, closed teams—whose members are bound by confidentiality agreements—enable the acquirer to process and analyze data on a confidential basis before the deal is closed. After the transaction is finalized, the team’s results can be shared and acted upon immediately.

This approach was successfully employed in a recent music-industry deal. During the transaction, U.S. regulatory approval came very early in the process, but European approval came 18 months later, creating a period of uncertainty about the likely outcome of the deal. To make up for potential lost time, a clean team was created to do all the data analyses in advance. This ensured that the actions of the acquirer could at no time be construed as jumping the regulatory gun, yet it allowed the buyer to use the regulatory review period to prepare and plan the integration. As soon as the deal closed, the company

was ready to implement many of the key decisions that had been analyzed by the clean team.

While clean teams can help overcome regulatory delays, what about dealing with potential employment-law obstacles? There are numerous solutions here, from reducing work hours and introducing part-time employment contracts to offering voluntary severance, early retirement, and short-term contracts with appropriate incentives, among many others. All of these options can contribute to a strategy for reducing the overall workforce that is far more palatable to all parties concerned than layoffs. In all cases, it is essential to engage and involve unions and work councils early in the process in order to avoid lengthy and costly labor unrest. Acquirers should create an environment and a timetable that allow unions' concerns to be voiced and accommodated.

Challenge 3—and Its Solutions: Selecting the Right Speed for the Integration

Choosing the speed and the timing of different aspects of an integration is possibly one of the most critical decisions that an acquirer will make. This decision will be shaped by several factors, including the following:

- ◇ *The Strategic Logic of the Deal.* Is it for consolidation, growth, or a combination of the two?
- ◇ *The Spirit of the Integration.* Is it a takeover or more a merger of equals?
- ◇ *The Systems to Be Chosen.* Should the systems combine the “best of

both worlds,” be led by the acquirer’s model, or be based on a totally new approach?

- ◇ *The Scope of the Integration.* Will it involve just a few units or all units at once?

These factors establish the proper mindset for the integration. (See Exhibit 2.)

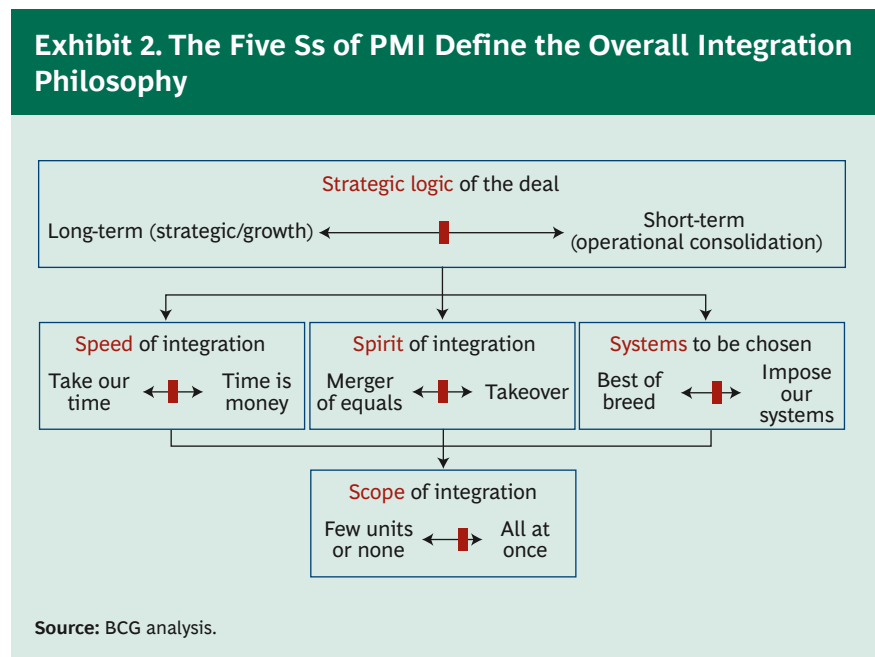
Different types of mergers fare better at different speeds. Consolidation mergers require rapid integration: realizing the synergies quickly is vital. Growth mergers, on the other hand, can progress more gradually because the overriding priority is to maintain the target’s growth potential, staff, ideas, and customers.

In a cross-border PMI, there is a higher likelihood that different parts of the organization will be integrated at different speeds than in a domestic merger. Although there will inevitably be a greater focus on generating rapid cost synergies in certain parts

of the organization—for example, by consolidating headquarters functions and sites—growth objectives are often a major factor for doing cross-border deals, and this requires a higher level of care. Specifically, a slower, more cautious style of integration is required for the growth components of a merger in order to gain a more intimate understanding of local customers and to retain local staff and knowledge.

A phased approach usually works well in growth-oriented cross-border mergers: acquirers should first establish a senior management team, then develop a comprehensive communications program, and finally define and carefully share best practices across both companies.

Operating the acquired business as a separate division for a period can also be prudent, especially if there is relatively little overlap between the target’s and the acquirer’s geographic markets. This will provide the breathing space needed to decide



the appropriate speed and extent of integration, taking into account all the variables and functions. A gradual integration can work particularly well in sectors such as the biopharmaceutical industry, where it is often important to retain and nurture the target's R&D portfolio, know-how, and talent.

Challenge 4—and Its Solutions: Bridging the Cultural Divide Between the Two Companies

Experience has shown that the cultural differences between companies—how things get done in each organization, including the attitudes and behaviors of its workforce—are often more pronounced than the cultural differences between nations. For example, a large, risk-averse multinational pharmaceutical company is likely to have far less in common, from a cultural perspective, with a small, entrepreneurial biotech business than with a large pharmaceutical player from a different continent. Similarly, a nimble Web-based financial services company will have a very different attitude toward risk and decision making than a hierarchical brick-and-mortar retail bank.

A cross-border merger amplifies these intercompany cultural differences because, in addition to the intensity and anxiety that is part of any PMI, a cross-border deal injects different national cultural identities and approaches into the mix.

But a cross-border merger also provides an often unique opportunity to redefine the culture of an organization around its key strategic objectives. Why? Because PMI involves forming a new senior team, estab-

lishing new roles in the organization, and designing the key performance indicators that will help the business meet its objectives.

There are many areas of cultural difference that need to be managed in

Cultural differences between companies are often more pronounced than those between nations.

a cross-border PMI. Typically, tensions surface around three main areas: how the two parties make decisions, how they conduct meetings, and how they communicate. Cross-border PMIs require literally thousands of decisions to be made that create a corresponding need for many meetings and intense communication—and how a company meets these challenges is a manifestation of how it treats and values its employees.

To avoid conflict, the acquirer needs to fully understand the target's culture in each of these areas. Specifically, companies should address the following three main questions:

◇ *How are decisions made in the target organization?* Is the decision-making process pushed down to the front line in a decentralized and consensual fashion, or is it centralized and dictated by the organizational levels above? Are decisions made quickly or slowly? Are many or few people involved? What is the tolerance for ambiguity, incomplete information, and risk before decisions can be made? And, once decisions

are made, do they stick or are they often changed?

- ◇ *How does the target company conduct meetings?* Are meetings open forums in which employees can freely discuss, challenge, and resolve issues? Or are meetings intended to approve a carefully orchestrated “done deal” after the real debate and decision making have taken place behind closed doors?
- ◇ *How does the target company communicate with its employees?* Does it communicate frequently and in person, or more sporadically and in written form? Do communications tend to be detailed and explicit, or more general and open to interpretation?

In a Chinese-U.S. merger, for example, the two companies came to an impasse mainly owing to tensions created by their polar-opposite attitudes toward risk and speed of decision making, not the geographic gulf between the two businesses. The Chinese company's ability to cope with high levels of ambiguity and relatively loose decision-making processes (often based on gut instinct) contrasted sharply with the U.S. company's need for analytical rigor.

The U.S. company employed a highly structured decision-making process that was both factually and analytically rich. It made a strong commitment when a decision was made, but the process took a long time owing to the involvement of numerous experts and the large number of discussions. The Chinese adopted a much more entrepreneurial approach to decision making. Fewer people were involved, the burden of proof was significantly

lower, and they were willing to run calculated (or even uncalculated) risks based on a thorough knowledge of the local environment. Their overriding concern was to seize the opportunity at hand.

Their different approaches to decision making frequently put the two parties at odds, not only as to ongoing decisions about the integration but also in reassessing past decisions. A case in point was when the Chinese company wanted to backward integrate into the supply chain. The move was intended to reduce the company's dependence on suppliers and create a unique competitive advantage. But the U.S. acquirer agonized so long about the decision, conducting lengthy analyses and soliciting external opinions, that the economic conditions changed and the opportunity was lost.

The bottom line was that the Americans found their Chinese counterparts impossibly undisciplined and governed by gut instinct. The Chinese, in turn, felt stifled by the Americans' need to dot every i and cross every t before making a decision, and complained bitterly about missed market opportunities.

Communication, or rather miscommunication, was also a major issue, as it is in many cross-border mergers. Although the U.S. company had many Mandarin speakers, and the Chinese business many English speakers, language differences became problematic. When asked about "the measures being taken on change management during the integration," one person replied, "To my knowledge, there are no plans to change the management." This particular misunderstanding was caught

and rectified in its infancy; the worry is how many others slipped past unnoticed.

Different meeting styles also create friction in cross-border mergers. In an Anglo-French integration, the French

One advantage of a PMI is that it creates an opportunity to define a new or adapted culture for the new organization.

acquirer's hierarchical approach to board meetings, in which the CEO's views were rarely openly challenged, contrasted sharply with the rough-and-tumble debating style employed by the British target's board. What was the impact? The French found the challenge to their hierarchy offensive, while the British felt disempowered by the lack of open debate and left the company in large numbers.

While companies nearly always recognize the importance of cultural change in PMIs—especially in cross-border mergers—experience shows that relatively few businesses actively manage it or allocate sufficient time and resources to the issue.

All acquirers should conduct a cultural diagnosis of the two companies—using employee surveys and other tools—in order to systematically analyze and understand the true nature of the differences between the two parties' cultures. (See Exhibit 3.) Points of cultural misalignment should be systematically mapped out and prioritized. The most potentially burdensome cultural differences will quickly become apparent and should form the basis of a handful of priori-

ties, especially as management's capacity for change will be limited during the frantic "cut and thrust" of the integration.

For each priority area, it is important to drill down in order to understand the true obstacles to cultural alignment. In the example illustrated in Exhibit 4, one of the problems is that Company A delegates authority for decisions far down in the organization, while Company B operates a more command-and-control leadership, with decisions cascaded down from the top.

Taking into account the insights from the cultural diagnosis, companies need to decide the type of culture they want for the combined entity. As noted, one of the advantages of PMI is that it creates an opportunity to define a new or at least an adapted culture for the new organization that may be different from the culture of either company. The new culture may be based on a "best of both worlds" approach or it may adapt the two existing cultures so as to support the new organization's strategy effectively.

Acquirers can employ the following four main levers to drive cultural change: leadership behavior and communication, management appointments, organization design, and change management tools.

Leadership Behavior and Communication. Leaders must be committed to building a new culture and lead by example from the top, signaling behavioral change to their direct reports. Clear communication from the outset is an essential part of this process. Everyone throughout both organizations has to understand the

Exhibit 3. The Differences in Companies' Cultures Can Be Measured

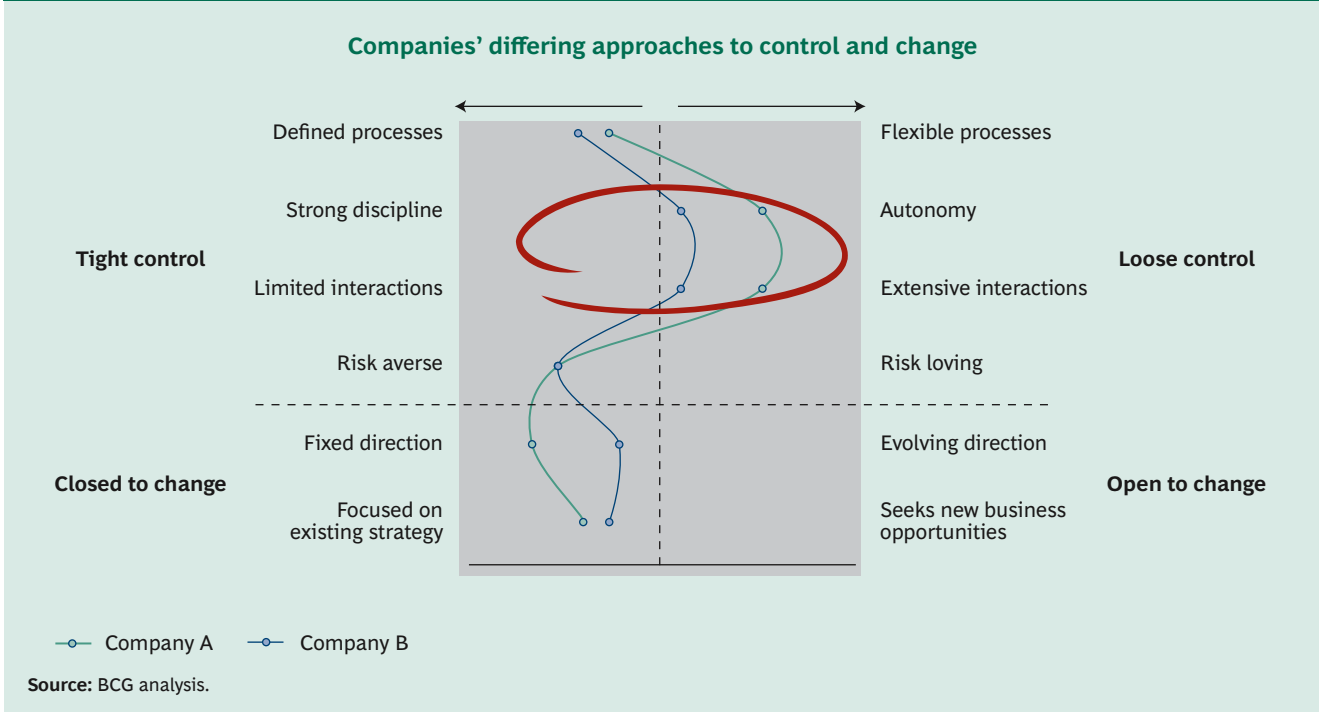
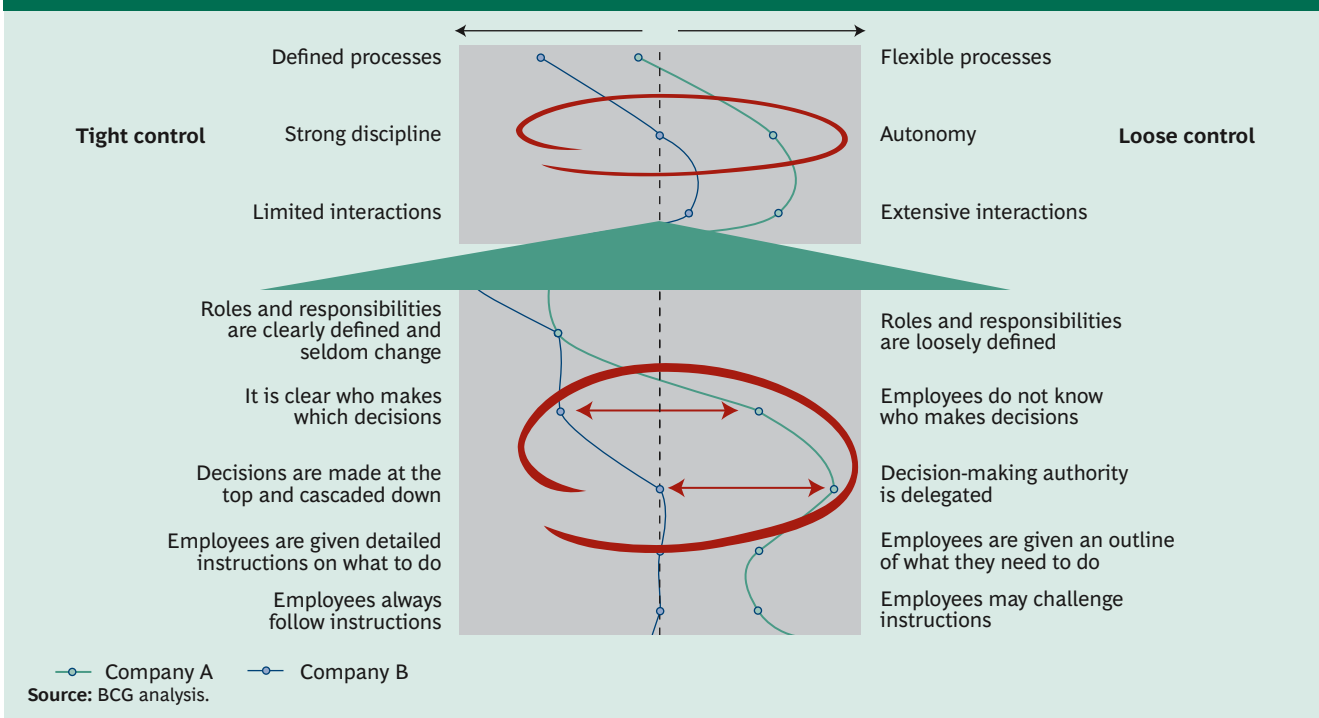


Exhibit 4. Drilling Down Reveals Key Differences Between Companies



desired behaviors and the role these behaviors will play in supporting the new company's objectives. Regular pulse checks should be taken to measure progress in changing the culture and to spot potential flash points.

Face-to-face meetings are the most powerful way to communicate, especially if employees are given the opportunity to ask questions and air their concerns and aspirations; written communication is a poor alternative. Although in-person communication can be time consuming and sometimes uncomfortable, it offers numerous benefits, including the opportunity to get to know employees and to hear their personal responses to proposals.

In a recent cross-border merger, the U.S. CEO of the acquiring company visited all of the target's 15 European sites in the first three months of the merger. Moreover, his behavior was mirrored by his senior executives, who, depending on their roles, spent between 30 and 90 percent of their time during these months visiting and interacting with their counterparts at the newly acquired company. They pressed the flesh, rolled up their sleeves, asked and asked again about the business, and broke bread with their new employees, making it a priority to understand—and be seen to understand—how things worked. They repeatedly explained the merger process and its implications. And the CFO was on the phone with his European counterpart at least twice a week.

Management Appointments. The process of selecting people for senior positions in the new organization during a PMI sends out a strong sig-

nal about expected behaviors and the new culture. The acquirer should introduce appropriate systems and criteria for recruitment, incentives, and promotions, supported by clear and well-communicated key performance indicators. Appointments in

The organization's structure should be aligned with its strategic and business imperatives.

the upper two or three layers of the organization will be keenly anticipated by all staff. Employees will be quick to connect the dots about the tone of the integration if, for example, the senior team is made up of well-known cost cutters. Similarly, failing to select any senior staff from the target can make it very difficult to retain that company's staff further down in the organization.

Organization Design. Designing the organization structure, including the role of the center, as well as defining each role and its associated decision-making rights, is essential.

The organization's structure should be aligned with its strategic and business imperatives. The number of business units and P&Ls needs to be determined, as well as the relative importance of product, function, and geography. The location of functions, the reporting lines, the number of layers, and the spans of control are equally important, since they determine not only the effectiveness and efficiency of the new organization but also the degree of freedom in the process of filling key positions. On a

cascade basis, each layer of the organization designs the detail of the next layer down, mindful of the overall design principles.

In order to make the organization structure work, the acquirer should create job descriptions that include key roles, objectives, and accountabilities, as well as articulate the capabilities and behaviors required to execute those roles—again, a task closely linked to the appointments process.

Change Management Tools. Employing a wide range of change management techniques always plays a key role in stimulating cultural change. The guiding principal here is to get employees from both companies talking and collaborating with each other as often as possible in work and (especially) in nonwork environments in order to understand each other and to forge and strengthen relationships. This can be done in a variety of ways, including role playing, boot camps, and temporary or permanent transfers.

Interestingly, music has been an especially effective change management tool in cross-border integrations—presumably because it is a common language in which neither party has an advantage or a disadvantage. The music paradigm uses a symphony orchestra as a metaphor for the organization undertaking a merger and seats the executives from both companies among members of a live, professional orchestra. The conductor leads the musicians through a series of carefully crafted exercises that help illustrate key qualities, reactions, and practices of high-performing business teams, with all the elements of the exercises designed to be strategically in line

with the needs and challenges of the executives and the merger.

The music paradigm provides a high-impact learning experience—a powerful personal and team journey—as well as an exciting instructional entertainment. Among other benefits, it reinforces the merger’s objectives and key strategic messages, and it builds momentum for addressing critical issues through a shared experience in a safe environment in which executives can rethink and recalibrate their assumptions and behaviors.

Challenge 5—and Its Solutions: Managing the “Foreign Fear Factor”

Lack of transparency and ignorance breed mistrust, anxiety, and (often) prejudice—especially in cross-border mergers involving companies from culturally and geographically diverse markets. Not surprisingly, many acquirers prefer to focus on targets domiciled in countries with cultures similar to their own. But the fear of foreign powers and environments is as often unjustified as it is surmountable—something that many Western companies discovered in the 1980s when they started to acquire businesses in Japan. Indeed, the dramatic success of many Japanese companies on the global stage—especially in the automobile industry, which built many very successful operations in the West by combining Japanese management and Western employees—has clearly demonstrated that it is possible to bring together “foreign” corporate cultures.

The Japanese experience is instructive, not least for companies considering mergers with businesses in Chi-

na, India, and other new growth markets. Japan’s business culture is very different from the business culture in the West—especially in terms of the value it attaches to various aspects of management and leadership. Typically, Japanese manage-

To dispel fears, it is essential to turn the unknown into the known by actively encouraging openness.

ment is less interested in numbers or detailed research and more concerned with the vision, the direction, and the broad shape of the business.

For example, when a Japanese supplier of digital office equipment was considering acquiring a complementary software business in the United States in the late 1980s, the acquirer was presented with in-depth financial and strategic analyses of different business models and possible future developments in order to test the logic of the deal. The Japanese company’s management was utterly unconvinced by, and not even interested in, these analyses. Instead, they traveled with a delegation of technicians to the target company’s site and spent long hours discussing with the target’s management the nature of their businesses and their philosophies—and, in the process, they discovered their combined technical and other strengths. These insights convinced the Japanese that the two companies were in the same technological domain, and the deal eventually went forward.

To dispel fears and counterproductive assumptions, it is essential to

turn the unknown into the known by actively encouraging openness and transparency. Companies need to bring employees from both organizations together and create opportunities for sharing information and experiences so that myths are replaced with real data and information. As discussed earlier, numerous cultural diagnostic tools can be used to excellent effect. Hardwiring transparency mechanisms into the governance and organization of the newly merged company will go a long way toward countering ignorance and reducing fear.

Actions speak volumes. For example, the signaling effect of early decisions on who will fill senior positions in any integration can be huge. In a recent integration in the energy sector, the acquirer’s senior management team espoused a “merger of equals” philosophy, yet employees were quick to draw their own conclusions when the top-level board appointments failed to include a single representative from the target company. Two large pharmaceutical companies adopted a very different approach when they merged, and their actions supported the collaborative message they communicated to employees of the new organization. They created a cross-company steering committee and integration team to lead the merger, comprising key talent from both sides. The result was a balanced view, very low attrition, and a genuine best-of-both philosophy that incorporated aspects of both companies’ business models.

Conclusion

PMI is challenging even in familiar environments. Cross-border deals inject even greater complexity and un-

certainty into the process, primarily owing to the difficulty of obtaining full and accurate information and the cultural divides between the acquirer and the target. Nevertheless, as with all PMIs, these additional hurdles can be overcome by carefully thinking through the strategic options and planning each step of the integration long before the deal is closed. As we have discussed in our previous reports on PMI, it is the strategic choices that are made before the two parties agree on the transaction that ultimately determine the success or failure of any merger.

Particular attention should be paid to the speed and style of the integration. In cross-border deals, there is a higher probability than in domestic mergers that a more granular, phased approach will be required, with different speeds and styles for different parts of the business and for different locations—particularly for growth mergers. Managing the “softer” cultural issues will probably be the most challenging aspect of a cross-border deal, especially in knowledge- and people-dependent mergers. Strong and effective communication will play a pivotal role in retaining top talent.

The current increase in cross-border mergers may subside in the short term, but there is a high probability that the long-term trend will be upward. Now is the time to prepare.



About the Authors

Peter Strüven is a senior partner and managing director in the Munich office of The Boston Consulting Group. You may contact him by e-mail at strueven.peter@bcg.com.

Christopher Barrett is a principal in the firm's Dallas office. You may contact him by e-mail at barrett.christopher@bcg.com.

Niamh Dawson is a principal in BCG's London office. You may contact her by e-mail at dawson.niamh@bcg.com.

Daniel Friedman is a partner and managing director in the firm's Los Angeles office. You may contact him by e-mail at friedman.daniel@bcg.com.

Peter Goldsbrough is a senior partner and managing director in BCG's London office. You may contact him by e-mail at goldsbrough.peter@bcg.com.

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For Further Contact

BCG's Corporate Development practice sponsored this report.

For inquiries about the Corporate Development practice, please contact the practice's global leader:

Daniel Stelter

Senior Partner and Managing Director
BCG Berlin
stelter.daniel@bcg.com

For inquiries about PMI, please contact BCG's global leader for PMI:

Peter Strüven

Senior Partner and Managing Director
BCG Munich
strueven.peter@bcg.com

Or you may contact BCG's regional leaders for PMI in the Americas and in Europe:

Daniel Friedman

Partner and Managing Director
BCG Los Angeles
friedman.daniel@bcg.com

Peter Goldsbrough

Senior Partner and Managing Director
BCG London
goldsbrough.peter@bcg.com

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