Interview with Ulf Hoof, Head of M&A at ABB Group

Risk Management & Compliance

Bryan DeBlanc (BdB): Ulf, you have been working as a corporate M&A director since the year 2000 and have seen many deals, both positive and negative. From the standpoint of a Board member, what are the three key areas that you think a Board member should be concentrating on when evaluating M&A deals?

Ulf Hoof (UH): In my view, the Board should ensure good governance over M&A, a sound M&A process and timely and adequate reporting:

i governance concerns the way that M&A is handled, the authorizations within the company and where the M&A function is located within a company;
ii the M&A process should be designed to allow for sufficient reviews and interventions and ensure that many different parts of the company are involved in the M&A evaluation and decision making;
iii the reporting to the Board should be focused and allow them to evaluate whether management has done a good job and whether the deal can be successful and generate shareholder value.

BdB: Can you tell us a little bit about governance within ABB?

UH: First of all, it is important to know that ABB has quite a history with M&A. Some of the key lessons learned from the early days of ABB were around ensuring that representatives from all parts of the organization are involved and that no one or two people within the organization can make an M&A decision on their own.

M&A is driven out of the strategy of our company and not opportunistically. We have approval limits for each M&A deal. The ideas for M&A transactions typically come from the Business Units. It is the Division Heads who have the authorization to proceed with transactions up to an initial, low threshold. For larger deals up to a next threshold, the CEO needs to decide and for anything exceeding that threshold, still a relatively small amount relative to ABB's $40 billion sales figure, the entire Board of Directors needs to decide.

In practice, this means that the CEO is involved in every transaction decision and that the Board is involved in anything except for minor transactions.

And the culture within ABB also ensures that people speak with each other and share ideas. No Division Head would do an M&A transaction – even if it were within his decision limit – without, at a minimum, discussing this with the Group CEO.

BdB: What about the location of the M&A function within an organization? Should this function report directly to the CEO, or to others within the organization?

UH: Well, that depends very much on the size of the organization and the culture and there is no right single answer. Within ABB, it was decided to have the M&A function report to the CFO. In our experience, we can see a risk that if only the CEO, the Division Head and Head of M&A are involved in a deal, financial and risk management considerations may not be

adequately addressed. The finance function is absolutely critical to evaluating the deal mathematics and mechanics, valuation, cash return requirements, synergy assessments, etc.

BdB: You mentioned the need for a strong M&A process. What do you think is critical when considering this process?

UH: Once again, it is important that the team is broad with all relevant functions included. Within ABB we have 14 different work-areas/stakeholders from the business and corporate functions involved in every M&A deal, regardless of the size. Don't forget… even a very small M&A deal can carry significant risks and have a negative financial impact if not properly reviewed and assessed prior to acquisition.

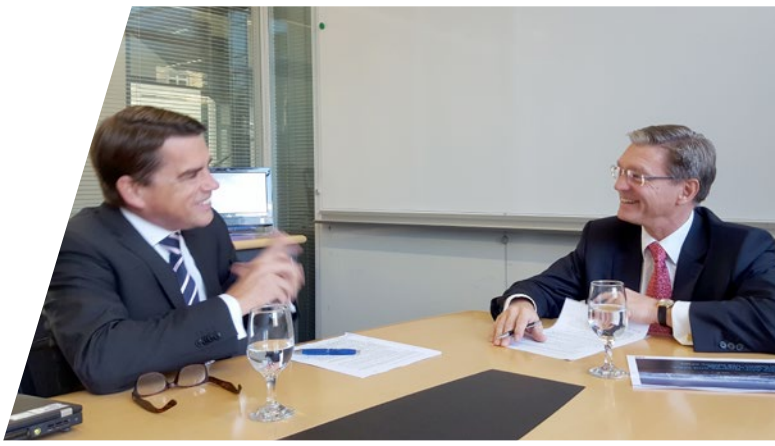
There is a need for a clear definition of responsibilities in M&A. At ABB most deals are identified by the business. The M&A function gets involved early in the transaction process. During the transaction execution, there is a co-lead between the M&A function and someone from the business. After the transaction is closed, the deal goes back to the business so that they can integrate the acquired business into ABB. This avoids a situation in which a central decision maker decides to buy a business and simply gives it to an uninformed and unprepared division for integration and management. It also avoids the situation where one party gets "deal fever" and there is no one who raises sufficient concerns.

BdB: What are some of the functions which are particularly important to be involved in a transaction?

UH: Everybody knows about the finance, tax and legal functions as well as pensions and HR. These are critical and normal. At ABB, we also have other functions involved such as compliance. One small compliance mistake can cost a lot. Also given the challenges today in the IT space, the IT function is critical in order to ensure that the latest technologies are being applied and that the business can easily be integrated into the rest of the ABB Group.

BdB: Let's talk a little bit about integration. Do you believe that every company should be completely integrated after being acquired?

UH: Well, generally that should be the goal. It is a normal requirement that the acquisition should be able to realize sufficient synergies in order to cover the acquisition premium, which is required today to win a deal in this competitive M&A environment. The ability to realize synergies out of an acquisition is dependent upon that business being able to work together with the ABB Group. However, some synergies are harder to achieve than others. Typically cost synergies, which are often fully under control of the buyer, are less difficult to attain than revenue synergies. Achieving revenue synergies is partly out of the control of ABB and requires ABB to convince



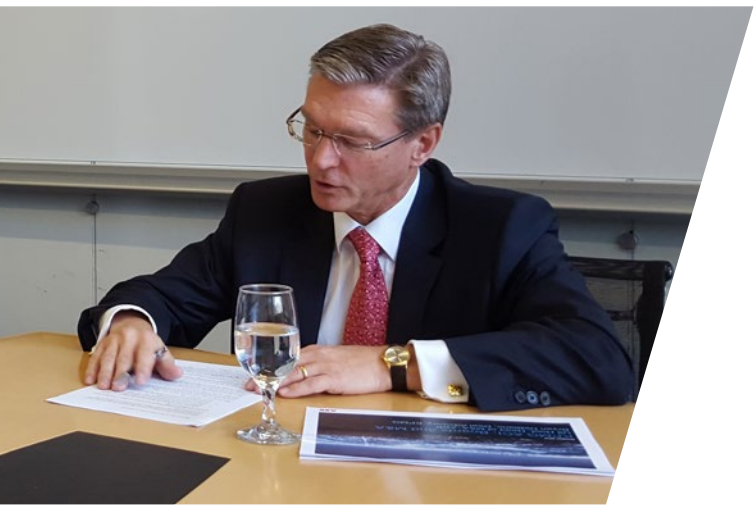
and satisfy customers and, in the end, to be better than our competition. Attaining revenue synergies, therefore, requires a full integration of the business including the front-end sales organization.

As a Board member, one should be extremely wary if management is intending to achieve large amounts of revenue synergies. A Board member must insist on seeing details of precisely how these revenue synergies would be achieved. If the intention, for instance, is for the existing business to sell products from the acquired company throughout its group, questions should be asked, such as: Is the sales force prepared to sell these new products? Are they incentivized, trained and equipped for it? Are there enough people assigned to ensure that this cross selling of products actually happens within the sales organization? It happens all too often that synergy potential is put into a plan, but it is not achieved.

Board members should also be aware that synergies may also be negative to the value and not positive. What I mean is, although one may be able to save some costs in procurement and possibly some overlapping personnel functions, negative synergies may prevail in the customer base. For instance, if the target and ABB are competitors prior to the deal and a third party customer is buying products from both, then there is a risk that the procurement function of those customers will continue to insist on having two suppliers for its products. This could result in half of the business of the joint operation that ABB and the target just combined disappearing overnight.

As a Board member, one should also understand the Internal Rate of Return (IRR) on the acquisition on a cash basis with and without synergies. That way, hopefully, if only cost synergies are achieved, the deal can still meet the IRR threshold. The achievement of revenue synergies can then, therefore, be considered "icing on the cake".

BdB: What else can you tell us about the ABB M&A process that could be useful and that a board member should be looking out for?



UH: Well, in addition to being founded in the strategy, during the transaction there should be very clear hurdles and milestones as well as meetings of all the relevant people involved. There should be a culture which allows everyone to speak up and not feel threatened if they speak out against the deal favored by the key players in the organization.

BdB: How to you ensure that the deals that ABB undertakes are actually tracked against the original business plan, including synergies?

UH: Well, Bryan, at ABB we follow up deals quarterly for at least 3 years. The comprehensive tracking covers both qualitative and financial dimensions. The qualitative dimension includes customer retention, operational excellence, management retention and employee satisfaction as well as progress on integration of the front-end, back-end of the business as well as the key business functions. The financial dimension covers the achievement of revenue and cost synergies and profitability against plan as well as cash return on the investment.

BdB: Let's talk about the information requirements. What do Board members need in order to evaluate a deal properly?

UH: There are a number of key metrics that a Board member needs: Valuation is key, both standalone and with synergies; as is the cash flow and impact on working capital. Let's not forget: cash is key to the shareholders. For large transactions, we also look at the impact that the transaction is going to have on the financial position of ABB going forward to ensure that there are no surprises down the road with amortization of intangible assets, debt/equity ratios, etc.

One other key area is information about synergies and understanding whether an acquisition is complementary or consolidating in nature. Complementary transactions have the benefit of being positive and motivational to the workforce, as their major goal is to achieve revenue growth. As mentioned, earlier, however, achieving revenue synergies is much more difficult than cost synergies. Consolidating transactions require a focus on cost reduction, primarily coming from workforce redundancies. These are, therefore, generally less motivating for the organization, however, the achievement of these cost synergies is much easier to obtain than revenue synergies.

As mentioned before, understanding how the synergies are going to be achieved in detail and ensuring that management has really given some thought as to how to achieve those synergies, including the potential to lose customer base as a result of the transaction, is key to success.

Finally, all of this has an impact on the motivation of the workforce. While there are exceptions to this rule, M&A transactions generally have a good chance of success when the workforce is engaged and motivated.

All of these aspects should be included in a board pack which is thorough and yet concise enough for a board member to be able to digest.

BdB: Do you have any other final words of wisdom for board members?

UH: The board plays a critical role in M&A. It is important to inform and involve the board upfront. Board members have extensive industry experience, business knowledge and connections that may be relevant to the proposed deal and should be brought into the discussion as early as possible. When it comes to the evaluation of a proposed deal, have an open discussion about the critical assumptions and "what could go wrong". Simply do not accept everything … as in life in general … at face value. Take the time and dig deeper and ask the hard questions; the "elephant in the room" questions that others may be blind to or not "dare" to ask.