



CULTURAL DUE-DILIGENCE TOOLKIT



Summary

- ∞ Cultural compatibility with the target—often a prerequisite for M&A success—is difficult for the acquirer to assess early in the deal when information is limited and without a substantial investment of resources.
- ∞ In addition to addressing traditional due-diligence issues (i.e., liability and compliance) during its document review, Sterling Financial searches for cues about the target’s corporate culture to determine the magnitude of cultural difference and proactively address potential alignment issues prior to close.
- ∞ Using their cultural due-diligence toolkit, Sterling has completed seven deals since 2000, producing strong organizational fit and financial returns.

Company Profile

With assets of approximately \$3.1 billion and investment assets under administration of \$2.5 billion, Sterling Financial Corporation is a diversified financial services company based in Lancaster, Pa. Sterling Banking Services Group affiliates offer a full range of banking services in south-central Pennsylvania, northern Maryland and northern Delaware; the group also offers correspondent banking services in the mid-Atlantic region to other companies within the financial services industry. Sterling Financial Services Group affiliates provide specialty commercial financing, fleet and equipment leasing, investment, trust and brokerage services, insurance services, and human resources consulting services.

Selected Statistics

FY2005 Revenue	US\$240 Million
FY2005 Assets Under Management	US\$2.9 Billion
FY2005 Employees	1,000

Source: <http://www.hoovers.com>; Corporate Strategy Board research.

STERLING RESULTS ON EMPLOYEE ENGAGEMENT

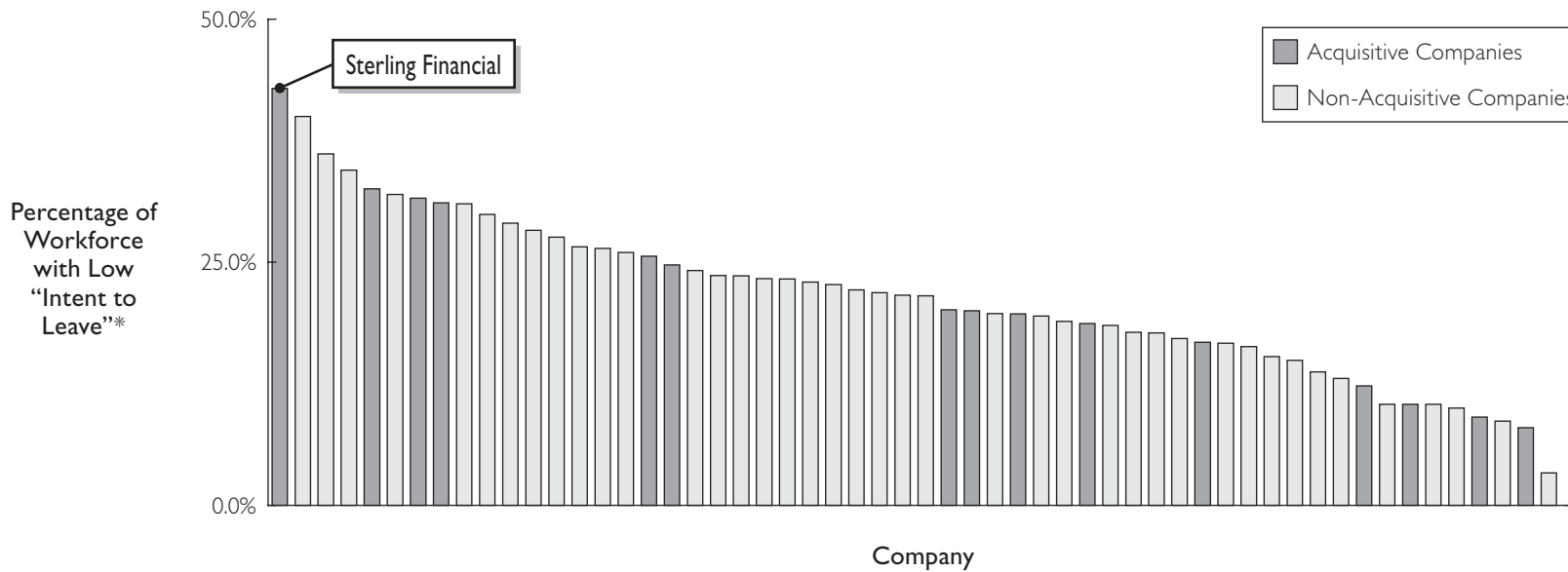
- When the Corporate Strategy Board's sister program, the Corporate Leadership Council, measured employee engagement at 59 organizations, Sterling Financial's employees scored the highest for engagement and were the least likely to leave their company.

STERLING RESULTS ON EMPLOYEE ENGAGEMENT

During a Period of Acquisitive Growth, Sterling Financial Demonstrates High Levels of Employee Engagement and Retention

Percentage of Workforce with Low “Intent to Leave”

Results from CLC Engagement Survey, 2004



MEASURING THE DRIVERS OF EMPLOYEE ENGAGEMENT

The Corporate Strategy Board’s sister program, the Corporate Leadership Council, assessed the drivers of workforce engagement and their impact on employee discretionary effort and intent to leave. The study analyzed more than 300 different levers for driving engagement. The respondent group consisted of more than 50,000 employees from 59 organizations in 10 industries and 27 countries covering.

* Low intent to leave is defined as the bottom 10% of all 54,000 employees surveyed in the study.

Source: Sterling Financial Corporation; Corporate Strategy Board research.

A TACTICAL ASSESSMENT OF CULTURE

- After initial discussion on acquisition possibilities and agreement to proceed, Sterling Financial gains access to the standard documents in the data room used during due-diligence.
- Sterling applies a cultural lens to the document screening process, with each executive on the team verifying financial, market, and operating information, while looking for cultural insights.
- Findings from the document-based cultural due-diligence are reported to the deal committee and used to plan future conversations with the target's executives and employees.
- Cultural "cautions" are fully surfaced in the target interviews, and findings are used to populate a cultural indicators scorecard to assess the level of fit between the target and acquirer for each key attribute of Sterling's culture.
- Cultural indicators are more anthropological than aspirational, as Sterling's due-diligence team seeks to assess the more tangible aspects of culture that can be addressed with specific activities to manage around differences in a constructive manner.

CSB View

Identify the organizational indicators that define your culture to assess compatibility with the target companies.

Use the standard document review to acquire additional insights about the target's culture.

A TACTICAL ASSESSMENT OF CULTURE

To evaluate the magnitude of differences in how work gets done between target and acquirer...

...Sterling Financial reviews target documents to evaluate potential cultural differences

Cultural Indicators Scorecard

Sterling Financial, Illustrative

Organizational Culture Indicator	Fit Relative to Sterling Financial			Future Conversation Emphasis
	Low	Medium	High	
Importance of teamwork				✓
Importance of relationship management				✓
Quality of communications across all levels				⚠
Readiness for change				✓
Resistance to change				✓
Importance of diversity				✓
Importance of learning and development				✓
Tolerance of risk				⚠

Q: How are decisions made? Informally or through committee?

Q: What is the strategy used by sales people—hard-sell or solutions approach?

Q: Do they inquire about Sterling's employee L&D policies?
Q: Time or Budget allocated per employee on L&D Activity?

✓ Clearly defined in cultural due-diligence
⚠ Requires further discussion

Cultural Due-Diligence Document Assessment

Sterling Financial, Illustrative

Employee/Employee Relations Checklist	
Corporation	Employment/Employee Relations
Obtain copies of the following:	
<input type="checkbox"/> Affirmative action plan	<input type="checkbox"/> Local recruiting environment
<input type="checkbox"/> Code of conduct	<input type="checkbox"/> Open positions now being recruited
<input type="checkbox"/> Communications regarding audits/findings	<input type="checkbox"/> Status of employees disciplinary actions
<input type="checkbox"/> Employee handbook	
<input type="checkbox"/> Organization values, vision, and mission	
<input type="checkbox"/> Personnel policy manual	
<input type="checkbox"/> Budget	

Questions

Employee Compensation and Benefits Plan Design

- How are compensation systems structured?
- How generous are the benefits and perquisites?

- Traditional Finding
- Size of benefit obligations
 - Cost per employee
- Cultural Insight
- Paternalistic approach to employees
 - Low tolerance for risk

Questions

Executive Meeting Minutes

- Formality of document
- Size and number of documents
- Explicitness of decision and guidance

- Traditional Finding
- Threats for the business
 - Liability exposure
- Cultural Insight
- Authoritative versus egalitarian decision-making processes

CULTURAL RISK MITIGATION

- Once the deal committee decides whether cultural fit is sufficient to proceed, any lingering concerns about culture are carried over into the integration planning process.
- Early on, Sterling mitigates cultural friction at the highest levels through contract structure with target executives and later on through team-building and training exercises with mid-level managers and employees.
- The head of HR remains involved past the scorecard assessment, continually monitoring the cultural compatibility between the two firms; Sterling will walk away from a deal even after announcement, if the two companies prove culturally incompatible.

CSB View

Use knowledge of cultural differences to determine the speed of post merger integration.

Continue to monitor target–acquirer interaction past the due-diligence phase for signs of cultural incongruity and proactively develop action plans at the first sign of friction.

CULTURAL RISK MITIGATION

Sterling's cultural due-diligence surfaces risks to integration success early...

...and facilitates mitigation efforts for cultural challenges requiring a quick response

Roll-Up of Cultural Indicators Scorecard

Signals of Cultural Conflict

Sterling Financial, Illustrative

Sterling Financial, Illustrative

Organizational Culture Indicator	Fit Relative to Sterling Financial		
	Low	Medium	High
Importance of teamwork			X
Importance of relationship management			X
Quality of communications across all levels		X	
Readiness for change		X	
Resistance to change		X	
Importance of diversity		X	
Importance of learning and development	X		
Tolerance of risk	X		

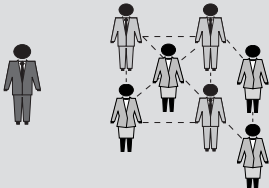
Sterling places strong emphasis on relationship management and teamwork and will walk away from targets scoring low in these categories.

Target's culture does not match Sterling's high-risk, high-reward environment.



Early in discussions, senior executives show opposition to adopting a new culture.

Walk away from deal
Mitigate through contract structure



During integration planning, mid-level executives resist network-building with Sterling counterparts.

Integration team works with Corporate University (Learning & Development) to craft training and communication materials that address the differences between the two cultures.



Post-announcement, employees resist initial training about Sterling's product offerings and vision.

The focus is on building on common strengths, open communication, and managing change.

TAKING CULTURE TO THE BANK

- Between 2000 and 2004, Sterling Financial completed seven deals while walking away from three opportunities due to cultural incompatibility.
- Robust cultural screens have helped Sterling Financial get a jump on cultural challenges improving deal performance, contributing to shareholder returns more than twice that of their direct competitors over the past five years.

TAKING CULTURE TO THE BANK

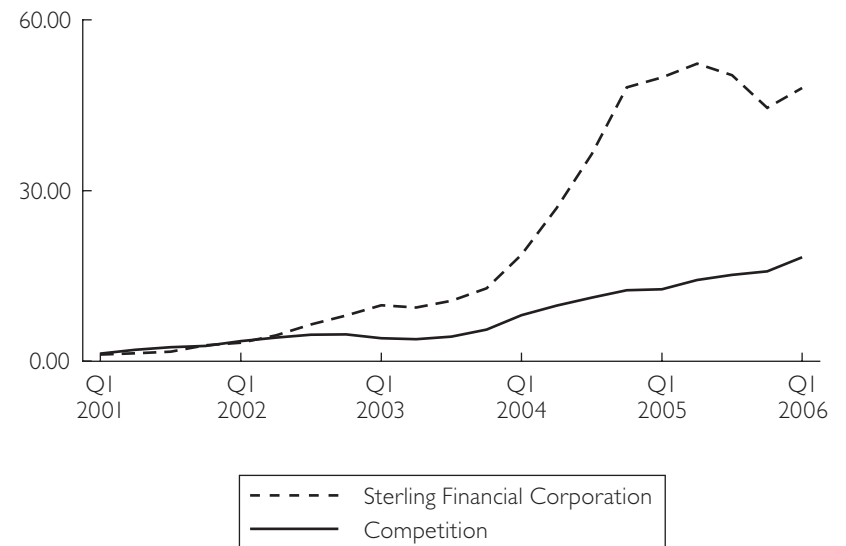
Sterling Financial passed on three culturally incompatible targets...

List of Potential Targets
Sterling Financial, Illustrative

- ① Bank of Hanover and Trust Co.
- ② BainBridge Securities, Inc.
- ③ Equipment Finance LLC
- ④ Pennsylvania State Bank
- ⑤ First National Bank of North East
- ⑥ Corporate Healthcare Strategies, LLC
- ⑦ Church Capital Management, LLC
- ⑧ ~~Omega Capital*~~
- ⑨ ~~Main Street Investments*~~
- ⑩ ~~Capital Account Survey*~~

...freeing resources to acquire seven targets that produced strong financial returns

Total Shareholder Return
Sterling Financial Versus Competition, 2001–2006



DRIVING PERFORMANCE

“Working in teams to achieve excellence in relationship management is what drives this company’s culture, as well as its business performance. Before acquiring a company, we need to assess, ‘can this company join us—without a lot of overhaul or disruption—and still perform strongly to deliver the financial return we need quickly?’ The best way to answer those questions is through a cultural audit.”

Kathy Prime
Senior Vice President, Human Resources and Chief People Officer
Sterling Financial Corporation

* Pseudonym.

Source: Compustat; Corporate Leadership Council, *Driving Employee Performance and Retention Through Engagement*, Washington, D.C.: Corporate Executive Board, 2004, p.25; Corporate Strategy Board research.

STERLING SUMMARY: CULTURAL DUE-DILIGENCE TOOLKIT

KEY PROPOSITIONS

Develop a scorecard based on your cultural norms to guide early due-diligence activity and accelerate mitigation efforts.

- First assess your norms (of how work gets done) to provide a baseline for comparison to those of the target.
- Apply a cultural lens to document reviews during due-diligence to surface insights about a target's culture and specific "red flags" to raise in executive and employee interviews.
- After identifying potential cultural risks, proactively implement mitigation plans during integration to reduce friction between the merging companies.