



A CASE STUDY OF SUCCESSFUL ORGANIZATIONAL RESTRUCTURING

The Strategic Merger of
Servicesfor the UnderServed and Palladia

Support Center | Partnership in Philanthropy

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The findings in this paper reflect the memories of participants and summarized documented information and do not necessarily reflect the views of the Support Center's board, staff or funders.

About the Support Center | Partnership in Philanthropy

The Support Center | Partnership in Philanthropy is a 501(c)(3) nonprofit management support organization dedicated to improving our society by increasing the effectiveness of nonprofit and philanthropic leaders and their organizations. Support Center services are designed to strengthen organizations so that they can better serve their clients and communities. Grantmaker partnerships foster this work, supporting consulting, executive search and transition management and professional development services. The Support Center works with organizations at all stages in their development and of all sizes, including small and mid-sized organizations. Find out more at www.supportcenteronline.org

About Enterprise Community Partners

Enterprise works with partners nationwide to build opportunity. We create and advocate for affordable homes in thriving communities linked to jobs, good schools, health care and transportation. We lend funds, finance development and manage and build affordable housing, while shaping new strategies, solutions and policy. Over more than 30 years, Enterprise has created nearly 320,000 homes, invested \$16 billion and touched millions of lives. Join us at www.EnterpriseCommunity.org.

About Services for the UnderServed

Services for the UnderServed, Inc. (SUS) is a 501(c)(3) nonprofit organization whose mission is to drive scalable solutions to transform the lives of people with disabilities, people in poverty and people facing homelessness: solutions that contribute to righting societal imbalances. SUS envisions a city where everyone has a roof over their head, is healthy, productive and can enjoy the social connections that create a life of purpose. SUS, at the time of this writing, is a nonprofit with a staff of close to 2,000 that provides \$185 million annually in services. SUS services are supported by various local, state and federal government entities as well as foundations, corporations and individual donors. Connect with SUS at <http://sus.org>.



“This merger has been a collaboration of the highest order and may stand as a textbook case of a thoughtful, strategic and powerful alliance. Palladia and SUS share compatible values and a culture centered on the people we serve, our staff, a common vision of inclusion and opportunity and a strong commitment to practice innovation and service excellence. As a merged organization, we will multiply what we were providing separately. It’s a huge win for New York.”

Mark Hurwitz,
former President and CEO, Palladia, Inc.

CONTENTS

Executive Summary | Page 4

Introduction | Page 6

- 6. The Human Services Landscape
- 7. Background: Success Factors in Nonprofit Mergers
- 8. Palladia and Services for the UnderServed: The Context

Preparing the Way: Planning and Exploration | Page 11

- 11. Realignment Planning for SUS
- 12. Realignment Planning for Palladia

Merger Assessment, Investments and Costs | Page 15

- 15. General Feasibility Assessment
- 16. Moving Forward
- 17. Investments and Costs

Merger and Integration | Page 19

- 19. Pre-Merger Integration
- 20. Formal Merger and Post-Merger Integration
- 21. Financial/Administrative Integration

The Role of Partners and Third-Party Consultants | Page 22

Keys to Success and Lessons Learned | Page 26

- 26. Keys to Success
- 27. Lessons Learned



“This new landscape begs for collaborations and redesign. Given the significant alignment of the services of SUS and Palladia, our merger could not have come at a more opportune time!”

Donna Colonna
CEO, Services for the UnderServed

EXECUTIVE SUMMARY

In December of 2014, two critical New York City human service agencies, Services for the UnderServed, Inc. (SUS) and Palladia, merged. Courageous leaders from management and the boards of both organizations guided the union, which was also supported by government and private funders as well as outside technical assistance providers. The merger was critical to insuring continued high-quality services for many thousands of individuals and families facing challenges including mental illness, intellectual/developmental disabilities, homelessness, substance use, poverty, unemployment, and HIV/AIDS.

In this case study, we discuss the challenging landscape of human services in which the merger occurred and share research on mergers and the context in which SUS and Palladia work. We examine what SUS and Palladia did to prepare the way for this merger and look at early efforts at organizational integration. Most importantly, we highlight keys to success and lessons learned from the merger through the eyes of the organizational leaders and other key participants.

Both Enterprise and the Support Center have been actively engaged with SUS for over 20 years. Enterprise has been a long-term and vitally important partner of both SUS and Palladia, contributing nearly \$38 million in investments, grants and loans. Other private advisors and grantmakers, such as the Nonprofit Finance Fund, the Robin Hood Foundation and SeaChange Capital Partners, made critical investments in support of this merger effort. Further, it is unlikely that this merger would have had success without the commitment of funders, including the New York City Department of Homeless Services, New York State Office of Substance Abuse Services and New York State Office of Mental Health, to work closely with SUS and Palladia to forge solutions.

Among the keys to success identified here are:

- The importance of strong leadership with a focus on the missions of each organization
- Prior experience and familiarity among the merger partners
- Third-party support for the merger
- Highly capable and motivated staff
- Understanding of and respect for the importance of organizational culture

The lessons learned include:

- » It takes more time than anticipated to integrate organizational culture.
- » Investment in building a strong board is worth the effort.
- » Real partnership and collaboration with funding agencies is critical to merger success.
- » Late payments by government and underfunded payment rates severely limit building a robust infrastructure as well as innovation and change.
- » Nimble outside assistance is essential to merger success.
- » The challenge of integration is hard to predict and takes time and resources.

More information about the Support Center's work on mergers and strategic restructuring can be found at <http://supportcenteronline.org/change-consulting>.



INTRODUCTION

In December 2015, with funding from Enterprise Community Partners, the Support Center/Partnership in Philanthropy (Support Center) embarked on a study of a successful merger between SUS and Palladia, which was formalized in December 2014. As a component of the study, we reviewed trends in the human services industry and literature on nonprofit mergers and interviewed key representatives from both organizations and numerous outside partners who were instrumental in ensuring that the merger went forward successfully. In the process, we identified several key success factors and lessons learned from this merger that may prove instructive for other mergers in the nonprofit health and human service sectors.

The Human Services Landscape

Before delving into the merger between SUS and Palladia, it is helpful to understand current changes impacting the work of human service organizations, especially those providing multiple services such as housing, employment, skills-building, treatment and rehabilitation.

As articulated in the 2016 Human Services Council report, “New York Nonprofits in the Aftermath of FEGS: A Call to Action,” “Nonprofit human services organizations play a critical and longstanding role in building and supporting the wellbeing of New Yorkers, enabling millions of people to contribute to their communities as students, parents, neighbors, and workers. These providers deliver services to an estimated 2.5 million New Yorkers annually. They train and help keep workers in good jobs, provide early childhood education and after-school programs, run food pantries, respond to emergencies and natural disasters, provide mental health counseling, shelter people experiencing homelessness and care for the elderly, among many other community services. By administering human services programs, nonprofits are building the wellbeing of New Yorkers, maximizing their potential and ensuring that New York maintains its global competitiveness. The collective services provided by human services nonprofits make the difference between success and failure for countless individuals and families. Yet the sector itself is facing a crisis.”

Even prior to the national economic crisis, the human services industry was undergoing a paradigm shift in both the delivery and the financing of services for individuals with mental illness, substance abuse and disabilities. The economic downturn accelerated that change at federal, state and local levels and has resulted in cuts in existing resources ahead of the implementation of reforms. At the same time, regulatory mandates continue to increase, further stretching already inadequate administrative funding.

As a component of these changes, New York State is restructuring Medicaid. The goal is to improve client care and contain costs by changing the way Medicaid

pays for services. By 2020, the New York State Department of Health anticipates that Medicaid funding will be conducted through managed care that integrates primary health care with mental health and substance abuse services under one roof. Payment will be value-based and tied to outcomes.

To successfully compete in the managed care environment, human service agencies will need to re-tool and address key issues, including:

- » **Investment in IT infrastructure** to accommodate electronic health records (now required for all health care and mental health providers).
- » **Focus on cost efficiencies and metrics** to ensure that payments cover all costs of the services provided, including administrative and reporting costs.
- » **Migration to managed care** with integration of multiple services from one provider (i.e., both physical and mental health services in one location). Alliances with community health clinics and other physical health providers will be important in the new landscape, as will the ability to offer more diverse services.
- » **Payments from Medicaid and third-party payors** such as insurance companies, requiring agencies to participate in insurance networks.

“27% of New York City human services providers had an operating deficit in fiscal 2014.”

Human Services Council

Unfortunately, most human services agencies in New York City are already financially fragile. According to the Human Services Council report, “27% of New York City human services providers had an operating deficit in fiscal 2014.” In addition, they reported that 60% of the organizations participating in a 2015 survey had less than three months of unrestricted operating reserves. These organizations are already on the financial edge, and many do not have the resources necessary to undertake the re-tooling and infrastructure upgrades needed for the new funding realities.

Background: Success Factors in Nonprofit Mergers

In its 2009 publication, “Merge Minnesota, nonprofit merger as an opportunity for survival and growth,” MAP for Nonprofits stated, “Often, merger partnerships begin with something very simple: a relationship. Out of that relationship emerges a conversation between two (or more) nonprofits that may already know each other well, have worked together before (perhaps in joint programs), and value working with other organizations. Their conversation evolves into ‘merger exploration,’ which refers to all the activities leading up to a board’s vote to complete a merger. The most successful mergers grow out of previously established relationships.”

The “Stanford Social Innovation Review” suggests that the nonprofit sector is slow to pursue mergers as an effective growth strategy, instead employing

mergers as a reaction to financial distress or a leadership vacuum. According to a 2012 study conducted by MAP for Nonprofits, 93% of the mergers studied were motivated, at least in part, by the need to preserve the long-term financial viability of at least one of the pre-merger organizations. “Synopsis—Success Factors in Nonprofit Mergers” (a MAP for Nonprofits & Wilder Research publication) finds that, “Merging is a complex and sometimes arduous process. It requires the successful negotiation of a wide range of relationships and sensitivities, as well as clarity about the ultimate social good that one is striving to achieve through the combining of services.” Below are a few of the key success factors revealed in the literature.

The importance of leadership. Mergers are most successful when leadership remains focused on the mission and leaves ego at the door. As Lois Savage, president of the Lodestar Foundation, explains, “Successful collaborations are easier when spearheaded by visionary leaders who...understand that maximizing mission impact often involves going beyond (and perhaps dissolving) organizational boundaries.”

Time and familiarity. When merger partners either know each other or have the time to get to know each other, both at the board and staff levels, the chances for success increase. Throughout the discussion and due diligence phases, transparency needs to be a priority, with both the board and staff working with the facts--both positive and negative--about each organization.

Values and culture. Big picture issues like values and organizational culture are important and must be addressed during the process. Plans must be developed for integrating these areas, and the strongest plans come from leadership of the two organizations working together to resolve the easy and difficult issues. The brand and culture of each of the two pre-merger organizations must be taken into account. Plans for integration need to address how each brand and culture will be treated after the merger occurs.

Third-party technical and financial support. Consultants and outside counsel can play a vital role in the merger process. In addition to providing guidance on financial issues and crafting legal documents, consultants with merger expertise can be helpful in addressing the many difficult and emotional issues that inevitably arise in nonprofit merger discussions. Outside funding that helps cover the costs involved in conducting due diligence, crafting legal agreements and carrying out integration plans is another invaluable resource.

Addressing the staffing “elephant in the room.” When organizations merge, overlap in staff functions is inevitable. Prior to merging, both organizations will likely have had finance, human resource and IT staffing. Sometimes there is overlap among program staff as well. Avoiding discussion of this overlap only leads to greater anxiety for staff and can become the elephant in the room

blocking progress. Successful mergers address staffing directly and create a plan for how to handle placement and evaluation of all staff in the new organization, and those plans include input from and seek to be viewed as fair and reasonable by staff and board members from both sides.

Financial goals. Many mergers come with an expectation that cost savings will emerge. Successful mergers look realistically at the financial impact of merging and understand where savings can be achieved and where expenditures will be incurred. For example, there may be staff overlap that could reduce costs, but integrating disparate IT infrastructures will require expenditures. The better goal may be to reduce the percentage of the new organization's administrative costs or increase the resources available for infrastructure rather than an absolute reduction in costs.

Palladia and Services for the UnderServed: The Context

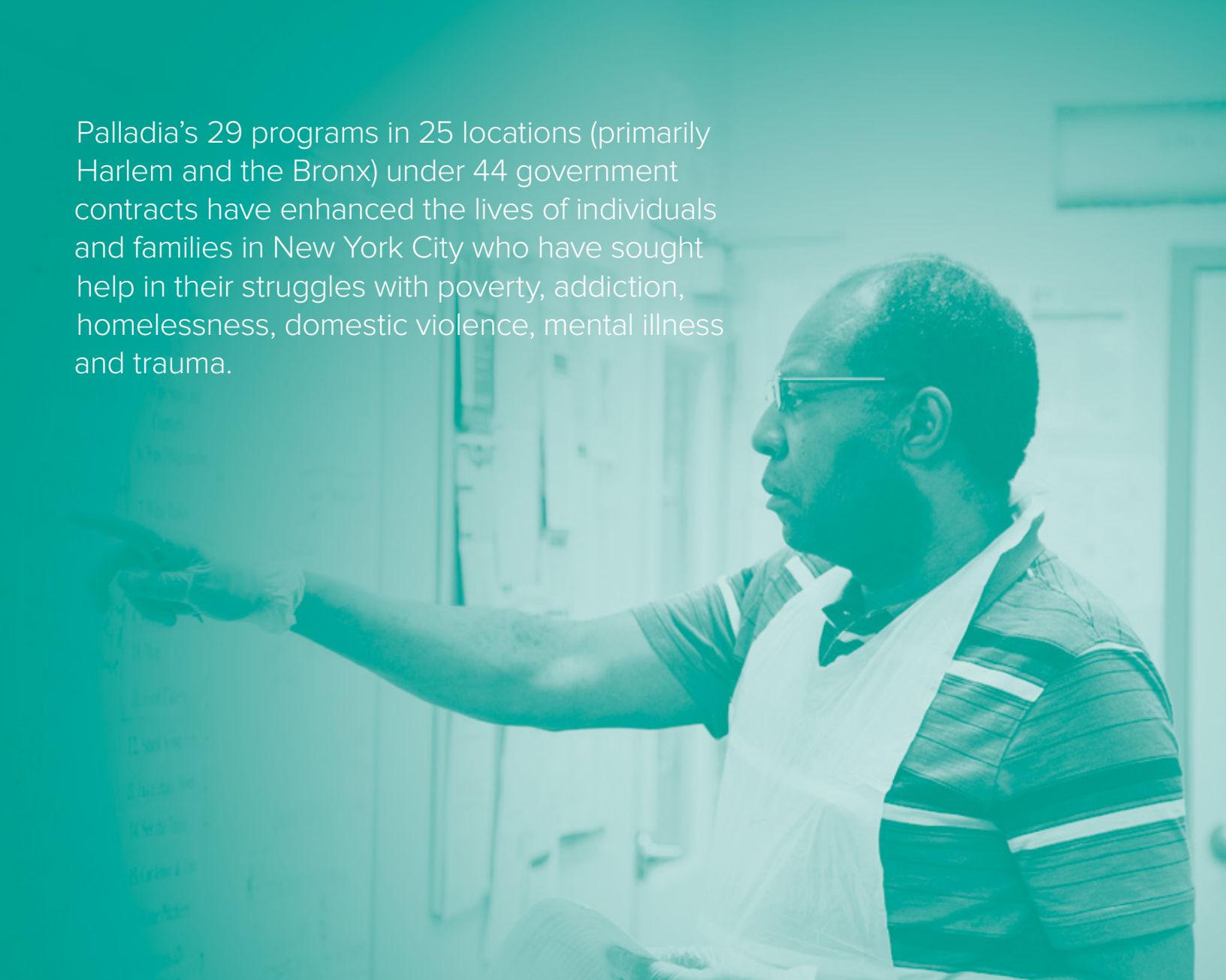
SUS stood as a “community of opportunity” dedicated to the belief that every New Yorker has the right to lead a life with purpose.

Founded in 1978, SUS was a large multi-service nonprofit organization, which in 2014 had an annual operating budget in excess of \$120 million. SUS employed over 1,200 people at the time. It had become the “agency of choice” for thousands of individuals and families facing challenges such as mental illness, intellectual/developmental disabilities and HIV/AIDS. These challenges are often compounded by histories of homelessness, substance use, poverty, trauma and unemployment. In addition, SUS worked with veterans, offering a range of services to address their unique needs. SUS stood as a “community of opportunity” dedicated to the belief that every New Yorker has the right to lead a life with purpose. With a significant presence in Brooklyn, Queens, Manhattan and the Bronx, and in partnership with those who came seeking services, SUS created pathways to a rich and productive life for all.

Founded in 1970 as the Project Return Foundation, Palladia was also a multi-service nonprofit organization, with an annual operating budget in 2014 in excess of \$40 million annually. At the time of the merger, Palladia employed 500 staff members serving more than 17,000 clients annually in three main areas: behavioral health services, homeless and shelter services and housing. It changed lives by providing innovative programming, compassionate care and expert solutions to critical social problems. Palladia's 29 programs in 25 locations (primarily Harlem and the Bronx) under 44 government contracts have enhanced the lives of individuals and families in New York City who have sought help in their struggles with poverty, addiction, homelessness, domestic violence, mental illness and trauma.

These two respected and relied upon nonprofit agencies formally merged on December 4, 2014, to form one entity that would be a potent provider of housing, health and human services for vulnerable residents of New York City. Operating under the name Services for the UnderServed (SUS), the merged entity now seeks to increase its reach in both depth and breadth and thus be

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able to significantly increase its impact on individuals, families and communities in accessing housing, integrated care, employment and other related supports. The annual revenue of the merged entity exceeds \$180 million, with additional plans already underway that would allow it to serve 30,000 people each year throughout 65 New York City communities.

Announcing the merger, SUS CEO Donna Colonna commented, “The need for fresh solutions and effective approaches has never been greater. We cannot ignore the scale of our challenge, including the 58,000 homeless people living in shelters each night, 43% of whom are children.”

PREPARING THE WAY: PLANNING AND EXPLORATION

Realignment Planning for SUS

SUS began discussing the opportunities available in merging with other human service organizations almost 10 years ago. As an early step in 2008, the SUS board engaged the Support Center to facilitate a board self-assessment and determined that board change was needed to prepare SUS for the future. SUS leadership, including Colonna and Board Chair Carolyn Powell, recognized that while they had a strong board in some respects, they “didn’t have the right board make-up” to address the long-term challenges they would face as an organization. Coming out of that assessment, SUS identified the following areas of focus:

Changing the focus and make-up of the board. Senior staff and the board worked with the Support Center on a three-year program of board change that would help SUS create a new organizational structure and strengthen the board. The focus of change was to move from a board that was primarily a “receiver” of information to a board that would be pro-actively engaged in strategy and focused on the sustainability of SUS – both using and bringing information to strategy discussions. Also, going forward, the expectation was for the board to be more fully engaged in fundraising and raising public awareness about SUS and its work. Arthur Webb, owner and principal of the Arthur Webb Group, met with the board to help them understand the changes taking place within the industry. Powell met individually with each member to discuss the new vision for SUS and the role the board would play. Over the next several years, the make-up of the board changed and many new board members were engaged, allowing SUS to build a board focused on and actively engaged in strategy and mission advancement.

Increasing fundraising and private support. The need to increase philanthropic dollars to support SUS’ work and create opportunities for innovation became an important strategic priority. Through the emerging governance process, SUS board members built their understanding of government contracts, acknowledging that these can be restrictive and hinder research, innovation and development. This recognition led to the hiring of SUS’ first chief development officer and the identification of new board members who could support the fundraising efforts.

Taking a hard look at the programs and their fit with mission and vision. As a result of the planning process, SUS refined its program focus and determined that several of its programs, including home care and a charter school on Long Island for children with special needs, no longer fit within its vision, and in some cases were stretching SUS geographically and programmatically. While the decision

to shed the programs was not easy, SUS gained capacity to strengthen its core competencies in mental health and services for the developmentally disabled.

Focusing on culture and values. SUS embraced a deep commitment to building and maintaining a strong culture revolving around the values of collaboration, quality service delivery and respect for staff and consumers. Continued focus on these core values helped SUS become a stronger organization with more highly qualified and dedicated staff. Building SUS' internal strength and structure was a key component of the strategic plan. By doing this, SUS was positioned to identify and pursue future opportunities, including organizational redesign opportunities.

Exploring organizational redesign. Colonna and the board began talking regularly about the changing dynamics and environment in which SUS operated. At a board retreat facilitated by the Support Center in October of 2010, Colonna made a presentation entitled "If Not Now, When?" which outlined many changes in health care and social service delivery that would impact SUS operations in the years to come. She anticipated potential changes and highlighted a number of financial challenges. She concluded by letting the board know that "organizations will have to continually re-tool to address cuts in funding and redesign systems. However, out-of-the-box innovation will be the essential ingredient that will differentiate good organizations from great ones."

Over the next several years, senior staff and the board continued to discuss changes in the landscape, creating a strong partnership based on mutual understanding, transparency and trust. Powell noted, "We built a strong bond of transparency and strategy-thinking between the board and the leadership team at SUS." Colonna also helped the board clearly understand that smaller organizations would have a harder time surviving in the new environment. When the Palladia merger opportunity was brought to the SUS board, no one was surprised.

Realignment Planning for Palladia

By 2012, Palladia served roughly 1,300 clients daily. Like many other human service organizations, Palladia began to experience financial challenges following the 2008 downturn. Between 2008 and 2011, Palladia's revenue fell by \$5 million, and the organization found itself in a much more difficult operating environment. Payments from government funders were more than a year behind.

Some Palladia board members suggested that Palladia's administrative infrastructure was not robust enough to cope effectively with the many continuing changes in reporting and billing requirements from the various government funding sources. This observation reinforces the finding of the Human Services Council Commission report: "Because of weak internal financial and programmatic reporting, providers may not be alerted to short-term and

“Delays in government payments put Palladia in the position of providing up-front cash to support paying salaries and other program-related costs while waiting for reimbursements and funding to arrive.”

Palladia Board Member

long-term fiscal dangers early enough to address them. Inadequate funding of indirect expenses has contributed to the lack of resources available for investment in effective risk identification mechanisms.”

Despite Palladia management’s best efforts to stay ahead of these rapid changes, this lack of investment in administrative infrastructure put tremendous strain on the cashflow of the organization. The HSC Commission report noted, “Chronic delays in contract payments force providers to undertake costly borrowing to make payroll and rents, often accruing interest not covered by government contracts.” One Palladia board member commented that “delays in government payments put Palladia in the position of providing up-front cash to support paying salaries and other program-related costs while waiting for reimbursements and funding to arrive.”

A National Council of Nonprofits 2014 report, “Toward Common Sense Contracting: What Taxpayers Deserve,” noted: “When new requirements are added after an agreement has been established, the compliance costs associated with these changes have not been included in the budget, and therefore are unexpected. Changes do not just entail additional time to complete the new reporting requirements; it often includes costs to develop and implement new measurement tools, acquire unique software, and provide staff training. Retroactively imposing new requirements can result in a technical non-compliance by the nonprofit because the information needed may not even be available. This growing proliferation of reporting requirements add to a nonprofit’s administrative costs, but do not appear to improve accountability or have an impact on the quality of the services provided.”

In the same publication, the Council stated: “Nationwide, almost half of nonprofits (45%) surveyed by the Urban Institute reported governments paying them late under the terms of the legally binding contracts/grants is a problem. Not just that they were paid late – beyond the contract specification – but because they were paid so late that it created problems. The situation is worse in many states. The data reveal a widespread expectation among government officials that nonprofits will tolerate late payments.” In New York, for example, 62% of nonprofits reported late payments.

In 2012, the Palladia Board of Directors hired Mark Hurwitz to replace the previous executive director upon her retirement. During his selection process, Hurwitz recognized that while the organization had a very good public reputation and provided an important set of services to clients in a holistic way, Palladia was under serious financial stress and had cash flow issues.

In his first months as president and CEO, Hurwitz focused on identifying operating inefficiencies, cash inefficiencies and unnecessary expenses. Layoffs were considered but not implemented. There was a hiring freeze for

administrative positions and efforts were made to raise new private funding. A Palladia property on East 15th Street in Manhattan was sold. At the end of Hurwitz's first year, Palladia had cut a \$2 million operating deficit in half. While some discussions were had about how to nurture Palladia toward increased effectiveness and nimbleness, the financial pressure severely limited opportunities for channeling energy to any sustainable efforts to pursue innovation and change.

At the end of 2013, with the annual budget shortfall still at \$1 million, Palladia's line of credit from a commercial lender was reduced from \$4.5 million to \$4 million. The line of credit was necessary to cover expenses when government payments were delayed, as was often the case. However, the line of credit had become permanent debt (one which Palladia was never able to repay). When the line of credit came up for renewal, Palladia needed a plan to eliminate the annual operating deficit and ultimately repay the loan. Palladia sought to increase revenue through programs. Layoffs totaling \$500,000 were considered once again, but Hurwitz was concerned that staff reduction could in effect "knock down a weight-bearing wall," significantly compromising the delivery of services.

Hurwitz received support that included a change capital grant and consulting/ advisory services from the Nonprofit Finance Fund (NFF) through its Community Resilience Fund. NFF looked at past and current financial statements, cash flow and possible cost-cutting and revenue-generating initiatives that could move the organization to financial sustainability. Its analysis showed that while Palladia could identify a set of initiatives that could take it along a narrow path to breakeven on a cash basis, there were significant execution and timing risks associated with implementing these initiatives.

Combined with the prospect of future unanticipated expenses or revenue loss, this analysis led Hurwitz and Palladia management and the board to believe that merger could be the best path to sustainability and a direction in the best interest of Palladia's clients. Merger had always been an option but not one without its own risk.

In early 2014, Hurwitz discussed the possibility of a merger with Sandra Stark, Palladia's board chair and Larry Hamden, a board member for 15 years and a current member of the finance committee. A merger subcommittee, headed by Hamden, was formed and recognized that the alternatives to a merger were not good. These alternatives included implementing layoffs, closing programs and making significant structural change. In exploring a merger, the committee considered the potential new partner's structure and balance sheet (Palladia would need to merge with an organization that had the ability to retire a portion of Palladia's debt). Additionally, organizational compatibility and philosophy were prime considerations in finding a nonprofit with whom Palladia could merge effectively and efficiently.

MERGER ASSESSMENT, INVESTMENTS AND COSTS

General Feasibility Assessment

SUS and Palladia had collaborated on projects prior to the merger discussions. Colonna and Hurwitz worked together (along with other agency leaders) to create Coordinated Behavioral Care, Inc., an organization that marshals the expertise of multiple community-based organizations to deliver integrated medical and behavioral health care, achieving the triple aim of the federal Affordable Care Act—improving people’s health, providing a better health care experience and reducing costs. Colonna and Hurwitz had come to know each other through this collaborative effort.

When Hurwitz approached Colonna about a possible merger, she turned to Mike Whelan, chief financial officer at SUS, to begin looking at Palladia as a partner. With indications that a merger might present a solid strategic opportunity, Colonna took the idea to the SUS board.

Webb, the outside advisor hired by SUS, talked with its board about strategic issues to consider: Why Palladia? Why now? Why this? He emphasized the opportunity of expanding market share and the prospect of having a wider, more diverse set of services that would position SUS for future success. He suggested that financial due diligence was critical and emphasized that it would be important to get in early before additional financial challenges mounted.

The board formed a merger review committee to work with staff on investigating Palladia’s compatibility with SUS. The merger review committee included a number of board members with skills and expertise in various aspects of a merger -- legal and financial in particular -- as well as experience with mergers in the private sector.

Gareth Old, current SUS board chair and a member of the SUS merger review committee, noted, “It became clear very early on that Palladia ...would be an excellent fit. It simply found itself in an unfortunate position as a result of just one or two decisions that had not worked out well at the management level rather than the program level. It was to some extent the perfect opportunity for us.”

Some programmatic and geographic overlap existed between the two organizations, but they also brought complementary services to each other that would become increasingly important in the new service delivery environment. For example, Palladia had robust substance abuse programs while SUS had significant mental health programs. Under managed care, these two types of services would need to be offered together, and the combined expertise of SUS and Palladia would allow the new SUS to more effectively deliver these services.

SUS and Palladia faced a number of questions when looking at the merger, including:

- » What were the synergies and what were the differences between the two organizations?
- » Did the areas of difference fit with SUS' strategic goals without diverting attention from its core competencies?
- » Would this merger overload SUS and result in a weaker organization instead of a stronger one?
- » What were Palladia's financial challenges, and could they be resolved to the benefit of the programs and clients at both agencies?

The SUS merger review committee addressed these questions at a meeting in late May 2014 and determined that there were enough synergies to keep the evaluation process moving forward. The SUS and Palladia boards met jointly the first week of June. The potential merger's benefits and risks were presented and discussed. From that meeting, it was clear to SUS board members that Palladia's board was looking for a respectful partner that would appreciate Palladia's history and nurture its client base and staff.

MOVING FORWARD

The two organizations signed a letter of intent on June 10, 2014 and embarked on the fact-finding stage of due diligence. The SUS senior staff, led by Colonna, Whelan and Terry Blackwell, chief operating officer, spent the rest of June and much of July reviewing the various issues that would impact an SUS/Palladia merger. Among the considerations were:

- » Overall future potential with and without Palladia
- » Financial analysis of Palladia's operating loss and its potential impact on SUS, including short-term cash needs to accomplish a merger
- » Assessment of Palladia's housing limited partnerships
- » Evaluation of the Starhill Residential Treatment facility's program capacity and potential
- » Analysis of options related to the Palladia headquarters building
- » Review of current Palladia contracts with various government funding agencies
- » Evaluation of Palladia's mental health outpatient clinic
- » Impact of a merger on SUS net assets in the short-, medium- and long-term

SUS staff, with assistance from external financial consultants, reviewed these issues in detail. While challenges clearly existed, the major challenges could be overcome while synergies between the two agencies had the potential to produce many positive benefits. Staff presented their findings to the SUS merger review committee at the end of July. The main challenges were around Palladia's financial circumstances and the nuts and bolts of integrating the two organizations. The committee was satisfied with the findings, especially the extensive financial analysis provided by the SUS staff with assistance from outside counsel, and agreed to continue to the next phase of due diligence.

As due diligence efforts continued, SUS began discussions with Palladia's primary funders and contracting agencies. Discussions also began with Palladia's bank representatives regarding sale of its headquarters building and with the U.S. Department of Housing and Urban Development and the New York State Office of Alcoholism and Substance Abuse Services among others. It was essential to ensure that the funding agencies would continue funding existing Palladia programs if Palladia merged with SUS. The funding agencies were supportive of the merger and worked closely with the two organizations to ensure they would be able to formalize the merger agreement within the time frame necessary to avoid further financial disruptions and crises for Palladia.

Over the summer, members of the SUS merger review committee met individually with Palladia board members. They were tasked with learning about Palladia's board dynamics and the organization's culture. SUS board member and merger review committee member Ed Hubbard recalled that, to their credit, what Palladia's board members cared most about was "making sure that the client base at Palladia would continue to be served and strategically concluded the best way was to merge into a stronger organization."

Palladia's board members also understood that they were in a cash crunch that would make future operations as a stand-alone organization impossible and that merging with SUS was the best alternative for reaching Palladia's goal of sustaining client services.

Investments and Costs

It was clear on both sides that a merger would include some up-front costs. However, the greater medium- and long-term savings from anticipated synergies would cover those costs in the long run. Through the due diligence process, the teams identified a short-term investment need of \$3.5 million. Expenses included addressing projected operating losses from Palladia, urgently needed capital investments at some facilities and the cost of retiring the mortgage on Palladia's headquarters building. At the same time, sources of capital and synergies of \$3.8 million were identified, including sale of the Palladia headquarters building, limited staff reductions and SUS making the case for full, proactive reimbursement for provided services from major funding agencies. Colonna

highlighted the benefit of having strong partnership support from the New York City Department of Homeless Services, New York State Office of Substance Abuse Services and New York State Office of Mental Health in making this merger possible. The strength of SUS' balance sheet at the time of the merger, combined with the anticipation of a short-term break-even point, reduced the threat posed by Palladia's debt.

Staff time also was a major consideration. Conducting due diligence and planning for and implementing the proposed merger would require substantial staff time and resources. Meanwhile, regular operations needed to continue throughout the process and neither organization could allow merger issues to get in the way of program delivery. Both agencies committed to the work involved, but external funding for the merger that supported the involvement of third-party consultants and helped reduce the internal burden was cited as a benefit and a source of relief to staff immediately involved in the merger.

MERGER AND INTEGRATION

Pre-Merger Integration

As due diligence continued and a merger between Palladia and SUS became increasingly likely, Colonna began speaking with other members of the SUS senior staff, especially Nancy Southwell, senior vice president of homeless and treatment services and Wanda Lopez, senior vice president of housing and behavioral health services, each of whom would be involved in integrating Palladia and SUS programs. Both were familiar with Palladia and felt it had a good reputation for delivering quality services. Each staff member began looking at Palladia programs that would fall under her jurisdiction after the merger and they began conversations with senior staff from Palladia.

Colonna and Hurwitz proactively sought and welcomed third-party consulting assistance and advice. This assistance included BDO (financial assessment), Enterprise Community Partners (supporter, grantmaker), the Nonprofit Finance Fund (consulting, advice, funding), the Robin Hood Foundation, Sea Change Capital Partners (advice, funding), Support Center (board development, facilitation), The Arthur Webb Group (advisory and consultation services, board education), and Curt Middleton Design (external communication). These groups made major contributions to move the process ahead and helping the two organizations overcome obstacles to the merger. (More information on the roles of these entities is included later in the narrative.)

By September, the SUS and Palladia boards had both agreed to move forward with the merger. Their agreement included a commitment that none of Palladia's programs could be shut down until all of the stakeholders were satisfied. Additionally, it was agreed that Palladia would not merge without commitment from outside funders.

Attention then turned to the task of getting ahead of the challenge to integrate these two agencies. Early in the process, Colonna and Judith Jackson, SUS chief of staff, held a meeting with Palladia's senior staff. The goal of that meeting was to discuss SUS hopes for the merger and listen to the concerns Palladia staff had about it. In early October, SUS and Palladia held a joint staff meeting facilitated by The Support Center. The goal of the meeting was for key staff members to meet each other and to bring them into the conversation about how integration between the two agencies would happen.

The Palladia staff was understandably concerned about their future employment prospects in the newly merged agency. Colonna worked to allay these fears prior to finalization of the merger. She acknowledged at the October meeting that the merger would require some realignment in staff responsibilities but also committed to jointly working through staff changes in a thoughtful way to minimize disruptions in both employment and service provision. She was clear

SUS and Palladia staff approached the merger with a common goal of continuing high-quality services and serving as many consumers as possible.

that Palladia program staff were vital to the successful continuation of Palladia's programs. In addition, open positions at both agencies were promoted internally to staff members of both agencies to show that the merger would open new career development opportunities.

Understanding and acknowledging the culture and values of each organization were key to these early conversations between SUS and Palladia staff. The agencies approached the merger with a common goal of continuing high-quality services and serving as many consumers as possible. The merger would allow ongoing programs to expand and develop new programs. While the two agencies served similar populations and were committed to delivering high-quality, person-centered services, differences emerged in how the two agencies implemented those values. Creating a common culture became one of the key implementation challenges after the merger took place and continues to present challenges to SUS.

Formal Merger and Post-Merger Integration

The merger agreement was signed on December 4, 2014. Under the agreement, Palladia became one of several SUS affiliates within the SUS corporate structure. Palladia continues to operate under the SUS umbrella in order to preserve some of the government contracts Palladia had at the time of the merger. Colonna became the CEO of the newly merged entity and Hurwitz assumed a new role as chief legal and strategy officer for SUS.

As soon as the merger was official, SUS and Palladia staff began a more formal integration process. All client service programs were divided into two main areas:

- » Homeless and treatment services, led by Southwell
- » Housing and behavioral health services, led by Lopez

All Palladia and SUS programs would fall into one of these areas. Southwell and Lopez each created several cross-agency teams of staff working on similar programs. The teams spent time visiting each other's programs to learn how their programs operated, the clients they served and the culture of the two organizations. These exchanges proved critical in creating a new organizational set of best practices.

They also built trust between the staff of the formerly separate organizations. Over the course of the first year, supervisory responsibilities that had carried over from the separate structures were integrated. Palladia program supervisors began taking on some SUS programs while SUS supervisors began taking on some former Palladia programs. As roles and responsibilities changed, distinctions began to blur and an integrated SUS/Palladia began to emerge.

Both agencies placed high value on delivering the highest quality person-centered services possible. However, integrating the culture and values of the two organizations continues to be a challenge and perhaps the biggest difference was in the approach to quality control. As Southwell noted, “Our compliance officer is very much a leader in the organization and on the executive team and has been for over 10 years.” Continuous quality improvements are at the forefront at all times at SUS. Standard operating procedures include reporting all problems and incidents and constant efforts to resolve issues to the benefit of clients. At Palladia, the long-term financial stress reduced its ability to invest in quality assurance monitoring, staff training and development and modifications to service delivery to adapt to best practices.

This difference in organizational culture as it applies to quality control was perhaps one of the biggest lessons learned in the process. Colonna likened the integration of Palladia staff into the SUS culture to that of an organ transplant: “It takes time for a transplanted staff to adapt to the new system within which they now need to operate. It presents challenges for both the transplanted folks and those who are working to integrate them into the existing system.”

Financial/Administrative Integration

The three main financial challenges before the merger also came to the fore post-merger. First, outstanding Palladia debt was \$3.5 million when the organization approached SUS. As part of the merger agreement, SUS retired that debt in full when the merger closed.

Second, Palladia owned its headquarters building in Harlem, but the mortgage was a financial drain on the agency. Through the due diligence process, SUS and Palladia spoke with brokers and the bank about sale options. In the spring of 2015, SUS sold the building for a better price than originally anticipated. As a result, staff in that building needed new office space, providing the opportunity to bring program operations and administrative staff together in ways that made sense for the new agency.

Third, the Starhill Facility is a large, older residential treatment facility in the Bronx with a long list of deferred maintenance issues. The SUS senior management team is working closely with Office of Alcoholism and Substance Abuse Services to address issues at Starhill and create an overall program vision that will provide the best possible continuum of services for the community, incorporating three elements of treatment: stabilization, rehabilitation and re-integration.

The integration of property management, financial management, human resources and information technology systems is and will continue to be critical to full integration. A merger of this magnitude will demand a higher level of systems in order to meet the demands of best-in-class planning and operations.

The Robin Hood Foundation, through its Management Assistance Group, has provided both advice and funding for a review of IT support for the general ledger, leading to recommendations of the best systems for organizational integration. IT integration continues to this day. While many aspects of integration have occurred during the first year following the merger, others remain, most notably in these back office-functions. The challenge of integrating systems will take time and resources and is a work in progress.

“Nonprofit human services organizations play a critical and longstanding role in building and supporting the wellbeing of New Yorkers, enabling millions of people to contribute to their communities as students, parents, neighbors, and workers.”

2016 Human Services Council Report



THE ROLE OF PARTNERS AND THIRD-PARTY CONSULTANTS

As is the case with many mergers, SUS and Palladia turned to outside partners and third-party consultants to aid them in both evaluating the potential of a merger between the two organizations and implementing the integration plan. These were the key players and their roles:

BDO served as SUS' financial auditor. SUS knew at the outset that the merger presented a complex financial picture and in-depth financial due diligence was critical to SUS' ability to properly analyze the risks involved in the merger. BDO worked closely with SUS financial staff to ask the right questions and find the answers. In addition, funding partners, including banks, were concerned about the short-, mid- and long-term financial implications of the merger for SUS. BDO was able to assist in providing projections that satisfied both boards as well as key funders and lenders.

Curt Middleton Design is a design firm that SUS engaged to assist it in creating external communications strategies, messages, graphics and products. The firm created the post-merger communications theme and helped design the first post-merger direct mail package and a short video that talked about the merger.

Enterprise Community Partners has been a long-term and vitally important partner of both SUS and Palladia for 20 years, contributing nearly \$38 million in investments, grants and loans. In 1996, Enterprise made a \$2.4 million low-income housing tax credit (LIHTC) investment in Palladia's Cedar Tremont House. Since that time Enterprise has invested in eight additional SUS/Palladia LIHTC projects with over \$34 million in LIHTC equity to create more than 300 units for low-income households and formerly homeless people in New York. Additionally, between 2005 and 2011, Palladia received \$3.25 million in loans from Enterprise.

Since 2011, Enterprise has provided \$480,000 in grants to SUS/Palladia. The Enterprise relationship with SUS/Palladia also expanded to include participation in Enterprise's Resilience Learning Collaborative, acquisition and working capital lending, participation in the Build it Back Program and resiliency efforts.

Today, post-merger, SUS serves nearly 12,000 low-income New Yorkers through its community-based sites in the Bronx, Brooklyn, Manhattan, Queens and Nassau County, and Enterprise has continued to support its growth and invest in its success. In 2012, Enterprise invested \$6.9 million in the Truxton Project in Brooklyn, which created 48 new units, 39 of which are reserved for the formerly homeless or those with special needs, and has more recently underwritten the Third Avenue project.

The Nonprofit Finance Fund (NFF), through its Community Resilience Fund (CRF), combines business advice with innovative grant money designed to make participating organizations financially stronger and more resilient in this era of scarce resources. CRF provided Palladia and other New York City organizations supporting vulnerable populations with deep advisory services intended to strengthen each organization's business. The grant funding helps participants implement their plans and invest in their change initiatives. NFF consultants work closely with participants to help them leverage change capital from other sources.

The Robin Hood Foundation, through its Management Assistance initiative, lends expertise directly to nonprofits; other times, it recruits the best-in-class providers of professional services for its grant recipients. Each year, Robin Hood staff and corporate partners provide professional services to grant recipients worth more than \$5 million.

The Robin Hood Foundation provided both advice and a grant of \$100,000 through the Management Assistance team in support of implementation of a best-in-class system to integrate the general ledger system of the combined entity.

SeaChange Capital Partners is a merchant bank serving the nonprofit sector. Its mission is to enable transactions that increase the impact of nonprofits and offer leveraged opportunities for funders. In its role as a merchant bank, it facilitates transactions by making grants, loans and investments from its funds and by providing advisory services. Hurwitz approached SeaChange when the merger was first being explored. SeaChange stepped in to provide funding and support once SUS was identified as the leading merger partner for Palladia. John MacIntosh, SeaChange partner, sat in on a joint SUS and Palladia board meeting and afterward recommended that the organizations take on a joint third-party consultant. The Support Center was engaged to provide support and assistance. SeaChange committed to a grant in support of the merger in January 2014 and funded it the following September.

From the beginning, MacIntosh and SeaChange advised with a light touch. Hurwitz had advised his board that, although they had done a lot to shrink the deficit, they couldn't do it on their own. MacIntosh explained that Palladia would benefit most by finding an organization that was as broad and large (or larger) than Palladia, and one that would allow it to create enough operational efficiency to close the debt and sell its headquarters. MacIntosh pointed out that, of the two most likely organizations, "SUS was more eager because of the complementary programs, and because SUS management was able to get the board comfortable that the cost savings and cash to cover the cost of the merger could be realized." The geographic and programmatic fit of the two organizations made sense. MacIntosh, who has supported numerous mergers, points out that the

communication between SUS and Palladia was excellent, “For a merger involving pretty big organizations with lots of stakeholders, I would say that the process was second to none.”

Support Center/Partnership in Philanthropy is a management support organization and has been a partner for strategy and “change management” with SUS for over 20 years. The Support Center worked with SUS on many fronts, including strategic planning, board development and retreats and leadership restructuring (among others). Early board planning and board development work conducted between 2008 and 2011 helped set the stage for SUS to take advantage of the Palladia merger opportunity. Don Crocker, then executive director of The Support Center, noted that Colonna and Powell recognized the “need for board change and organizational change in order for SUS to be positioned to move quickly to take advantage of new opportunities.” Crocker served as an ongoing advisor to Colonna, in addition to the various consulting supports provided by the Support Center to SUS. The Support Center began working with Palladia and SUS on the merger in July 2014 when both boards were in agreement that the merger should move forward pending the final outcome of additional due diligence.

Throughout the merger process, the Support Center’s main role was to assist in the integration process. Support Center consultants worked with Colonna and Hurwitz to coordinate the first joint staff meeting, which took place in October 2014, and continued this work to frame the discussions held with the Palladia board about SUS structure and how Palladia would fit with SUS.

The Arthur Webb Group offers integrated and practical solutions to the key players whose business and services will be impacted by health reform measures in the post-acute arena and that are serving or managing patients who have Medicaid or Medicare as their primary source of support. Its services include strategic thinking and positioning, data analytics and practical solutions. The group also helps clients operationalize many of the key features of health reform to increase their capacity to serve their patients. These solutions are created for each particular situation, tailored to the organization’s unique needs.

KEYS TO SUCCESS AND LESSONS LEARNED

Based upon interviews with over a dozen key participants in the merger process, the following keys to success and lessons learned may provide insight that could be helpful to the exploration of nonprofit mergers in the future:

Keys to Success

Leadership with a focus on the mission and the future. The importance of strong leadership in this effort cannot be overstated. Both Colonna and Hurwitz played essential roles in keeping the merger effort moving forward. Both boards demonstrated leadership in their roles. Open and honest communication on all fronts helped to drive the effort to success. Colonna's reputation for integrity and her strong relationships and credibility with funding entities played a key role.

"It's critical for the board – together with leadership/management – to assess what is needed for the future. An organization needs to be clear about keeping the core of the organization strong."

Carolyn Powell
Board Member, SUS

The Palladia board came to the table with a clear understanding of its own financial position and a focus on maintaining service for its clients. It offered transparency to SUS from the beginning about its financial situation and debt-load along with its financial and programmatic assets. Hubbard, noted that "there is a certain selflessness at the Palladia board level and also with the management team that struck me as a surprise because I could easily imagine other organizations where the most important thing would be for them as individuals (either leaders or board members) to maintain their own personal legacy and resist merging into an organization that would not distinguish their independent identity." Hurwitz and Palladia board members recognized that a merger would be the best means to ensure that the people served by Palladia would have the quality services they need and deserve.

The SUS leadership and board had a clear understanding of SUS' core strengths and financial capacity. Powell notes that "it's critical for the board – together with leadership/management – to assess what is needed for the future. An organization needs to be clear about keeping the core of the organization strong. If you are not strong at the core, you probably are not strong enough to engage in a merger." SUS was not aggressively seeking a merger, but when this opportunity presented itself, it was ready to evaluate it in the context of clear strategic goals that focused on providing outstanding service for clients.

Prior experience and familiarity among the merger partners: The earlier experiences that brought together Colonna and Hurwitz were critical. Working together over several years to address the changes brought about by the advent of managed care helped engender respect and trust between the two leaders. They were familiar with each other's working styles, and as Palladia board member Abby Jo Sigal stated, "We were happy with the cultural fit with SUS, and of the universe of possible organizations for a merger, we felt quite comfortable with SUS."

Both organizations were well known and well regarded in the human services field. In fact, some employees had worked at both agencies before any discussion of a merger. The SUS board made a concerted effort to get to know members of the Palladia board during the initial stages of the discussions. The time invested in further building upon the pre-existing familiarity and trust is seen as one of the key ingredients of success based upon our interviews with SUS and Palladia staff and board members.

Third-party support for due diligence and completing the merger. SUS relied on a number of outside partners over the years to help identify and pursue key strategic goals. The Support Center was an important cog in the original strategic plan that set SUS on the path that resulted in the merger with Palladia. The Support Center also supported the integration process at the request of Palladia and SUS. Outside funders, including SeaChange Capital Partners, Enterprise Community Partners and BDO, were instrumental in facilitating the merger efforts with funding and technical assistance.

Highly capable and motivated staff. Staff involvement was critical to the success of this merger. Both organizations had strong staff dedicated to providing the best services possible within the financial resources available. The SUS board had a very high degree of confidence in its senior staff leadership. As SUS conducted its due diligence regarding a merger with Palladia, the board was confident that the information it was receiving was thorough and accurate. Gareth Old noted, “You’ve got to have the right team in place at the time. It’s got to be there already.” The combination of a strong board and a strong management team that trusted each other and worked well together was critical to the merger of SUS and Palladia and fits the pattern identified in the nonprofit merger research.

Understanding and respecting the importance of culture. Through clear communication, SUS and Colonna sought to ease tension among the staff regarding the transition and the resulting roles of the staff. SUS and Palladia took the appropriate steps prior to, during and are continuing now, after the merger, to address issues of culture to ensure success.

Lessons Learned

It takes more time than anticipated to integrate organizational culture. Even though the cultures of the two organizations had similarities, any differences become pronounced once a merger is formalized and the “rubber meets the road.” Colonna said, “We underestimated the cultural differences between our organizations. Although subtle, the differences need to be addressed in order to have a smooth working system. We forgot that it took us many years to build the quality “values-based” culture we live with, and now we had to help a third of our workforce that needed to catch up in a short period of time. It continues to be a focus for us!”

Investing in building a strong board is worth the effort. Early on Colonna and Powell saw the need to make board change that would put people in the board seats who could bring the skills, experience and engagement that allowed SUS to be nimble and ready for opportunities. They worked closely with Crocker and the Support Center to change board members' expectations and commitments and to identify, recruit and engage a cadre of new members who were well-placed to nurture the organization through this complex, time-intensive effort.

Real partnership and cooperation with funding agencies is critical to merger success. The cooperation and working partnerships with the government funders and the bank were essential to the success of the merger. In-depth meetings with hard discussions that led to real commitments took a substantial amount of time and effort on everyone's part. Both funding commitments and nimble action were required to enable both organizations to meet critical deadlines that made the merger possible. It is unlikely that the merger would have had success without the commitment of funders, including the New York City Department of Homeless Services, New York State Office of Substance Abuse Services and New York State Office of Mental Health, to work closely with SUS and Palladia to forge solutions.



Late payments by government and underfunded payment rates severely limit the ability to build a robust infrastructure, innovate and change. In retrospect, it should be acknowledged that the day-to-day challenges of late payments and resulting cash flow issues significantly impaired Palladia’s ability to be innovative and make the changes needed for future organizational success. As was pointed out in the Human Services Council report, “Underfunded government payment rates are the primary driver of financial distress. Government contracts dominate provider budgets but pay only about 80 cents or less of each dollar of true program delivery costs. Chronic delays in contract payments force providers to undertake costly borrowing to make payroll and rents, often accruing interest not covered by government contracts.” Quick action on the part of Palladia and SUS likely averted real disaster for those consumers served by Palladia and suggests that mergers should be on the strategy screen for nonprofits seeking to ensure quality services for their constituents going forward.

“Careful planning cannot be overemphasized, and for a nonprofit merger to be successful, it is essential that leadership put a structured plan in place early in the process.”

MAP for Nonprofits

Nimble outside assistance is essential to success. In its Merge Minnesota publication, MAP for Nonprofits suggested that “Careful planning cannot be overemphasized, and for a nonprofit merger to be successful, it is essential that leadership put a structured plan in place early in the process.” Most mergers, because they are complicated, confusing, and highly technical, require skilled, outside expertise. SUS benefitted by having multiple third-party partners providing assistance. These partners listened carefully to the needs articulated by the merger partners, were flexible in providing assistance when and where needed and played roles appropriate to their expertise and the needs of this merger. A rigid approach to providing assistance would likely have resulted in obstacles rather than solutions and success for the teams leading this merger forward.

The challenge of integration is hard to predict, and takes time and resources. Webb stated, “If you’ve seen one merger, you’ve seen one merger.” Each merger has its own challenges and needs to address the unique needs of the merged entities. It can be hard to predict what it will take to move the integration of the two organizations forward effectively and efficiently. Working to stay ahead of the integration challenges helped Palladia and SUS to be more efficient (for example, bringing the boards together early in the process and integrating senior management sooner rather than later). Nonetheless, full integration of human resources, financial management, information technology and property management (among others) will be a major work in progress that will continue to take time and resources in the months ahead.