DIRECTOR DIALOGUE SERIES

Navigating M&A Deals in an Uncertain Environment: Five Questions for Directors

Introduction

Over the years, researchers have found that the vast majority of merger and acquisition (M&A) deals—from 70% to almost 90%, depending on the study—fail to achieve their objectives in one way or another. Yet these figures have not put a damper on deal activity. Worldwide M&A reached $3.7 trillion in 2016, following a record-high year of more than $4.3 trillion in 2015[1]—and M&A has been consistently cited as a top board priority by respondents to NACD's governance surveys (see Sidebar, M&A by the Numbers).

NACD and Protiviti recently held a series of roundtables that brought together more than 60 directors to discuss current challenges and effective practices in board-level M&A oversight, focusing on those situations in which the board's company is the acquirer. Protiviti managing director Jim DeLoach asked, "How can the board ensure a deal is compelling? Oversight is an end-to-end process, not a transactional activity."

The sessions highlighted five questions for board members:

- Have we clarified the company's acquisition philosophy and its link with our overall strategy?
- How thorough is our due-diligence process?
- What role is the board playing to help overcome "deal heat"?
- How do we measure the success of the integration process?
- What insights have we gained from post-deal reviews over time?

[1] *Dealogic Investment Banking Scorecard*, *WSJ Moneybeat* (blog).

M&A by the Numbers

- U.S. M&A transactions in 2016 exceeded $1.6 trillion in value, not too far from the 2015 record high of $1.98 trillion. The technology, real estate, and utilities and energy sectors were particularly active in M&A during these years.
- Eighty-four percent of respondents to NACD's most recent public-company governance survey want to improve the board's M&A oversight practices within the next 12 months, and 45 percent identified improving M&A oversight as an "important or very important priority."
- Globally, the Middle East and Africa, Australasia, and Canada saw the biggest gains in year-over-year deal growth.
- Acquisition activity among small and midsize businesses may continue to gain steam in 2017. According to one recent survey, a majority of corporate and private-equity executives are seeking acquisitions under $1 billion.

Sources: The *Dealogic Investment Banking Scorecard*; Protiviti analysis; *NACD 2016-2017 Public Company Governance Survey*; Vipal Monga, "M&A Seen Surging in 2017, but Deal Size to Drop," *CFO Journal* (blog), Dec. 9, 2016.

Have we clarified the company's acquisition philosophy and its link with our overall strategy?

In all three roundtables, participants agreed that the board's discussions with management about the role that acquisitions will play in the company's strategy for creating long-term value should begin long before a deal is on the table. *"Have a framework that can help identify why any acquisition is additive,"* said one director. *"During the strategy process we talk about the . . . acquisition pipeline and our risk appetite—even in the absence of specific targets."*[2] Another director observed, *"Acquisitions can play a role in extending strategy in a range of different ways. Some targets might be attractive because of synergies, but others might help the company move in a different direction with innovation or new markets."* These and similar remarks from the roundtable discussions suggest that directors view acquisition targets as typically falling into two groups: those that are additive to the core business and those that open up new business opportunities.

Once a prospective acquisition has been identified, directors should ask for specific information about the target. One director said, *"When I was the head of M&A at [a previous company], we kept the board apprised of potential acquisition targets on an ongoing basis. Once the deal process was underway, we established a transaction committee headed by the chairman of the board. They met with us as [often] as once or twice a week in the midst of the deal via conference call."* A different participant described how the board was feeling *"rushed by management [when we discussed deals]. So we asked them to produce a white paper outlining the*

protiviti®
Face the Future with Confidence

[2] Roundtable discussions were conducted under the Chatham House Rule. Italicized quotations are from participating directors.

NACD®

specific connections with our overall strategy. It's now part of the process—a business plan that lays out the goals of the acquisition." At another director's company, the board *"made some of our criteria for acquisitions—size, intent, and so on—public. It forced a lot of discipline, and we also got very positive reactions from our top investors. Management now has a clear roadmap, so if an opportunity is brought to the board, there are established criteria for evaluation."*

Roundtable participants noted that in some cases, the board may need to encourage management to think more expansively about how acquisitions might strengthen the company's strategy. *"On one of my boards we had to push the CEO and his team to go bigger,"* one participant said. *"They were focused on 'string of pearls'-type deals—small acquisitions concentrated in one category. We encouraged them to diversify, and look for transformative opportunities."* Nonetheless, directors emphasized that *"M&A can't be a smoke screen for ineffective execution in the core business. The board needs to challenge management on a continuous basis."*

How thorough is our due-diligence process?

A common theme throughout the discussions was the notion that *"the integration plan should be the due-diligence playbook."* Participants suggested boards should ask management to *"bring the integration plan forward, so that it can help frame and guide the due-diligence process."* One director said, *"We require a well-thought-out plan for the first 100 days post-acquisition in order for the board to approve a deal."*

Robust due-diligence processes include analyses of

- personnel—including those it is essential to retain, and those who may be "flight risks";
- culture;
- systems and technologies;
- regulatory issues;
- customers (*"Assume at least some customers will migrate. The question is: how many?"*); and
- reputation risks.

Many boards also are insisting on forensic audits of acquisition targets in order to uncover potential Foreign Corrupt Practices Act violations or other compliance issues, especially in global M&A deals. Roundtable participants also reported that cybersecurity is becoming an increasingly important aspect of the due diligence process (see Cybersecurity and M&A).

protiviti®
Face the Future with Confidence

NACD®

Cybersecurity and M&A

Directors at the roundtables highlighted two important considerations:

- **Conduct an independent assessment of the target:** "*At one company, management hired a cybersecurity expert firm to evaluate the target company. When was the last time they were breached? How did they know? How long did it take them to detect [the intrusion]? You can't rely on the target company's IT department to provide this information, and you don't want to inherit the other firm's problems.*"
- **Evaluate the security of the deal process itself:** "*I've seen two recent instances where cybersecurity was a factor in acquisitions. In one case the bidder was extremely smart. We later discovered that our law firm was hacked and the other bidder had seen our information.*"

For additional guidance on cybersecurity at various stages of the M&A process, see Appendix B of the *NACD Director's Handbook on Cyber-Risk Oversight*.

The board must also ask detailed questions about management's ability to execute on the vision outlined in the M&A proposals and pro forma projections. Jim Ryan, Protiviti managing director and leader of the firm's Transaction Services practice, observed, "The skills required for successful integration can be very different from those needed for day-to-day activities. Many organizations don't have good processes and lack cross-functional coordination, which can undermine post-deal execution. Board members should make sure they know the members of the leadership team that will have responsibility for integration, so they can assess whether the right skills are there."

What role is the board playing to help overcome "deal heat"?

Even in cases where the management team has a successful track record of consummating deals and executing integration plans, board members need to ensure that prospective deals are analyzed objectively and must be mindful of the potential for management to overpromise. As one director put it, "*Management can get enthralled with the size and scope of a proposed deal and pass on that enthusiasm to the board, so that everyone starts to ignore red flags. The CEO may do a good belly dance, but as directors we can't let ourselves get dazzled by big numbers.*"

Participants shared a number of tactics their boards use to combat deal heat:

- **Red Teams:** "*Our corporate secretary's job is to present to the board the case against a proposed deal—the contrary point of view and alternatives that might not otherwise make it into the boardroom. It's not always popular, but it stimulates great discussions.*"
- **Valuation committees:** "*We set these up on one of my boards to help take the emotionality out of the deal process. It's a small committee that can have objective, probing discussions with management about how much we should really be paying.*"

protiviti®
Face the Future with Confidence

NACD®

- **Scenario analysis:** *"If the pro forma [projections are] off by a certain percent, is it still a good deal? We ask management to model a few different potential outcomes so we can identify the margin of error. If it still makes sense at 75 percent, it's probably a good deal. If it's only going to succeed at 90 percent or more, probably not."*

- **Executive sessions:** *"These are a great place to identify whether there are any dissenting opinions within the management team. For major acquisitions, we make sure all of the key voices are heard. It may not change the outcome, but we make a much more informed decision."*

Several directors noted that the way in which the board views deals that are not done is also important: *"It's important to celebrate walking away from an acquisition for the right reasons. Management has had the courage to tell it like it is."*

How do we measure the success of the integration process?

Early and active discussion between the board and management about how integration will unfold is an important element in successful deals, especially those that are complex or higher in risk. Many directors reported that their boards use information from the pro forma analysis generated during the due-diligence phase to hold management accountable after a deal closes: *"Comparing pro forma projections with actual results is an important part of how we score management's success. It also helps keep the pro forma analysis more realistic."* Another director added, *"We used an outside firm to validate the synergies identified in the forecasts before the deal closed. It was money well spent, as it created a baseline for evaluating performance that everyone could agree upon."*

A director observed, *"Mergers may fail not because they didn't hit the projected numbers, but because it took twice or three times as long as expected to get there and achieve the benefits."* As a result, participants highlighted that the board should set expectations with management regarding the cadence and timing of integration activities, as well as the frequency of reporting. Most roundtable attendees said their boards receive quarterly reports on the integration progress, barring unusual situations or crises. One participant described a post-deal process where *"We established the trajectory of the business for the next three years, including the top and bottom line, versus what we paid for the deal. The board identified a set of stretch goals and associated incentives, including cliff vesting for the equity portion in order to ensure that the top people stayed. Even if the team falls behind on a couple of variables, overall we're still moving in the right direction."*

What insights have we gained from post-deal reviews over time?

Protiviti's Jim Ryan emphasized, "It's extremely important to do 'look-back' reviews periodically in order to assess the success of multiple deals over time. These reviews should have a learning focus—they should not be finger-pointing exercises." Given the high percentage of deals that fail to meet objectives, thorough discussion between directors and executives about what worked and what didn't work in previous acquisitions is especially important. At one director's company, *"We did this for the first time, and management was astounded. It turned out*

protiviti®
Face the Future with Confidence

NACD®

the success numbers were lower than expected. They made some changes to the corporate development department. It didn't stop us from doing acquisitions, but it led to real improvements in the M&A process, and overall it had a very positive impact on the culture of the company."

Conclusion

As one director said, *"When you buy another company, the only thing you know for sure the day the deal closes is that you were the ones willing to pay the most."* Participants at the three roundtables agreed that the diverse experiences and perspectives of a well-composed board enable it to provide valuable oversight and guidance to management at all stages of the acquisition process, from strategic-option generation to integration and post-deal analysis. *"M&A is often viewed opportunistically—if we don't buy this company, someone else will—but it's really just one potential solution to a problem. The board has to ask management, 'What problem are we trying to solve, and are there other ways to do it?'"*

Related Resources

NACD Resource Center: M&A Oversight

Protiviti, *Guide to Mergers and Acquisitions: Frequently Asked Questions* (Protiviti, 2016).

National Association of Corporate Directors
2001 Pennsylvania Ave. NW, Suite 500
Washington, DC 20006
202-775-0509
NACDonline.org