Sextant Consulting Pty Ltd

Article 4: Governing the Transaction Stage

This is the fourth article in a quintet of articles on board governance of M&A, published by the AICD Governance Leadership Centre.

It is often said that, more often than not, acquisitions are value-eroding events that fall short of investor expectations. A range of empirical studies support these claims. This begs the question: what can the boards of acquirers do to improve the chances of success? Or, put differently, what is the 'right' M&A governance by boards of the acquiring enterprise?

This series of papers has been divided into the following four stages that characterise the full M&A lifecycle:

1. **Targeting** (including development of the M&A intent and strategy)
2. **Transaction** (the deal)
3. **Transition** (post-deal or the first 100–180 days); and beyond that to the fourth and final stage
4. **Transformation** of the combined enterprise.

This article deals with the **Transaction** stage, or the deal closure, which is the second stage of the M&A lifecycle above.

By way of a brief recap, Article 1 of the series commenced with an encouragement for executives and boards to begin with the end in mind. Consistent with that approach, Article 2 examined the final stage of the M&A lifecycle, **Transformation,** and encouraged executives and boards to think deeply about the purpose of the acquisition and what the intended outcomes of the transaction were.

Article 3 related to the third stage of the M&A lifecycle, **Transition,** and emphasised the need to be well-prepared for Day 1 post-transaction, so as to mobilise early against a well-organised plan – especially a communications and engagement plan.

Copyright in this article belongs to the author, Dr Dean Blomson, and is kindly reproduced under licence between the AICD and the author. This article, and any links to it, must not be used or reproduced in any materials without the author's prior written permission.

First, some words from the wise

"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

[Source: Warren Buffet, letter to shareholders, 1989]

"Theorem 1 says that whichever projects the firm ends up selecting (optimally) will turn out to have been valued optimistically, on average."

[Source: Compte, O., *Prediction errors and the winner's curse,* ENPC[1] working paper, September 2004]

This article focuses on the **Transaction** stage which is about ensuring that:

- there is an investment or deal thesis; that is, a clear working hypothesis of where the value lies, which is tested thoroughly during due diligence; and
- preparation and planning for integration takes place early enough to provide a jump start after the deal is concluded.

This stage is as much about setting up a deal for success down the track, as it is about having the discipline and objectivity to walk away from a transaction where needed.

In this stage, the board's role is to be a constructive critic and challenger – especially of the rigour of the business case and funding strategy – and the gatekeeper for the final investment decision before the deal goes through, or is rejected.

Why is this stage so important?

The Transaction stage is where the deal value is lost or won – not simply in the sense of securing the target for a fair price, but having confidence that (1) the right target is being bought for the right reasons; (2) at a reasonable price; and (3) management is focusing on the right levers of value.

This phase goes to the heart of several key themes arising from my research, namely:

(1) Planning and preparation (*'Early preparation and planning'*)
(2) The extent of board members' cultural due diligence ('*Proper understanding of culture*')
(3) Robust business-case scrutiny and investment assessment ('*Rigorous testing of the investment business case and funding strategy*')
(4) The quality of their mutual challenge and critical debate ('*Well-chaired board with constructive challenge*').

As one director put it:

"To me that sort of stress testing, you know, getting into the detail, it's a given. And you have to really sort of look at close testing …those assumptions…"

[1] ENPC: École Nationale des Ponts et Chaussées.

Copyright in this article belongs to the author, Dr Dean Blomson, and is kindly reproduced under licence between the AICD and the author. This article, and any links to it, must not be used or reproduced in any materials without the author's prior written permission.

This stage is also important in achieving alignment between the board and management on what it will take to make a success of the transaction, post deal, and having a clear understanding of the tasks ahead.

What typically goes wrong?

The seeds of disaster, or at least M&A under-performance, are usually sown in this stage, and relate not only to gaps or lapses in "hard skills" such as deal-making experience and know-how, but also failure to attend to soft systems or behavioural aspects.

In my view, technical-deal skills are widely available to management teams in Australia and can be bought or hired. The failure of complicated (or even more so, complex) transactions usually lies in not mastering soft system skills, or in not applying the right intervention at the right time.

Behavioural aspects could be termed the "seven deadly sins" of deal-makers: (1) management naivety; (2) unbridled optimism (the conspiracy of optimism); (3) hubris (arrogance or pride); (4) complacency; (5) undue haste; (6) greed; (7) deal myopia and deal fever.

As Pogo famously said: "We have met the enemy and he is us."

What does the board need to do?

I have previously argued that executive teams and boards should begin the M&A process with the end in mind; that is, where do they believe the transaction should land the enterprise 3-5 years from now. Accordingly, begin by imagining that it is three years since the deal was undertaken and ask yourself: Where are we today? What have we really accomplished? What is the investment market saying about us? Our staff? Our customers? Our competitors?

Asking and answering these questions will help to frame the targeted outcome. If you are able to undertake this simple exercise in the first stage (i.e. during Targeting) and significantly tighten it and lock it down in the Transaction stage, as a board you are far more likely to be aligned with the management team on what you collectively really want to achieve.

A cautionary tale

Slater & Gordon's fall from grace was chronicled in the *Australian Financial Review* (23-28 December 2015) as an Icarus-like example of a company whose ambitions overwhelmed its objectivity and due diligence, and allowed short sellers to take full advantage of its vulnerability.

A bridge too far…

It could be said that Slater & Gordon had mastered the capability to execute acquisitions through a range of acquisitions (approximately 50) made since listing in 2007. This had allowed it to become a well-regarded and desirable stock amongst mid-caps. In expanding to the UK, it acquired a slew of firms in 2013 including Taylor Vinters, Goodmans Solicitors, John Pickering and Partners, and Fentons Solicitors; and then came Pannone in 2014. Roll-ups provided access to new revenues and cash flow from the acquisitions to fund its shopping list.

Copyright in this article belongs to the author, Dr Dean Blomson, and is kindly reproduced under licence between the AICD and the author. This article, and any links to it, must not be used or reproduced in any materials without the author's prior written permission.

Part of the growing revenue of Slater & Gordon was accounted for as a work in progress line item, covering expected settlements yet to be achieved from its class actions and other current cases across its growing portfolio of operating businesses.

In March 2015 Slater & Gordon unveiled an agreement to buy Quindell in the UK for $1.3 billion using a mix of debt (new bank loans), and a share rights issue that would double the size of their firm. The total deal was about the size of Slater & Gordon's then market cap – and more than four times larger than the aggregate value of all of their previous deals since 2007. If successful, it would move Slater & Gordon into the ASX 100.

What followed was a classic case of executives dismissing concerns of one or two analysts (initially perceived as naysayers) about Quindell's "aggressive accounting policies, eccentric history of acquisitions and suggestions of widespread related party transactions". (*AFR* 23 Dec. 2015)

Despite a growing set of concerns and some renegotiation of the deal, including excising certain parts of the book and writing down part of the work in progress, the deal proceeded. But what followed caused a collapse of 90 per cent in the Slater & Gordon share price as trading losses were announced based on disappointing results.

Accounting adjustments were made for work in progress write-downs; ASIC conducted probes, as did a major investor, Fidelity, via a forensic accounting firm; and significant and aggressive short selling was driven by a few hedge fund operators. All of this was further amplified by UK government legislation changes announced to curb rampant compensation arrangements for personal injury claims.

The ultimate irony is that Slater & Gordon now finds itself in the cross-hairs of a potential class action suit for breaches of continuous disclosure obligations; Maurice Blackburn has reportedly registered 2500 retail investors and has strong interest from institutional investors. This may turn out to be a watershed moment – even though it represents an indirect consequence – in holding boards to account for entering into ill-conceived transactions.

So what are the key things boards should be looking out for in this stage?

First, is being alert to bias and listening carefully for divergent views.

One of the pivotal tasks of the chair and board members is to remain alert to various forms of bias creeping into decisions, such as: loss aversion ("we've put so much money and effort into this already, let's not walk away just yet"); confirmation bias ("we can see evidence that the value is there; the naysayers just can't see what we can see"); and value attribution ("we have paid top dollar for the best advisers and they have told us this is a great deal").

Astute chairs will keep injecting challenge to flush out blind spots, group think etc. There are a number of useful mechanisms: independent reviews are one way of doing this; red teams are another; pre-mortems a third (see breakout box below)

Pre-mortems

The simple but powerful technique of a pre-mortem, helps to address several key behavioural issues associated with major capital commitments, namely blind optimism, bias and hubris.

Copyright in this article belongs to the author, Dr Dean Blomson, and is kindly reproduced under licence between the AICD and the author. This article, and any links to it, must not be used or reproduced in any materials without the author's prior written permission.

Ask yourself:

It is three years on after the deal and things have gone horribly wrong? What happened?

"We should say, "We're looking in a crystal ball, and this project has failed; it's a fiasco. Now, everybody, take two minutes and write down all the reasons why you think the project failed." (Daniel Kahneman, 2010)

Ask yourselves not only what happened, but what were the underlying causes? What did we foresee but not act on? What did we not see? Where did we screw up? What did we under-cook?

M&A skills and experience are valuable prerequisites on a board planning to engage in M&A activity. But perhaps the best protection against narrow-mindedness, bias and deal fever lies in boards that are built on a diversity of thinking styles. These boards deliberately select board members not just for age, experience, gender or ethnicity (or other demographic factors, which may be entirely valid, depending on context), but with a clear understanding of what thinking styles they want.

Another key problem is under-cooking the cultural due diligence. A key finding of my research was the emphasis that board members should place on cultural due diligence – although there was not always a consistent interpretation of what this means or involves.

The board needs to know **before** the deal is done that management has conducted an accurate assessment of the acquiring company's compatibility with the culture (attitudes, values, behaviours, leadership style, reward systems, decision-making processes) of the target company.

As one interviewee put it:

"… I think you have really got to try and push down those culture questions with management and make sure that they understand what the culture is. It's funny because people … don't really take you seriously when you ask about culture and yet everyone blames it when things go wrong, always. You read all the reports that have come out of analysis of acquisitions gone wrong, every single one of them starts with culture."

The due diligence has *"to be deliberate and disciplined, and very deep, very deep. I think that you really need to spend the time, and you can't rely on consultants for that stuff …"*

Transaction Stage

Tips and Traps

What to do right: conditions for success

1. Deal team with a well-worked plan and clear roles
2. Red team to run counter factual
3. Maintain objectivity – guard against loss aversion and target fixation
4. Keep coming back to the outcome

What to look out for:

5. Bias and deal fatigue
6. A conspiracy of optimism i.e. naivety about what it will take to deliver value post deal
7. Spruiking by advisers
8. Lack of ownership and leadership by the executive team

Remember:

9. Intangibles matter, especially culture
10. The Board's and executive team's deal and delivery expertise matters greatly

Copyright in this article belongs to the author, Dr Dean Blomson, and is kindly reproduced under licence between the AICD and the author. This article, and any links to it, must not be used or reproduced in any materials without the author's prior written permission.

Culture – the silent killer missed in due diligence

As one research interviewee put it:

"… you've got to keep circling back … things like culture and values, which are often taken for granted; they are in fact also things that will destroy you if there's incompatibility."

And another:

"… you really do have to put in a hell of a lot of effort to get it right and I think that at that front end and on these sort of cultural… values sort of compatibility type issues (sic) that there's not nearly enough weight given to that…."

Additionally, in a 2002 survey of 250 global executives[2] involved in M&A, Bain & Co. found that one of the top two reasons for success cited by executives was "cultural integration addressed early on and actively" (83 per cent of executives cited this factor as important or very important).

A third key issue is planning too late – all attention is on the deal and too little energy goes into thinking through what it will take to deliver post-deal results. The board needs to ask and test: what is the plan for "go live" post-deal, and is it viable? Is there a possible 'conspiracy of optimism' i.e. is management thinking it will be cheaper, easier and quicker to deliver targeted outcomes than reality would otherwise dictate?

Test yourself with five key moment-of-truth questions

To conclude the Transaction stage, *ask yourself five critical questions on how* you and your fellow board members govern "*transaction management*":

1.	Are we clear on the intended outcomes from the transaction? Have we clearly defined success and the conditions for success?	✓
2.	Do we understand the tolerances and sensitivities with key drivers of value for the merged entity?	✓
3.	Are we all clear on the key assumptions/unknowns on which the financial model is based? Which factors have you discounted and why?	✓
4.	Do we know what it will take to achieve the target run-rate to deliver the expected results? And do we know what could prevent us from performing to expectations?	✓
5.	Have we adequately tested how management's view corresponds with or differs from that of other industry experts? Can we substantiate the differences? Have we adequately anticipated changes in the *status quo* with regards to key customers, key suppliers, prices, key people, key competitors?	✓

Think about these five questions. We will invite you to take a short survey at the end of the final article to assess how M&A capable and prepared your board is.

[2] Bain & Co, *Mastering the Merger*, 2004, by David Harding and Sam Rovit at pg. 96

Copyright in this article belongs to the author, Dr Dean Blomson, and is kindly reproduced under licence between the AICD and the author. This article, and any links to it, must not be used or reproduced in any materials without the author's prior written permission.