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Prelude to M&A – a game of four quarters for boards

Scene Set and Context

Mergers and acquisitions (M&A) are critical mechanisms for corporate growth and potentially for increased shareholder returns. The reality, however, often does not live up to the promise. This is borne out by empirical data on the high incidence of M&A under-performance.

Two of the most commonly quoted statistics come from a 1998 study by Mark Sirower (currently a US-based partner at Deloitte) indicating that:

1) 77% of acquisitions do not earn or exceed their cost of capital.
2) On average, the acquirer's stock trailed the S&P 500 by 8.6% one year after the deal announcement.

More recent literature has continued to point to acquisitions as frequently being 'losing events' for the shareholders of acquiring companies due to value destruction. For example, according to Bain and Company, "A commonly accepted benchmark of a successful merger is one that generates an *excess return* of 10 per cent or more.… Seventy per cent of all deals fail to meet even this modest target."

While this is a startling and regularly quoted headline, if you did deeper there is significant research that suggests that frequent acquirers significantly outperform 'well-meaning amateurs' and periodic acquirers. These improved outcomes are not surprising, if M&A is treated like other corporate competitive capabilities that need to be carefully nurtured and managed.

Despite this generally poor track-record of value delivery, Australian directors and executive management, particularly of the acquiring company, have considerable latitude to put at risk shareholder value via M&A. There are virtually no pre-requisites to embarking on a transaction – other than executive ambitions – or requirements to keep your own shareholders informed. So, exposed shareholders are left with few, if any, meaningful pre-event restraints or post-event sanctions. The old adage *caveat emptor* ('let the buyer beware') still rings true.

Most non-executive directors will be familiar with M&A deals in the past decade that have adversely impacted Australian investors. Even a cursory read of the financial press over the past 4 months highlights new such examples, including Slater & Gordon's M&A fuelled fall from grace (helped, in no small measure, by predatory share-shorting activity), and Aurizon's far less ambitious but still painful participation in the acquisition of Aquila Resources.

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So where does this leave boards?

For board members of the acquiring company who want to do the right thing by their shareholders, there is little clarity on what are responsible standards of conduct, including acceptable 'checks and balances', key activities and behaviours.

For non-executive directors looking for guidance, there is a wealth of literature on M&A, but it is targeted mostly at practitioners and covers the activities of executive managers, deal architects, investment bankers, consultants etc. There a paucity of evidence-based information providing clear guidance to non-executive directors on 'right' governance practices over transactions.

The term used in this paper ***right governance*** recognises that there is 'no one size fits all' for M&A. Board oversight must be 'right' for the unique circumstances and context of the enterprise and the complexity of every acquisition. The nature of board oversight that needs to be applied to one transaction may be different to that applied to another, even if there are common elements.

Given the absence of a chronicled set of right governance practices (supported by research), my own observations are that non-executive directors tend to do one, or a combination, of four things:

- rely on what they previously did in functional executive roles;
- do what they have heard by word of mouth is the done thing (conventional wisdom);
- be swayed by what the management team (who themselves may have their own biases and competency gaps) tells them they should focus on; and/or
- place an undue reliance on external advisers, including investment bankers who are incentivised to land a deal.

Such reliance leaves non-executive directors and their shareholders quite exposed.

How do non-executive directors know what is 'right practice'?

My recently completed doctoral thesis considered whether there is a discernible set of 'right practices' that provide a reference point for non-executive directors to gauge whether they are exercising the care, diligence and skill necessary to protect the interests of their shareholders before, during and after an acquisition.

Looking from the 'outside in', the corollary is 'How do shareholders in the acquiring company have sufficient visibility and assurance that their executive management team and board are exercising (or have exercised) sufficient due diligence?'

Six key themes have emerged from the research

In addition to a deep and extensive literature review, the research methodology involved interviews with seasoned non-executive directors. From this, six key themes emerged that make a real difference to deal performance:

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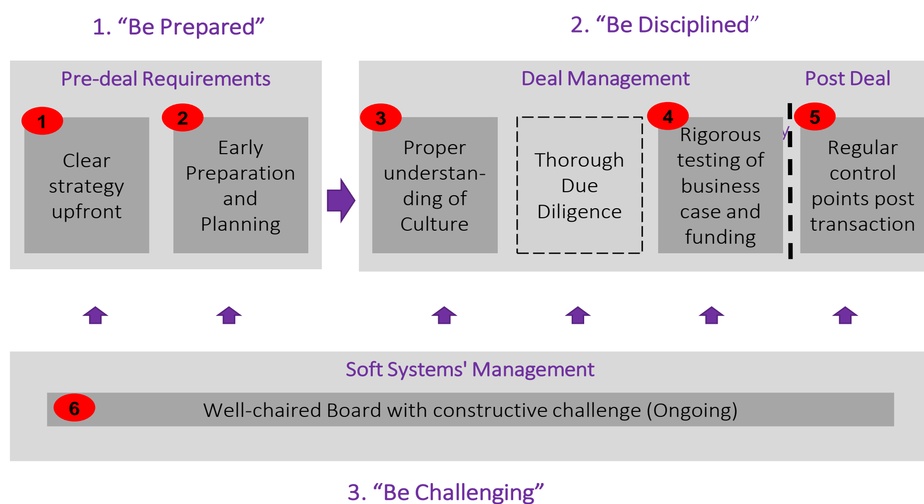
(1) the board’s degree of strategic thinking (*‘Clear strategy upfront’*);
(2) planning and preparation (*‘Early preparation and planning’*);
(3) the extent of board members’ cultural due-diligence (‘*Proper understanding of culture*’);
(4) robust business-case scrutiny and investment assessment (‘*Rigorous testing of the investment business case and funding strategy*’);
(5) the board’s focus on tracking the delivery of the targeted benefits (‘*Effective monitoring post transaction*’); and
(6) the quality of their mutual challenge and critical debate (‘*Well-chaired board with constructive challenge*’).

These six themes are captured in the figure below.

There are three principles, that over-arch the six themes, for directors to achieve successful results from transactions



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The six themes help to clarify how boards can better meet shareholder expectations for more predictable outcomes in M&A transactions.

M&A research series

This article is the first in a series of papers, each of which focuses on a different stage in the full M&A lifecycle:

1) Targeting (including development of the M&A intent and strategy)
2) The Transaction (executing the deal or terminating it, if necessary)
3) The post deal Transition (or First 100–180 days); and beyond that to the fourth and final stage
4) The Transformation of the combined enterprise.

These stages (which may be called the 'four Ts'), are depicted in the figure below.

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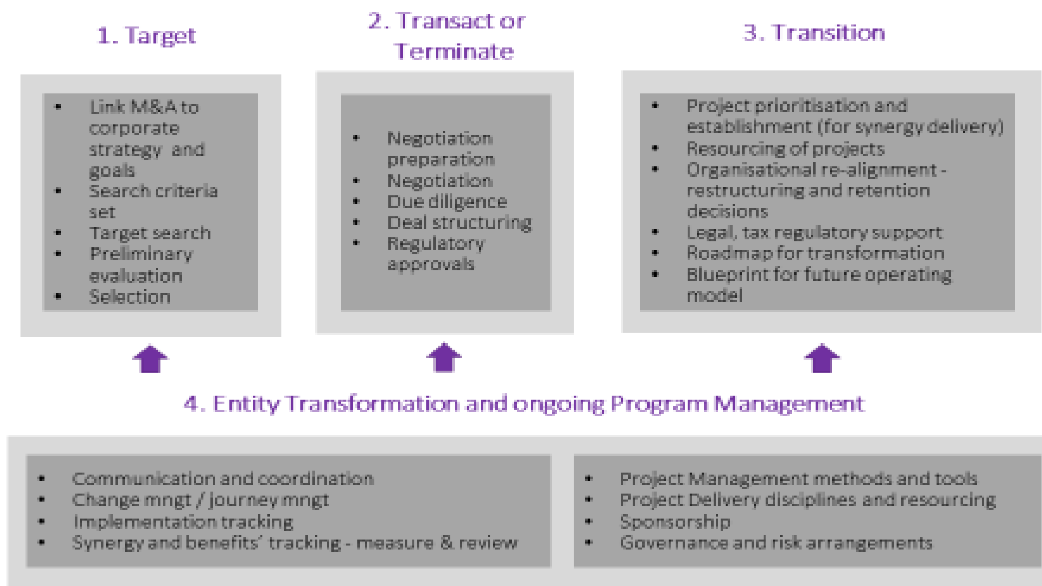

To make matters interesting, I will tackle these stages in reverse order; that is, starting with stage 4, Transformation. Transformation is focused on getting to the ultimate outcome - why the enterprise took on the transaction in the first place and what it intended to achieve.

The series is designed to help busy non-executive directors to be on the lookout for the traps and pitfalls of acquisitions, and to gain insights from my research and the wisdom of others. It is not intended to be a panacea or a prescription to avoid failure, but to offer a set of thought-starters and activities that may enhance the chances of successful oversight.

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