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M&A Best Practices for Boards of Directors

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Mergers and acquisitions are often exceptional external growth opportunities for companies, but also involve considerable risks for the firm and its shareholders.

Most studies carried out in this area show that the probability of a merger failing (as measured in terms of financial return) is greater than the probability of success. Empirically, the probability of failure increases with the size and complexity of the merger and with the degree of unfamiliarity with the target business.

In general, the purchaser tends to pay too much for the target because it is over-optimistic in terms of its ability to (i) do better than the existing management, (ii) implement the synergies identified; and (iii) integrate the target within its own company in a timely manner.

The application of the new international accounting standards (and more particularly IAS 36 on impairment of assets) will force companies to examine the value of their assets, especially that of their intangible assets, on a recurring basis. As a result, each overpaid acquisition will inevitably result in impairment of goodwill and, sooner or later, the board and management will have to publicly admit that their decision has destroyed shareholder value. If only to protect it against shareholder allegations, the board of directors is expected to become much more actively involved in M&A than in the past.

Even now, the board always approves major transactions (or at the very least it is consulted). In future, however, more than for any other board decision, it must be capable of fully assessing the extent of what is being proposed by management.

Unfortunately, the very nature of the M&A process makes the board's involvement a particularly sensitive issue. An acquisition frequently results from a long, confidential negotiation process, often involving extremely technical issues, and its outcome is largely uncertain. These factors lead management to present the board with only summary and high-level information on the opportunity and to wait for the outcome of the process before organizing in-depth discussions with the board.

This is unfortunate, as M&A is an area in which the board may be of great use to senior management. In fact, at least at the beginning of the M&A process, management has scarcely more information on the target than the board has. The outside view offered by the board at an early stage may counterbalance the optimism of the teams in charge of the deal or the partiality of numerous experts pushing for its completion, resulting in a more "realistic" attitude to the opportunity.

In this way, chief executives make good use of the combined skills and experience of the board members to put M&A transactions on a secure footing and decrease the likelihood of poor execution, which may have disastrous consequences for the company.

Best practices for boards of directorsValidating the strategic benefit of the transaction

Every acquisition must take place within an established strategic framework. Too often, priority is given to action, which is only justified after the fact as a "strategic fit." How the opportunity came about is an important question: is it something that the company's management has been contemplating for a long time and for which a "window" of opportunity has just opened? Does it concern a business activity or market with which the company is familiar? Does it involve geographical or sectorial diversification?

An acquisition can never be justified solely on the grounds of the savings it will generate. It must either meet a need that has been clearly defined previously, and which the company cannot meet using its own resources, or it must enhance the competitive position of the purchaser or the target. In order to create value, the acquisition must make it possible to build a genuine competitive advantage or to decisively prolong an existing competitive advantage. The directors' role is to test the solidity of this strategic advantage.

The business plan (taking account of the acquisition) presented by management or its advisors must highlight a scenario indicating "business as usual," as well as a series of scenarios that make it possible to estimate the expected return on assets committed and the uncertainties in respect to anticipated synergies. It must also simulate the consequences that the acquisition may have on the purchaser's financial structure (by taking account of potential adverse market reaction).

Verifying that the price paid is reasonable

Analyzing an opportunity culminates in a valuation. Concrete evaluation work must be carried out to be able to form an opinion on:

- The intrinsic value of the target in accordance with a number of different scenarios.
- The value of expected synergies (and the cost of implementing them).
- The positive and negative impacts on the value of the purchaser's company (bearing in mind that management will have to devote considerable time to integrating the target, which may have an adverse impact on the purchaser's business activities).
- The price which management offers to pay the seller and the terms and conditions of payment.

When a proposed acquisition is of particular significance in light of the company's size and when there is a possibility of a conflict of interest or a challenge by the minority shareholders concerning the price paid, it is advisable to have a fairness opinion drawn up by an independent expert.

Currently, such opinions are often prepared by the company's financial advisors or other consultants hired by management (who naturally hope to gain repeat business). The board must make sure that this expert appraisal is carried out in a truly independent manner. The board must thus verify the independence and skills of the expert(s) and, when the report is submitted, it must ensure that the work was carried out properly, in accordance with the professional standards in force. This assumes that at least one member of the board has adequate relevant experience or that the board is assisted by another expert to help it in this task of supervision.

Ensuring that the due diligence process has been carried out correctly

The purchaser generally carries out significant verifications (known as "due diligence ") before signing the agreement, unless the transaction involves a hostile takeover bid launched on the financial markets. Due diligence is of critical importance as it enables the purchaser to verify the integrity of the seller's financial statements, representations and warranties, and to identify potential problems.

Furthermore, this due diligence must be based on broad (but relevant) objectives concerning the integration of the target. All too often, due diligence is mainly based on legal and accounting criteria, whereas the company needs to identify all the areas of major risk and, in particular, current and future operating risks, or others that may constitute an obstacle to effective integration.

Specifically, due diligence should take account of the following points: highlighting competitive advantages and their durability, identifying key people (in particular those that the company may rely on for the purposes of integration), and measuring the stability of the most significant customer relations and the long-term prospects of formal or informal alliances. Directors do not play a direct role in this analysis; however, they must ensure that:

- The due diligence has covered all of the essential aspects of the target's different business activities.
- The disclaimers included in any due diligence report do not render its findings meaningless.
- The directors have taken the report's findings on board (via a revision of the price proposed, a more stringent seller's warranty clause, a review of the assumptions concerning synergies and modification of the business plan presented to the board, etc.).

The directors must not consider the fact that due diligence has been carried out as sufficient in itself. In a complex or large transaction, the board must question the experts who have carried out the work directly in order to benefit from their verbal comments. These discussions with the due diligence team can be extremely instructive and enable the board or the committee responsible to considerably enrich its perspective.

Approving a specific integration plan

Experience shows that integrating the target is the most complex part of the M&A process. In spite of a broad consensus on this point, this difficulty remains largely underestimated. The board can play an important role in alleviating this major problem by asking management to provide it with an integration plan prior to concluding the transaction.

In particular, this plan would need to include the following:

- A timetable for the integration program. The integration program begins upon completion of the due diligence, one of the objectives of which is to identify the potential problem areas. It continues with a detailed planning schedule for the tasks and the teams to be provided for, prior to and after the completion of the acquisition.
- Identification of the main initiatives undertaken by management in order to recover a significant portion of the control premium paid. This is carried out in order to avoid the classic dilemma of management becoming bogged down in operating problems. Unless they are carried out during the first few months after the acquisition, such initiatives will have little chance of being implemented and the loss in value will be irreversible.
- An assessment of the human resources and expertise to be earmarked for the integration process. The time and energy to be devoted to rapid integration is always considerable and companies always tend to underestimate this. The board must pay particular attention to this aspect, which can have a serious adverse impact on the purchaser's business operations.
- A detailed business plan showing all the costs and benefits associated with integration. This plan, which estimates the synergies available, should be updated regularly in order to provide the board with the most recent estimate of the initiatives undertaken to make the acquisition profitable.

Lastly, best practice consists in asking management to review the progress made with regard to integration on a regular

basis, based on a specific timetable. A comparison should also be made on a regular basis, at least once a year during the three years following the transaction, between the operating assumptions used to justify the price paid and the actual performance, in order to identify the errors made and to draw lessons for subsequent acquisitions.

Organizing work by the board so that it is able to assist management upstream

The board's contribution will be even more useful if it is able to contribute to management's thought process as early as possible in the analytical and decision-making process. Setting up a committee that is specialized in M&A makes it possible to combine efficiency, confidentiality and the constraints inherent in a long and uncertain negotiating process.

Obviously, this committee cannot replace the board; however, it would be informed at an early stage of the possible acquisition to:

- Present its observations concerning the substance and form of the transaction.
- Choose the best time for officially submitting the transaction for consideration by the board.
- Ensure that the information submitted to the directors is complete and that it accurately reflects the detail of the transaction.

The strategy committee or the audit committee could perform this role.

In conclusion, the board of directors plays a key role in complex corporate transactions such as mergers and acquisitions. The experienced and objective viewpoint that board members bring to bear is a critical counterbalancing element in an activity potentially fraught with risk and strong emotions. By maintaining strict oversight in areas such as strategic benefit, valuation, due diligence and integration, board members can help ensure that strategic acquisitions add value to the corporation, rather than creating problems that are difficult to reverse.

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