Grant Thornton

Defining what is vital for deal success

Value curve study validates holistic approach to M&A

MAY 2018

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From strategy to implementation, there is significant opportunity to capture more value from M&A deals. Those were the overall findings from a recent Grant Thornton LLP survey of CEOs, managing directors, CFOs and other high-level executives. The 2018 Deal Value Curve Study found that only 14 percent of all deals exceed their initial expectations for income or rate of return.

The findings confirmed what Grant Thornton professionals have often found in M&A deals, in which trillions of shareholder dollars change hands every year: Thoroughly scrutinizing the details of transactions, well before the transaction begins and well beyond tax and earnings due diligence, helps highlight the precise drivers of value and leads to a much greater chance of success.

To increase the probability of deal success, Grant Thornton developed the "purple curve," a distinctive point of view on M&A best practices. This holistic, rigorous approach expands the early focus in M&A to encompass commercial, operations, HR, IT and cultural diligence. It also seeks to more quickly and meticulously identify and capture synergies, to create tight connections between the various stages of the process, and to create momentum going into integration—resulting in measurable deal value and higher post-close earnings.

> "With valuations near all-time highs and a high degree of competition for deals, it's more important than ever to take a holistic approach to diligence, including financial, operational and cultural diligence, to identify additional synergies and realize those synergies to drive transaction value."
>
> **Jim Peko, National Managing Principal**

Only

14%

of all survey respondents found that deals exceed their initial expectations for income or rate of return.

Only

36.8%

of respondents strongly agree that efficient M&A execution (diligence, planning, integration, optimization) is a well-understood core competency of their company.

The importance of clarity at the start

The survey showed that companies can achieve much greater clarity at the beginning of the transaction process. Only 38.2% of respondents indicated they were very clear on precisely which acquisition targets they should pursue, and still fewer (32.5%) were very clear on what they should be paying.

There are a number of possible reasons for this. Ironically, the sheer vitality and velocity of the M&A market may make companies less rigorous. Between the inexorable pressure to grow, the availability of capital and the constant exposure to "pitched" deals, it is very easy to get into a frantic, reactive position rather than remaining focused and disciplined. The best approach is multi-dimensional, encompassing strategic clarity, target focus, diligence rigor, process discipline and execution accountability.

> "We've found that if you are proactive in your M&A approach, you can achieve higher conversion rates, and deals just turn out better across the board, but being proactive starts with being clear—that means translating your larger corporate strategy into a defined M&A strategy."
>
> **Ed Kleinguetl, Partner**

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Oversight and insight: 4 M&A best practices for boards

Bryan Benoit, Partner

Unfortunately M&A transactions often fail to add shareholder value. When evaluating a deal:

1 **Be skeptical.** You can provide value by asking hard questions and testing management's financial assumptions.

2 **Take care with lock-ups and defensive measures.** Scrutinize deal protection terms, and in hostile situations, defensive measures.

3 **Understand deal structure, motivations and terms.** Discern why management seeks to pursue (or oppose) a transaction, consider important financial and strategic aspects of the transaction and determine why a particular deal structure has been chosen.

4 **Test assumptions about value.** Carefully review analyses prepared by management and financial advisers and verify key assumptions inherent in the analyses.

The need for a strategy within a strategy

Best practice suggests a company develop a clear, incisive M&A strategy as a natural development of the macro corporate strategy. However, only 30% of respondents in the survey indicated they were operating with a clear, well understood M&A strategy. Since so much else flows from this initial articulation of objectives, its absence inevitably causes inefficiencies that appear throughout the process, leaking value at every stage.

When due diligence was broken down into specific areas of focus, it became clear that operational and cultural components of the deal received insufficient attention. While 54.5 percent of respondents rated their performance as strong on meetings with top management, and over 40 percent described their financial, commercial and general operations due diligence as strong, those numbers dropped precipitously around suppliers (14.7 percent), safety and environmental concerns (17.6 percent), HR (22 percent), IT (19.1 percent) and culture (22.6 percent). Insufficient attention and rigor to these broader, more holistic perspectives inevitably compromises the solidity of the deal's financial picture.

Additionally, only 26.5 percent believed their tax due diligence, planning and structuring were strong, suggesting that the new tax reforms have yet to be confidently interpreted.

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"It's clear there's a real opportunity to help companies improve the return on their M&A investments. Given the magnitude of the M&A market—as well as the great importance of the typical transaction for a given company—the potential risks and rewards are significant."

Chris Nemeth, Principal

Question: How do you typically perform at these [M&A] tasks and rate your overall effectiveness? Below shows percent of those who responded "**Strong.**"

48.5%	We distill/articulate/understand the strategic fit and specific value drivers of the potential target.
42.7%	We pursue an integrated "business due diligence" approach.
42.7%	Post-closing, we proactively monitor the transaction's actual results against the anticipated results developed as part of our M&A process.
41.2%	We have a clear stage-gate process for vetting, approving and pursuing transactions and are disciplined in adhering to this process.
38.2%	Our targets and deal pipeline are primarily self-generated and proactive.
30.9%	We have a clear, well-understood M&A strategy.
20.6%	We understand the potential impact of the 2017 Tax Cuts and Jobs Act on our M&A strategy.

Good news and bad news: Tax reform implications

Christopher Schenkenberg, Partner

The Tax Cuts and Jobs Act has arguably caused many businesses to become more valuable. But reform is impacting long-established M&A tax planning strategies and necessitating a re-examination of critical elements of M&A.

1. **Examine the "stock vs. asset" question.** Analyze in light of the new "full expensing" provision.
2. **Pay special attention to the valuation of assets and purchase price allocation issues.** These may cause increased tension among buyers, sellers and taxing authorities.
3. **Model the new international tax elements of U.S. tax reform.** This is the best way to fully understand their impact.
4. **Check for changes to state policies on decoupling state tax rules from the new federal rule.** Account for any effects on due diligence, structuring, and post transaction integration, compliance, and planning.

Risky business

When asked to rate their success at identifying specific risks, respondents confirmed that a handful of important tactical aspects of integration were often overlooked, confirming the Grant Thornton thesis that M&A is not yet viewed in an integrated way. Only about two-fifths of respondents rated as strong their efforts at customer retention (39.7 percent), key employee retention (42.7 percent) and financial reporting compatibility (39.7 percent). Those numbers dropped when asked about cultural alignment; organizational alignment; operating practices and policy alignment; environmental, health, and safety matters; and information systems compatibility.

More than one in five (22.1 percent) reported they were "actively challenged" and had an "opportunity for improvement" in achieving information system compatibility, indicating a major vulnerability given the critical role IT systems play in virtually any modern enterprise.

> "IT is overlooked in many due diligence efforts because management doesn't understand IT, or it's simply missed as it never comes up. IT is pervasive and supports all business processes. Ignoring the function invites increased costs and missed potential for innovation in the new company."
>
> **Steven Sparks, Partner**

Acknowledge strategy, anticipate complexity: 4 key IT considerations

Steven Sparks, Partner

1. **Recognize the impact.** The integration strategy (keeping it separate or folding it into the organization) will affect one-time acquisition costs and complexity.
2. **Factor in competitive advantages.** The target may have some special or competitive advantage with its enterprise systems that may require you to support its IT environment for longer than anticipated.
3. **Account for IT separation.** For carve-outs, IT separation becomes the most time-consuming and costly part of the transaction before and after the close.
4. **Be ready on Day One.** Readiness planning is required for any kind of transaction, carve-out or standalone, to manage costs and achieve integration success.

When 1 + 1 doesn't make 3

The identification of synergies—those value drivers distinctive to mergers—poses similar challenges. Just 35.5% of respondents were very clear that they had vetted and understood the synergies associated with their deals.

Grant Thornton has found that having the operations team involved early in the process helps with the identification of synergies, as well as the downstream ownership and accountability for synergy realization. But less than a third of respondents (30.9 percent) felt their operations teams were involved early enough. Around 32 percent strongly felt they appropriately leveraged outside expertise/perspectives to help validate the investment thesis, including synergies.

Similarly, only 22.1 percent strongly believed they were meticulous in identifying potential synergy risks and "dis-synergies." Fully understanding dis-synergy risk, particularly as it relates to top-line performance, is a critical element of M&A planning and execution. Grant Thornton experience shows that, despite a compelling deal thesis and market statement, an acquirer's customers may find a merged entity harder to deal with; they may be unsure of their pricing; they may fear inventory levels on preferred products will not be maintained; or they may feel the need to further diversify their suppliers in response to the market concentration effected by the merger. While not always discussed in the planning stages, such dynamics are common.

"All of these downstream reactions to a merger can reduce the top line, which can in turn undermine the initial deal valuation. The challenge immediately after Day One isn't always making 1 plus 1 equals 3. It's sometimes ensuring 1 plus 1 still equals 2."

Wade Kruse, Partner

Capturing momentum

In an M&A deal, time is of the essence, and resources are typically limited. Acquirers can little afford to “reinvent the wheel” or to improvise in the midst of a transaction. Just over a third (36.6 percent) of respondents strongly agreed that M&A execution—which breaks down into diligence, planning, integration and optimization—was a core competency of their organization.

Just over

1/3

of respondents strongly agree that efficient M&A execution (diligence, planning, integration, optimization) is a well-understood, core competency of their company.

The importance of Day One—and Day Two

When asked about the particular components of M&A execution, few respondents described themselves as "strong." Most companies indicated they could do a better job of planning integration further in advance of close, utilizing a well-understood M&A playbook, creating a disciplined prioritization process, allocating sufficient internal resources or meticulously monitoring synergy realization.

On Day One, when the target formally becomes part of the acquiring company, less than 30 percent of respondents described as "strong" their attempts to address personnel matters (such as stock deals and benefits programs), to establish approval authorities and reporting structures, or to promulgate policy changes for the target company.

What's a problem on Day One is often a bigger problem on Day Two. The longer such nuts-and-bolts issues are put off, the more ambiguity and uncertainty predominate -- and the more value can leak from a deal. The sooner those issues are addressed, the sooner an organization can focus on the "business of the business," and the more value is captured.

"The need for an assigned team to handle merger-related issues is especially important on Day One. You need to be able to say, I know who to route this issue to; they will take care of it, and I can do my day job."

Scott Davis, Partner

Hard truths about soft stuff: Seven tenets of successful cultural integration

Jennifer Morelli, Director

1. **Never ignore or underestimate culture.** According to the late Peter Drucker, renowned marketing consultant considered a pillar of the modern business model, "Culture eats strategy for breakfast." According to multiple studies, cultural misalignment is a leading cause of underperforming M&As.
2. **Address it early.** Form a culture team and have them share their findings with other teams.
3. **Conduct due diligence.** There are a number of proven ways to gather intelligence—e.g., focus groups, observation, document review and cultural dynamics surveys. At Grant Thornton, we look at twelve cultural attributes and seven indicators of core beliefs.
4. **Understand why you bought the target.** Value their entrepreneurial spirit? Take steps to preserve that.
5. **Reinforce commonalities.** You want to create one company. The best way to do that is to focus on what you share.
6. **Address significant differences.** Integration works better when differences are openly acknowledged, discussed and, in some instances, incorporated.
7. **Look beyond the obvious.** You may have similar mission statements and values. But subtle differences such as degree of hierarchy or attitudes toward change can derail you.

Take steps to make surprises less surprising

Because they merge two complex systems into one even more complex system, mergers inevitably present surprises. The sooner these surprises are anticipated, the better they can be managed—thus preserving value for all involved. When asked if they had “been good at avoiding/managing unexpected, post-close surprises,” a mere 17.6% of respondents strongly agreed. Similarly, 17.4% described as strong their efforts at executing a seamless people and culture transition. Such transitions are crucial because of the role cultural misalignment plays in deals underperforming expectations.

The sooner these surprises are anticipated, the better they can be managed—thus preserving value for all involved.

In the end

Ultimately, the survey confirmed that the tremendous volume of M&A deal-making has highlighted the value of taking an early and holistic approach to M&A execution. Quality execution delivers myriad benefits including financial, operational, commercial and cultural success.

"The hard work of deal execution should be rigorously studied and improved to ensure the achievement of the underlying investment thesis and to drive shareholder value."

Jim Peko, National Managing Principal

Contacts

Jim Peko
National Managing Principal
Transaction Services
T +1 646 825 8400
E jim.peko@us.gt.com

Chris Nemeth
Principal
Transaction Services
T +1 312 754 7180
E chris.nemeth@us.gt.com

Ed Kleinguetl
Partner
Transaction Services
T +1 832 476 3760
E ed.kleinguetl@us.gt.com

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