ARTICLE

Active Collaboration Throughout the Deal

Preserving and Creating Value for Target Companies in M&A

During the M&A cycle, we observe that the likelihood of value creation for the acquirer and emerging NewCo is proportional to the level of involvement of the target company in deal strategy and integration planning. In this paper, we explore the major obstacles to value creation in an acquisition and how the increased involvement of the target company might mitigate those risks.

The typical M&A process nearsightedness

M&A deals are usually initiated by the acquirer, with targets initiating only about 35% of deals.[1] The buy side typically has strategy, operations, legal and financial advisers, whereas the sell side usually has minimal involvement from non-financial or legal advisers.

There is evidence to support that sell-side initiated deals generate less value for their shareholders compared to the buy-side. Buy-side generated deals present higher returns by different measures. For example:

- The average bid premium[2] is higher in buyer-initiated deals than in target-initiated deals.
- The excess deal value to EBITDA multiple[3] averages 90% in bidder-initiated deals, vs. only 35% in target-initiated deals.[4]

In addition, studies show that between 70% and 90% of acquisitions lead to value destruction for the acquiring shareholders.[5] A pressing but addressable cause of value destruction in M&A transactions stems from excluding the target company's operating model during the integration process.

The typical M&A approach (where the target company's C-suite has little involvement in the target operating model definition post-acquisition) often undermines deal value creation by:

1. Ronald W. Masulis and Serif Aziz Simsir. *Deal Initiation in Mergers and Acquisitions*. ECGI Working Paper Series in Finance, Working Paper N° 371/2013, December 2018.
2. https://ecgi.global/sites/default/files/working_papers/documents/finalmasulissimsir.pdf
3. https://ecgi.global/sites/default/files/working_papers/documents/finalmasulissimsir.pdf
4. Ronald W. Masulis and Serif Aziz Simsir. *Deal Initiation in Mergers and Acquisitions*. ECGI Working Paper Series in Finance, Working Paper N° 371/2013, December 2018.
5. Clayton M. Christensen, et al., "The Big Idea: The New M&A Playbook," Harvard Business Review (March 2011).

A. Accelerating loss of key talent at the target company across all deal phases due to employment uncertainties;

B. Misunderstanding the target company's differentiators and drivers of success (know-how, technologies, policies and procedures, biased target operating model design); and

C. Overlooking target company executives' approach in building a bottom-up, inside-out support for growth/cost synergies to enrich the acquirer's business case.

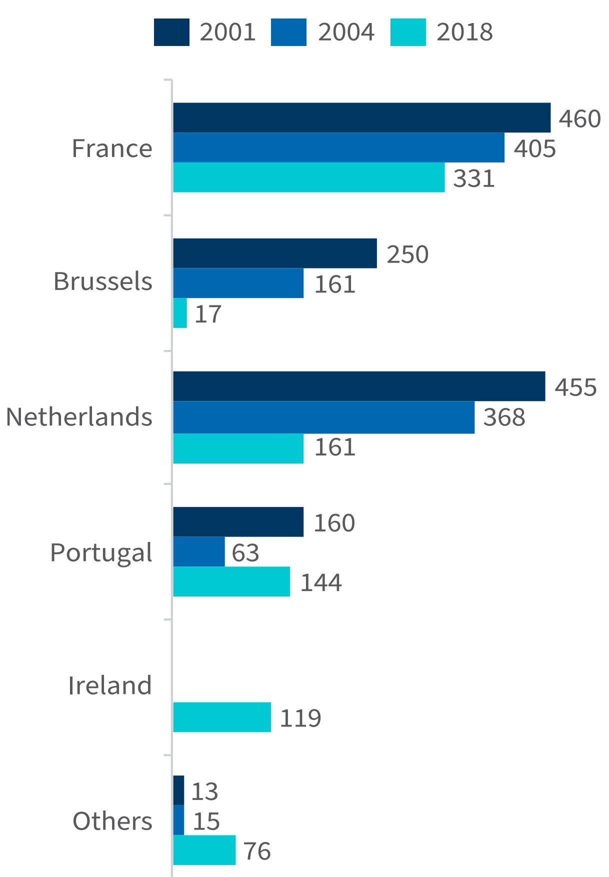
Accelerating loss of key talent at the target company across all deal phases due to employment uncertainties

Human capital is key in the service and knowledge economy. A high priority during transactions is to retain the most relevant personnel during the transition period (from closing to Day 100) in order to avoid value erosion. However, communication silos often occur during this time, especially at the pre-close phase, which generate uncertainty and mixed messages, and hence potentially jeopardize talent retention.

We notice that in cases in which the target company has played an active role in the merger process, losses or sharp shifts in headcount occurred at a slower pace compared to deals in which the target was a silent partner. For example, per FTI analysis below, we can see this happening in the model used by a leading stock exchange in Europe acquiring other stock exchanges and then centralizing operations (Centralized Case), in which the targets took a relatively less active role, compared to the case of another capital market leader when it acquired a stock exchange in a merger of complementary companies (Buildup of New Capabilities).

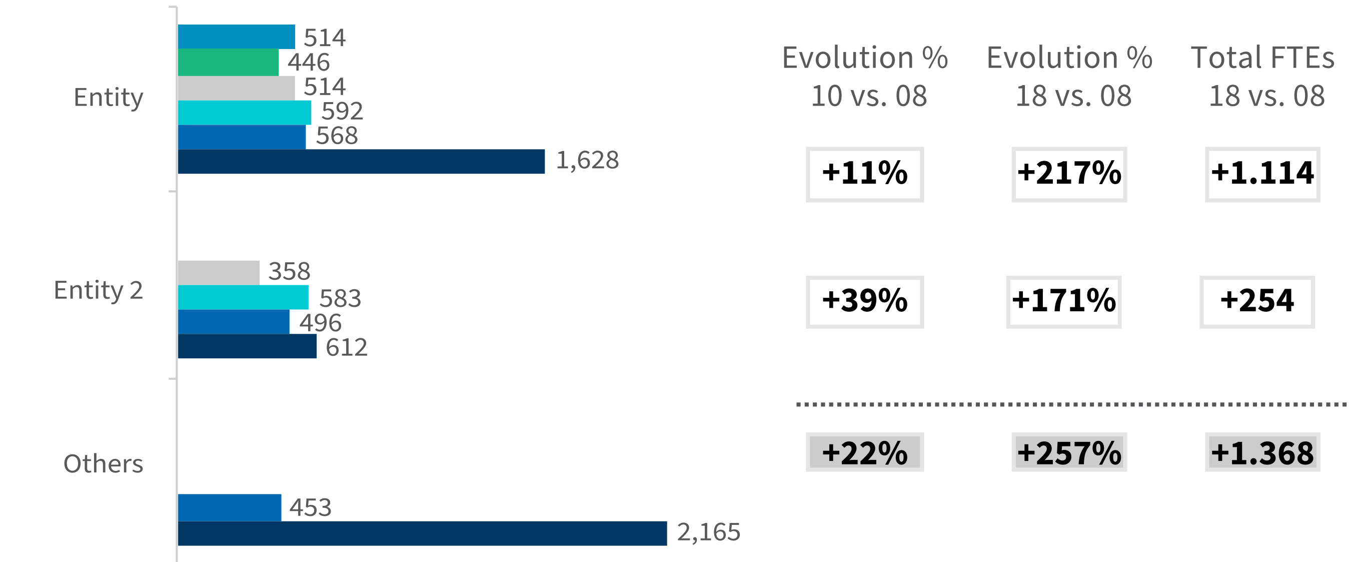
A mindset for a merger to build up new capabilities, is a common example of a merger process in which the target has an active role in the deal, synergy creation and operating model creation/implementation. The Centralized Case, in the example above, shows a steep FTE reduction while the Merger of Equals shows an opposite outcome. This is despite both acquisition models reducing operating costs and delivering the acquisition value.

Evolution of headcount (FTEs) at the Centralized Case



Evolution % 04 vs. 01	Evolution % 18 vs. 01	Total FTEs 18 vs. 01
-12%	-28%	-129
-36%	-93%	-233
-19%	-65%	-294
-61%	-10%	-16
-25%	**-49%**	**-672**

Evolution of headcount (FTEs) at the Merger of Equals



Misunderstanding the target company's differentiators and drivers of success

A target operating model (TOM) enables the strategy and investment thesis of the new company (NewCo) created by a merger. The acquirer has a perspective on how NewCo will operate. This outside-in perspective needs to be validated and even challenged in the post-closing period, once there is full access to the target company's management and data.

In cases where the target has less involvement, assumptions about value drivers operating or commercial differentiators may be made erroneously. This may lead to the loss or discontinuation of proprietary data and technology or to the processes and policies that contributed to the target's value at the outset.

One useful mitigation tool to ensure the TOM preserves and creates value is for the target to embed itself in the integration governance model (IGM). As the target gains positions and functions in the structure governing the integration planning, it will articulate value drivers (technology, processes and policies, etc.) more clearly and effectively.

Bottom-up build of synergies without target company input

A major driver of value erosion for mergers post-close stems from the preliminary build-up of synergies. As the transaction closes, there are more data and access to target management to assess and build a bottom-up view of synergies (revenue and cost). It is understandable that these synergies are built initially without the input of the target pre-close, but the target should be part of the post-close build as soon as the transaction closes.

Continuing with a bottom-up build of synergies with limited or no support from the target will subject the merger to value erosion and hamper the ability to track synergies.

How to navigate the sell-side for value building; an agenda for the C-suite involved in the deal

Provide clarity to the target C-suite on the M&A process

Typically, an integration process has four phases normally led by the acquirer: preparation for integration, strategic alignment and target operating model (TOM) framework, Day 1 readiness preparation, and integration execution.

In the pan-European capital markets merger, FTI experts supported the target companies C-suite by detailing and prioritizing the tasks to be done at each phase encompassing the acquirer, regulators and new potential bidder's calendars. For this purpose, it is critical to form a strong but nimble integration committee with the C-suite and other key leaders to institute an action-driven mindset across the relevant actors at early stages.

Act as independent value seekers for the NewCo and the C-suite

In the same capital markets merger case, the target company C-suite had a clear objective during the preparation and the strategic alignment phases: to maximize forward-looking negotiation strength by taking the initiative in proposing and challenging the acquirer's pre-established thesis on the strategic intent and the target operating model. For this, we assisted the target company C-suite to identify and quantify the areas in which they had the right to win, that is, where they had the comparative and competitive advantage compared to the acquiring company.

The target company demonstrated the differential value added to NewCo by providing an articulated, fact-based joint strategic vision, future TOM and synergies initiatives, among other topics. A key success factor is being able to select and populate critical KPIs that will support the acquired company thesis. This dual collaboration between both parties provides focus on value and strategic vision and avoids value erosion.

There is also an alternative scenario approach. During the value assessment in a global chemical company carve-out, the team (FTI + target co.) identified nine different areas of synergies and set three different scenarios for each of the value levers within them, generating more than 100 potential synergy outcomes based on critical milestones achievement, market trends and competitors' movements. This dynamic approach maximizes visibility around synergies when executing the integration and allows both buyer and seller to achieve better agreement on the acquisition price and facilitates shareholder's value creation in the long term.

Identify and mobilize key talent for the target operating model of the NewCo

During the Day 1 readiness phase, it is imperative to mobilize the organization under the guidelines of the agreed integration governance model and calendar while identifying key talent groups to be managed actively to avoid loss of this critical asset. Internal communications help avoid, or at least manage, questions and uncertainty within the target organization. Additionally, it is at this stage when leaders of the integration track, and the names on the organization of the future joint entity materialize. The target's C-suite should move quickly and proactively to propose leadership names based on differential value added as well as expertise and alignment with the interim and future operating models.

Conclusion

In this article, we explored some of the major obstacles to value creation in an acquisition and how the increased involvement of the target company mitigates those risks.

Partnering with the target as a complementary and valuable addition to the new emerging organization enhances trust. This active collaboration pulls the levers of value-creation in a deal: operating and revenue synergies, best practices, retention of key talent and an efficient operating model that brings the best of the entities coming together.

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