Center for Board Effectiveness

On the board's agenda | US

In M&A, how can boards help companies avoid the synergy trap?

Few tools of corporate development and growth can change the value of a company and its competitive future as quickly and dramatically as a major acquisition. Although the results of major mergers and acquisitions over the past several decades have not achieved the intended outcomes for many companies and their shareholders, acquirers who apply M&A fundamentals can still realize significant rewards.

According to *The Synergy Solution: How Companies Win the Mergers & Acquisitions Game,* an analysis of more than 1,200 major deals worth more than $5 trillion over a 24-year period found acquirers realized negative average returns, both when deals were announced and a year later.[1] More important, when the returns are de-averaged, the data reveals an enormous difference in returns—60 percentage points—between deals where acquirers began with a positive market reaction and delivered versus those deals that began with a negative reaction and confirmed initial investor forecasts.[2]

In other words, some acquisitions exceed the synergies that are expected at the outset. However, it's more common for acquisitions to not achieve sufficient synergies, dragging returns in the aggregate.

1. Mark Sirower and Jeffrey Weirens, *The Synergy Solution: How Companies Win the Mergers and Acquisitions Game* (Brighton, MA: Harvard Business Review Press, 2022).
2. Ibid.

When a major capital investment with such potential to impact growth and value produces such disappointing results overall, it begs an important question. What differentiates the good deals from the bad ones? And what can boards do in their oversight capacity to help improve the likelihood of success for acquirers and their shareholders?

Many answers lie in the fundamental elements of becoming a prepared acquirer and executing sound governance throughout the M&A process, from strategy through integration. The board of directors can significantly affect the likelihood of deal success. In fulfilling its duty of care, the board has an important part to play in helping drive an effective approach to M&A throughout the M&A life cycle, not just when it's time to approve a deal.

M&A fundamentals and the board

Acquisition success often is a result of management's commitment to developing an identifiable M&A strategy. Execution of such a strategy includes performing diligence that tests the assumptions in the valuation model and builds an early integration road map. It also includes communicating defensible performance promises that underpin the acquisition premium and managing the integration to realize the promised synergies in building a successful combined enterprise.

Boards can hold management accountable for each of these elements. Roles and responsibilities for management should be defined for the entire M&A process so the management team is prepared for the board's scrutiny before and after approval. Boards can set expectations of management regarding M&A strategy, due diligence, announcement day, and integration, and they can leverage some innovative governance tools to help drive more effective discussions when evaluating management's proposals for material transactions.

Am I a prepared acquirer?

Many companies do not have an M&A strategy with a watch list of their most important deals. They have not determined what they want, so they are reactive rather than proactive buyers.

A successful approach to M&A can be rooted in positioning an organization to become a prepared "always on" acquirer. Companies can have a readiness approach to M&A by developing and monitoring a watch list of their priority deals, examining deals their competitors are doing, and being ready to strike when an opportunity arises that is consistent with the company's larger strategic aspirations and capability needs.

Prepared acquirers have an identifiable M&A strategy that defines what they want to acquire, why, and how they plan to create value. Because they can identify their most important deals, prepared acquirers are generally better positioned than reactors to perform the necessary diligence required for a sensible valuation.

Prepared acquirers do not look at individual deals in isolation. They think about portfolios of assets that the deals on their watch list represent and how those portfolios can be assembled over time to grow the core businesses or create new ones.

Governance is a critical component of being prepared. A formalized approval process with consistent procedures and metrics helps create an understood, repeatable pathway for deals. Executive leadership sets the strategy—with oversight by the board—and aligns with the board on issues such as strategic priorities, risk appetite, implications of competitor moves, and a changing industry landscape.

Does it make sense?

Diligence is not merely about arriving at a go or no-go decision. It's about testing the investment thesis of the deal—its value-creation logic—and how the value of the deal will be captured.

Proper diligence helps develop or test assumptions and inputs used in the valuation model, particularly the synergy projections. It also provides an early view of the integration road map that shows the size, timing, and cost to achieve major synergy initiatives as well as issues that will require the most attention and need to be managed effectively to realize the expected value of the deal.

The analyses performed during the diligence process are intended to identify financial, commercial, and operational issues as well as critical red flags. Financial diligence establishes a normalized baseline of the target business given past performance; operational diligence examines the cost base of the current business and opportunities for cost reductions; and commercial diligence provides a perspective on growth potential and revenue improvement opportunities. When these insights come together, they can help provide a more complete, three-dimensional picture of the value of the opportunity before the price is paid.

Prepared acquirers perform diligence regularly on their markets to learn over time about the landscape of players, competitive positions, executive talent, market trends, and changing customer demands. This is valuable information that can be incorporated into improving the overall business, including ongoing corporate development and M&A efforts.

Will investors have reason to cheer?

Announcement day is an incredibly important moment when the disciplines of strategy, corporate finance, communications, competitor behavior, and human behavior come together. It is an inflection point that can immediately affect the value of the acquirer.

As agents of the shareholders, boards should put themselves in the shoes of investors before announcement when evaluating proposed material transactions. Directors should consider what an ordinary, prudent person in similar circumstances would want to know about this deal. How will it affect the share price and why? What are the timelines for completing the transaction and seeing positive results from it? What questions will various stakeholder groups likely ask?

It's imperative for acquirers to know what they are promising and clearly communicate it to investors, especially when offering a significant premium, because investors will react on the day the deal is announced based on what management tells them. Is management giving investors more reasons to buy versus sell the shares?

Market reactions matter in a way that should be very important to boards and management alike. Negative market reactions immediately reduce the expected growth value in the shares of the acquirer.

To help mitigate the risk of negative reactions, boards can leverage tools to stress test the economics and synergy assumptions behind proposed deals, the messages management is delivering, and the readiness of the management team to quickly begin delivering on the promises that are embedded in the acquisition premium and total price of the deal.

Tools for the board

Management often provides boards with a board book that reviews the strategy and valuation of a deal, and directors often ask plenty of questions, but it's still common for value-destructive deals to emerge from this process. Directors may need more information, and better information, about proposed deals to arrive at better decisions.

Boards can consider leveraging some innovative tools to drive more informed discussions and decisions about proposed deals. These tools can help the board dig into the strategic and financial logic behind deals, evaluate whether the plan for executing them is prudent, and better consider whether they make sense.

Fundamentally, the board should understand how much shareholder value will be at risk and whether the initial plans for post-merger integration are feasible. The board can also provide a check on management's preparation by evaluating whether the synergy mix of cost reductions and revenue increases for a given deal is sensible given the assets that are coming together and assessing how investors are likely to synthesize the information they're presented.

How much shareholder value is at risk?

The materiality of a deal can be measured by identifying how much shareholder value is at risk (SVAR), which represents the dollar premium amount to be paid for an acquisition divided by the market value of the acquiring company's shares before a deal is announced. The greater the premium paid to sellers for a given deal, the greater the market value of the acquiring company that is at risk if synergies do not materialize. A significant SVAR is not inherently alarming, but it emphasizes the need for boards to understand the sources of synergy that are built into the valuation model and the planned road map to achieve them.

SVAR can also provide an important perspective on how a deal's value might be affected if the method of payment is in cash, stock, or some combination. When stock is being offered, it can become less clear distinguishing the buyer from the seller because the seller's shareholders may end up owning a substantial part of the new company.

Boards of both acquiring and target companies have a fiduciary duty to understand these effects and consider them in the deal decision-making process. Boards of acquirers should understand whether the company's shares are undervalued, fairly valued, or overvalued as well as the risk that the expected synergies needed to pay for the acquisition premium will not be realized. Boards of sellers, when accepting stock, can perform the same analysis because they have a significant interest in the ultimate value of the deal as their shareholders will be joint owners of the enterprise.

What is the plan for post-merger integration?

Integrating business units after a merger is highly complex and can be fraught with pitfalls. Immediately at close, the cost-of-capital clock starts ticking on the price paid in a transaction. Deal value is often lost between announcement and integration as a result of lapses such as poor planning, wasted time, inability to pivot based on changes in the business environment, and a failure to follow through on plans.

The board should hold management accountable for not only presenting a strategically and financially sound deal, but also for doing the necessary groundwork to deliver the intended results. Before a deal is approved by a board, the board can require management to provide a post-merger integration (PMI) board pack that includes five essential components:

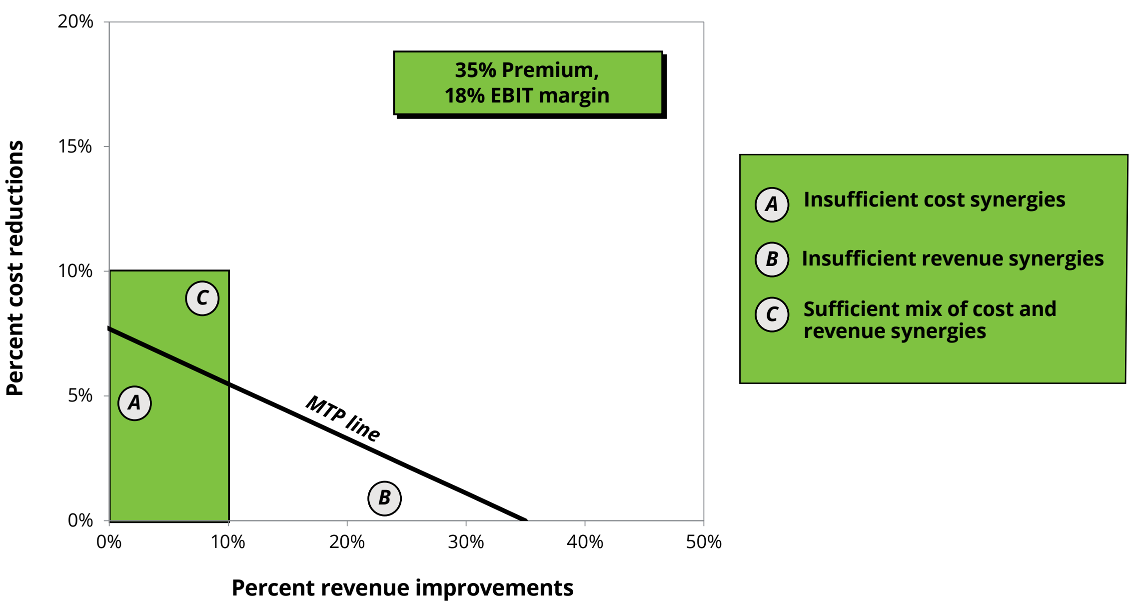
- **PMI process calendar.** A schedule of activities and required decisions can provide a view of the phasing of PMI activities and the extent to which management is prepared for the pace, importance, and number of decisions that need to be made while still managing the ongoing businesses.
- **Top-level shaping decisions.** Management should be able to articulate the integration scope and high-level organizational issues such as identifying the CEO of the integrated business, the CEO's direct reports, and the new operating model and organization structure. Some such decisions may be reached in negotiating the deal, and some may need to be deliberately postponed depending on data availability or other factors, which management should be able to anticipate and describe.
- **Tailored integration approach.** The board should expect management to clearly communicate a tailored approach, setting expectations on both sides for integrating the businesses. The approach should include the scope of the integration, as well as it pace, tone, early integration priorities, and how major decisions will be communicated.
- **Structure, teams, and resources.** Senior management cannot be fully involved in the thousands of large and small decisions that must be made during PMI. A discrete, resourced integration team with clear leadership roles, responsibilities, and reporting structures is essential. The board should understand the structure, key executives within it, and HR support needed to drive integration so that efforts can be launched immediately after the deal is announced.
- **Business plan.** Management should present the board with a credible business plan based on the valuation for the new entity that articulates synergy targets, major initiatives and goals, and upfront costs of integration. The board should understand how management intends to achieve targets, and it should be clear to the board that synergy targets exceed a baseline of what the acquirer and target might have achieved if the deal had not happened.

Perform deeper financial analysis

Short-term earnings accretion is a popular threshold for judging whether to do a deal, but there may be a more insightful way to use financial information to evaluate a transaction, focusing on the premium and the current profitability of the seller. For a deal with a significant SVAR, a simple algebraic equation can identify a "meet the premium" (MTP) line, which represents combinations of cost reductions and revenue increases that could justify a given premium.

Management should be able to describe the percentage cost reduction and percentage revenue improvement for the target that they plan to offer investors on announcement day. That point can be plotted relative to the MTP line as illustrated in figure 1.

Figure 1. The meet-the-premium line and plausibility box



Source: *The Synergy Solution: How Companies Win the Mergers and Acquisitions Game (Harvard Business Review Press, 2022). Reprinted with permission.*

Deals representing a point that falls below the line represent those to be avoided or further scrutinized. For deals that fall above the line, the evaluation includes further consideration for setting reasonable thresholds for cost reductions and revenue improvements, based on industry benchmarks or the acquirer's experience, which can lead to a view of whether synergy targets may be plausible. This represents the "plausibility box" in figure 1.

The MTP line enables deals to be scrutinized in operating terms that are familiar to most corporate managers and investors. This deeper analysis can help boards understand the extent to which operating challenges associated with a deal are being contemplated by management.

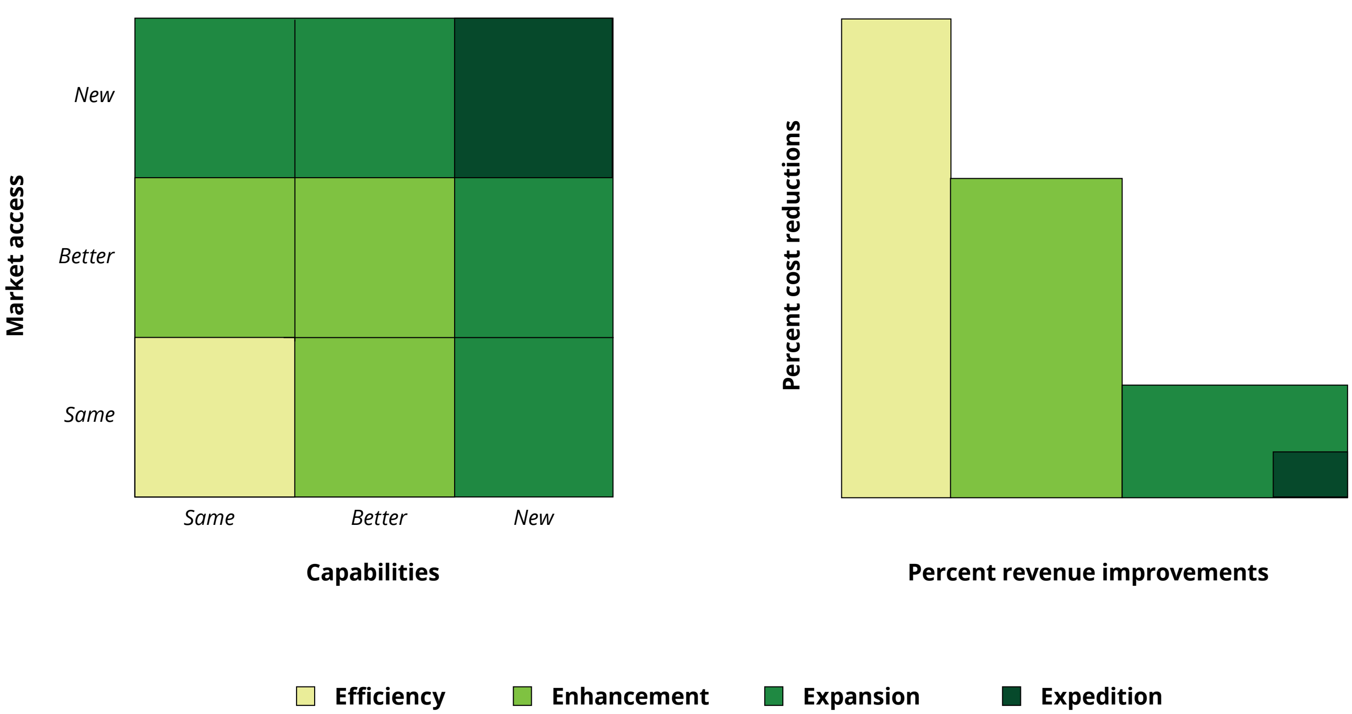
A matrix for measuring capabilities and market access

Another tool for boards is an analysis to consider whether the proposed combination of cost and revenue synergies makes operating sense. A proposed deal can be evaluated in terms of:

- The parts of the businesses that offer the same capabilities (product design, operations, supply chain, etc.) and the same means of accessing the market (sales force, third-party relationships, brand, etc.)
- Where one company has a clear advantage over the other and is simply better
- The parts of the businesses that bring together new or non-overlapping capabilities or market access

Figure 2 illustrates a three-by-three matrix that can help boards understand how the elements of a deal fall into different combinations of categories—and likely synergy mix—depending on the strategy for creating value and the assets that are being combined.

Figure 2. A matrix for measuring capabilities, market access, and synergy mix



Source: *The Synergy Solution: How Companies Win the Mergers and Acquisitions Game (Harvard Business Review Press, 2022). Reprinted with permission.*

The matrix provides a visual representation for deals that should yield mainly cost benefits because of the potential scale (efficiency), deals that can yield both revenue and cost synergies (enhancement), and deals that are expected to break new ground in market access, capabilities, or both (expansion, expedition), yielding mainly revenue synergies.

Significant deals should be expected to involve some combination of the nine spaces in the matrix, with the result forming the basis for a sensible mix of cost and revenue synergy expectations and a deconstruction of total synergies into their components of value. This analysis yields not only a useful check for boards but also important information for management to convey to investors to help them understand the economics of the deal, which can enhance the market reaction when the deal is announced.

Conclusion

Mergers and acquisitions offer one way that shareholder value can be increased. By exercising their responsibilities and providing advice and perspective, boards can help increase shareholder value, reduce tension within the organization, and ultimately improve the odds of success in M&A efforts.

M&A can and should produce enduring value for companies, their stakeholders, and the economy as a whole. A process rooted in strategy and governance can help bring M&A visions to reality. It's important for boards to establish a culture wherein successful M&A execution is not just a project. It's a change of state or a transformation that affects how companies approach acquisitions, improving their chances of success.

Questions for the board to consider asking:

1. Is there evidence this deal emerged from a clear strategic process?
2. How is the deal consistent with the company's long-term objectives for customers, markets, and products or technologies?
3. Why is the deal better than alternative investments or other deals?
4. What are the standalone growth expectations of the acquirer and target?
5. Where will performance gains—synergies—emerge as a result of this merger?
6. Are the projected synergies in line with the premium being paid?
7. Which competitors are likely to be affected by the deal?
8. How will those and other competitors likely respond?
9. What are the operational milestones in a 12-to-18-month integration plan?
10. What additional investments or one-time costs will be required to support the plan?
11. Who are the key executives responsible for implementing the plan?
12. Which pieces of either company are good candidates for sell-off or spin-off?

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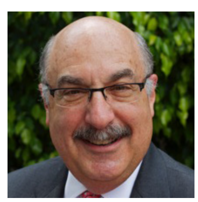

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