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Improving the M&A scoreboard:
Navigating the risks of the contemporary M&A market

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Agenda

- Webinar – summary of goals
- Survey background and process
- Risks by category
- International transactions – additional concerns
- Overlooked risks
- Concluding comments

Survey background and process

Survey background and process

M&A is a major source of growth. In 2015, $4.28 trillion in global value, the highest total of all time. In the first half of 2016, $1.71 trillion of deals were consummated around the globe.

- Finance function is being asked to expand its responsibilities
  - Assessing the strategic fit of the M&A opportunity
  - Investigating the financial, tax, and commercial affairs of the target company
  - Planning for the integration of financial departments and information-reporting systems
  - Creating and pressure-testing the valuation model and synergy assumptions
  - Developing a scorecard to track the transaction results
  - Providing an objective view of the deal to the CEO and the board
  - Providing executive-level guidance about post-close optimization opportunities
- For this year's survey, Crowe partnered with Financial Executives Research Foundation (FERF), to conduct a survey focused on both the predictable and overlooked risks inherent in contemporary M&A execution.
- **The approx. 200 survey respondents were a mix of public and private companies, both domestic and international. An "average respondent" had the following profile:**
  - Chief financial officer
  - Privately-held company
  - Domestic (U.S.) headquarters
  - $350 million in annual revenue
  - 6 targeted transactions
  - 2 due diligence completions
  - 1 deal closed (worth $47 million)

Risks by category

Risks by category

The centerpiece of the survey was registering respondents' experiences with the risks within the following M&A execution categories:

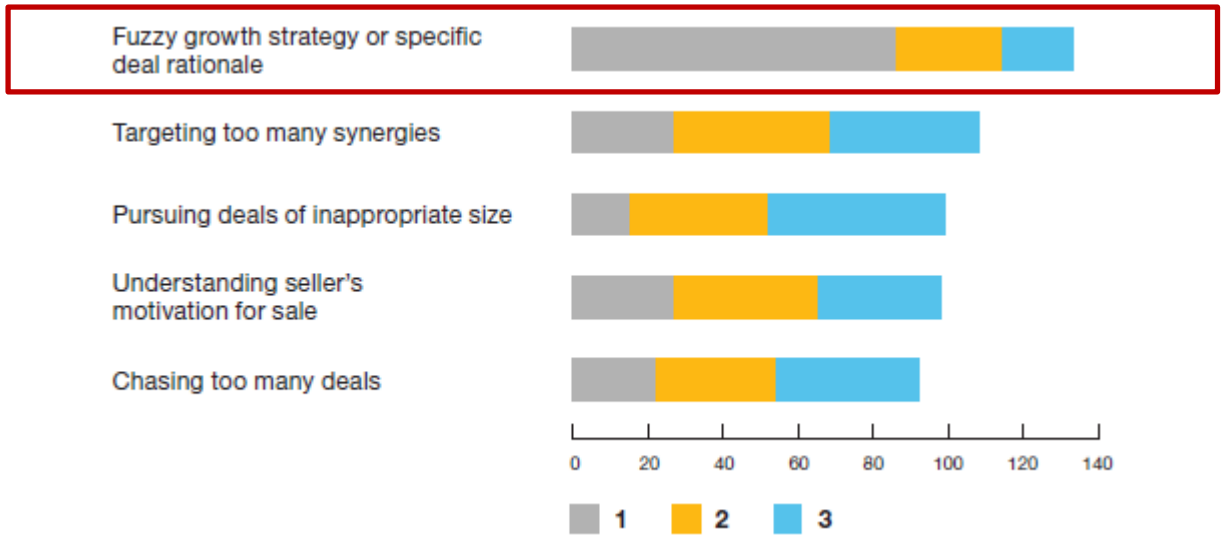
1. Target – as is a target company to acquire
2. Valuation
3. Due diligence
4. Integration
5. Commercial – aka: top-line risks
6. Operational
7. People & culture
8. Internal resources
9. Governance & decision-making

Targeting risks

- Insufficient strategic clarity is a killer in many business contexts, but never more so than in the competitive, high-stakes world of M&A. **Without strategic clarity, companies invariably end up:**
  - Being more reactive than proactive
  - Participating in a higher percentage of auctions than proprietary deals
  - Overpaying
  - Being less disciplined about post-close synergies and operating priorities
  - Undermining post-close focus and accountability
  - Chasing too many targets

- **Some effective practical steps include:**
  - Developing a specific M&A strategy as an outgrowth of the overall strategy
  - Developing a pipeline of proactive, proprietary targets that fit the M&A strategy profile precisely
  - Instituting a simple M&A governance process that includes controls such as stage gates and a deal committee
  - Involving the responsible operations leaders in the due diligence activity
  - Involving professional, third-party experts, where possible, in due diligence and integration to maintain objectivity, focus, and sustained execution.

Targeting risks



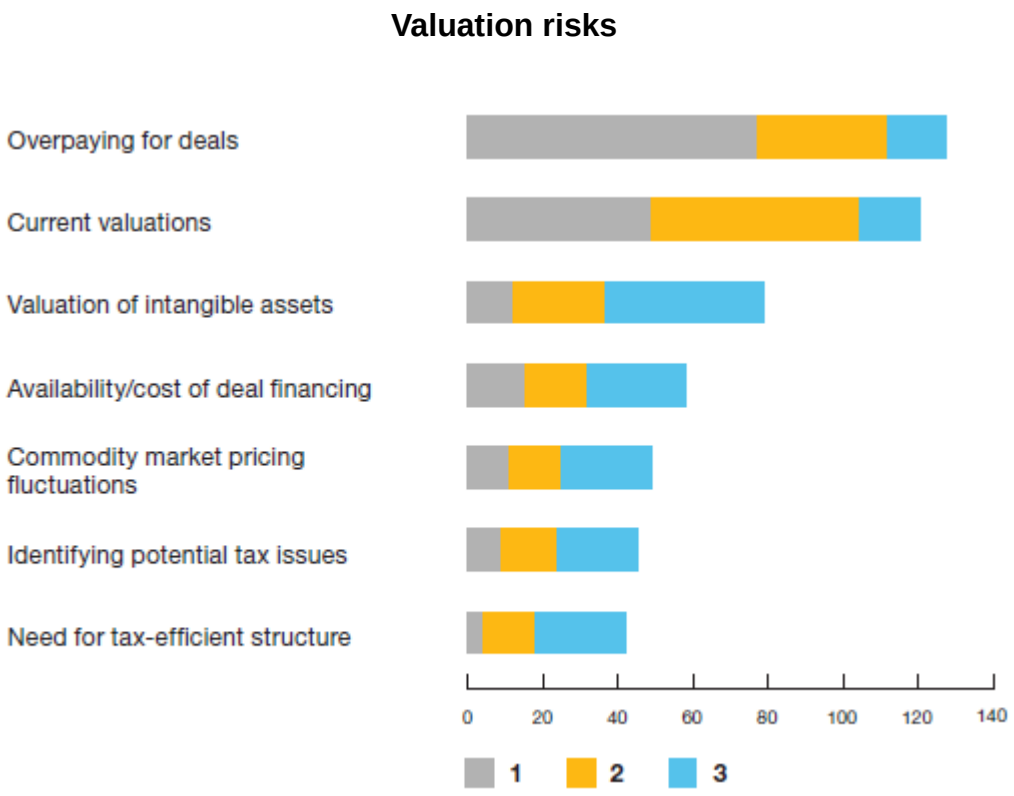
1 = Highest risk
2 = Moderate risk
3 = Lowest risk

Valuation risks

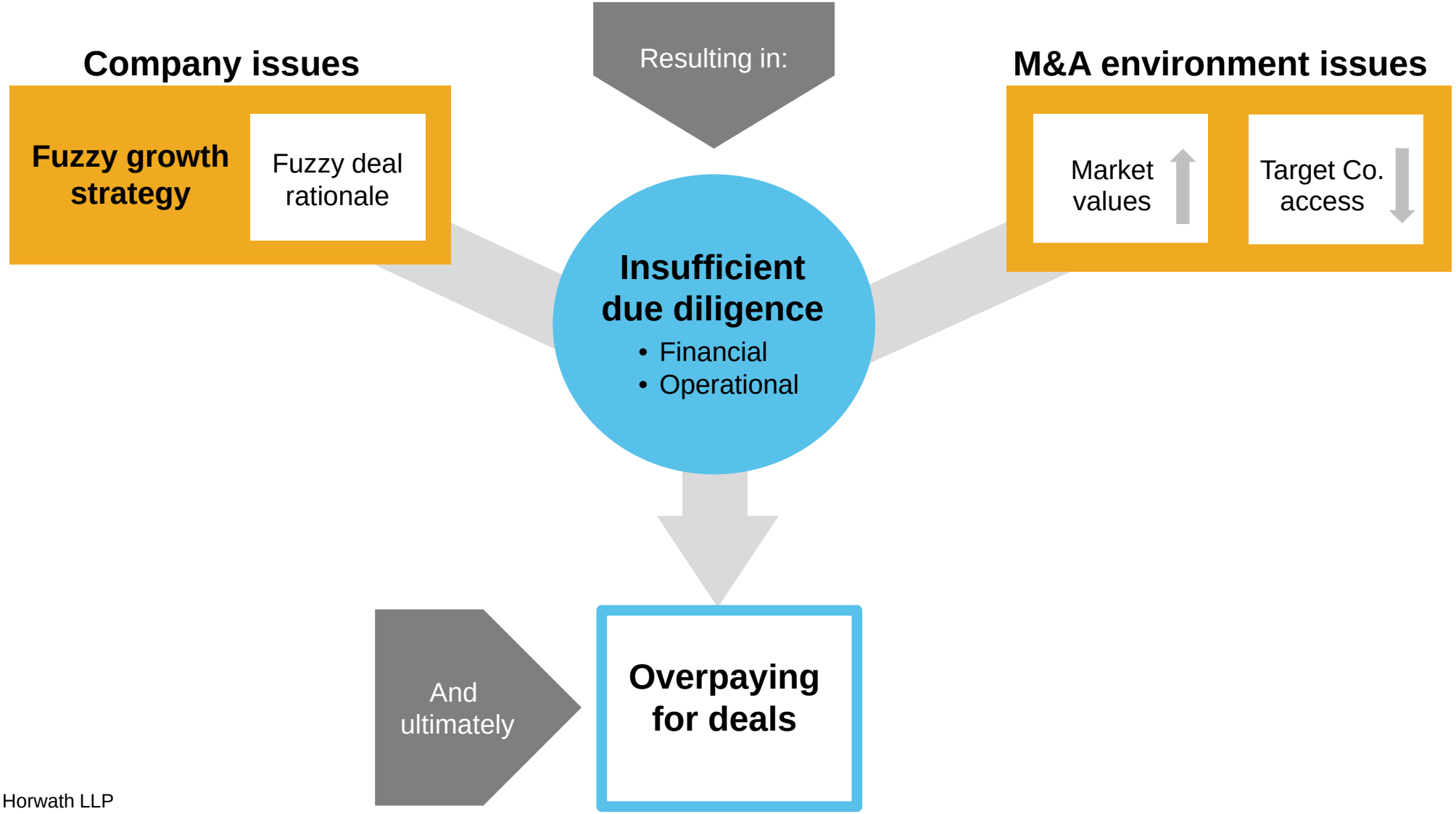
Respondents identified the risk of overpaying for deals as the top valuation risk.

This could be driven by:

- High marketplace valuations
- High availability of low cost capital
- Fuzzy deal rationale
- Limited access to the target company



Valuation risks



Valuation risks

The summary of the major concerns are:

- Buyers lacking discipline to avoid chasing market valuations up
- Buyers chase deals that ultimately will provide less value to their company
- Buyers not fully understanding the target's value drivers, risks, and opportunities
- Poor targeting due to poor strategy alignment

Polling question #1

Which item is an M&A environment issue that often leads to overpaying for deals?

a) Fuzzy growth strategy
b) Need for a tax efficient structure
c) Restricted access to target companies
d) Fuzzy deal rationale

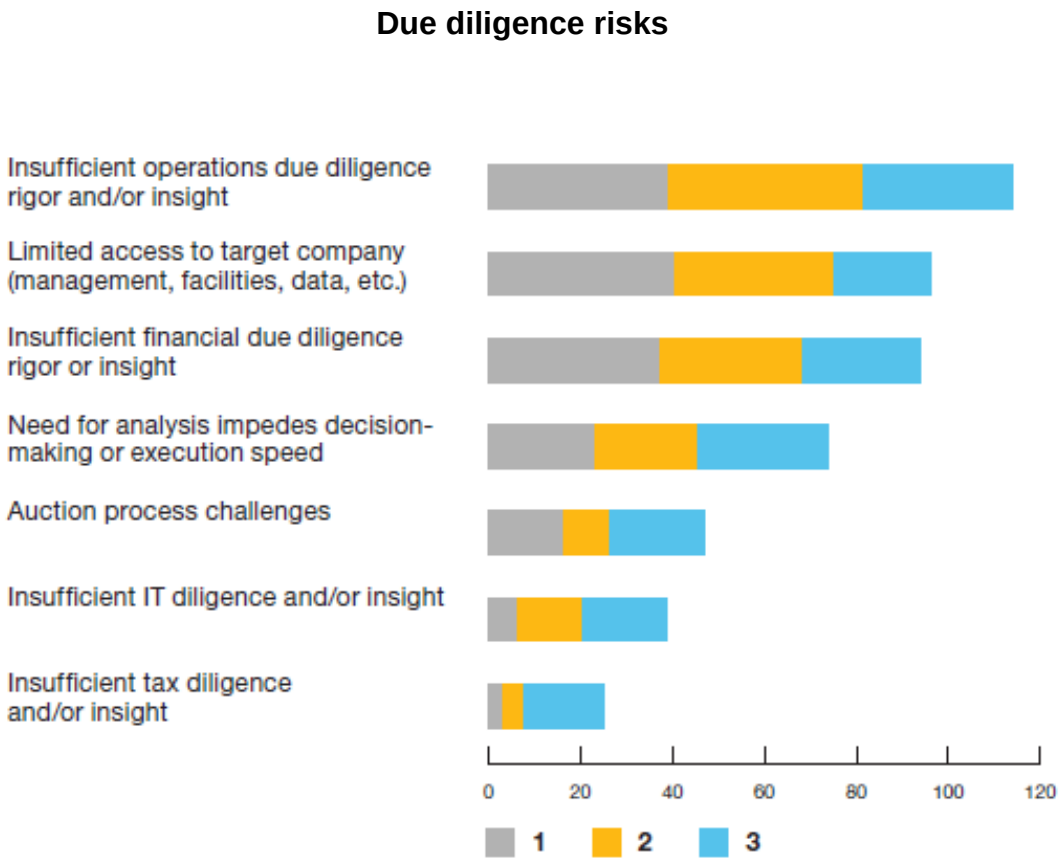
Due diligence risks

The summary results of the due diligence risks are:

- Operations and financial functions have more risk than the information technology and tax functions
- Access to target company personnel, data, operations, and key stakeholders is insufficient
- Operations due diligence - companies not giving enough attention
- Insufficient financial due diligence continues to be a problem

Risks related to the desire for extensive analyses and buyer auction processes are ranked as mid-level concerns

Due diligence risks



Due diligence risks

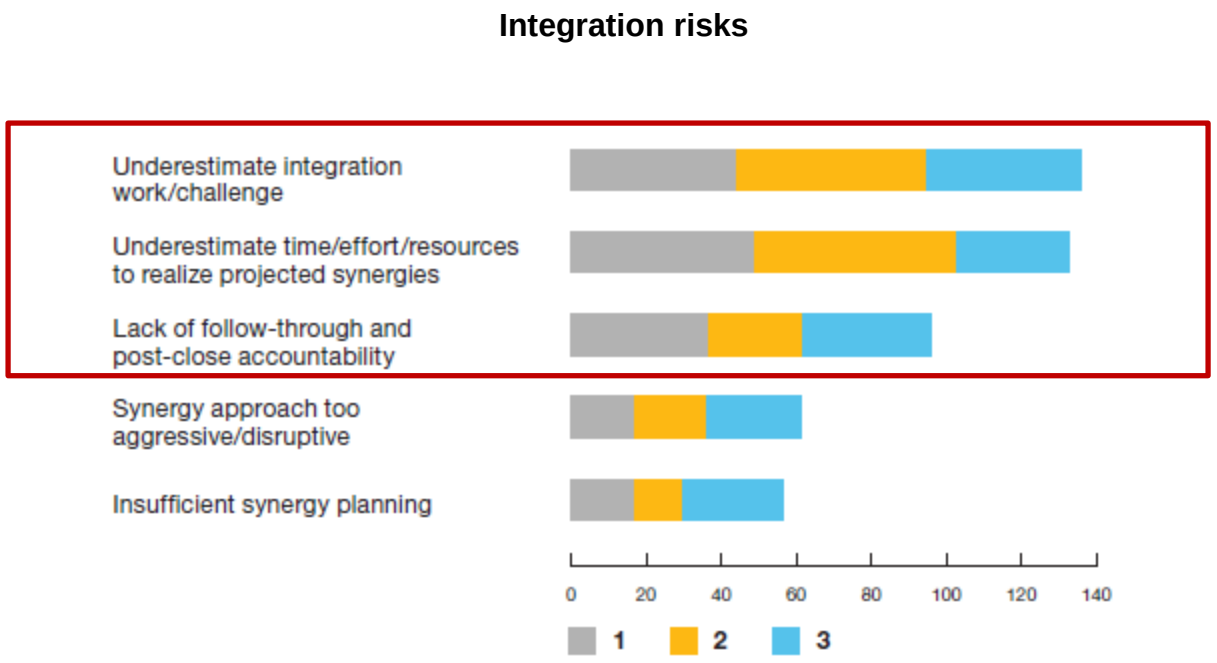
Due diligence risk mitigation tactics:

- Proprietary deal targets
- Key deal points in a one-page presentation
- Offer contingent on the ability to adequately investigate the prioritized opportunities and risks
- Use an M&A playbook
- Focus solely on items that might change the buyer’s view of value or cause withdrawal
- Assess whether synergies can be achieved
- Prioritize financial, operational, and human resources aspects
- Use personnel experienced with M&A and industry
- Require target to provide projected financial statements
- Use the “clean room” concept for critical competitive data
- Commission market due diligence study
- Switch to integration planning requirements once deal values have been confirmed

Integration risks

Of the five specific risk issues listed, it was the top three that were highlighted as the most troubling and critical by survey respondents:

- Underestimate integration work/challenge
- Underestimate time/effort/resources
- Lack of follow-through and post-close accountability

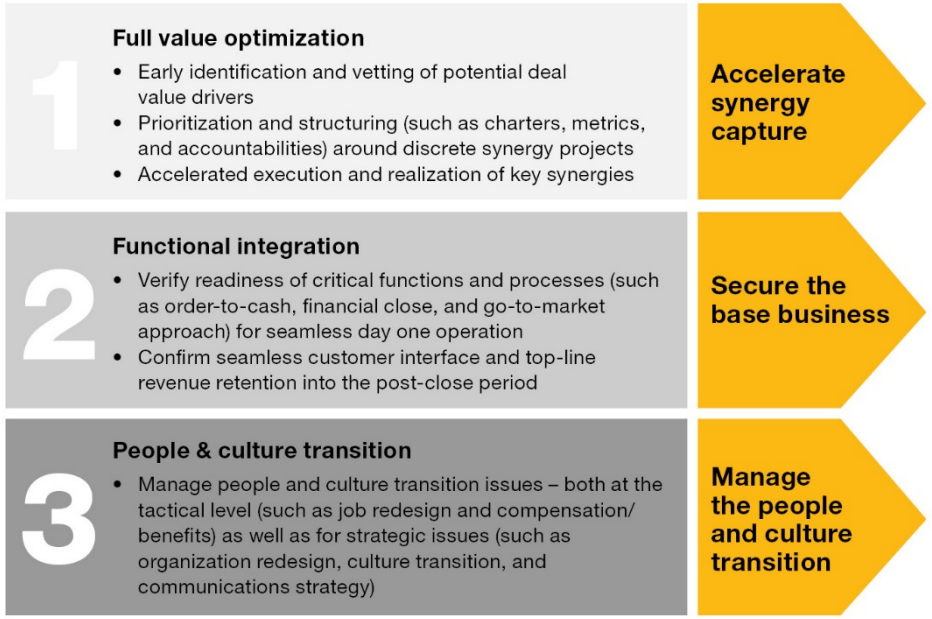


Integration risks

It's important to note that by identifying these three risks as the most critical, respondents point specifically to the challenges related to real-world execution.

Most expensive; scrapping the product at the end of the "production line"

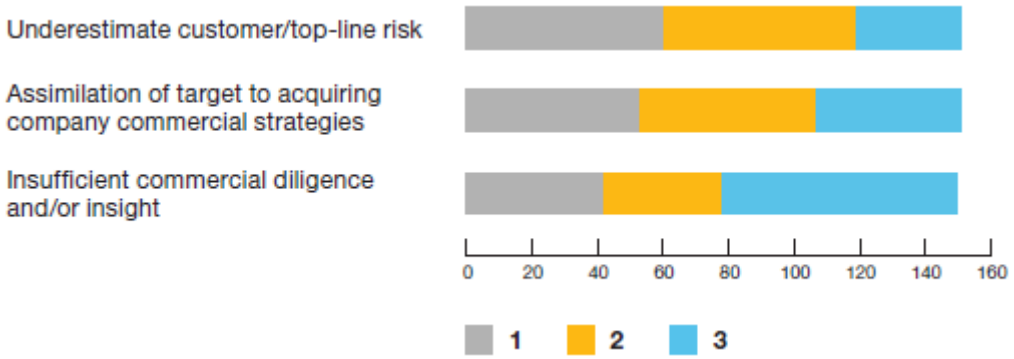
Three macro integration priorities



Commercial transition/synergy risks

- Equal split between insight, planning, and execution
- Increasing # of deals are strategic (vs. cost savings) = higher risk to achieve, such that boards/investors not pricing commercial synergies into deal
- **Some practical steps can help companies navigate the commercial transition more effectively:**
  - Incorporate an element of commercial/customer diligence in the due diligence process
  - Highlight potential product and/or customer overlaps between the companies
  - Communicate early and often with key customers
  - Realign the sales force early in the process, if necessary, instead of prolonging ambiguity
  - Focus on executing on the tangible opportunities, like sales force execution, rather than chasing new, “blue sky” opportunities

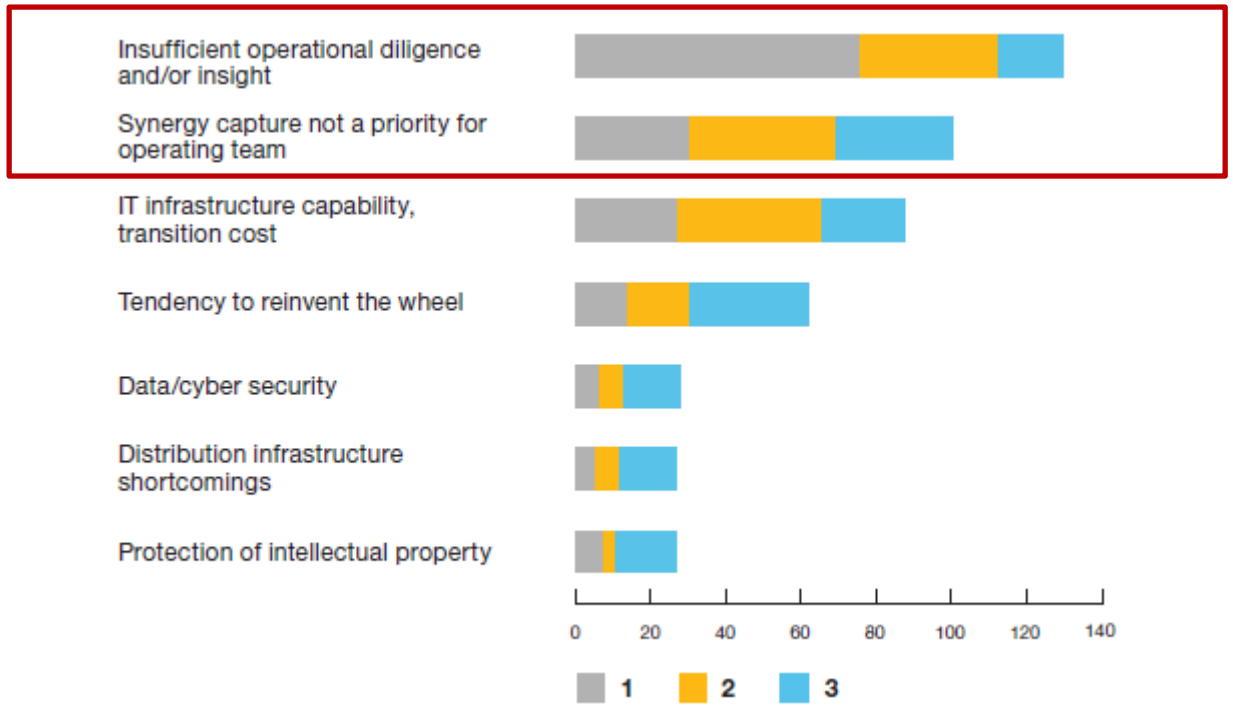
Commercial transition/synergy risks



Operational transition/synergy risks

- Operating team involvement is recurring theme
- **This reported shortage of operating team involvement is doubly problematic considering:**
  - The M&A market is increasingly competitive thereby limiting purely financial arbitrage opportunities and necessitating true operational value optimization to justify deal premiums
  - The “limited access to target company (management, facilities, data, etc.)” highlighted in the due diligence risks section, necessitates the involvement of an even more experienced operating team to yield quality insights
- The second risk, “synergy capture not a priority for the operating team,” also troubling due to the high <u>ROI of speed</u>

Operational transition/synergy risks



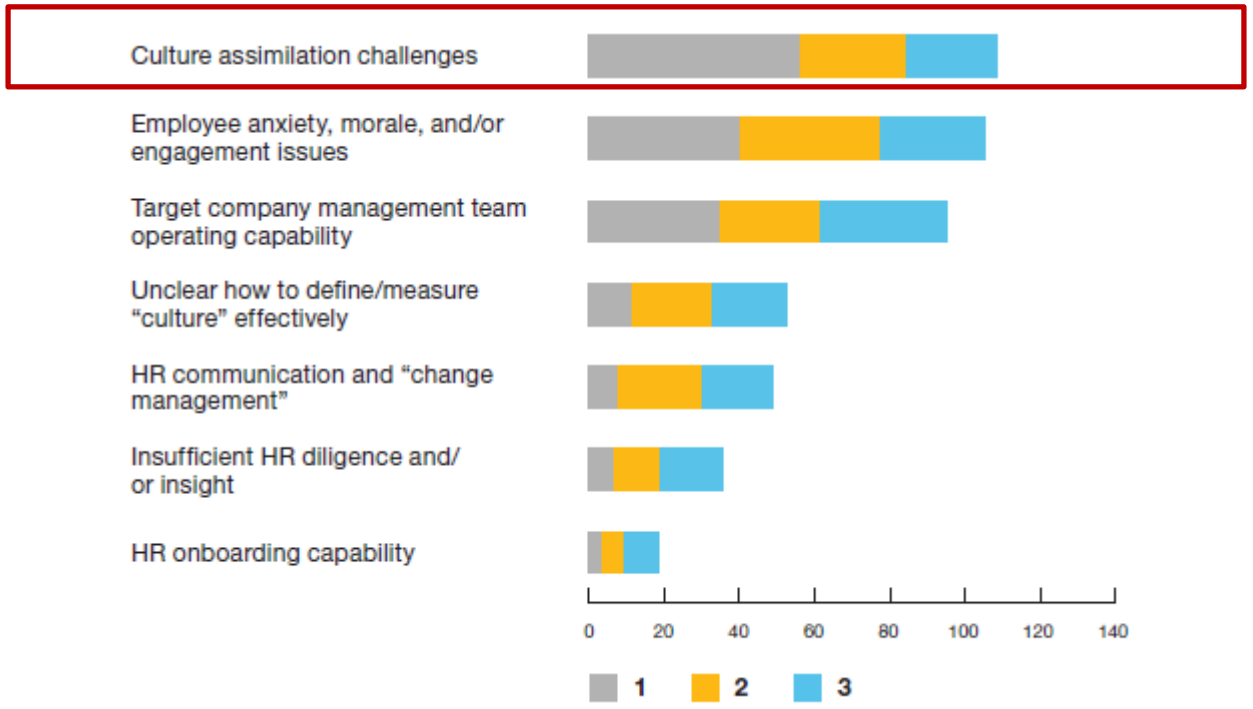
People/cultural transition risks

#1 people/cultural transition risk is “Culture assimilation challenges”

“Unclear how to define/measure ‘culture’ effectively” is less of a risk, which is particularly interesting given:

- “Strong values alignment” and “culture fit” are referenced as key value drivers for virtually every M&A
- Whole industry of experts focused on “defining culture” with tools such as culture models and diagnostic instruments

People/cultural transition risks



People/cultural transition risks

Issues underlying culture assimilation are very pragmatic and tangible, including issues related to:

- Organization structure and reporting relationship
- Compensation changes
- Benefits changes
- Title changes
- Decision-making protocols and comfort with risk
- Reliance on hierarchy

Polling question #2

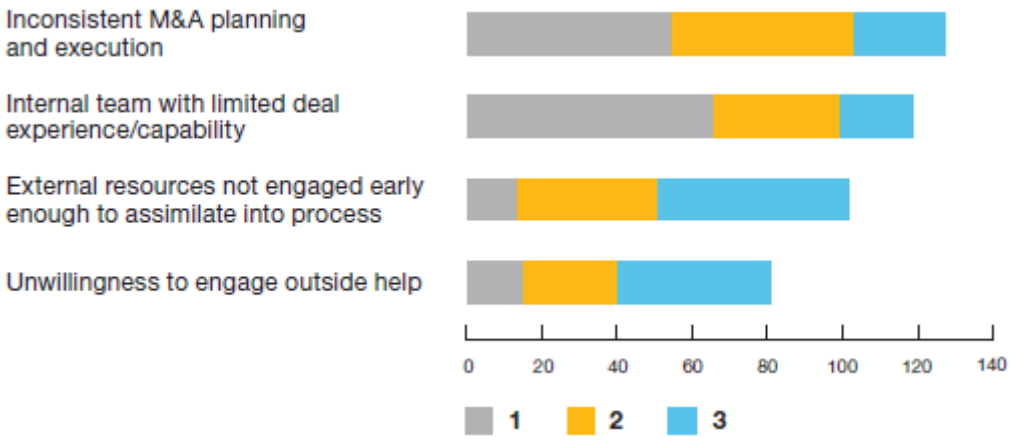
Which people/cultural transition item did respondents rank as the highest risk?

a) HR onboarding capability
b) HR communication and change management
c) Cultural assimilation challenges
d) Employee anxiety morale and/or engagement issues

Internal resources risks

- Typical conundrum - need for help/resources, but it is often “more work” to bring them in
- Consultants often don’t help their case, either
  - Ambulance chasing
  - Junior staff
  - Over-promise, under-deliver
- 2 simple suggestions
  - M&A Playbook
  - Utilize “down time” to vet and pre-qualify outside advisors and resources

Internal resources risks

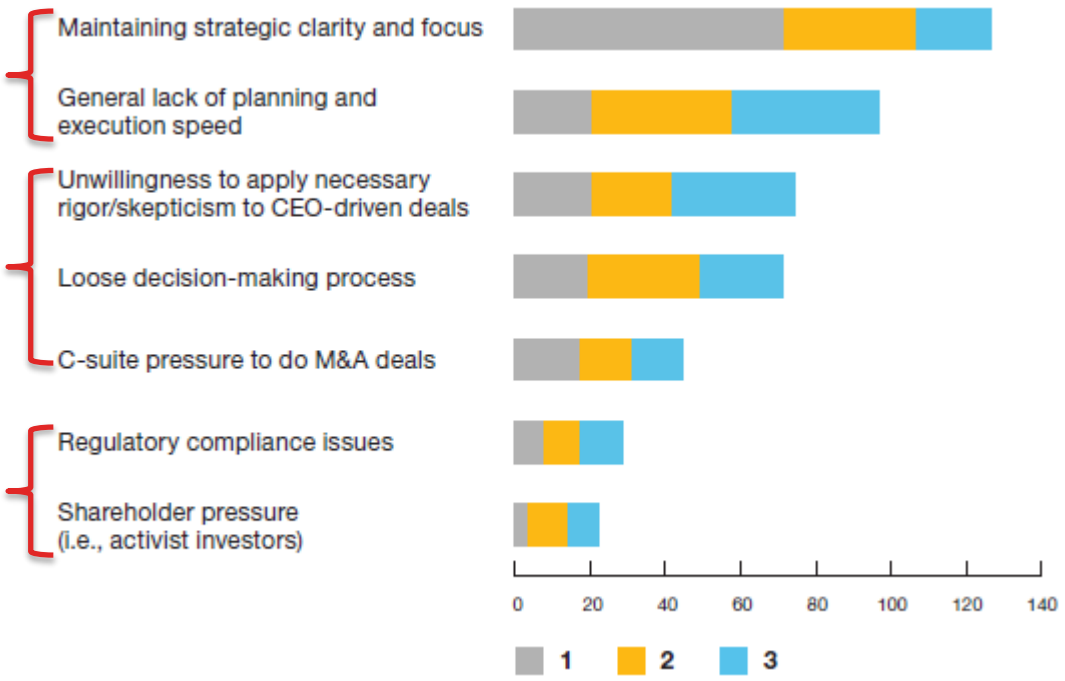


Governance & decision-making risks

With respect to governance and decision-making risks, the top issue was "maintaining strategic clarity and focus"

- 1st two ranked risks are M&A process items that a buyer should be able to manage
- Next three ranked risks are C-suite issues where good corporate governance should provide controls
- The last two ranked risks are 'environmental' and cannot be controlled by the buyer

Governance & decision-making risks



International transactions – additional concerns

International (cross-border) M&A transactions

- Growing importance and prevalence of cross-border transactions
- To gain a broader perspective on M&A transactions we asked survey respondents about their international or cross-border M&A experience. For those 55% of respondents with international experience, additional questions focused on both pre-close and post-close deal risks for cross-border transactions.
- **In order to better examine and interpret the survey results concerning international deal execution, Crowe assembled a panel of experts from the firm's international M&A team. The Crowe Horwath global panel members include:**
  - Marc de Prémare - France
  - Aymeric Stievenart - France
  - Franklin Bendoraytes - Brazil
  - Justin Audcent - Australia
  - Vijay Thacker – India
  - Michael Krüger – Germany
  - James Swan – U.K.
  - Peter Varley – U.K.

Pre-deal international risks

By far the biggest pre-deal risk was "identifying the right opportunity on a global basis versus staying in a comfort zone."

Pre-deal international risks

Post-deal international risks

The top risk was adapting sales and marketing efforts to the target country's culture.

This 2nd highest concern is restructuring the workforce.

Post-deal international risks

Polling question #3

Which issue did respondents indicate posed the highest risk for international deals, post-close.

a) Lack of court protection for foreign investors
b) Adapting sales and marketing efforts to the target country's culture
c) FCPA issues
d) Political and economic stability issues

Overlooked risks

Overlooked risks

- Respondents asked to identify the “most overlooked risks” in M&A execution.
- Issues were organized within the 15 categories shown to the right.

Most overlooked risks

Polling question #4

Which risk category did respondents rank as the most overlooked risk category in M&A execution?

a) Valuation
b) Funding
c) Integration
d) Regulations
e) People issues

Concluding comments

Concluding remarks

M&A (and interest in M&A) increasing, but a myriad of risks.
Risks heightened due to:

- Competitive M&A market, pricing multiples, etc.
- Increasing prevalence of international deals
- Increasing criticality and expense of IT transition

While some percentage of these risks are true externalities, it seems clear that the bulk of the risks are largely “controllable”, e.g.,

- Strategic clarity and targeting/valuation discipline
- Operating team involvement, focus and post-close accountability
- M&A execution resources and readiness (e.g., M&A Playbook, vetting and pre-qualifying external partners)
- Adhering to a conservative approach regarding commercial synergies
- Paying careful attention to people/culture issues, particularly as they relate to international deals

Questions?

Material creation: 10/24/2016
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Thank you

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