

M&A Strategies: What Boards Need to Know

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Corporate Board Member

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Discipline, discipline, discipline. The side of the road is littered with short-term deal decisions, so boards that instill a framework around their M&A strategy and keep a long-term approach will be those whose companies experience successful transactions. These days, when many companies with strong balance sheets are searching for new ways to add growth, mergers and acquisitions offer a probable path to get there. But all too often, M&A destroys shareholder value, whether it's due to paying too much for a target, the hemorrhaging of talent after a deal closes, or poor integration of separate staffs and cultures.

Yet while M&A is inherently risky, there's upside for a deal done right, and managements and boards are likely spending more time on the topic than in past years. So while deal volume is up, so is the time and resources spent on legal and regulatory issues. Sell-side lawsuits are now standard for large deals, which often focus on disputes over valuation. New regulatory matters add new questions for boards, such as a Dodd-Frank provision that requires shareholder approval of golden parachutes. Bottom line, management and boardrooms must have a strong decision-making framework to execute successful acquisitions, one that includes evaluations of strategy, valuation, due diligence, integration, and shareholder reaction.

For boards and management, the common thread is having discipline. "Successful businesses—just like successful sports teams—perfect a discipline about how they go about things," says Rajeev Singh, co-founder, president, and chief operating officer of Concur Technologies, a travel and expense management software company based in Redmond, Washington. "Even if they have to go really fast, they go really fast with discipline. That discipline pays off with successful transactions, because you have a methodology and a framework. Abandon that discipline and you will get results commensurate with that abandonment."

While deal-making receded to a trickle after the financial crisis hit in 2008, volume has picked up this year. Many corporate buyers have come back to the table after restructuring their balance sheets and slashing costs. Stronger capital markets, more available financing, and healthy cash levels have helped fuel the increase. Slower growth rates in sales due to a weak economy have also put pressure on management to grow by acquisition.

To be sure, idle cash hardly generates income, given the historically low interest rates. “Cash has never had so little value in terms of high-liquidity investments,” says Robert Hotz, senior managing director and co-chairman at investment bank Houlihan Lokey. “Any corporation sitting on substantial cash is earning nothing from it, which is another stimulus to making acquisitions,” Hotz says.

For the first half of the year, deal volume rose to \$589 billion, up from \$415 billion for the same period last year, according to research and consulting firm Dealogic. While volume was \$263 billion in the second quarter, down from \$326 billion in the first quarter, it was well above \$212 billion for the same period a year ago. Active sectors include areas such as health care, industrials, and technology.

A sizable chunk of the deal-making by U.S. companies is for overseas targets, which offer the lure of higher growth rates. For “growing overseas, you quite frequently need to do an acquisition in order to get into new markets and get the talent and capabilities to be successful,” says Ted Rouse, global co-head of mergers and acquisitions at Bain & Co., a New York-based consulting firm.

Deal volume for U.S. companies acquiring foreign targets more than doubled for the first half of this year, rising to \$125 billion, up from \$48 billion for the same period a year earlier, according to Thomson Reuters. One company on that path, Eastman Chemical Co.—a Kingsport, Tennessee-based manufacturer of industrial products such as polymers, resins, and plastics—last year bought Genovique Specialties Corp., a Rosemont, Illinois, manufacturer of plasticizers, benzoic acid, and sodium benzoate with manufacturing facilities in Estonia. The deal also included a joint venture in Wuhan, China.

“We do a good job of making products here and selling overseas,” says James Rogers, chairman and chief executive officer of Eastman. “However, the management team and our board feel like as we look again long term, and you see where growth in the world is going to be, we need a larger presence in the fast-growing markets.”

M&A outlook

Given all the market volatility this year, it’s anyone’s guess as to whether deal volume will continue at a healthy pace, Hotz says. “The question is, ‘How much dry powder do I need to feel comfortable?’” he says. “Companies will tend to be cautious.” On the other hand, any correction in the markets may spur more deals, not less. “Acquisitions can become mouthwatering in terms of what you can buy. It’s almost like there’s a sale—15% off,” Hotz adds.

Overall, the outlook for M&A remains bullish. Despite slow growth in unemployment and an uncertain economy, 60% of business professionals in the United States and Canada say they expect an increase in the average number of deals their companies will undertake in the next two to five years, according to a 2011 survey of 325 corporate development executives by Deloitte.

The demographics for owners of private, mid-market companies may also bode well for deal volume in the coming years. Owners may be looking to sell over the next few years, says Mike Lux, a partner in consulting firm Crowe Horwath's Chicago office. Many of these owners are aging baby boomers who may look to cash in before the tax break for capital gains expires on Jan. 1, 2013. "You've got a lot of things that can contribute to a robust transaction volume in the mid-market," Lux says.

Strategy: Getting it right

Of course, the uptick in M&A deal volume means that boards and managements are spending more time scrutinizing transactions. Boards must evaluate whether a deal fits the company's strategy, thus there must be a solid framework directors can use to make the right decisions.

Perrigo Co., an Allegan, Michigan-based manufacturer of over-the-counter and prescription pharmaceuticals, uses return on invested capital as a key metric for its decision making. The company likes targets that have a higher ROIC than its own, says Joseph Papa, chairman, president, and chief executive officer of Perrigo. ROIC (defined as net operating profits less adjusted taxes divided by the sum of working capital and fixed assets) essentially measures how well a company generates earnings from capital invested in the business.

Thought of another way, Perrigo's acquisition strategy comes down to how it can build operating margin by getting another product on the next truck leaving the warehouse. These so-called adjacent categories make up part of a strategic framework Perrigo's management and board use to make deals.

"It puts you all on the same page," Papa says. "It starts with strategy. Two, it's about a disciplined process. Three, there has to be a long-term focus."

Completed deals over the last two years include Paddock Laboratories Inc., a manufacturer of generic pharmaceuticals and over-the-counter specialty products, for \$540 million; PBM Holdings, an infant formula manufacturer, for \$808 million; and Orion Laboratories, an Australian-based OTC independent store brand pharmaceutical manufacturer, for \$48 million. Overall, Perrigo's organic growth and deal-making have lifted its market capitalization to over \$8.4 billion, up from \$1.4 billion five years ago. Operating margins now hover above 19%, up from 8.1% then.

In similar fashion, for Pep Boys, Manny, Moe & Jack, a Philadelphia-based automotive supply retailer and servicer, a solid strategy helps guide its acquisitions, says Hotz, who serves on the board. Pep Boys' growth strategy involves acquiring service and tire centers as a way to capture market share and enhance sales of its supercenter stores, with growth mainly targeted in its existing markets. This gives the board a backdrop to work against. Its acquisition this year of Big 10 Tires Inc., with 85 service centers in Alabama, Florida, and Georgia, met the test. "The directors have had a clear framework on what it is we are trying to accomplish," Hotz says.

For Concur, the travel and expense management software company, its boardroom strategy and discussion for acquisitions boils down to three buckets, Singh says. One bucket has to do with whether the target brings an incremental technology or service not offered by Concur, or if the target offers a product that is more advanced than its own comparable solution. A second bucket asks, “Does the deal either offer increased market share, or allow Concur to enter a new market at a price lower than what it would take to build it from scratch?” And a third bucket queries, “Does the deal offer talented individuals that will help accelerate growth?” Concur’s deals generally satisfy two of the three buckets. “The way we would characterize any M&A opportunity would be talking about those three classifications,” Singh says.

Concur, for example, acquired TripIt, a seller of trip manager software for mobile devices, in January for \$82 million. With the deal, Concur expanded its capabilities in expense management via mobile devices—the second bucket. The deal also brought along key talent, filling the third bucket, Singh says.

When it comes to strategy, Eastman Chemical uses a “deal board,” which is simply a flow chart that chronicles the timelines of target companies for acquisitions and joint ventures from initial contact, to letter of understanding, to due diligence, to closing, and finally, to integration. At the top of the chart, there’s a so-called “park box,” where names are temporarily put aside. A “kill box” at the bottom has names of companies that management has recently eliminated from consideration. The summary helps give the board the information it needs, though not too much information for a group that generally meets every few months. “That one simple chart helps center the board on what is the state of our JV and acquisition activity,” Chair and CEO Rogers says. “Because in this environment, they need to be able to be proactive very quickly.”

Boards should also be composed of several members with M&A experience, Rogers adds. Eastman’s board is made up of directors from other companies well versed in M&A, such as Dow Corning Corp., Cargill Inc., and Monsanto Co.

“You need to have a healthy component of directors who are comfortable thinking about acquisitions, being able to look at them at a high level, and just in a couple of meetings be able to reach a decision,” Rogers says. “A lot of that comes from experience. It’s hard never to have been in an acquisition mode and then respond with the speed that is necessary if you haven’t had that in your background.”

Deal scrutiny

Boards must also be prepared to fight the rubber-stamp mentality that often dooms deals, where the chairman or chief executive officer brings a deal to the board and gains approval, thanks to the leader’s charisma. Otherwise, boards might open themselves up to trouble.

“You can be criticized if you don’t question the CEO carefully,” says Craig Leonard, a partner in the corporate group in the New York office of law firm Morrison & Foerster. “A lot of CEOs will come in, and they are the CEO. They want to do this. So it’s fairly

hard for a board member who thinks it's a bad idea when the ship is going the other way. It's a difficult position to be [in] if you really think it's a dumb idea."

Directors must also rigorously question the numbers. "You have to be very leery of projections that are supporting doing a deal that is real rosy," says Van Conway, chief executive of Conway MacKenzie, a consulting firm based in Birmingham, Michigan. "You as a board member really need to get into that."

Gary Kunkle, a director for Perrigo, says boards need to be especially vigilant when opportunistic deals come along, such as entrepreneurs looking to sell their companies. Kunkle, who was involved in more than 40 deals over a 10-year stretch as a lead executive and later a director at Dentsply International, a dental supply company based in York, Pennsylvania, says these types of small deals can end up taking too much time to execute in the end. "You need to make sure you have the reins on and that management doesn't get too carried away with its opportunities."

This goes hand in hand with the due diligence role of the board. For example, for a management team that says cross selling will lead to accretive earnings, did the acquirer talk to any of the customers and find out whether they would buy its product? "Due diligence is about finding the things that could go wrong," says Rouse of Bain. "Think the unthinkable."

Also, start talking early in the game. When it comes to discussions, management and the board should meet well in advance of having conversations with a target company, in order to vet the rationale for the deal and its integration. "The strategy of how you pick your targets should be happening early on," Rouse says. "The board shouldn't be brought in late in the process."

Integration and investor reaction

While deals might offer the potential of expansion and earnings growth, they might only do so if the organizations are well integrated. Culture and fit must be key considerations. "We would rather walk away from a lucrative transaction than bring in a team that is potentially detrimental to the fabric of the culture," concurs Singh. "Break that rule, and you are going to have an unsuccessful acquisition."

Of course, boards must delve into management's proposal with regard to social issues, which start at the top: Who will be the chief executive officer? What is the role of the company being acquired? "You have to make sure you are not going to lose key people because they are unhappy with the social integration going forward," Houlihan Lokey's Hotz warns. It's natural for directors to look at their own companies. But you have to look at the other guy and ask, "Are we going to get what we bought?"

"If you start integration at the time you close, it's too late," says Chris Ruggeri, a principal with the financial advisory service of New York-based Deloitte. "You have to start the integration process earlier, during due diligence."

Acquisitive companies should also consider creating an executive role for the task, such as head of integration, Ruggeri adds. Some boards have taken it as far as asking management to develop an integration playbook, which systematizes and professionalizes the process of any integration of an acquired business.

Boards must also be attuned to making sure management has given itself breathing room when handling the integration, says Brian Levy, a partner in the transactions services practice at New York-based consulting firm PwC. “As a board member, you want to make sure that the expectations are set appropriately, that the benchmarks that are set by the company are not too much of a reach, and that the company will be able to deliver and exceed those expectations so that the market has a favorable reaction to future announcements as the integration and synergies develop,” Levy says.

If management and the board stick to a strategy already in place, the company can better defend its actions, and worry less about shareholder reaction. Singh says the board should be asking key questions when considering an acquisition: Does this abide by our framework? Is it consistent strategically with where we are going? Do we have an opportunity to be operationally successful at getting there? “If the answer to those three questions is ‘Yes,’ and it is consistent with our long-term framework, short-term investor reaction is less of a factor,” he says.

Simply put, the job of a board member is to make sure management knows the details. As a director, “I wouldn’t know a margin on a widget at a plant in South Bend, but somebody ought to know that,” says Conway, the consulting firm executive who has served on boards himself. “My job is to make sure somebody knows.”