

Modernizing the board's role in M&A

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Active involvement can help companies capture more value—and develop a competitive advantage in deal making.

In many conversations with senior executives and corporate directors, we've heard variations on the theme that deep board involvement in M&A encroaches on the line that separates governance from management. That line is critical. Yet our experience suggests that when it comes to M&A, many boards and management teams are drawing it in the wrong place.

Consider the stakes: many large corporations depend on M&A¹ for growth, and by executing it well they can significantly boost the value those deals create. But poorly executed M&A can saddle investors with weak returns on capital for decades. What's more, the margin between success and failure is slim. In most transactions, the net value creation to the buyer is usually a small fraction of the deal's value and therefore easy to wipe out with indifferent execution or ill-informed economic assumptions.

Many boards, reluctant to cross the line between governance and management, miss opportunities to help senior executives win at M&A. Boards are well placed to take a long-term view of a deal's value: the CEO or the business-unit leader may have tenures shorter than the time needed to realize it fully. Boards are also well positioned to challenge the biases that often cloud M&A decision making and goal setting. Furthermore, the diverse experiences of board members with long leadership careers in different corporate

¹In this article, M&A refers to mergers, acquisitions, joint ventures, and divestitures; it does not include sales of companies, leveraged buyouts, or other recapitalization events.

settings can shed useful light on common organizational risks in deals. Finally, boards can embolden senior management to pursue promising deals that may seem unfashionable or likely to be unpopular with investors initially.

Of course, a board cannot substitute for an effective management team. Yet it can play roles that go beyond the legal, regulatory, and fiduciary obligations that virtually every board fulfills on M&A—thereby helping executive teams to pursue deals and manage the associated risks in ways that create more value. In this article, we describe three such roles: challenging value-creation possibilities, testing merger-integration plans, and helping managers to create a corporate competitive advantage in M&A.

This final role is crucial because M&A is central to the strategy of many value-creating companies. Active M&A programs offer a window on the external world—product innovations, talent, new business models—and a way to bring fresh skills and ideas to the development of new products and geographies. They also help leaders keep corporate portfolios vibrant by training resources on the most attractive businesses and avoiding inertia in the allocation of cash and talent. In short, the benefits of M&A often transcend those of individual deals, making boards that engage with it better able to fulfill their broader stewardship functions.

Challenging value-creation potential

To understand how boards can help to create value, consider the example of one we know that's created a subcommittee to challenge the thinking of executives on potential transactions. That subcommittee is in constant touch with the company's M&A strategy, the pipeline of potential targets, and emerging deals. Its involvement allows the full board to feel more confident about (and to move much faster than other possible buyers on) large-scale transactions—even company-shaping ones, with all their accompanying risks—because the board is always current on how specific deals create value. This approach isn't common, but it's the right idea.

Providing such a challenge lies at the heart of the value boards can offer in M&A: helping managers to exploit its impact on performance while avoiding its traps. Why the board? Because without its

input, ways of working that serve corporations well for ongoing business operations can work against consistent value creation through M&A. The board's independence from daily operations and its long-term perspective enable it to challenge the tendency of management to emphasize income statements over balance sheets; to adhere, sometimes slavishly, to budget targets obscuring the potential of transactions; or to behave in risk-averse ways that inhibit the consideration of aggressive deals and prevent managers from discussing any but the most certain synergies. Specifically, boards can enhance decision making in M&A by closely challenging the following.

The strategic fit

While opportunistic transactions can succeed, recent analysis by our McKinsey colleagues has underscored the importance of strategic fit: deals driven by strategy succeed more often when they are part of a stream of similar transactions supporting that strategy.² Boards should push to clarify the relationship between a potential transaction and corporate strategy: how the deal will support organic-growth efforts in target markets and provide complementary sources of value creation, for example. Above all, why is the company a “better owner” than competing buyers?

The pro forma

In reviewing pro forma financial statements prepared for a transaction, a board should test the assumptions used to justify a deal, not just make decisions based on estimates of net present value or internal rates of return. Many boards place too much emphasis on, for example, whether a transaction is accretive or dilutive of the acquirer's earnings per share or on basing the outlay for deals on price-to-earnings multiples. Instead, they should demand clarity—using discounted-cash-flow methods—about the value created by various growth, asset, and cost synergies compared with the value-creation potential other bidders would bring to the deal. Are the forecast growth rates and return-on-invested-capital (ROIC) estimates consistent with industry norms and the long-run tendency of these metrics to converge? What business-model or product disruptions may lie on the horizon? Does the pro forma account for a competitive response? Are its price assumptions consistent with its assumptions about market-share capture? Is there enough new spending to support growth projections?

²Werner Rehm, Robert Uhlener, and Andy West, “Taking a longer-term look at M&A value creation,” mckinseyquarterly.com, January 2012.

The risks and rewards

Frequently, best case/worst case risk analyses that a board sees reflect a heavily negotiated pro forma that barely meets the minimum financial threshold to secure approval for a deal. These analyses may fail to highlight important risks or upside opportunities. Boards must indicate clearly that it's OK to acknowledge uncertainties in pro formas; what matters is management's ability to assess both those risks and the upside realistically and to develop plans that address them. For example, boards should explore the correlation between different types of risks inherent in a transaction and understand the impact they might have on future growth or returns. Similarly, boards shouldn't miss a chance to push companies to capture cost or revenue synergies more quickly. Setting high expectations for management—and rewarding it accordingly—boost the odds of creating value.

Testing the merger-integration plan

Important as it is to scrutinize a deal's value-creation potential, one board we know has decided that postmerger-integration (PMI) oversight, not a challenge to a deal's pro forma, represents its primary opportunity. In that company's industry, acquirers must typically rationalize costs and accelerate growth in the new entity—a tricky combination—to create value through deals. The board pressure-tests the PMI plan's specifics against stretch-growth and cost goals before and after a deal's announcement.

Boards should examine a transaction's PMI plan in as much detail as they do pro forma statements. While this might seem to verge on meddling in management, our experience suggests otherwise. We see more variation in the quality of postmerger plans than in the financial analysis and pricing of transactions. We've also seen effective PMI plans boost net value creation for the buyer by as much as two to three times the net value created through ineffective PMI plans. Boards can help realize these opportunities without micro-managing, by asking questions such as the following:

- Is the PMI designed to capture maximum value? A surprising number of PMIs and associated management incentives are designed, implicitly, just to integrate transactions smoothly and to meet, not beat, the value-creation pro forma approved by

boards. Unfortunately, PMIs are inherently messy; the priority should be finding and exploiting every source of value, not merely keeping things orderly. The PMI plan also must be adaptable enough to accommodate new value-creation opportunities and risks uncovered in the early weeks of integration.

- Is the PMI leader well equipped to realize the deal's value? Particularly for large transactions, it's often important to appoint fairly senior integration managers. In a world of scarce senior talent, a board should make sure that when a complex transaction is under consideration, PMI leadership is on the table. Is a senior leader available with the skill and independence to manage what is often a tricky and high-stakes role?
- Can we launch the PMI on the day the deal is announced and complete it rapidly? If the answer is no, value leakage is inevitable. Our experience suggests that lost value is difficult to recover—and is rarely captured at all if a board accepts a strategy of “we'll integrate the business later.”

Creating a competitive advantage in M&A

The third arena of board involvement is unrelated to a transaction's deadline; it is the decision to create a competitive advantage through M&A skills—a corporate asset that can be difficult for competitors to copy. Boards can help management along three dimensions.

M&A strategy

As part of a board's corporate-strategy oversight, the board and management must agree on the role M&A plays in creating value for shareholders—how material is that role, which of course varies across companies, and what critical sources of value can M&A provide? The dialogue between management and the board about sources of value must be quite specific, and the board should know how those sources fit in with the prospective deal pipeline, whose size, flow, and quality help determine the performance of M&A. While active involvement in the pipeline by the full board is rarely feasible or desirable, the board should periodically review it.

M&A leadership

Even if a company doesn't appoint a single executive to oversee M&A, it must have clear organizational-structure and process linkages between the creation of a healthy pipeline, the closing of deals, and their integration. The board can help the CEO and CFO become more explicit about the roles of the corporate center and business units in M&A and a permanent M&A organization's ideal scale and scope. Moreover, the executives leading various elements of M&A can significantly affect the creation of value. It's often harder to provide mentorship for these roles and to develop in them. They deserve the same attention from the board as do, for example, business-unit leadership roles.

M&A processes

Directors should read and challenge their company's M&A playbook—its guide for the types of deals it pursues. The playbook typically covers topics ranging from capturing cost synergies to integrating IT to jump-starting growth, and translates M&A strategy into specifics for delivering value. With the playbook in mind, a board can also help make M&A decision making more effective. The board should ensure that the company structures each phase of decision making to counter risks ranging from risk aversion in the early stages to biases in financial analysis to deal advocacy in the final stages. Once a deal is complete, boards can ensure that its performance is transparent, with incentives tied to realizing its full value.



This level of engagement will be outside the comfort zone for some executives and directors—but need not cause friction between them. In fact, it can align the board and management on the need for bolder transactions with more upside potential. The risks will be clearer all around, while management will be able to focus on capturing value instead of securing the board's approval. Above all, greater engagement can convert what is typically a sequence of discrete deals into a set of ongoing deal processes and dialogues to deliver value from M&A. ○

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