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Reducing the **risks** of early M&A discussions

Used early in negotiations, a third-party clean team can help companies assess a deal and protect sensitive data.

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Every executive knows what a high-stakes game M&A talks can become. But even before the formal negotiations start, a one-on-one conversation that plants the seed of a deal or a back-of-the-envelope sketch of the business case for it may present deal makers with conflicts of interest and strategic vulnerabilities. Who would get what value from a deal? Who would govern the new entity? What legal boundaries must prospective partners be careful not to cross? Moreover, deal makers also know that failing to close a transaction can turn today's potential partner into tomorrow's better-informed competitor.

Tension often grows as each company increases its investment in time and advisers. The longer negotiations go on, the more anxiety builds to complete the deal—if only to avoid the embarrassment of failing to deliver it. Transaction costs rise, constraining a company's ability to capture synergies and in some cases even causing good opportunities to vanish.

To successfully navigate the complexities of even the earliest discussions about mergers, acquisitions, and joint ventures, some companies are borrowing an approach that merger specialists sometimes use much later in the process to expedite postmerger integration plans and business strategies: they appoint a clean team. In the preannouncement period, such a team can serve as a neutral and objective resource that supports the executives of the companies involved during the very earliest stages of their discussions. The team conducts analyses that neither party can complete by itself (or complete as accurately) to assess a potential deal. A clean team adds the greatest value in specific types of M&A transactions, such as mergers of equals, alliances and joint ventures in industries with close regulatory scrutiny, or deals involving more than two partners.

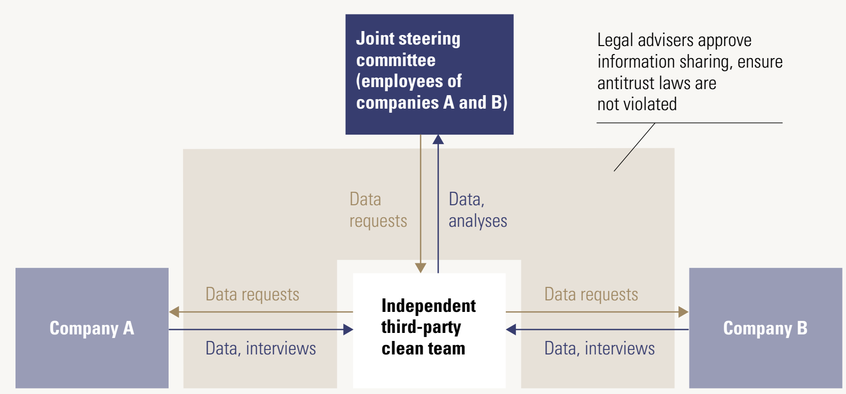
When the use of a preannouncement clean team is appropriate, one major benefit is its ability, through its unrestricted access to the confidential data of all parties, to give executives greater clarity about the potential value of consolidation long before the companies make formal commitments or disclose sensitive information to one another. A clean team often helps companies to negotiate their agreements more quickly as well, by setting aside the inevitable "win-lose" negotiation items—where one party benefits more than the other—until the very end and focusing instead on the "win-win" elements. Indeed, analyses by a clean team that served the steel companies Arbed, Aceralia, and Usinor provided "the justification for the merger," says Guy Dollé, chairman and CEO of the merged company, now called Arcelor. "When the negotiations became difficult," he adds, the team's analysis "brought us back to reality."

Setting the rules

As a neutral party, a pre-deal clean team has access to privileged information from all sides and can therefore conduct an early assessment of a deal's business rationale, develop an integrated business plan for the new entity, and ultimately support

EXHIBIT

Keeping information confidential



the formal negotiation process. Since companies share confidential information only through the clean team, this approach also reduces the risk of sharing too much of it and of rushing into formal negotiations too early (exhibit). To achieve these goals—and to keep a potential deal fully reversible, with no harm to the parties involved, until the transaction closes—the clean team must operate under strict, mutually agreed-upon rules (see sidebar, "Clean-team management: The rules of the game").

Clean-team management: The rules of the game

Successfully implementing a clean team requires meticulous preparation. In particular, the negotiating companies must have an unambiguous shared understanding of all the conditions under which the clean team will work—and of what happens to the members if a transaction isn't concluded. Most important, a clean team must be structured so that it doesn't favor the interests of any one party over the others.

A clean team doesn't share confidential information with the companies involved in negotiations but rather uses it only to develop recommendations and assessments that can be shared with all. It keeps a detailed log specifying which information has been shared with whom and when. If questions arise about what can be shared, the clean team always secures the consent of the parties or their legal teams.

At the outset, the parties should specify the team's intended end products as clearly as possible. Details (such as data aggregation and analytical methodologies, definitions, assumptions, and decision-making rules) should be resolved within the clean team's governance structure—typically, a committee of executives from each negotiating party. All parties must accept a confidentiality and indemnification agreement that spells out the expected levels of disclosure, such as the handling of data or the past connections of outside advisers with the companies involved in the transaction.

As in any other M&A setting that involves a data room with confidential information, the parties must agree on clean-room guidelines and on a code of conduct subject to local regulation. Only clean-team members may enter the room. Documents must be stored in a locked cabinet and a list kept detailing what information about the

These strict rules allow a clean team to help companies verify their business plans and assess the likely extent of synergies by making it possible for the team to have free access to sensitive data (such as customer lists and raw-materials and production costs) that companies can't or don't want to share, because of regulatory or competitive considerations. Instead of sharing sensitive information directly, the companies provide it to the clean team, which consolidates the analyses into figures and reports that can be presented without risk to the top management of all parties.

The advantage of adhering to the rules can't be overstated. This point is most critical when companies focus on win-win issues, where an objective solution can be identified that is in the best interest of all parties. In the case of a joint venture involving two logistics companies, for example, the clean team helped them agree, very early in their discussions, on a common, objective set of principles for setting transfer prices—an issue that otherwise could have become contentious during later negotiations, perhaps even scuttling the deal. Once these common principles were settled explicitly, no major differences of opinion on this subject arose later on, and the deal's champions on both sides remained in alignment.

Resolving such issues in the early stages of a deal by ensuring overall adherence to agreed-upon rules and harmonizing the assumptions behind the business plans of the various parties are two fundamental aspects of the clean team's role.

An adaptive approach

Typically, a clean team can support three phases of pre-deal discussions. Given the typical pressures and complexity of M&A transactions, the best approach is to use a single team throughout all three. In the first phase, the clean team helps the two (or more) parties to investigate the transaction in its early stages (for instance,

companies has been stored in which places. Making copies must be forbidden.

Managers and executives from the parties to the transaction must be involved in the process. But a preannouncement clean team can't include their own employees, who would by definition threaten its neutrality, which is essential at the preannouncement stage. By contrast, a clean team that supports integration efforts from the announcement to the closing may include employees of the negotiating companies—often recent retirees, people about to retire, or those who can be assigned to different business units should the deal fall through.

The parties must also agree about what would happen to the team (both their own employees and the outside advisers) if the deal were to fall through. Typically, individual members of a clean team can't work for any of the parties, at least in the business or function related to the team's work, for a specified time period—often two years.

A preannouncement clean team doesn't get involved with the win-lose elements of negotiations, such as splitting the value of synergies between the parties. Instead, the team flags these issues and returns them to the deal's steering committee for direct negotiations by the parties. This is typically less of an issue for integration clean teams, since the parties have an interest in maximizing the value of the newly combined company or joint venture.

Finally, to ensure full impartiality the parties involved should share equally the cost of outside advisers working on a clean team.

A clean team works with both parties to establish contractually enforceable rules that protect sensitive information, ensure impartial treatment, and maintain a focused and transparent process

following exploratory talks at the CEO level). At this point, the team focuses on assessing the high-level strategic rationale, drawing on sensitive information from the parties involved. If the clean team's analysis helps the companies to confirm that the deal's business rationale makes sense, the process continues as it would in any other M&A transaction—typically, with executives signing a nonbinding letter of intent. In the second phase, the clean team continues to build the detailed business case in preparation for the final negotiations. In the third phase, when negotiations inevitably turn to the deal's more contentious elements, the clean team becomes less prominent but remains active as a neutral facilitator, answering specific questions about the details of the business case.

Confirming the business rationale

In the absence of a clean team, the business rationale for a deal is often scoped out only in informal discussions between the CEOs and a handful of other senior executives. In our experience, they often have little time to investigate the specifics. The risks of this approach are that momentum may slow because no executive has sole responsibility for pushing the deal through to completion or that, conversely, the partners may rush into final negotiations too quickly. In any event, the records from this crucial first stage are often vague and incomplete, which may waste valuable time later on if issues must be reexamined. Sometimes, serious problems that turn into deal breakers emerge late in the process. At worst, such a deal might simply evaporate.

By appointing a clean team, companies make the analysis more thorough and ensure that they commit enough resources to explore the merits of a potential deal early on. Thus they ensure that its business rationale gets evaluated adequately and that they understand the critical issues while they are still in a cooperative phase of discussion. Also, the appointment of a clean team makes the process of investigating a potential deal more formal. Typically, greater formality encourages champions to emerge naturally on both sides, even during this early stage, and gives them a vested interest in moving the deal to completion once its merits have been confirmed.

In the case of the two logistics companies, the clean team's access to all of their confidential data made it possible to compute the deal's cost and revenue synergies with a high degree of detail and accuracy. The clean team was also able to confirm for the prospective partners that their respective business plans were based on similar expectations about the impact of restructuring.

Keeping the focus on an integrated business plan

In conventional merger or alliance talks, companies typically appoint a joint team to negotiate an integrated business plan. In our experience, such a team often spends a great deal of time reaching agreement on procedural issues, such as the business plan's format, the alignment of valuation assumptions (such as depreciation policies), and even the future positions of individual managers. These secondary issues inevitably sidetrack the negotiations from a focus on developing a solid business plan for the integrated entity.

A clean team, by contrast, works with both parties to establish contractually enforceable rules from the outset not only to protect sensitive information and ensure equal, impartial treatment of the companies involved but also to maintain a focused and transparent process. Such rules and processes prevent managers on all sides from pursuing their personal agendas, so the members of the clean team can quickly agree on or dispose of secondary issues. Sticking tightly to the rules builds trust in the process and in the clean team and makes it possible for both the team and the companies involved to focus on harmonizing the assumptions behind its analysis and on building a solid integrated business plan.

After two midsize European banks had spent almost a year conducting negotiations on a wide-ranging cooperative agreement, for example, the talks broke down over disagreements about the structure of the complex deal and the banks' respective valuations. Frustrated about the time, the money, and the energy that would have been spent in vain if the deal collapsed, the two institutions appointed a clean team to help get their discussions back on track. Under the leadership of a joint steering committee, the clean team helped executives on both sides to set aside some of the more complex aspects of the deal structure and instead to concentrate on an analysis of the merits and implications of the business case. Supported by the clean team, the two companies reached agreement in principle within three months. The deal closed fully about six months later.

Supporting negotiations

While win-win issues lie at the core of any effort to develop an integrated business plan, win-lose issues take center stage in the third and final phase of negotiations. One classic example is the problem of dividing the value of the synergies identified and valued during the first and second phases among the merging companies. Resolving this issue is a matter solely for negotiations between the interested parties. As a neutral intermediary, the clean team cannot take a stance.

During this phase, the role of the clean team thus changes from facilitating discussions based on the results of its analyses to supporting the negotiations. The team will have completed most of the background work of justifying the rationale of the transaction, building the business case for it, and identifying its synergies. Now the team usually works on responding to questions that come up in the negotiations—for example, the deal's value if putative growth rates or margins rise or fall.

Typically, investment banks or other counselors support the companies during this phase, whether or not a clean team is in place. But without a clean team's objective record of agreements and parameters, every aspect of the deal may be subject to lengthy discussion. A clean team can therefore still add value in a supporting role, if only by ensuring that the parties don't reopen issues on which they have previously agreed.

Common structuring tools, such as the negotiation grid the logistics companies mentioned previously used in their effort to form a joint venture, help a clean team to ensure that negotiations remain focused, timely, and on track. All of the parameters (about 50, in this case) driving the valuations of the respective companies were assessed, and for each parameter the clean team helped to forge a consensus on whether an identical value was required for both parties (for example, an identical cost of capital to value the business plans of both but different multiples to value their subsidiaries). The team then indicated the parameter's impact (low, medium, high) on both parties, thus ensuring that precious time wasn't lost on minor issues that had little impact on value. The members of the team, who attended the negotiating sessions only to take notes and to ensure that the parties had a common understanding of its analyses, scrupulously sent back to the negotiators any questions it couldn't answer by using the results of its analyses in a way that was consistent with the previously agreed-upon rules of engagement.

A clean team delivers the greatest possible value if it can take a deal all the way through to this final stage. By then, the team will have become the deal's memory and conscience, thus ensuring—together with the champions on either side—that the negotiations reach closure.

Clean teams can be as effective in preannouncement discussions of an M&A deal as they often are in preparing companies to integrate after the deal closes (see "Smoothing postmerger integration," on mckinsey.com). Indeed, when used in the very earliest stages of discussion, such teams increase the likelihood of closing valuable deals and help companies to strike better and stronger agreements—or, alternatively, to conclude early in the process that a deal's business rationale doesn't stand up to scrutiny. MoF

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