Modernizing the board’s role in M&A

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. While we wouldn’t argue with the importance of such a line, 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&A 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 and little hope for recovery. 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 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 are initially unpopular with investors.

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 create value, consider the example of one we know that’s created a subcommittee to challenge the thinking of the CEO and deal managers 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, and the company has been particularly successful in generating both growth and returns through M&A.

Providing such a challenge lies at the heart of the value boards can offer in M&A: helping managers to exploit M&A’s 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 understating 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. 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 give a quick approval 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. Effective value-creation challenges probe deeply. Are the forecast growth rates and estimates of return on invested capital 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 year-one spending to support growth projections?

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 clearly indicate 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—boosts 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 oversight of postmerger integration (PMI), not a challenge to a deal’s pro forma, represents its primary opportunity to add value to M&A. 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 post-merger 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 micromanaging, 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. Given competing priorities, will a company find a senior leader 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 build such a competitive advantage 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 the three stages of M&A—building a healthy pipeline linked to strategy, closing value-creating deals, and ensuring timely, effective integration—it must have clear organizational-structure and process linkages between those stages. The board can help the CEO and the CFO become more explicit about the roles of the corporate center and business units in M&A and the ideal scale and scope of a permanent M&A organization. Moreover, the executives leading various elements of M&A can significantly affect the creation of value, positively or negatively. It’s often harder to provide mentorship for these roles and to develop in them than it is for a standard line position, but they deserve the same attention from the board as do, for example, business unit leadership roles.

**M&A processes**
Board directors should read and challenge their company’s M&A playbook—its how-to guide for the different types of deals it pursues. The playbook typically covers topics ranging from capturing cost
synergies to integrating IT to jump-starting growth, and translates a corporation’s M&A strategy into specifics for delivering value. With the playbook in mind, a board can also help to make risk-fraught M&A decision making more effective. The board should ensure that the company structures each phase of decision making to counter these risks explicitly, from risk aversion in the early stages to biases in financial analysis to deal advocacy in the final stages. Finally, once a deal is complete, boards can ensure that the deal’s performance in creating value is transparent. Incentives should be tied to the realization of a deal’s full value, ideally informed by stretch targets.

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

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Chinta Bhagat (Chinta_Bhagat@McKinsey.com) is a partner in McKinsey’s Singapore office, and Bill Huyett (Bill_Huyett@McKinsey.com) is a partner in the Boston office. Copyright © 2013 McKinsey & Company. All rights reserved.