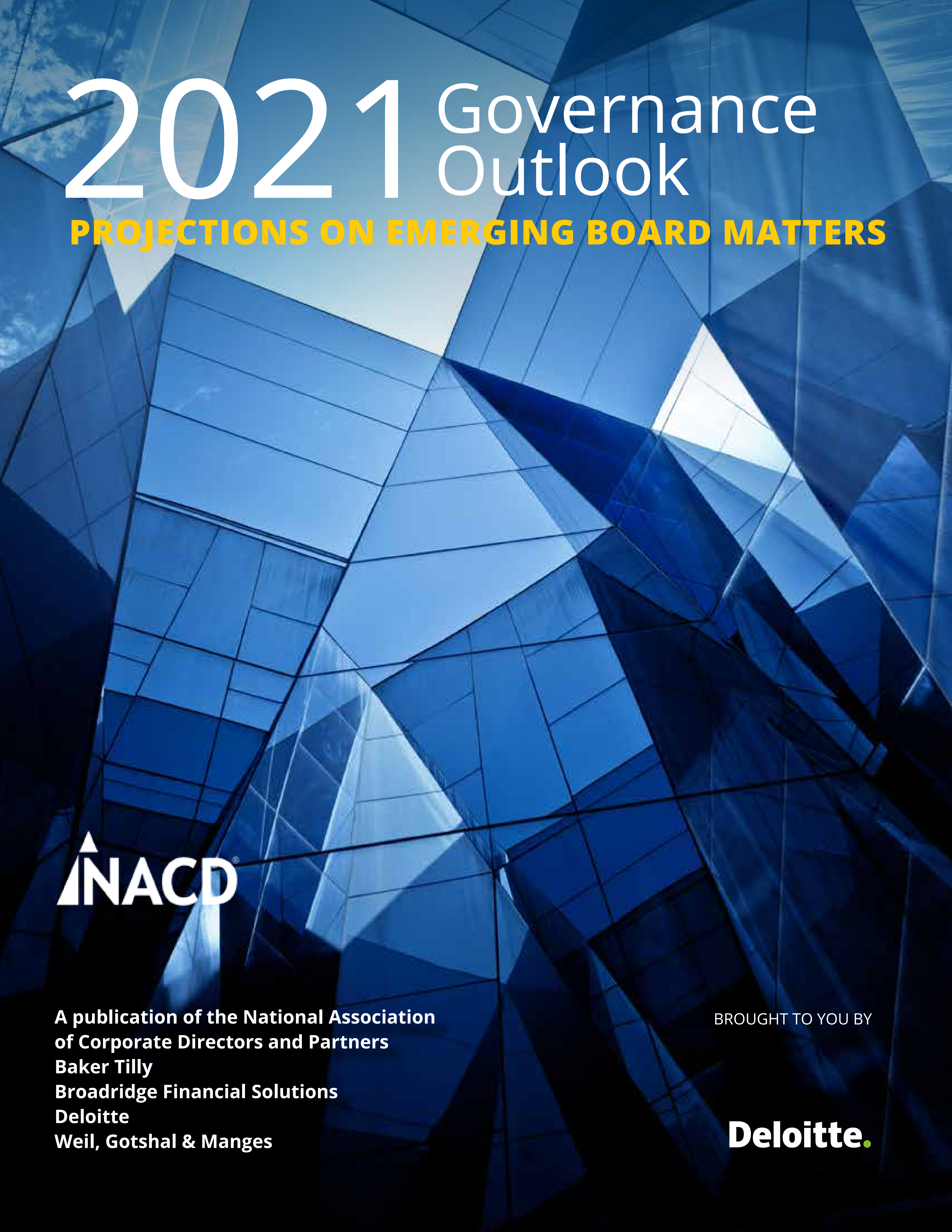

2021 Governance Outlook

PROJECTIONS ON EMERGING BOARD MATTERS

NACD

A publication of the National Association of Corporate Directors and Partners
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ABOUT THIS REPORT

The *2021 Governance Outlook: Projections on Emerging Board Matters* is designed to give corporate directors and senior executives a comprehensive overview of major business and governance issues that are likely to demand board focus over the coming year. The report begins with an introduction from NACD that highlights survey findings about leading board priorities for 2021 and follows with five partner contributions that provide distinct insights and projections on the following themes: strategic business risks, legal risks, data privacy, M&A oversight, and virtual shareholder engagement.

Each partner contribution provides (1) an overview of key trends in a particular area of governance, (2) an outlook for how those trends will play out in 2021, and (3) relevant implications and questions for boards to consider. The *2021 Governance Outlook: Projections on Emerging Board Matters* is designed as a collection of observations to help corporate boards to prioritize their focus in 2021 and increase their awareness of emerging issues through both detailed topical analysis and coverage of broader governance implications.

National Association of Corporate Directors

Contents

Strengthening Board M&A Oversight in an Uncertain Time

By Trevear Thomas, Joel Schlachtenhaufen, Andrew Wilson, Annie Adams, Deloitte & Touche LLP

INTRODUCTION

Among the matters that have the greatest relevance to the long-term success of a company is its strategy for mergers and acquisitions (M&A). Executive leadership must have the right skills to develop the strategy, pursue the deals, and execute when the time comes. Boards must fulfill their role in overseeing and guiding management's M&A pursuits—ensuring that management stays aligned with the strategy, conducts effective diligence, and actively guides value-creation efforts through completion.

None of this has been easy, to say the least, with a pandemic disrupting M&A activity and shifting priorities. As the coronavirus spread in the first quarter, dealmaking slowed almost to a halt. Markets grew volatile, and management's attention became consumed by the response to the crisis, which threw some industries into turmoil and materially affected almost every business.

While M&A activity has begun to rebound, dealmaking is occurring in a changed world. Some companies have been divesting assets to raise cash or to shed operations that no longer fit their purpose. Others in better circumstances have had the luxury of being opportunistic. Few can afford to stand still, given the uncertainty the pandemic has injected into the business environment and the premium it puts on building resilience into every business organization.

To better understand how directors see their M&A role, how their views are changing, and where there might be need for greater attention, the National Association of Corporate Directors (NACD) and Deloitte gathered the views of directors of US companies for the second year in a row.[1] Even with the business environment having changed so dramatically in such a short time, the results of our survey allow us to track the progress boards of directors are making to strengthen their engagement with management's dealmaking and their efforts to oversee M&A strategy.

We see indications that directors are sharpening their focus on key M&A issues. Survey respondents are confident that they have the skills they need on their boards, and they report regular engagement with M&A topics as part of their ongoing oversight of the organization's strategy. They are focused on deal valuation, among other key areas, in a market environment where overpaying for assets is an obvious risk.

The COVID-19 pandemic upended many companies' plans in 2020. As the initial pressures of responding to the crisis have eased, resilient leaders have been considering what steps they will need to take to allow their companies to thrive in the current economic and business environment as well as that of a post-pandemic world. This effort to pivot has to include a reexamination of M&A strategy—and that has to include the board.

Directors are sharpening their focus on key M&A issues.

1. KEY PROJECTIONS

Boards face obstacles to engagement.

More than half of our survey respondents (53%) say the pandemic either significantly or moderately impacted their ability to pursue, finance, and close deals. Another 33 percent say there was a minimal impact in this area, while 14 percent cited no impact at all.

This significant effect on M&A activity should not come as much of a surprise. Recall how, early in the pandemic, management had to rush to figure out how to run an organization through virtual meetings and deal with the responsibility of keeping employees and customers safe while maintaining business continuity. Dealmaking was pushed aside by these demands on leadership attention, and, if that wasn't enough, the stock market plunged, ending the longest bull market on record and throwing valuations into limbo.[2]

[1] Survey conducted Aug. 5–25, 2020, with responses from 165 directors from US companies representing a cross section of industries. A majority of respondents were from companies with $5 billion or more in annual revenue.

[2] Deloitte's 2021 M&A Trends research (page 16) has further information. In our survey of executives for that study, 58 percent said COVID-19 moderately impacted their ability to pursue, finance, and close deals; 92 percent said they have paused at least one of their deals; and 78 percent said they have abandoned a deal.

Just as a checklist is a rigorous risk-management tool for an airplane pilot, the deal playbook for any company can help keep the M&A team's focus clearly on the most important M&A priorities and goals.

Asked whether the board became more involved during the pandemic in overseeing M&A activity, 29 percent of respondents say they did, while most (71%) say the board did not become more involved.

The board's role in M&A strategy is growing.

Still, our findings suggest that directors generally have grown more comfortable with their role in overseeing M&A strategy and execution. Fully 95 percent of respondents say they consider M&A matters as a regular part of ongoing strategy discussions with management, independent of any specific deal. This is a notable increase from our 2019 study,[3] when 82 percent said the same. This perhaps signals that the complexities of the current environment may have encouraged greater board involvement in M&A strategy. It is also a sign that there could be increased opportunities in the market given the disruption. It will be interesting to see if this trend persists even after the most acute disruptions related to the pandemic have receded.

Among other responses to the question of which M&A matters the board addresses, 78 percent of directors say they obtain regular updates on the timing, challenges, and critical-issue milestones that occur during a deal's life cycle, while 61 percent question management's assumptions during all phases of the M&A life cycle.

Greater use of a deal playbook may be possible.

One surprising result in this year's survey is that just 14 percent of respondents say they use a deal playbook, a similar result to last year's 17 percent. This presents an opportunity for boards. Using a deal playbook is a leading practice that many successful companies have embraced. Just as a checklist is a rigorous risk-management tool for an airplane pilot, the deal playbook for any company can help keep the M&A team's focus clearly on the most important M&A priorities and goals.

Boards are developing M&A depth.

Our survey responses suggest that boards have confidence about the level of expertise they bring to their M&A oversight function. Almost all of our respondents (96%) say they have directors on their boards with M&A experience. At the same time, 26 percent say they are considering bringing on new board members with specific M&A expertise; this is with similar to with the 24 percent who said this in our 2019 survey. This implies a recognition of the importance of the board's role in this area—and an interest in building even greater depth of M&A knowledge on the board, perhaps across different industries or transaction types.

[3] Survey conducted May 22 to June 24, 2019, with responses from 206 directors.

Executives may be relying less on the board's expertise.
Even as the board seeks to engage within M&A activities, and has become more confident in this role, executive leadership may be hesitant to take full advantage of director expertise on M&A issues. Asked whether senior management has tried to more frequently engage the board in discussions around M&A issues, 46 percent of directors in this year's survey agree with the premise; in last year's survey, 61 percent endorsed that statement.

Meanwhile, 67 percent of respondents in this year's study agree with the statement that there is a greater role and opportunity for nonexecutive board members to lend their experience to management during M&A discussions, versus 7 percent who disagree and 26 percent who neither agree nor disagree.

2. BOARD IMPLICATIONS

Directors need to pick the proper entry points for board involvement in M&A. Our survey results show where they are setting their priorities.

Boards need clear priorities.
Board members, in their role as overseers of M&A activities, need to have clear priorities. They cannot be involved—and be effective—in every aspect of the complex task of setting strategy, pursuing a deal, seeing it through to close, and then realizing the value envisioned in the deal thesis. Directors need to pick the proper entry points for board involvement in M&A. Our survey results show where many are setting their priorities.

Asked to rank the relative importance of various risks that the board might address when considering M&A transactions, survey respondents put valuation as their top priority, recognizing their concern about the possibility of overpaying for an asset in the current, volatile environment. That item is followed in second place in the respondents' rankings by value creation, as exemplified by synergy realization and execution risk.

With a majority of respondents ranking these as their top two priorities, they signal the importance of, and interest in, valuation and value creation at the board level. There's a good argument that this is as it should be.

The next three risks in the ranking are, in order, an unidentified risk such as a hidden liability, deal structure concerns, and change management and culture risks. Getting all these priorities right can (of course) help a company get the valuation calculation correct and make value realization happen, while getting them wrong can undermine the top priorities.

Responses show mixed results on size thresholds for board involvement.
Asked if there is a financial threshold above which the board tends to get involved in an M&A transaction, 60 percent of our survey participants say there is, versus 40 percent who say there is not. Boards should be focusing

The completion of a complex M&A transaction can be challenging, with the risk that business gets disrupted, customers lost, and value eroded while integration efforts are being refined and implemented.

on larger, material deals, and this finding suggests many do set clear priorities. Still, such guidance about when boards should be involved in M&A could be more universal.

The response in favor of a minimum financial threshold was lopsided across most of the economic sectors represented in our survey, including consumer staples and discretionary, industrials, communications services, health care, and energy. But the result was reversed in the financial sector (35% say they have a financial threshold for board involvement), information technology (34%), and utilities (25%). This may signal that board members see M&A risks differently for banks and technology firms and some other companies in these sectors.

Boards can do more on integration risk.

The completion of a complex M&A transaction can be challenging, with the risk that business gets disrupted, customers lost, and value eroded while integration efforts are being refined and implemented. Even so, our survey responses suggest that boards may give too little weight to the role they can play in overseeing integration and value creation post-close.

Asked about the stages in the M&A process that get discussed and addressed at the board level, 87 percent of respondents cite pre-deal M&A strategy, 69 percent say value creation, and 61 percent say due diligence. Respondents were less likely to include integration strategy (57%) and integration execution (50%).[4] The takeaway here may be that there's room for boards to embrace a bigger role in overseeing the integration phase. ■

[4] Executives surveyed for Deloitte's M&A Trends research tell a slightly different story than directors do. Asked to indicate when in the life cycle of an M&A deal boards usually get involved, executives ranked integration strategy (54%) and pre-deal M&A strategy (53%) highest, while integration execution was cited by 40 percent.

BOARD OVERSIGHT QUESTIONS

As the pandemic continues to sow uncertainty across the business landscape, businesses should be asking how dealmaking can play a role in boosting the resilience of the organization and positioning it to thrive.

For the board, this M&A effort is likely to create new challenges and raise the stakes surrounding its oversight role. The following are some questions that directors might ask of themselves or the executive leadership team. They are designed to help directors assess the role they are currently playing—and the role they might assume—in this new and rapidly shifting world.

- Is the board fully engaged with the company's M&A activities, and does the board have clear priorities to define its involvement in M&A strategy and execution through post-close integration?
- Is the executive leadership fully engaged with the board on M&A strategy and execution, and if not, how can that engagement and their relationship be strengthened?
- Does the board have the full scope of M&A skills, spanning the spectrum of deal types and industry groups, to help steward the company's activities?
- Has the board set a deal-size threshold above which the board will be involved in oversight of a specific M&A transaction, and if not, should it set one?
- Should the board be following the company's M&A playbook, or if the company does not have one, should directors be working with executive management to create one?
- Is the board giving sufficient attention to integration risk and other post-close activities where the value that's expected from a deal may be eroded?

Clearly, there are subtleties in the story of how boards see their role in dealmaking—or how they might reshape their oversight involvement.


Trevear Thomas


Joel Schlachtenhaufen


Andrew Wilson


Annie Adams

Trevear Thomas is a principal with Deloitte Consulting LLP; he is the national managing principal for M&A Services and serves on the Deloitte Touche Tohmatsu Ltd. board of directors. Joel Schlachtenhaufen is a principal with Deloitte Consulting LLP with 20+ years of professional experience advising clients in maximizing value across the full life cycle of M&A transactions. Andrew Wilson is a partner with Deloitte & Touche LLP, specializing in accounting and financial due diligence and structuring. Annie Adams is a senior manager with Deloitte Consulting LLP and focuses on the strategy, operating model design, and execution of deal and non-deal transformations.

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