

2019 Governance Outlook

PROJECTIONS ON EMERGING BOARD MATTERS

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Baker Tilly

Ceres

Deloitte

Spencer Stuart

ABOUT THIS REPORT

The *2019 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 likely to demand board focus over the coming year. The report begins with an introduction from NACD, highlighting survey findings about leading board priorities for 2019, and follows with four partner contributions that provide distinct insights and projections on the following themes: business risks, climate change, M&A, regulatory priorities, and board composition and succession.

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 2019, and (3) relevant implications and questions for boards to consider. The *2019 Governance Outlook: Projections on Emerging Board Matters* is designed as a collection of observations to help corporate boards prioritize their focus in 2019 and increase their awareness of emerging issues, through both detailed topical analysis and coverage of broader governance implications.

Mergers and Acquisitions: What Should Boards Expect in 2019

By Larry Hitchcock, Tonie Leatherberry, Joel Schlachtenhaufen, and Russell Thomson, Deloitte

Every year, Deloitte surveys more than 1,000 corporate and private equity (PE) executives about the current state of mergers and acquisitions (M&A) and their expectations for the next 12 months. Presented in the *Deloitte 2019 M&A Trends report*,¹ the survey findings—combined with client interviews and insights from Deloitte senior leaders who frequently work with boards on M&A strategy—shed light on potential M&A opportunities and need to get M&A right. In our article, we find that boards may consider four strategies to prepare for future M&A transactions: increase deal review rigor, develop multiple deal scenarios, improve technology proficiency, and apply cross-border deal experience.

To place 2019 in context, the 2018 global M&A activity as of September is accelerating at a pace that might match or even exceed that of 2015, the high-water mark for global dealmaking over the past 25 years (Figure 1). A Deloitte analysis of Thomson Reuters’s strategic M&A deals data indicates that through the end of August, 2018 has already seen \$2.5 trillion in deal value across more than 25,000 proposed transactions, lagging behind last year in terms of volume, but indicating an uptick in value. With this context in mind, M&A deal activity and cycles over the past 25 years can provide a strong base of experience for executives and board members to draw upon when evaluating potential deals in the current market.

Drivers of deal activity vary by industry and geographic market; how-

Figure 1.

Global M&A 1990–August 2018 YTD (Strategic deals only)



Source: Deloitte analysis of Thomson Reuters’s M&A data, as of September 2018

¹The state of the deal: M&A trends 2019, Deloitte.

ever, given that the United States commonly accounts for 40 to 45 percent of global M&A, based on Thomson Reuters’s M&A data, important factors likely include pro-business legislation (such as a repeal of many restrictive regulations which free businesses to pursue growth and expansion for coal, oil and gas, or financial services), US tax reform, and undistributed corporate profits, which have continued to climb since early 2017.²

Will 2018’s robust deal activity continue into 2019? Based on Deloitte’s 2019 M&A Trends Report of more than 1,000 executives involved in M&A transactions, client conversations, market observations, and analyses, we identified the following trends per Figure 2 below:

Figure 2.



Source: Deloitte’s 2019 M&A Trends Report

What are the implications of these 2019 projections for the corporate boards of directors and management teams that need to get M&A deals right? Activity over the past 25 years provides a significant experience base from which they may draw when considering how to address opportunities and risks associated with proposed transactions.

Look to the future, learn from the past

Corporate boards and executives pursuing a merger or acquisition—to grow inorganically, to expand in geographic markets, to gain new capabilities, or to block competitors—have a continuing duty to shareholders to optimize value from each deal they undertake. However, Deloitte analyses of Standard & Poor’s Capital IQ data for recent transactions by strategic buyers continue to show significant variance in deal outcomes. While

Activity over the past 25 years provides a significant experience base from which boards may draw when considering how to address opportunities and risks associated with proposed transactions.

² Undistributed Corporate Profits (UCP) With Inventory Valuation and Capital Consumption Adjustments, Bureau of Economic Analysis (BEA).

While trends are moving in the right direction, it is evident that deals do not consistently achieve their expected returns.

some transactions are remarkably successful, others still lag significantly and continue to diminish shareholder value.

The good news is that some companies consistently exceed estimates used to justify the deals to investors. In our review of Capital IQ data for Fortune 500 companies with the highest total shareholder returns over the past five years, we found that at least eight in the 75th percentile pursued M&A as a core strategy.

Further, stakeholders (particularly investors) evaluate boards and management teams, in large part, based on their ability to build healthy companies that consistently grow profitably. Our analyses of Capital IQ data show that, across a range of industries, companies that acquire effectively typically improve earnings growth in the years following M&A activity.

While trends are moving in the right direction, it is evident that deals do not consistently achieve their expected returns, a fact borne out by our survey participants. Twelve percent of corporate respondents say that a majority of their M&A deals are not generating the expected return on investment. This is down from just under 40 percent in spring 2016. Six percent of PE survey respondents say that a majority of their deals are missing the mark—this is consistent with what respondents reported a year ago and continues the downward trend from a high of 54 percent in spring 2016.³ Considering the steep rise in deal volume alongside a decline in deal value since 2016 (Figure 1), survey respondents' shifts in answers might stem from increased confidence of more easily being able to extract a return on investment on smaller deals than focusing on fewer larger deals—something that will be interesting to monitor going forward.

What can boards do to prepare for future M&A transactions? How can they leverage previous deal experience and lessons learned to improve their chances of delivering on expected returns? Many public company boards have established practices for reviewing the growth strategies that management uses when contemplating M&A. Moreover, many companies have policies that specify board review points when pursuing deals that are consistent with the organization's overall direction in strategic plans, capital allocation plans, and annual operating budgets. Our research and interviews with subject-matter experts point to four other recommended actions:

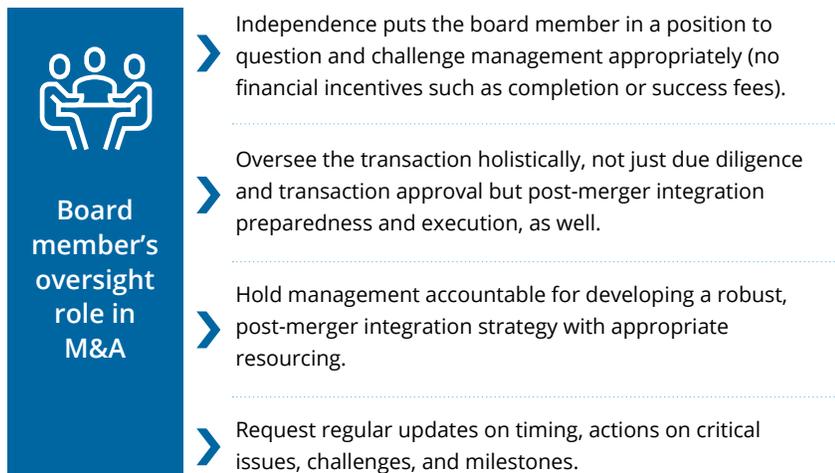
1. Increase deal review rigor
2. Develop multiple deal scenarios
3. Improve technology proficiency
4. Apply cross-border deal experience

³The state of the deal: M&A trends 2018, Deloitte.

Increase deal review rigor

Boards have an important oversight responsibility for all phases of an M&A transaction (Figure 3) and, therefore, should be very deliberate in their proceedings.

Figure 3.



Source: Deloitte

However, some board members—who are often recruited for their contacts and deep functional knowledge—lack substantive transactional and/or operational M&A experience, which may cause them to miss potential red flags during the diligence process.

One way boards can increase the rigor of pre- and post-transaction deal reviews is to seek and share back-and-forth input from all involved committees. In addition, a deal playbook can help board members confirm that the committees answer relevant questions. Board members also should have specific deal-related training to support their committee responsibilities. Here are some examples:

- A specific committee could be identified to regularly review a proposed acquisition to determine its fit with approved corporate strategies and long-range growth plans.
- The compensation committee would recommend methods and incentives to retain key talent.
- A specific committee could be identified to review potential cyber risk issues and insist that they be covered in diligence.
- The audit committee would review accounting and financial policy and other factors that may pose reputational risk.
- Some companies have added an independent director with M&A experience to help add oversight expertise to their boards.

Some board members—who are often recruited for their contacts and deep functional knowledge—lack substantive transactional and/or operational M&A experience.

When boards review integration plans, a single-scenario approach usually prevails.

Each deal thesis identifies critical value-creation elements that are anticipated for that transaction. Board members should be educated about these value levers so they can pressure test against them—probe management’s thought process and its plan to deliver on each element’s anticipated value.

Develop multiple deal scenarios

Boards should consider whether deal reviews should include multiple scenarios. Our experience suggests that management typically presents to the board an acquisition case with clearly stated assumptions pertaining to overall trends, competitive landscape, deal rationale, supporting economic justification, and potential risks. However, it is less common to engage the board in a dialogue that involves multiple scenarios—an approach that can create a richer discussion and a better understanding of the opportunities and risks.

Take for example, a US-based Fortune 500 company that acquired a much smaller business in an emerging market to gain access to customers and new technology for packaging consumer and industrial products. In this case, the rationale was clear and the business case met established thresholds for the internal rate of return so the board approved the deal. However, management and the board members did not engage in a dialogue centered on future scenarios that could affect the viability of the business; for example, a scenario in which the customer base and the business’s production locations shifted in response to tariffs—even though these developments were plausible and central to justifying the deal.

Similarly, when boards review integration plans, a single-scenario approach usually prevails: an integration leader presents a time-sequenced plan of activities that cover areas such as combining back-office functions, merging information technology systems, and revising sales incentives to promote cross selling. Here, too, board members can initiate dialogue around multiple scenarios that consider numerous internal and external factors that could impact integration efforts.

Improve technology proficiency

Responses to Deloitte’s 2018 *M&A Trends Report* revealed a significant change in executives’ motivation for conducting M&A: technology had become the top reason for pursuing deals. This finding tracks with corporations’ growing adoption of technologies including blockchain, cognitive technologies, and cloud computing. The responses also reflect a decided shift in the ways companies interact with their customers and channel partners, who increasingly rely on smartphones and other digital devices.

A broad range of technology-related considerations may arise during an M&A transaction, which may pose challenges for boards. Examples include these:

- Assessing specific technologies and deciding whether M&A (versus partnering or internal development) is the preferred strategy to address important industry changes
- Determining whether the company can quickly and effectively apply acquired technologies to capitalize on opportunities and whether the technologies offer sustained or only transitory advantages
- Evaluating how the acquiring company can manage talent associated with a technology-based deal so unplanned turnover does not negate the value of the acquisition
- Gauging the risks of pursuing deals with companies whose cybersecurity standards and programs may not be fully revealed until the asset is acquired

One way boards have sought to strengthen their technology proficiency is by recruiting tech-savvy members. Deloitte analysis suggests that only 3 percent of public companies appointed a technologist to newly opened board seats in 2016.⁴ Other steps include insisting on technology-specific diligence with a strong commercial dimension (competitive factors, alternate and potential disrupting technology, commercial fit within current organization, etc.), conducting ongoing board member training in technology-related considerations, insisting on a technology chapter in the deal playbook, and engaging advisors with appropriate expertise.

Apply cross-border deal experience

Based on our analysis of Thomson Reuters's M&A data, cross-border dealmaking continues at a strong pace. Upwards of one-third of deals (whether measured by value or volume) are now cross-border deals (Figure 4). With increased risk of rising trade protectionism in different regions, it is likely that companies will consider cross-border M&A as a hedge against fluctuating input cost as well as a way to maintain access to attractive consumer markets.

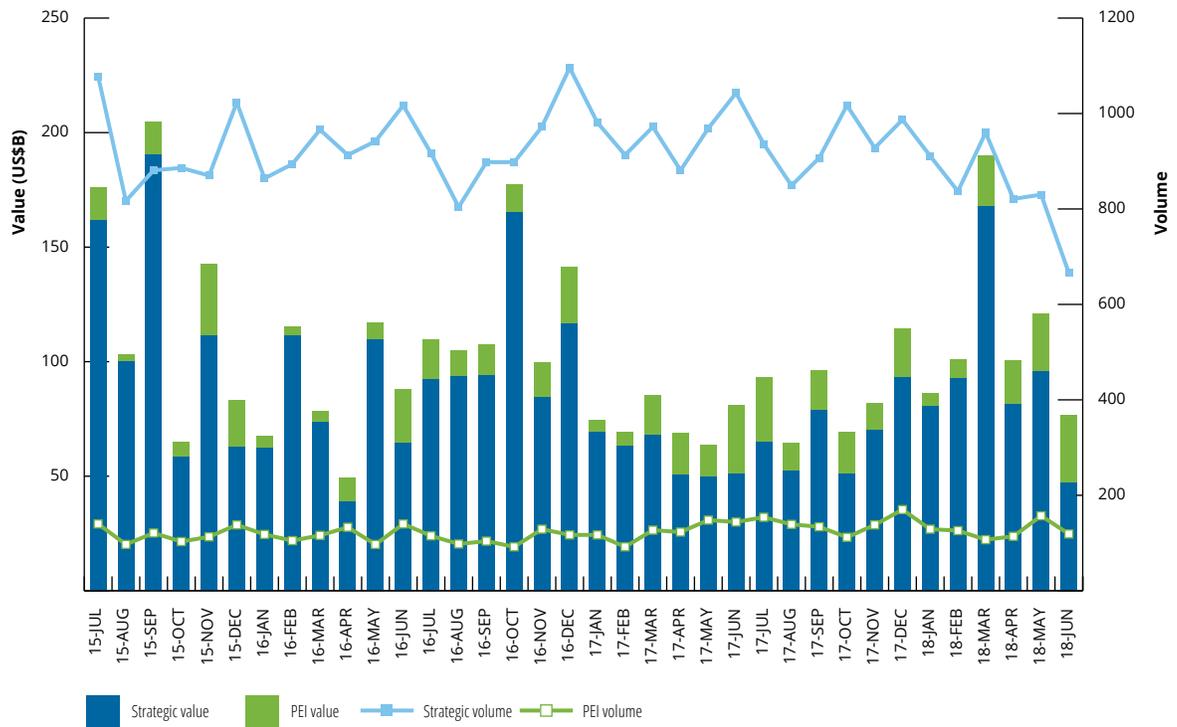
In order to provide effective oversight of cross-border transactions, board members need insight into how macroeconomic forces, industry-specific trends, regional business practices, and regulatory requirements may shape deals that management proposes and pursues. In particular, longer-term M&A trends and 2018 cross-border activity suggest that boards of US-headquartered companies may need to cultivate a careful understanding of transactions that involve investments in countries that are receiving significant attention in terms of M&A transactions,

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⁴*Bridging the boardroom's technology gap*, Deloitte.

Figure 4.

Value and Volume of Cross-Border M&A: July 2015 to May 2018



Source: Deloitte analysis of Thomson Reuters's M&A data, as of September 2018.

such as the United Kingdom, Ireland, Germany, and China. For example, in evaluating a proposed deal, especially one with multicountry integration plans, board members should consider tax policies and practices that may underlie the deal's economic justification: labor and contract laws that may influence talent retention, currency rate fluctuations that may impact the combined company, potential for Foreign Corrupt Practices Act (FCPA) violations that could raise post-close issues, and cybersecurity and intellectual property protection.

An educated board is an effective board

M&A can be one of a company's most strategically important and significant undertakings—no matter the size, a merger or acquisition presents numerous opportunities and challenges that a board should weigh when approving and overseeing its pursuit and execution. Still, considering the risk associated with other ways of executing a growth strategy—green-field construction of a facility in a new market, funding technology

development internally, or expanding into a new product area—M&A is an important strategic option.

An educated board is an effective board. To that end, we suggest that all deal participants—board members, executive management, committee members—collaborate to increase deal review rigor, develop multiple deal scenarios, improve technology proficiency, and apply cross-border deal experience. A good starting point is to work together to answer questions in each of the four focus areas, such as the following:

1. Increase deal review rigor

- When pursuing an acquisition that considerably increases the debt-to-earnings ratio, has the board tested the plausibility of generating the cash necessary to return the company to debt levels that are more manageable and sustainable?
- Has the audit committee considered that off-contract deductions and slow payments by key customers may constrain cash flow and slow the ability to pay down debt?
- Has the compensation committee reviewed and approved the incentive and retention plans for leaders who join the company?
- Does the board across committees understand that departures of key leaders could be followed by turnover among top sales staff, which then may hamper the ability to generate sales and pay down debt?
- Has a committee been charged with identifying the risk posed by the acquired company's IT infrastructure (for example, if its systems are not structured in a way to enforce compliance to customer contracts)?

2. Develop multiple deal scenarios

- What disruptive technologies exist in the market or are emerging that could significantly impact the fundamentals of the deal thesis?
- How sound or risky are the tax strategies being employed for the cross-border elements and what are the implications of various outcomes?
- What financial impact assumptions have the greatest impact on value sensitivity and what can be done in advance to mitigate the potential downsides?
- What if competition intensifies after the acquisition closes? How would management respond to aggressive actions by competitors? What is the plan to retain key accounts?
- To what degree could emerging technologies like cloud computing accelerate the integration, offsetting the risk of a large-scale integration of technology infrastructure and systems?

Has the board considered adding a board-level technology committee, an individual board member with technology experience, or a management-level technology committee that would report to the board?

3. Improve technology proficiency

- Has the board considered adding a board-level technology committee, an individual board member with technology experience, or a management-level technology committee that would report to the board?
- What efforts can the board undertake to infuse technology expertise into its decision making?
- What can be done to spot technology challenges earlier?
- What metrics should be used to evaluate success?

4. Apply cross-border deal experience

- What type of experience has management had in cross-border deals?
- What challenges exist with different regulatory bodies (e.g., European Union, US Federal Trade Commission)?
- Have sufficient up-to-date risk scenarios related to escalating trade conflicts been incorporated into our cross-border acquisition strategy? Especially consider these:
 - The possibility that the performance of the acquired business could be adversely impacted by public policy, trade, and tariffs
 - The potential need to evaluate scenarios like asset divestitures or country exits (embargoed nations) that may be necessary to secure regulatory approval for the deal and the investment thesis
 - Delays in regulatory approval that influence the duration and investment in pre-close planning
- Is there clear understanding of labor complexities in key markets (e.g., German and French work councils)?
- Has the deal team addressed rules around license to operate and complexities around legal entity changes around transactions?

Rebounding deal-making activity and the highly visible nature of deals combined with the increasing confidence of management teams who view their deals as regularly “hitting the mark” point to the need for boards to assert their objectivity and to apply their experience when evaluating and approving potential transactions. As noted in this article, that suggests looking at proposed deals from different vantage points and recognizing areas that fall outside the direct experience of board members. Drawing upon the experience of management teams and board members sets up the productive engagement needed when considering and pursuing acquisitions given the stakes involved. Certainly, positive outcomes work to the benefit of a broad set of stakeholders that benefit from M&A activity including shareholders, customers, and employees.



Larry Hitchcock



Tonie Leatherberry



Joel Schlachtenhaufen



Russell Thomson

[Larry Hitchcock](#) is a principal with the Merger & Acquisition Consultative Services practice with Deloitte Consulting LLP. [Tonie Leatherberry](#) is a principal of Deloitte Consulting LLP and the president of the Deloitte Foundation. [Joel Schlachtenhaufen](#) Joel is a principal in the Merger & Acquisition Consultative Services practice with Deloitte Consulting LLP. [Russell Thomson](#), a partner with Deloitte & Touche LLP, leads Deloitte's US Merger & Acquisition Services practice.



National Association of Corporate Directors
1515 N. Courthouse Road, Suite 1200
Arlington VA 22201
571-367-3700
NACDonline.org