

6. A guide to Mergers and Acquisitions in the UK

Mergers & Acquisitions (M&A) are becoming increasingly popular for the aspiring foreign company wanting to invest in the UK.

Business growth can be achieved in a variety of ways. Organic expansion through marketing and business development – is perhaps the most conventional option, but it may not be the fastest. In addition, growing organically in overseas markets is challenging where local customs, rules and regulations are not fully understood. One, often quicker option, that can avoid the challenges of setting up in a new market, is to either invest in, or buy outright, a business operating in the market of interest.

Today, acquisitions of Western businesses by overseas (buyers are at an all time high, and levels are growing. Foreign companies may undertake M&A for a variety of reasons, including obtaining brands and intellectual property, market access, and market knowledge.

Foreign companies are becoming increasingly confident in their ability to finance and execute deals. And foreign private equity acquirers, those who buy in to a company primarily as an investment rather than as an addition to their existing business, are becoming more established.

Despite the growing volume and value of deals, M&A transactions are not without risks, and proper advice should be sought when contemplating this option. This chapter sets out some of the key considerations. In each of these areas, Deloitte has a specialist team available to assist.

6.1 M&A strategy

In considering whether M&A is the appropriate method to improve shareholder value, performance and market competitiveness, a company should first review its corporate strategy. Corporate strategy makes the company greater than the sum of its business units, and sets out the organisation's direction and goals, business portfolio, resource allocation and growth plans.

A corporate strategy review is critical for success, yet is often neglected by executives under pressure to achieve short term results. One of the primary causes for acquisition failures is a lack of insight into the target company, its core competencies and limitations, and changing market conditions.

The rigorous analysis conducted in a strategy review enables a company to understand its internal strengths and external market conditions, both in its home country and overseas, over the coming few years. This analysis helps to develop a set of prioritised options, such as an acquisition or divestment, to achieve its objectives.

As challenges and opportunities for growth are defined, options to defend, grow, fix or exit can be assessed and prioritised based on the company's goals, capabilities and financial position. Generally, companies can choose from a myriad of strategic objectives such as:

- profitable growth – to increase business breadth or depth through revenue growth, market share capture, margin enhancement or improved asset utilisation;
- skill strengthening – to acquire the necessary talent to remain competitive (e.g. personnel, technology, capability, geographies, etc.);
- portfolio management – to manage a portfolio of businesses in order to maximise existing and evolving capabilities, reduce risk, or reposition a business;
- defensive action – to ward off potential take-over attempts or fix existing business/operational problems;
- opportunistic posture – to capitalise on a unique market/competitive opportunity or a developing business formula; and
- globalisation – to expand market share and sales in international venues.

Depending on a company's strategy, acquisitions may serve as a way to quickly achieve strategic and financial objectives.

6.2 Target sourcing and selection

Once the company has determined that an acquisition fits with its wider corporate strategy, the next phase is to identify potential targets, synergy opportunities and to arrive at a valuation.

Developing a pool of targets

In assessing investment opportunities, a company should evaluate the attractiveness of the sector in which it plans to conduct an acquisition by:

- understanding the industry structure and leverage points, where value can be captured;
- appreciating the market scale, and growth potentials;
- understanding the key players, both domestic and foreign-owned, along with competitive dynamics;
- envisaging any technological trend; and
- identifying entry barriers.

Once the decision is made to pursue opportunities in a sector, the company can begin its preliminary research on potential acquisition candidates.

Developing the acquisition candidate pool

The first step in a target selection process is to develop a long list of potential acquisition candidates. This involves a high-level search based on criteria such as:

- Sector/industry.
- Competitive position within the industry/product mix.
- Revenue/size.
- Market capitalisation.
- Location of operations.

Often a search will come up with more than 100 potential candidates in the long list. These potential candidates will be further screened and profiled.

Sourcing potential acquisition candidates

Finding the right candidate, a buyer or a seller, requires time and patience. A search for a target requires an extensive review of potential candidates before finding one that fits a company's strategic needs, whilst being fairly priced.

A company could identify potential acquisition targets by conducting internal analysis or using its own network. Some business owners would search openly for a buyer whilst others would identify potential candidates through:

- *examining the financial position of potential companies.* Financial problems such as cash shortages or excessive debt may indicate that a sale may be necessary; and
- *investigating the potential company's shareholding and management.* Indications of possible future sales include an owner nearing retirement with no heirs in key management positions, absentee owners, or financial investors potentially interested in an exit strategy.

Defining screening criteria

The criteria used for the screening process should be developed based on corporate objectives and may include:

(i) Strategic and financial criteria

- *affordability* – potential acquisition targets are reviewed in terms of market capitalisation, revenues, net assets value;
- *profitability* – i.e. targets' EBITDA/EBIT, net margin and free cashflow;

- *shareholding preferences* – i.e. determining the desired level of control over the target and defining a criteria for either a majority or a minority shareholding;
- *transaction structure preferences* – i.e. acquisition of shares against assets; and
- *management requirements* – i.e. taking into consideration leadership style, expertise, receptivity to change, compatibility of culture, and modality of management after the completion of the transaction.

(ii) Operational

- marketing criteria: product lines, customer base, brand reputation, geographic area, distribution channels;
- research & development requirements: e.g. licences, patents, research & development centres, product pipeline, research & development expenses; and
- production criteria, such as facilities, labour supply, production techniques and capacity.

Short-listed targets should be further screened to determine:

- their fit into the buyer's current business portfolio;
- their competitive position and future prospects; and
- the value they create for the buyer.

(iii) Collecting target data

Availability of target data in the UK is generally good. UK companies have to file publicly available financial statements on an annual basis. These must be audited wherever a company exceeds certain size limits. For listed or quoted companies, more regular reporting is required and information may be available from investment analyst coverage.

(iv) Prioritising targets

Buyers should prioritise potential targets according to the number of screening criteria the target companies fulfil. This is also an opportunity to establish under what circumstances the company would walk away from one target and move on to the next.

Prior to approaching the target company, additional research and information gathering should be conducted by a financial advisor to provide a more complete picture of the candidate. This would include information on ownership and management teams in the target companies, and include subjective elements such as family situations and succession plans (e.g. the willingness of children to take over the business). Very often, negotiation levers are identified during this process.

An experienced lead advisor will:

- assist in prioritising the targets;
- develop appropriate strategies and tactics to approach the targets;
- prepare appropriate Confidentiality and Exclusivity Agreements; and
- develop the right time frame for negotiations and due diligence.

(v) Synergy expectations

The synergies available can be significant and are often the reason for the acquisition. Synergies can be difficult to quantify and their capture is uncertain. It is therefore essential that they are considered carefully throughout the M&A process.

An initial part of due diligence is identifying potential synergy opportunities between targets and the buyer. Only targets that bring additional value to a company should be considered in an M&A exercise.

A synergy may be defined as the increase in performance of the combined company over what the two companies are already expected or required to accomplish as independent companies. Put simply, synergy is either the revenue enhancing or cost savings achieved by integrating.

Revenue enhancing synergies. A revenue enhancing synergy results in additional revenue above and beyond what the two companies are expected to accomplish independently. Revenue enhancements promote higher returns and facilitate long-term growth more than cost savings, but they tend to be difficult to quantify. Most initiatives that can enhance revenue can be grouped into:

- market expansion: Entering new markets and expanding market share;
- margin improvement , by implementing a better pricing strategy;
- asset utilisation: Enhanced performance through better and more efficient use of existing assets;
- investments: Better return on investment (ROI) on existing investments. For example, the acquiring company has an extensive IT infrastructure which the target company can also access; and
- products and services: Increasing product portfolios and service portfolios by creating better product mixes, or removing a potential substitution option.

Cost saving synergies. Cost saving synergies can generally be categorised into:

- duplication avoidance: Avoidance by consolidating functions on a centralised basis, i.e. shared services, or by combining similar expenditures, e.g. licenses;

- economies of scale: Increased purchasing power, e.g. improved pricing on contract services;
- expenditure avoidance: For instance, avoiding the expense of new distributor relationships or the duplication of existing capacities such as IT systems;
- operational efficiency: Increasing your control of processes, e.g. maintenance scheduling;
- practices adoption: Using technology from the target company, i.e. technology transfer;
- organisational streamlining: Reducing organisational layers and breadth, e.g. spans of control, substitution of external/internal sources; and
- performance realignment: Considering more efficient structures, e.g. centralising certain departments or outsourcing.

Figure 8. Synergy opportunities in various organisation functions and areas

Functions	Opportunities
Supply Chain Management	Reduce Cost of Goods Sold (COGS) through scale and consolidation efficiencies.
Information Technology	Reduce IT costs by consolidating systems.
Customer Relationship Management	Strengthen customer relationships with broader offerings and improved channel positioning.
Finance and Administration	Reduce Finance and Administrative costs by leveraging resources over larger business base.
Product Development	Create end-to-end product and service solutions.
Tax	Tax savings from transaction and resulting enterprise structure.
Human Capital	Reduce HR costs by integrating and streamlining HR processes.
Valuation	Constantly monitor and adjust valuation.
Corporate Real Estate	Realise both quick cost reductions and longer-term optimisation strategies when integrating the corporate real estates of both companies.

Identifying and reviewing synergy opportunities is critical to determining whether a candidate company should be further considered as an acquisition target. Selecting the appropriate target will enhance the performance of the buyer after integrating the entity.

6.3 Valuation

Determining the value of the target to the acquiring company is clearly a key part of the M&A process. The valuation should enable the buyer to avoid paying more than the target is worth.

(i) Financial modelling

Building a financial model is an essential step towards accurate valuation of the target. By going deep into the target's financials, buyers will be able to make well-informed decisions by assessing its real growth potential and associated risks.

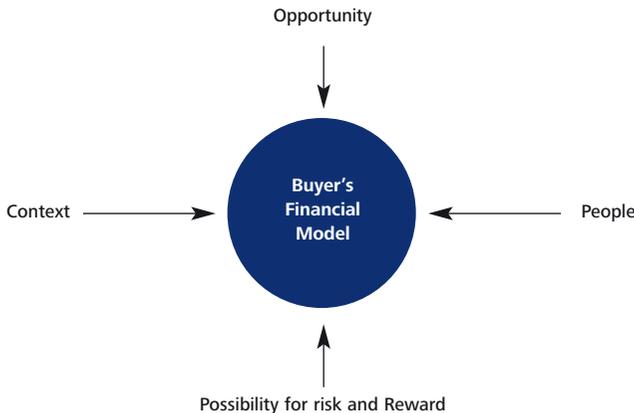
Buyers should compile three elements from the target financials: an income statement, a balance sheet and a cashflow statement with historical, current, and forecasted figures. Forecasted figures should cover at least five years and include three scenarios with different sets of assumptions:

- most likely;
- most pessimistic; and
- most optimistic.

All too often, people take a binary view, either they underestimate uncertainty or they overestimate it and go with their gut instinct. Building three different models (base, good and bad cases) will help to come up with reasonably satisfying forecasts by spreading the risks and adopting a disciplined method.

It is not easy to compose a great financial model. This is largely because the focus is often on inputting figures rather than appreciating the underlying factors. As seen in the diagram below, buyers have to challenge their financial model with at least four major factors that are critical to the success of every new venture: the people, the opportunity, the context, and the possibilities for both risks and rewards.

Figure 9. Four factors to challenge the buyer's financial model



Deriving forecasts when they are not available remains a hard exercise, particularly if the potential target is out of a company's core sector(s). To build a suitable financial model requires buyers to raise the necessary questions, make critical assumptions, and develop an in-depth understanding of the context in which the target operates, for example, is the market rapidly growing? Is the industry structurally active?

(ii) Valuation approaches

Three approaches are commonly used in the valuation of a company. The first approach uses the future cashflow of the company, the second examines market comparables, and the third analyses the balance sheet to arrive at a fair value of net assets. Combinations of these approaches may be used to obtain an appropriate range of fair market value.

Figure 10. Major valuation methodologies

Discounted cashflow Income approach	Market comparison	Net assets approach Balance sheet methods
<ul style="list-style-type: none"> • Discount rate • Growth rate • Terminal value • Margin improvement 	<ul style="list-style-type: none"> • Price/earnings • Price/revenues • Price/net worth • Enterprise value/EBITDA • Enterprise value/EBIT 	<ul style="list-style-type: none"> • Net book value • Adjusted book value • Liquidation value

The above valuation methodologies aim to determine the fair market value, although that sum may not represent the final transaction price. Valuation is an art. While the use of formulas in a valuation implies exactness, it is very difficult to set the worth of a company at a single figure.

To establish a market value, "hard" figures such as historical earnings, cashflow, assets and liabilities are used. But "soft" or subjective figures such as projected earnings, future cashflow, and the value of intangibles (e.g. patents, brands, expertise and leases at below-market rate) are also considered.

The "deal environment" may influence the final transaction price; factors such as the current market conditions, industry popularity, acquisition structure, tax attributes, and the objectives of the seller or buyer often have an impact on pricing.

Indeed, the final transaction price is largely influenced by the eagerness of the buyer to buy and the seller to sell, the demand and supply for targets, the form of consideration paid (e.g. shares, cash) and the negotiation skills of the parties.

6.4 Executing the deal: The diligence process

Having determined that M&A is consistent with the corporate strategy, identified and valued the target, the deal must then be executed. At this stage, identification of key issues within the target business can make the difference between a successful deal at the right price and an expensive failure.

Evaluating the target

It is critical for the company Directors to consider both the risks and rewards associated with a prospective acquisition. In broad terms the due diligence would seek to understand the underlying profitability of the business, the identification of potential liabilities and exposures, and any matters to be addressed in the integration of the target's operations into those of the acquirer.

The scope and depth of the review will depend on many factors, including the complexity, size and geographical spread of the target's operations. It is important that the due diligence is performed by professionals with a balance of financial and sector knowledge.

Due diligence would normally include a commercial review of the market and competitors, a detailed review of the historical financial performance of the business, a review of the target's tax affairs to identify potential exposures and tax compliance, and a robust review of the target's business plans. The due diligence would also cover an assessment of the target's financial reporting procedures and management capabilities. The negotiation of the sale and purchase agreement (SPA, see 6.4 'Finalising the transaction') is a critical part of the process – contractual provisions are built into the SPA to protect the acquirer from the impact of potential exposures identified as part of the due diligence process.

Investigating management

In recent years it has become commonplace for acquirers of UK companies to conduct background checks on the target and senior management (the Subjects) – frequently referred to as Integrity Due Diligence (IDD). These checks seek to identify information that can assist the acquirer both with better understanding the Subjects and identifying 'red flag' information that may be found on public records.

IDD checks on UK targets involve searches through a wealth of UK public record information. Companies House not only holds a company's filings (such as Financial Statements and Annual Returns), but also a list of those individuals who have been disqualified from holding UK directorships. A wealth of information is also held in media databases, which cover both specialist and national press, with some articles even dating back to the late 1980s. Litigation databases are also accessible and, whilst they don't cover criminal records (which are not a matter of public record in the UK), they do cover certain criminal cases heard by the Court of Appeal. Also available to the public are records covering insolvency or bankruptcy and civil debt judgements awarded against a company or individual by a County court.

Assessing the target's operations

In most cases the deal execution starts with an initial understanding of the target via an Information Memorandum (IM). However, the operational due diligence will provide a broader insight into the target's operations as it will allow the acquirer to compare the target's operational performance relative to its industry competitors.

Operational due diligence is increasingly being used by corporations and private equity firms to help identify operational risks and/or opportunities in a target. Typical operational risks might include separating a division from its parent company or the successful delivery of a planned operational restructuring/performance improvement initiative, which often support forecast EBIT growth (Earnings Before Interest and Tax). Operational opportunities identified during a due diligence typically include cost synergies from the post merger integration, or the identification of potential opportunities to deliver performance improvement/cost reduction within the target.

The target's operations are assessed for their ability to support the forecast assumptions that underpin the target's valuation: outputs, costs, quality, delivery, cost savings, management structure and capabilities. The diligence can then be refined and enhanced as access to the target and further information become available.

Considering pension costs

Many UK companies operate large staff pension plans which have built up substantial liabilities over the years. Assets are held by these pension plans in order to meet these liabilities. However, the amount of assets held is often insufficient, giving rise to a deficit in the pension plan. This is the legal responsibility of the sponsoring company.

Pension deficits and the contributions required to meet them are a big issue in UK transactions. A strong Pensions Regulator and the powers of the Trustees who run the pension plan mean negotiations with these additional parties are often required during a transaction to agree upon cash contributions or alternative security for the Trustees. Early consideration of pension issues in a UK transaction is important to avoid shocks later in the process.

Company accounting disclosures for pension plans in the UK appear full and informative. However, the mortality tables used are often out of date and other assumptions can be optimistic relative to the Trustees' viewpoint. High proportions of equity assets also mean the financial positions of plans are volatile. This means comprehensive pensions due diligence is an essential item in a UK transaction process.

6.5 Executing the deal

Deal structuring

A buyer should generally structure the transaction by taking into account the needs expressed by the seller as well as their own requirements. There are many ways to structure and specify terms for a transaction. Essential to formulating the optimal transaction structure, the buyer (with the assistance of a financial advisor) should:

- conduct a scenario analysis on different possible transactional structures;
- evaluate the financial impact on the company for each scenario; and
- identify and determine the appropriate deal structure.

A buyer can either buy the shares from existing shareholders or directly acquire the assets from the target company. Acquiring shares tends to be more popular than acquiring assets because:

- all shareholders of the acquired entity will share the risks of the merger;
- an asset acquisition may require consent from third parties not directly involved in the transaction; and
- tax considerations (see section 'Tax Structuring' below).

In addition to the financial structure of the deal, buyers may also consider management, assets, tax and financing issues, in order to structure the transaction in a way that suits all parties involved.

(i) Continuity in management

The continued employment of management is often subject to considerable negotiation. A buyer often considers the management team as a key asset in an acquisition, particularly if the buyer is a financial investor. Under such circumstances, employment agreements are often negotiated with key people, specifying terms, responsibilities, remuneration, and equity participation. Buyers should recognise that retaining existing management would provide continuity in business operations while slowing down cultural integration.

(ii) Consideration

The consideration a prospective buyer can offer may be in the form of cash, notes, stocks, shareholders loans, or a combination of the above. Since each form of consideration has different implications and liquidity, the transaction price may be subject to further negotiation depending on the form of consideration offered. The two most common forms of consideration are cash and stock. Figure 11 summarises the characteristics of each.

Figure 11. Key characteristics of cash and stock considerations

Key characteristics	
Cash	<ul style="list-style-type: none"> • A liquid financial instrument. • Simple exit for target shareholders. • Increases bid credibility and attractiveness. • Can be paid in instalments – but will create a collection risk and discount for time value of money.
Stock	<ul style="list-style-type: none"> • A less liquid financial instrument, particularly if the company's shares are not publicly traded, or is not liquid enough for a small cap stock. • A less liquid financial instrument, particularly if the company's shares are not publicly traded, or is not liquid enough for a small cap stock. • Increased complexity as there is a need to determine both the buyer's share value and the target's fair market value. • The seller will share benefits and risks of the transaction by: <ul style="list-style-type: none"> – assuming the risk that the buyer's shares are over-valued; – taking benefit of future synergies.

(iii) Contingent payouts

During price negotiations, points of view may diverge on business forecasts. The buyer may believe the growth rate will be lower than what the seller presents. Considering that the price might be based on forecasts provided by management, it is critical to make sure that the figures are as accurate and achievable as possible. One way to break the impasse may be a contingent payment agreement, where additional payments will be made only if the company meets certain pre-defined goals after the transaction is completed.

Before signing any Sales & Purchase Agreement, both parties should understand that there is a chance the deal may not happen for the following types of reasons:

- a potential candidate may receive a better offer after the exclusivity period ends;
- the shareholders of the target company may ask for a higher price; or
- findings from due diligence may reveal new issues or may not meet expectations.

There are many factors that may halt the M&A process. Whether a company will want to search and pursue another target will depend on a number of factors – strategic need, business conditions, morale of the M&A team, and time already spent.

Tax structuring

In any given M&A project, structuring the transaction in a tax efficient manner can add significant value. It is particularly important to ensure that tax advice is fully integrated into the wider deal process, for example to ensure that the planning is appropriately reflected in the deal documentation (e.g. sale and purchase agreement and financing documents).

The detailed structuring advice usually includes some or all of the following features:

- An analysis of which countries the target (and the buyer if the target is to be integrated into the buyer's wider group) is likely to be taxpaying over the next 3-5 years. This often involves building tax models (driven by forecast earnings – see 6.2 'Financial Modelling') to determine in which countries material amounts of tax would be paid (absent any planning), taking into account any tax attributes (and other issues) that may have been identified during the due diligence process. Depending on any given client's concerns, this should assist in forecasting the integrated group's effective tax rate, estimated cash taxes, future earnings per share.
- Advice on the tax implications of acquiring assets or shares (or a combination). This is an area where other considerations (egg legal, regulatory).
- Advice on holding company jurisdictions and minimising tax leakage, for example withholding tax mitigation on interest and dividends on repatriation of profits to the buyer (and onwards to its shareholders) and the impact on the buyer's own tax position in its home country (egg availability of double tax relief).

- Advice on integrating the target into any existing group (which often results in ideas for a post-acquisition 100 day plan), for example a review of the new group's transfer pricing policies, tax efficient supply chain management, cash pooling and group treasury functions, planning around intangible assets (egg intellectual property), effective tax consolidation, opportunities for tax credits (egg research & development credits available in many countries) and key compliance/tax risk management features of the new structure.
- Advice regarding financing the acquisition tax efficiently, including issuing stock as consideration to sellers and/or taking on third party acquisition debt. Where there are third party lenders, they sometimes require reports (common where the buyers are financial buyers) to satisfy themselves that the structure is tax efficient (egg effective tax relief for interest on acquisition debt) and that there are no restrictions to their debt being serviced.
- Mitigating acquisition costs, including VAT on transaction costs, tax deductibility of transaction costs, transfer taxes (shares & real estate) and capital duty.
- Anticipated exit strategies and sales of non-core businesses. Often, a client's strategy includes selling off non-core businesses in the target group in the months following an acquisition. Setting up an acquisition structure that is flexible to achieve a range of possible exit scenarios is a crucial part of the advice. Many European jurisdictions have tax exemptions for sales of subsidiaries in certain circumstances, so planning upfront can often result in non-core businesses being sold tax efficiently (often tax-free).
- On multi-jurisdictional transactions (egg for European groups), taking responsibility for integrating advice from tax advisers across multiple jurisdictions to ensure that the end product is complete and covers all of the areas necessary.

Overall, tax considerations must be integrated into other areas of the deal. For example, all of the above structuring has to be achievable within the legal framework of the jurisdictions involved, so ensuring that tax and legal advisers work closely together enables a complete and workable solution, as opposed to one that works for tax but which is not capable of being implemented for legal reasons.

Financing

(i) Optimising the target's finances

The level of investment that needs to be made in working capital for UK businesses varies tremendously between different sectors. This is driven by a combination of the nature of the product and its supply chain, the commercial norms in the sector, and the power balance between a business and its customers and suppliers.

Payment terms are part of the commercial arrangements between companies; although negotiations are often based on sector standards and practice as opposed to legislation. There is however legislation in place to claim interest on late payments with small businesses having the additional benefit of being able to challenge grossly unfair contract terms.

There are a number of payment methods employed, ranging from cash to electronic fund transfer. Direct debit payments have become widely used which give a higher level of assurance that payments will be made on time for the correct amount.

Larger businesses are increasingly using shared services or outsourcing to manage the administration of payables and receivables in their business. These operations tend to be situated offshore, although some are being moved back to the UK.

It is relatively common practice for companies to have a year end push on working capital to ensure that the reported numbers are looking as favourable as possible. This will typically involve chasing customer payments through phone calls and delaying supplier payments until the following month.

(ii) Raising debt to finance the deal

The banking market in the UK is large and well developed. The most dominant participants in lending to businesses are generally banks which have a large high-street presence and a strong retail deposit base.

Corporate banking departments provide companies with the full range of banking services and are relationship led. Many banks have dedicated acquisition finance functions which support the active private equity industry, providing debt finance for leveraged buy-outs. In larger transactions, debt finance will be led by an arranging bank or banks that will subsequently syndicate the debt to a group of participating banks. The UK financial markets are amongst the most sophisticated in the world. As such, they support the issuance and secondary trading of a wide variety of debt instruments, in addition to traditional bank debt such as bonds, convertible bonds, private placements and interest rate and foreign currency hedging instruments.

Negotiations and the role of the lead advisor

The lead advisor plays a key role in the negotiation process. In addition to managing the many professional advisors involved, including legal advisors, accountants, tax advisors and valuers, the advisor provides negotiation support throughout the deal execution. In supporting the buyer, an experienced lead advisor will generally help to understand and evaluate risks, advise on deal structuring techniques as a competitive advantage, consider the maximum purchase price that can be paid for the target, and compare the premium with the expected value creation to maximise shareholder value.

During negotiations, the lead advisor generally should support a buyer by:

- developing the initial strategy to be applied to kick off the negotiation process;
- mapping the sequence of steps to be used in the negotiations;
- advising on the transaction details proposed and counter-proposed;
- developing responses to counter-offers made by counter-parties.

Finalising the transaction

Often a business that is for sale will be auctioned; a process whereby the investment banks will solicit interest from prospective buyers. Bidders will be asked to give an indicative (non binding) price based on limited information. And, if their price and ability to deliver the transaction are acceptable, they will be allowed through to a later round in the auction with a smaller number of participants. It is important to specify your assumptions in these offer letters, for example, “this price assumes that the business is trading in line with budget”, as any subsequent downward changes in the price you offer may need to be explained and justified if you are to win the auction.

If you are the successful bidder, the sale and purchase agreement will set out the mechanism for finalising the price payable for the business. Often this is only determined after completion, by reference to a balance sheet at that date. The definitions of the items that are to be included in the calculation (such as cash, debt and working capital) and the accounting policies to be applied in their valuation can have a significant impact on the final price. Hence this area needs to be approached with particular care.

6.6 Post deal integration

Having concluded the transaction, integrating the target ensures that the value envisaged throughout the process is actually realised. Failure to integrate acquired businesses is one of the most common reasons for failed acquisitions.

Integration planning and strategy

The integration and reorganisation aspect of the M&A process is often the longest and the most challenging. Studies show that about 85 per cent of mergers do not realise value as expected due to integration problems. M&A surveys conducted by Deloitte found the following:

- synergies are not achieved in 60 per cent of cases;
- only 23 per cent earn their cost of capital;
- 47 per cent of executives leave in the first year of integration; 75 per cent leave by the third year;
- productivity in the first four to eight months is generally reduced by 50 per cent; and
- when value is not created, poor integration is to blame in 70 per cent of cases.

Realising the value of an M&A deal will depend on how the buyer addresses and mitigates integration risk factors, and how the buyer manages an extremely complex integration project.

The importance of integration

Merger integration and reorganisation is a complex exercise. It entails change in all functions, simultaneously, with inter-dependencies that have to be managed day-to-day in an environment where people are anxious about their futures. Integration generally involves though is not limited to:

- strategy and organisational consolidation;
- business process standardisation;
- human resources integration; and
- information technology infrastructure integration.

When integrating two business organisations, the merged entity needs to ask a number of organisational and operational questions:

- What is the best structure for the new entity?
- What can be done to facilitate a fast and successful integration?
- How can a company ensure a successful Day One operation?
- How can a company identify and capture merger benefits?
- How should the changes within the organisation be managed?
- What can be done to minimise potential conflicts among locations during the integration?
- How should processes be redesigned to capture integration benefits and support IT implementation?
- How will products and infrastructure be integrated?
- Do people have the skills and capabilities required to perform in the new organisation?

An important determinant of merger success is the ability to develop and execute an integration plan that addresses these issues.

Figure 12. Types of integration approaches

Integration approach	Status quo	Take-over/Reverse take-over	Best of both
	Merger or acquisition with minimal integration, perhaps only for financial reporting purposes.	Outright acquisition and integration of target into buyer.	Merger or acquisition focused on integrating the best people, processes, products/services, and technology of both companies.
Level of integration	Low.	Medium.	High.
Level of synergy potential	Low.	Medium.	High.
Level of risk to be managed	Medium.	High.	High.
Pros	<p>Fast and limits debate.</p> <p>Strengths of both organisations are retained.</p> <p>Minimal interruption to each business.</p> <p>Limited resources required for integration.</p>	<p>May be able to incorporate a significant portion of the strengths of the acquired.</p> <p>Effective at capturing near-term synergies.</p> <p>Effective at gaining upside.</p>	<p>Combined company benefits and supports consensus building.</p> <p>Allows identity of acquired company to remain visible in the new company.</p> <p>Generates feeling of worth among acquired employees.</p> <p>Maximises synergy retention.</p>
Cons	<p>Limits cost synergy capture</p> <p>Limits interchange of culture and skills.</p> <p>Requires coordination processes for overlapping, market-facing areas.</p> <p>Worst practices of both companies are retained.</p> <p>Limits potential for revenue synergy.</p>	<p>Potential risk in losing acquired capabilities and customers.</p> <p>Potentially alienates acquired employees and reduces productivity.</p>	<p>Time-intensive. Must make key integration decisions quickly.</p> <p>Risk of choosing lowest common denominator rather than best practices.</p> <p>Best from both can be hard to define: 'Best' accounting system may not work with the 'best' billing system which may not work with the 'best' customer management system.</p>

Capturing synergies

Synergy capture should preferably be analysed early in the integration process to build momentum and credibility amongst employees, investors and analysts. A 'prioritisation exercise' should be performed with the initial focus on the high-end, quick-hit projects because these generate the greatest momentum. For each individual, synergy-capturing project, the integration team should develop a plan with detailed tasks, milestones, dates and accountability so that expected results can be monitored and achieved.

Talent retention

(i) Understanding the people issues

Buying a business brings many challenges from a people perspective. These vary from understanding the pay, benefits and grading structure of the target business, to integrating the new people.

During the transaction process, it is essential that employees of both target and acquirer feel they are being kept informed. Regular communication from management is important, which can be done by written or web-based materials, and/or employee presentations.

It is important to consider the structure of the new business from a people perspective, both in terms of organisation and structure, and also where people will fit and what their rewards will be. This will help to retain and 'lock in' key people, ensuring they are motivated and aligned to the goals of the new organisation. If this is not done successfully, then the business risks losing its key staff and thereby potentially risks losing its ability to deliver the anticipated benefits of the acquisition.

The execution of successful HR policies does not end at the date of the transaction; they should be regularly reviewed to ensure that the new arrangements are supporting the organisation to help to deliver business performance.

(ii) Retaining key talent

Key talent from the target must be identified in the early stages of the M&A process, preferably during due diligence or as soon as possible after the signing of the Term Sheet. It is customary to request the target to have agreements in place to retain key talent for a defined period, typically for at least six months to one year. A broader use of retention incentives can also be applied, and may take the form of individual incentives based on individual talent and attrition risk, or a group incentive linked to performance to support the integration effort.

(iii) Redundancy and severance

With any integration, inevitably there will be redundancies in the organisation. These redundancies need to be handled with care, as it is an extremely sensitive topic. Assessments should be conducted to ensure the right people are retained, and a programme should be in place to provide new opportunities for redundant staff. For staff who are made redundant, appropriate severance packages must be provided in accordance with local regulations. It is often invaluable to compile a headcount baseline on closure of the deal to understand who is in the business and which function is responsible for them, and against which to track changes throughout the integration.

Financial planning and design

(i) Finance and administration integration

In a merger, the finance function creates value by partnering with business units and provides leadership throughout the process so that the new organisation can realise value. The challenge is in capturing the benefits from integration without negatively impacting financial performance. Integrating finance functions could involve redesigning and/or integrating processes, implementing shared services, and building a strategic platform of new processes.

(ii) Engaging external service providers

It is beneficial when implementing shared services or engaging in business process re-engineering to engage external service providers for assistance. Establishing shared services centres and re-engineering processes is complex and time consuming, and requires a significant amount of resources and skills. As the process involves changing the way employees currently perform their duties, external service providers can bring objectivity to the project. They serve as a temporary resource and their experience in local requirements and culture, their proprietary tools and knowledge base are valuable.

Communicating the deal

Different messages are required for different stakeholders of the acquirer and target organisation. By developing separate messages and delivery formats (e.g. open forum meeting, official letter, memo, e-mail, newsletter and media), effective communications can be achieved. Key stakeholders of the acquirer and the target company may include:

- customers;
- internal staff;
- sales prospects;
- alliance partners and service providers
- business forums and media; and
- regulatory bodies.

Critical success factors in your communications strategy are:

Communicate early and often. It is nearly impossible to over-communicate during a merger or acquisition. Constant communication – even if it is a repetition of the same message – prevents uncertainty.

Communicate openly and honestly. Tell employees as much as possible, even if it means saying, “I don’t know” or “We are still looking into that”.

Communicate consistently, both internally and externally. Employees will compare notes. Make sure that everyone is receiving the same message to create trust. Employees will also listen to the media. Public messages should not be different from internal messages. This means delivering the tough messages to the staff at the same time as the “good” messages to shareholders.

Communicate proactively. Telling people that things are not changing is still valuable communication. It is important to deliver the right message to employees.

Communicate face-to-face. Employees are more open and receptive to face-to-face communication. Face-to-face communication provides the opportunity for immediate feedback from employees which can be used to tailor future messages. This also sets the tone for how important the integration is to senior management.

Performance culture

Communications and culture are two intrinsically linked issues and as such, they need to be managed together. Addressing the communications needs of employees through each phase of the integration from the onset of the official merger announcement can help address potential culture issues and humanise the merger. Poor attention to communications and insufficient focus on addressing culture can be very damaging to the integration.

Figure 13. Examples of merger issues

Issue	Merger integration results
Management disagree over control and differences between culture deemed too difficult to effectively overcome.	Deal cancelled.
Cash over culture and management control.	Divestiture of the acquired company.
Stiff imposition of management control over the acquired company and integrating new multinational workforce with distinct cultures.	Departure of key managers.

Communications is one of the most difficult aspects of merger integration and especially so where the integration is cross border. The organisations' management styles, culture, priorities and mindsets may differ significantly and management decisions may not be communicated across an organisation.

Designing a change management and communications strategy that takes into consideration the culture of the target company is important in an M&A exercise. A well-developed strategy will help minimise the integration risk while creating an adaptive operating style for the long term.

There are four steps to gaining an understanding of the culture of the acquired organisation and developing a plan to address it:

- (i) Understand the target's current operating style. This can be achieved by administering a culture diagnosis with leadership involvement, conducting interviews and analysing results.
- (ii) Determine the future operating style of the merged organisation. It is beneficial for senior management in the merged organisation to conduct an end-state workshop to identify long-term strategic cultural and business objectives, and conduct an operating gap assessment.

- (iii) Develop a plan to narrow the gap. A change management plan that involves communications and initiatives should be developed to ensure that key objectives and the intended culture can be obtained. The new organisation should select leaders, who may or may not be managers, who are influential within the organisation and obtain their 'buy-in' to kick start the culture and strategy alignment process.
- (iv) Implement solutions and monitor progress. Before commencing operations integration, it is helpful to communicate the vision and strategy of the new organisation, according to the change management plan, to all employees. Broadly communicating the changes taking place will help to alleviate concerns and set appropriate expectations. It also ensures that all levels of the organisation get the same unfiltered message.

How Can Deloitte Help?

M&A offers significant opportunities, but clearly there are risks associated with every deal. The key is to plan thoroughly and execute effectively. Few organisations possess all the skills necessary to ensure best practice in every transaction, but even those that do, usually take independent advice to get a second opinion.

Deloitte offers the broadest range of services in M&A, from origination to integration. Our specialist teams offer deep functional expertise combined with broad sector experience, and our global network offers the coverage even the most ambitious buyer might seek. No matter whether you are thinking or buying or selling, borrowing or lending, expanding or contracting, we are well placed to advise.