Management and the Board: A Crucial Relationship in M&A

*by Michele Rutigliano**

In acquisition operations, the buyer generally estimates the synergies generated by the aggregation of the two entities. This is a component of the value attributed to the target company that often represents a non-negligible percentage of the overall estimated value. On this point, there are some who believe that this component of value is very rarely confirmed ex post following the actual integration, and thus that management makes such estimates with excessive optimism in order to justify the operation to the Board of Directors, shareholders, and stakeholders in general, and that as a consequence numerous operations do not create value for the shareholders, or perhaps even destroy value.[1]

I believe that any attempt at generalization on the question, or to reach any a priori conclusions, is unacceptable, for three simple reasons.

1. The case history of M&A operations is so vast and diversified that it does not allow for any convincing synthesis.
2. A response could be given only with reference to specific cases, knowing in detail how the synergies identified were estimated and to what extent the post-integration evidence confirmed those estimates or not. This information is often not available, especially with reference to the results of integration, and when it is available, it is not immediate but appears on a long-term horizon, that is variable in the different cases.
3. Deriving an evaluation of the reliability of the estimated synergies, and thus of the plausibility of the

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transaction price, based on the (potentially negative) reaction of the stock market to the announcement of the acquisition – when the buyer is a listed company – is an unacceptable simplification. It is unreasonable to think that analysts and investors in general have more and better elements than the bodies of the acquiring entity to rapidly evaluate, with an ex ante view, the ability to achieve the estimated synergies in anything but a short-term perspective. That way, moreover, only listed entities would be considered, necessarily excluding all of the operations that involve unlisted companies (most of them).

This brief introduction must not however lead us to believe that the estimate of synergies proposed by the buyers is for the most part reliable and in general sufficiently realistic. To the contrary, it is reasonable to suspect that internal estimates can at times be conditioned by the desire to justify the transaction, with the support of advisors who are not always neutral in regard to the conclusion of the operation. It is thus advisable for estimates to be produced, to the extent possible, with a rigorous, reliable, and above all more transparent methodology with regard to the BoD, following an effective model of governance.

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TRANSPARENCY OF THE ESTIMATE OF SYNERGIES WITH REGARD TO THE BOD

It should be immediately stressed, however, that an initial estimate of the acquisition value is often made in the presence of information that is partial and fragmentary, and itself the result of estimates, in the absence of detailed information on the industrial plans of the target companies and before being able to conduct accounting, tax, and legal due diligence; information that sometimes could be available during the course of the relationship that develops with the counterparty and based on the nature of the operation and the relationships between the two entities. It follows that the initial estimate of the synergies also reflects the limits of the information base. Yet it is important for the decision-making process, that is divided into various phases, to demonstrate the degree of reliability of the estimates (that hopefully tends to increase), gradually allowing the management body and the other committees, including the supervisory body, all as per the matters under their own competence, to properly evaluate the relevant operation.

Taking these aspects into account, the management must certainly present a possible acquisition price to the corporate bodies, that is prudently estimated and attributes the appropriate value to possible synergies deriving from the acquisition to the extent possible to infer from incomplete information; provided that the corporate bodies are made aware of the intrinsic limits of the estimates and the effects of various assumptions in the area of a sensitivity analysis of the values. Having thus summarily outlined a transparent acquisition process, it is necessary to reassess the role of the potential strategic importance of the operation, which does not mean attributing a secondary role to the quantitative estimates, but rather remembering that, in an evaluation in conditions of uncertainty and in the presence of limited information, the management and strategic supervisory bodies must however exercise their decision-making prerogatives in light of their own knowledge of the company, business, sector, and any further options that the completion of the operation could allow. The board cannot always make decisions based only on the algorithms proposed by business finance, that are useful – actually, indispensable – technical instruments, but to be considered in the real life situation of decision-making processes and consistent with a well-argued prospective view, that in some specific circumstances could exceed strictly quantitative evaluations.

We therefore stress the centrality of the issue of transparency towards the BoD on the part of the departments required to prepare M&A and investment operations, with respect to assumptions, the quality and quantity of information, and the degree of declining, but still-present uncertainty; all elements that characterize the estimates proposed in the various phases of the decision-making process until the formal resolution. Obviously, the estimated synergies will never be exactly confirmed in the values measured subsequently, even if they were evaluated *ex ante* with the best comprehension of the processes and actions necessary to produce them. The post-acquisition management must implement all actions aimed at taking advantage of the expected synergies to the greatest extent possible, often based on the evaluations of convenience that justified the operation at the agreed-upon prices, and it should be hoped that they provide detailed reporting to the corporate bodies on the results of the integration process, not as part of the overall accounts with a broad perimeter that does not allow for evaluating the results of the operation *ex post*.

Establishing procedures that impose such levels of

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transparency should favor acquisition decisions at prices that acknowledge shares of synergies for the counterparty at the lowest level possible, while however acceptable in light of the negotiating dynamics. Otherwise, the seller would immediately obtain a significant anticipation of value that the management will have to commit to generating for amounts that are not certain, and certainly different from those anticipated, and in a timeframe that is not easy to predict, also in relation to the type of synergies expected.

Completeness and transparency of estimates are necessary in order to make decisions, but are qualities that are often insufficient, not necessarily due to management's intention not to give the bodies greater details on the expected results, risks, and uncertainties of the estimates. This may be common due to inadequate sensitivity of corporate bodies with regard to the complexity of the proposed operations and the evaluation processes on which the estimation of the acquisition values is based. So, there is also a significant and more comprehensive issue of governance that does not favor the quality of decision-making processes.

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INTERNAL TRANSPARENCY ON THE SHARING OF THE VALUE OF SYNERGIES

From a methodological standpoint, the estimation of synergies would theoretically, but I would say abstractly, require evaluating the two entities separately, to then evaluate the two entities when integrated, and lastly to calculate the difference between the value of the integrated entities and the sum of the value of the two entities considered separately. Yet it seems evident that this is de facto equivalent to giving up on the analytic estimate of the various components of the synergies, since the estimated cash flow for the entity resulting from the aggregation does not require and does not foresee having to detail its composition. Therefore, from the perspective of managerial evaluations and the actions that will have to be taken to identify the single sources of synergies and then implement the interventions to achieve them, it does not substitute that more targeted analysis that becomes necessary in every real acquisition operation. This approach is thus in a certain sense uselessly complex, and in another sense, simplified. It is complex because it requires three estimates, including that of the same buying entity, with the concrete risk of a summation of evaluation errors, or at least of significant approximations, due to the numerous parameters, assumptions, and predictions necessary. It is simplified, with respect to the goal of estimating synergies, because it is unlikely that the evaluation of the entity deriving from the aggregation will go into a level of analysis sufficient to allow for distinctly identifying the single categories of synergies, with an evident loss of information relevant for management, which would actually make it little useful to classify them as specific components of value manageable and monitorable by the management and the corporate bodies.

Therefore, in practice the estimated synergies and dyssynergies are generally algebraically added to the estimated stand-alone value for the target in order to contribute to the determination of its acquisition value, to be understood as the maximum theoretical price, considering that the creation of value for the shareholders of the buying entity evidently derives from a (positive) difference between the acquisition value and the price paid. Thus, the issue of transparency usually arises, obviously only within the buyer's organization, concerning the sharing between the two entities of synergies estimated as deriving from the acquisition. In this regard, we repeat that full transparency towards the strategic supervisory body regarding evaluation aspects of the acquisition could offset a potential excessive optimism implied in proposals coming from the management body that could prospectively be considered unable to ensure the creation of value.

To summarize, the stand-alone value should be subject to addition/subtraction of the following algebraic sum, in macrocategories, the amounts of which must be calculated net of taxes since they are considerable:

+ synergies on personnel costs;
+ synergies on administrative costs;
+ revenue synergies;
- cost and revenue dyssynergies;
+ financial synergies;
+ tax benefits;
± other potential synergies/dyssynergies;
- integration costs.

Cost synergies must be estimated in current values considering all of the main differential components that can be reasonably attributed to the acquisition based on the timeframe for actual execution, considering that it is unlikely for benefits to be felt immediately. The theoretical time horizon will be the same

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used for the estimate of the stand-alone value of the target (unlimited or limited), as it is not methodologically justifiable to consider a different period, without prejudice to the fact that the period in which those synergies are excepted to actually be realized could be much shorter, if temporary and permanent synergies are identified separately.

The situation is similar for net revenue synergies (synergies net of dyssynergies), whose degree of uncertainty is generally considered higher, with a consequent impact on the discount rate. The quantification of financial synergies is more difficult, as these are based on assumptions whose manifestation is for the most part outside of the control of the acquiring entity, and thus, if anything, it is reasonable to draw up a potential estimate only to enrich the information picture for the deciding body, while prudently not considering the value obtained as a realistic component of the acquisition value, also for the purpose of negotiation with the counterparty. The calculation of tax synergies, on the other hand, is less uncertain, provided there is the assumption of constancy of the relevant tax laws.

The estimated synergies thus represent a component of value attributed to the target company that can be shared to a certain extent with the counterparty following the negotiation process, granting a premium with respect to the stand-alone valuation. In the preparation phase it is also important for management to estimate the timeframe in which the anticipated synergies will allow for recouping that premium, for example calculating the financial breakeven period or payback period, as an indicator of the implicit risk in the percentage of sharing of synergies proposed and then agreed upon, a risk that obviously grows with the increase of the premium:

$$\text{Premium} - \sum_{t=0}^{p} \frac{SIN_t}{(1+k_e)^t} = 0$$

where:

SIN_t = net synergies estimated by the buyer for the year *t* (it is reasonable to assume that initially the integration costs will be greater than the synergies, and thus SIN<0);

k_e = discount rate;

p = unknown, payback period, and thus the number of years necessary for the estimated net synergies, at the current value, to allow for recouping the share of synergies granted to the counterparty.

Since the synergies estimated, and in part recognized in the offered price, generally represent the most uncertain component of value, in terms of amounts and times – since they are to be achieved with the subsequent maximum future commitment of all of the company functions involved, added to the commitment to achieve the goals already implicit in the expected results of the stand-alone acquired entity – it is evident that periods of breakeven/recovery of the premium that are relatively long weaken the credibility of the estimate and lead to greater prudence in defining the offer, or potentially to even abandoning the operation.

REPORTING OF SYNERGIES TO THE BOD

In M&A operations, it is not rare for there to be moments of periodic and transparent reporting on the synergies to be provided to the BoD, as the strategic supervisory body. But even before the realization phase itself, realistic estimates must be presented to the Board, that are supported by the most detailed post-acquisition information available, and the deviations with respect to the initial estimates that contributed to defining the offer price need to be adequately justified.

These moments of reporting undoubtedly represent a significant commitment for management but are absolutely necessary in order to confirm the value of the acquisition, evaluate the reasons for deviations and difficulties encountered, and the capacity of the M&A function, and of the management in general, to estimate these components of value *ex ante* and reasonably. This way the management body will also be able to determine if and to what extent the acquisition was essentially guided by the corporate bodies – starting with the CEO if that individual is also in charge of managing extraordinary transactions – with motivations not clearly linked to the goal of creating value for the shareholders, all evidently also in the interest of those shareholders of whom the body is a direct expression. On the other hand, it is evident that it could be excessive to require periodic reporting scheduled over the time horizon used for the managerial evaluation of the synergies; periodic reporting that is limited in time is sufficient for the purposes in question, without particular needs and situations that allow for shortening or require extending the monitoring period.

As regards the shareholders and the role of the Shareholders' Meeting in particular, a detailed operational model for the phases of prediction, sharing, and reporting would allow the BoD to give a prompt response in the Shareholders' Meeting regarding the reasons for and results of the acquisition, that if particularly significant, could be the subject of specific requests for adequate information to be reviewed by the shareholders.

The reporting model should evidently replicate in detail the one used for the estimates made by the com-

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petent offices at the moment the operation is drawn up, highlighting the following elements line by line, as typically takes place in the budgets presented to the corporate bodies: estimates, final costs, deviations, forecasts, and comments. In the absence of these elements, the acquisition process is incomplete and self-referential, and the corporate bodies would have responsibility but not control. Management that is engaged in a project of integration, that may be organized in a Project Management Office (PMO), should thus be given specific responsibilities for achieving the estimated synergies, reporting to the corporate bodies as indicated above. And it is evident that the degree of examination that characterized the estimation of the synergies in the pre-aggregation phase, that is necessarily and demonstrably corrected in the initial period after the acquisition based on the most precise information available, not only makes the estimate more precise – to the extent possible – but also imposes a more responsible involvement of management in the realization phase, more targeted verification and reporting regarding the reaching of the goals, and more precise monitoring of the administrative and control bodies, each as per their own responsibility.

We cannot hide the fact that in the reporting phase it is not always easy to concretely distinguish the results obtained that derive from the expected synergies, based on specific planning and responsibility assumed by the management, from results that depend on independent market or company variables, whose economic effects would have appeared anyway and are not traceable to the category of synergies and the actions planned. It can be held, though, that it is not necessary to attempt to separate the two effects in the useless search for difficult precision; reporting will be usefully classified under an analysis of the favorable or unfavorable scenarios in which the management of the process of integration is carried out, thus allowing, from this standpoint and from a performance attribution standpoint, for sufficient qualitative evaluations, as is always the case when comparing targets, budgets, and final costs.

[1] *This and other issues for discussion are addressed in the book: M. Rutigliano (edited by),* Temi di valutazione d'azienda. Letture e casi, *Milan, Egea, 2022.*

SYNOPSIS

- There are some who doubt that significant synergies can be achieved in acquisition operations, but generalization is not legitimate given the broad case record, the need to refer to specific cases, and the impossibility, in the case of listed companies, to determine the reliability of estimates based on stock market reactions. The estimates made by the management of the acquiring company, though, could be influenced by the desire to convince the board of the convenience of the acquisition. Thus a rigorous methodology for ex ante valuation is needed, that ensures responsibility on the part of management and the proper value of the role of the BoD.
- A central aspect is that of the completeness and transparency of the estimates in regard to the BoD, so that it can decide based on the best information available. The initial estimates reflect the limits of a partial information base; the board's perspective, however, must not be limited only to quantitative evaluations, when the strategic importance of the operation is evident. It is also important for the board to have a clear idea of the share of estimated synergies that is to be transferred to the counterparty in the agreed-upon price, meaning the "premium" with respect to the stand-alone value of the target, and that there be an estimate of the "payback period" for that premium through the anticipated synergies.
- Each acquisition operation must be followed by the relative reporting provided to the BoD, according to an operational model that must replicate the one used to develop estimates on the synergies. This phase implies involvement by management in measuring and communicating the reaching of goals, the reasons for deviations, and the considerations on the difficulties encountered. Only this way can the necessary dialectic with the board be developed, giving the proper value to its role as a body exercising strategic supervision.

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