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Sharpening the Board's Focus on M&A Due Diligence

Whether an acquisition is a stand-alone, complementary entity or an integration, the due diligence process is undergoing a paradigm shift due to the higher cost of funding and the impact of failed transactions. Boards should expect a more aggressive focus on due diligence.

How has the due diligence process changed in recent years? For sure, the complexity of certain topics, such as environmental impacts, the supply chain, cybersecurity and data privacy, has increased. When COVID-19-triggered border closings and government lockdowns precluded in-person meetings, the data-gathering process underpinning dealmaking was driven by videoconferencing. That practice continues in the post-pandemic world to increase efficiency, consistent with the high-touch, high-tech hybrid approach so prevalent in business.[1]

But the more important shift is due to cheap money becoming a relic of the past. It enabled buyers to raise funding to execute deals, putting sellers in an advantageous "sellers' market" whereby they could emphasize speed and competition by limiting the time available for buyer due diligence. As the cost of capital rises, however, sellers' influence over due diligence wanes and the mergers and acquisitions (M&A) space shifts toward a "buyers' market," which allows buyers to exert more control over the scope of the due diligence process. Thus, traditional due diligence has given way to a risk-based approach that considers the higher cost of capital and potential issues that could frustrate the combined entity's achievement of the value expected from the acquisition. This shift in due diligence is toward a deeper dive into several areas through more focused questions.

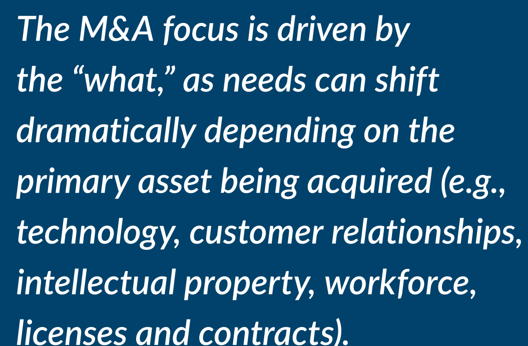
[1] "Adapting to the 'New Normal': Best Practices in M&A Due Diligence," by Richard Summerfield, Financier Worldwide, June 2022: www.financierworldwide.com/adapting-to-the-new-normal-best-practices-in-ma-due-diligence.

In the discussion below, our intention is not to add yet another list of questions to the literature. Rather, our focus is to suggest the most important questions directors should ask during the due diligence process in specific areas. Fundamental to the process is the “primary asset” question: *What are we buying?* Answers to this question influence so much of the deal preparation, due diligence, and integration and separation planning and execution processes that it must be answered early and repeated often. The M&A focus is driven by the “what,” as needs can shift dramatically depending on the primary asset being acquired (e.g., technology, customer relationships, intellectual property, workforce, licenses and contracts). Key questions include:

- What is the primary asset acquired in this transaction? How does it support our strategic objectives? Are we buying capabilities or seeking cost synergies?
- What asset-specific considerations do we need to make? How is the due diligence process affected by these considerations?
- Could we develop this primary asset more cost-effectively if we built it ourselves?

With this context, we address six areas of interest. We acknowledge that there may be others.

Supply chain resilience. With the pandemic exposing the fragility of global supply chains, third-party evaluations have become increasingly important. In this post-pandemic world, there is a need to evaluate all aspects of a supply chain that the target may use going forward. This means careful assessment of worst-case scenarios and structuring the diligence questions to focus on them, given the target’s supplier and third-party dependencies, and reviewing documented, actionable response plans and established accountabilities for the execution of those plans. Relevant questions include:



- Who are the target’s key suppliers, and do vulnerabilities exist within the supply chain looking all the way upstream to second- and third-tier suppliers, considering financial stability, concentration risk and potentially disruptive bottlenecks to inbound logistics?
- What is the target’s global footprint, and how could it impact the supply chain? Where are materials-handling processes being administered? What contractor or talent relationships are in place, and how do they work together with the materials supply chain?

- Are there any sustainability or social responsibility issues embedded in the target's supply chain that are not aligned with our company's values and could present post-acquisition reputational issues?
- Are there potential value-creating synergies between the target's supply chain and our supply chain that will facilitate future growth?
- If the transaction is an integration, can major supplier contracts be voided post-acquisition to realize expected savings and efficiencies?
- What are the target's other significant third-party relationships, and do the contractual relationships with them present any post-acquisition concerns?

Due diligence of talent can identify risk, enhance transaction value and provide integration clarity and direction.

Talent pipeline and retention. Due diligence of talent can identify risk, enhance transaction value and provide integration clarity and direction. While attrition rates have returned to historical pre-pandemic averages,[2] companies are asking how they can best identify and retain talent during due diligence rather than after the deal is consummated. Talent retention can make or break a deal. Relevant questions include:

- Who are the target's top performers who harbor the experience and institutional memory needed to ensure post-acquisition success? Among them, who presents the greatest flight risk, and what steps should we take sooner than later to retain them? Are any of these performers of such value to the business that a non-compete agreement is needed before the deal is signed? If the target represents that non-competes exist, have we validated that representation? Are the non-competes in place valid under existing legal constraints?
- Is there sufficient bench strength to facilitate succession planning?
- How does the target's culture differ from ours? What are the workplace expectations (e.g., remote, hybrid, in-person)? What steps should we take to accelerate the integration process in assimilating the two cultures and enabling effective team-building?
- Do the target's employee contracts include contractual obligations that could impact deal-pricing negotiations (e.g., change-of-control clauses, termination payments or mandatory outplacement costs)? Are the appropriate costs accrued on the target's balance sheet?

[2] "The 'Great Resignation' — a Trend That Defined the Pandemic-Era Labor Market — Seems to Be Over," by Greg Iacurci, CNBC, May 31, 2023: www.cnbc.com/2023/05/31/great-resignation-trend-defining-pandemic-era-labor-market-seems-over.html.

Environmental, social and governance (ESG). Evaluating the ESG performance of M&A targets has become an integral part of the due diligence process, particularly regarding environmental issues. The focus of the process is shifting from a *qualitative* perspective that considers the target's stated values, marketing communications and other external reports to a review of its ESG *quantitative* performance. It should focus on identifying ESG initiatives and issues that present significant post-acquisition opportunities and risks to the combined company's bottom line, reputation and external reporting. Relevant questions include:

- Does the target have an ESG strategy? What ESG procedures, policies, processes and disclosure controls does it have in place?
- What ESG metrics does the target create and monitor?
- What is the target's track record related to ESG? Whether it is negative or positive, how does that record impact the deal?
- Are there environmental, legal and regulatory exposures that the buyer would have to assume post-acquisition?

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Cybersecurity and data privacy. Due diligence cannot ignore cybersecurity issues. Too often, these issues lie hidden in the weeds. Here are two examples to illustrate this point:

- After acquiring Starwood Hotels in 2016, Marriott discovered a data breach within the Starwood guest reservation database in 2018 that had been ongoing for two years prior to the acquisition. Having exposed the personal information of about 500 million guests, the breach led to regulatory investigations, lawsuits and the loss of customer trust.[3]
- Prior to closing its acquisition of Yahoo seven years ago, Verizon discovered two massive cyberattacks that resulted in a $350 million reduction in the acquisition price.[4]

The target's data management strategy and processes are also important considerations. The risks, associated penalties and fines could amount to significant unrecorded liabilities on the target's balance sheet. For example, following the Marriott breach mentioned above, the United Kingdom levied a fine of £99 million for violation of British citizens' privacy rights under the European Union's General Data Protection Regulation, citing the company's failure to exercise sufficient due diligence on Starwood's IT infrastructure.[5]

[3] "Marriott Data Breach FAQ: How Did It Happen and What Was the Impact?" by Josh Fruhlinger, CSO, February 12, 2020: www.csoonline.com/article/567795/marriott-data-breach-faq-how-did-it-happen-and-what-was-the-impact.html.

[4] "Verizon, Yahoo Agree to Lowered $4.48 Billion Deal Following Cyber Attacks," by Anjali Athavaley and David Shepardson, Reuters, February 21, 2017: www.reuters.com/article/idUSKBN1601EK/.

[5] "Marriott Data Breach FAQ: How Did It Happen and What Was the Impact?"

Relevant questions pertaining to cybersecurity and data privacy due diligence include:

- Does the target have a strategy to identify and mitigate cyber breaches? Has it invested sufficiently to execute that strategy effectively?
- If cybersecurity risks are present in the target's systems and infrastructure, are our decisions regarding the impact of these risks on the deal being made at the right levels? Given the time frames and resource constraints, how are we avoiding poor decisions?
- Given our assessment of the target's threat landscape and cybersecurity capabilities, have we established a post-acquisition strategy for addressing identified and potentially unidentified risks? What preventive measures do we have in place to reduce the risk of the acquired environment contaminating our company's existing systems and data?
- Do we have appropriate insurance underwriting for the transaction to cover risks that weren't disclosed or identified?
- What is the target's policy for collecting, processing, storing, using, sharing, archiving, monetizing and destroying personal data and for compliance with applicable data privacy laws and regulations?

Compliance with laws and regulations. While this topic is implicit in the areas discussed above, it merits a separate mention because companies acquiring a business ordinarily assume its unrecorded liabilities. Accordingly, a due diligence review of the compliance function is in order. Relevant questions to ask include:

- What is the target's history of compliance with laws and regulatory requirements, including its regulatory strategy, internal policies, results of internal and external audits and regulatory reviews, and overall compliance culture?
- What are the company's protocols and processes for remediating control deficiencies and addressing new regulatory requirements?
- Are there aspects of the target's operations that expose it to corporate misconduct (e.g., the nature of its operations, where it operates or unrealistic performance incentives)? Have there been instances of corporate misconduct in the past?
- Do we have legal advisers who can provide input on compliance, antitrust, securities and other issues germane to the transaction?

Realizing the true value of a deal relies upon successful integration and utilization of the target acquired. This reality places a premium on day-one preparation and readiness.

Integration effectiveness. With expectations of a 2024 rebound in M&A activity after a decade-low 2023,[6] is the company's readiness sufficient to engage in the process? Realizing the true value of a deal relies upon successful integration and utilization of the target acquired. This reality places a premium on day-one preparation and readiness. Relevant questions to ask:

- Have we evaluated prior acquisitions and assessed the effectiveness and efficiency of our integration process? What lessons have we learned? If this is our first time executing a deal, do we have the right knowledge and advisers in place to complete the integration successfully?
- Are there aspects of the target's operations to be integrated into our operations that warrant planning and preparations *before* the deal is consummated so that the integration process hits the ground running post-acquisition (e.g., the workforce, key processes and systems, and sources of supply)?
- Have we allocated the appropriate resources needed to execute an integration? Is our leadership team for executing the integration and each functional workstream defined?
- What synergies and dis-synergies are planned? Were they appropriately considered in the purchase price? Do our integration plans enable synergy capture?
- What are the costs of integrating the target, and do they drive any front-end or pricing impacts?
- What major changes are we expecting, and what change management plans are in place?

In addressing the above areas, it is important to keep in mind the sustainability of the target's governance plumbing. In this age of disruptive change, unexpected developments are the norm. Over the last two to three years, how has management reacted to unexpected speed bumps? How did they manage a crisis event? Penetrating questions addressing the resilience of the organization in responding to challenging issues and the unexpected can offer transparency regarding the target's leaders and their values and behavior under fire.

While due diligence focuses on identifying risks, confirming relevant financial information and other facts, verifying or identifying critical deal points, reviewing existing contracts, and establishing a road map to address a transaction's core issues via integration or separation planning, there are important questions and activities pertaining to the above areas that are germane after the deal is completed. These questions present opportunities for post-acquisition follow-up. We explore some of these questions in a supplement to this issue of *Board Perspectives*: www.protiviti.com/US-en/newsletter/bp175-board-focus-mergers-acquisitions-supplement.

[6] "Dealmakers See Rebound After Global M&A Volumes Hit Decade-Low," by Anirban Sen and Anousha Sakoui, Reuters, December 21, 2023: www.reuters.com/markets/deals/dealmakers-see-rebound-after-global-ma-volumes-hit-decade-low-2023-12-21/.

How Protiviti Can Help

Mergers and acquisitions are a great way for companies to drive growth, stay competitive and increase shareholder value. But the M&A process is one of the most challenging endeavors a business can undertake. Protiviti's M&A Consulting solution provides the guidance and expertise needed to navigate every step of the process.

Protiviti has assisted numerous organizations across the deal life cycle by bringing together the best teams to address challenges such as transaction management and advisory, human capital, supply chain, cybersecurity, due diligence, and integration and separation execution. Transactions bring added complexity to organizations and their various business units. When Protiviti works with clients, we strive to simplify complex issues.

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