THE one BRIEF
AON EXPLORES THE WORLD'S MOST PRESSING BUSINESS ISSUES

RISK & INNOVATION

Planning For M&A: How To Avoid Hidden Risks

OVERVIEW

Although M&A activity in the first half of 2016 is down compared to the record level of global M&A activity seen in 2015, deals are still making headlines. his year also saw more big deals fail than usual, though the announcement of Microsoft's planned $26.2 billion acquisition of LinkedIn in early June and Softbank's $32 billion acquisition of ARM Holdings in July indicate that high-value M&A is still on the agenda. These deals were big enough to make Verizon's late July acquisition of Yahoo! For $4.8 billion look almost small in comparison.

Even with activity down almost 20% this year compared to the first half of 2015, low interest rates and a perennial need for diversification keep M&A a consideration for organizations.

What are the key drivers behind this M&A activity, and will this trend remain tenable over the long term? Moreover, how can businesses mitigate unforeseen risks from a merger or acquisition? Read on to learn the key factors and financial considerations that businesses need to evaluate in order to ensure deals meet long-term financial goals.

IN DEPTH

It would be easy to dismiss last year's high levels of M&A as an economic anomaly, but a closer examination of the underlying dynamics suggests that "the increased activity reflects a long-term trend towards consolidation," says Paul Schultz, CEO of Aon Securities. A "challenging organic environment" will continue to be a motivating factor, he says, with large companies looking to M&A deals as a strategy to grow market share, boost revenues and reduce costs.

Low interest rates, excess capital requirements and fierce competition from new competitors have made organic growth difficult to achieve for many companies in the global economy. As a result, businesses have been forced to allocate existing capital more efficiently – and M&A is one way to achieve this.

The Key Financial Drivers Of M&A

According to Schultz, the surge in M&A activity over 2015 can be attributed to companies searching for diversification into new product and service categories, markets and distribution channels. This can help businesses scale while strengthening their customer, supplier and distributor relationships.

Likewise, historically low interest rates have made it easier to finance deals and generate superior returns with excess capital. "With traditional investments failing to achieve required returns, businesses are looking to M&A as a means to expand," says Shultz.

2016 has seen new uncertainties emerge:

1. An increasingly protectionist tone from US Presidential candidates, especially over proposed international free trade deals, increases uncertainties around the trading environment for the medium term.
2. June brought the UK's vote to leave the European Union. This brings new uncertainty – until new trade agreements are determined it will be a challenge for companies operating in the EU or the UK to calculate costs. The outcome of Brexit for the future of European politics – and therefore the future regulatory environment – is also as yet unclear.
3. Antitrust concerns loom larger in 2016 than in recent years. The European Commission has brought three antitrust charges against Google, for example, and the US announced in July that it would try to block two healthcare mergers on competition grounds.

These factors have slowed M&A activity rather than halted it, however. As Schultz says, "Confidence in the overall economy remains high as foreign buyers and alternative capital continue to assess opportunities."

Planning For M&A

There are a number of key factors that leaders should address to ensure that a proposed M&A deal can meet their long-term business goals:

- **Build out M&A capabilities**
  Companies should ensure that they are consulting with experienced M&A experts to effectively evaluate potential targets. "Experts can help you identify the costs and benefits of a deal. If you don't know what you're doing, you could put your business at risk," says Mark Oshima, Managing Partner, Aon Strategic Advisors & Transaction Solutions.
- **Be mindful of regulations**
  Businesses involved in M&A need to account for increased regulatory scrutiny, including antitrust laws. According to Kyle Kalinich, Senior Vice-President, Aon Strategic Advisors & Transaction Solutions, "Deals present a host of legal challenges. For example, acquirers need to be aware of labor law compliance. Also, are there foreign country regulations that need to be addressed?"
- **Capitalize on technology trends**
  New technology can help companies drive innovation, improve the quality and delivery of products and services, and enter new markets. Businesses can use targeted mergers or acquisitions to add new technologies into their production and distribution strategies. But with technology changing fast, a clear understanding of the potential value such moves are likely to add is vital.

- **Focus on the ROI**

Executives should ask what competitive advantages they are seeking when acquiring a firm, and how those lines of business complement their existing ones, advises Schultz. By comparing the costs of acquisition and integration to the potential business benefits, the true value of a potential deal will become clear. That involves taking the time to do thorough risk assessment and scenario analysis. The benefits can be more or less than they first appear.

Managing M&A Risk

Avoiding hidden liabilities and potential write-downs is an important part of any merger or acquisition. Kalinich advises buyers to establish a due diligence process that includes a study of the target's historical risk issues. "Due diligence should identify liabilities that the buyer is expected to assume and quantify those liabilities for ultimate loss costs," he says. "It should identify collateral requirements tied to those liabilities, and assess opportunities for reduction."

Piers Johansen, Managing Director, at Aon Risk Solutions UK, notes that even though M&A activity is down in 2016 compared to 2015, deals are still being completed. "We expect the pace to pick up for the rest of the year, and with a weakened British pound, there will be aggressive competition both from within the UK and outside for the available assets."

Johansen explains that 'topping' – being outbid by a rival buyer – is "a significant challenge." Being 'topped' can be expensive; "not only does the organization miss out on a wanted asset, but the cost of due diligence, legal review and integration assessment can be significant. If the marketplace is hot, it sometimes prevents organizations from even considering a deal.

Once a company decides that a bid will go ahead, due diligence should include scenario analysis to test the operational and strategic alignment of the businesses. That should include an assessment of crisis management and business continuity plans, testing insurance claims scenarios, and a business model risk assessment.

Assessing risks and opportunities through scenario planning can illuminate the true value of a deal in a way that balance sheets and assets alone often cannot.

In addition, a successful M&A strategy should also take a thorough look at the human aspects, not just the financial side, Shultz warns. That means managing integration effectively, and assessing what needs to be done to retain key talent – two make-or-break factors when it comes to making the deal a success.

TALKING POINTS

"It sounds obvious, but if you can't explain what the combined business looks like, the exact sources of synergy and their expected value before the deal, you will not be able to explain them post-execution either. Moreover, you've missed the opportunity of doing proper due diligence for your deal." – Maya Gudka, Leadership & Strategy Programme Director, London Business School

"Insurance due diligence can help in making informed decisions regarding the past liabilities and in structuring a cost-effective insurance programme that meets the future needs of the business. This assists the team in incorporating any unexpected costs into the deal." – Risk & Insurance in Mergers & Acquisitions, Aon/Airmic

"According to a poll of 1,300 professionals across industries ranging from financial services to technology and manufacturing, nearly 90 percent fail to conduct due diligence for compliance risks such as corruption, money laundering and fraud. Is it any wonder that only 10.4 percent express confidence in their management of M&A risks?" – LexisNexis

FURTHER READING

- So Many M&A Deals Fail Because Companies Fail To Follow This Simple Strategy – Harvard Business Review, May 10, 2016
- Here Are 6 M&A Mega-Deals From 2016 – Are There More To Come? – The Street, April 2, 2016
- The M&A Boom Isn't Over Yet – Business Insider, April 10, 2016
- Global M&A Activity To Decline In Q3 2016 – Forbes, May 3, 2016
- Examining China's M&A Boom – Is It Capital Flight Or Not? – SeekingAlpha, May 2, 2016

AON
Empower Results®