People and organization in M&A due diligence

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Kienbaum

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The overlooked value-drivers

Reflecting on M&A motivation during times of uncertainty

While there has been a slowdown in the number and value of M&A deals in recent years – likely linked to political and economic uncertainty, high interest rates and rising inflation in many European countries – looking forward, we expect a ramp-up in market consolidation. Selling business units that are in distress, gaining access to new markets and customer groups, securing supply chains, and planning succession in family businesses are all expected to be key drivers for M&A in 2024. Chances are, this also applies to your organization. Significant activity is anticipated in the telecommunications, media and technology sector (TMT), as well as in the energy and consumer goods industries. This expected surge in M&A activity will likely be attributable to the strategic importance of digital transformation and AI trends in the TMT sector, a further increase in the relevance of sustainability and renewable energies in the energy sector, and margin pressures in low-margin segments of the consumer goods industries.

While the objectives of M&A transactions strongly differ on a case-to-case basis, research shows that some underlying motivations will be more present in the coming months. Undervalued targets, an influx of cash reserves on the buy-side, and distressed and non-core asset sales on the sell-side are expected to be among the key motivators for increased deal activity (cf. figure 1).

When considering your M&A activities today and in the future, it is critical to reflect on the motivation behind the pursued activity. You may want to ask yourself some key questions:

- What is my current strategic situation as a company?
- What are motives behind the transaction?
- How are we planning to integrate or separate the entities?

Particularly in a cautious market environment, the strategic reasoning behind M&A becomes even more critical. Having a clear vision of the desired situation post-merger / post-transaction helps in assessing the most

Motivation		Relevance in 2024 (low – high)	Rationale
Buy-Side	**Undervalued targets**		Purchase of **assets below their actual value** with the aim of generating profits through value appreciation and strategic synergies
	Cash-rich corporates & PE firms		Use of large cash reserves of corporations and PE companies to **finance inorganic growth**
	Turnaround opportunities		Acquisition of **poorly managed companies** in need of comprehensive restructuring and change of management to add value
	Foreign strategic opportunities		Cross-border M&A to quickly gain strategic **access to new markets and customers groups**
Sell-Side	**Distress-driven**		**Reorganization or merge** of companies due to **unwanted events** such as insolvency or bankruptcy
	Non-core asset sales		Strategic divesture of non-core business or underperforming assets and **focusing on the company's core competencies**
	Raising capital		**Raising capital** in the short term to enable investment and transformation in faster growing or more profitable areas
	Succession		Search for **succession arrangements** triggered by various reasons such as age or the exit of key personnel

Source: Kienbaum analysis, CMS European M&A Outlook 2024

Figure 1: Buy– and sell-side motives for M&A in 2024

relevant and value-critical aspects to be considered during deal planning. To ensure your M&A avoids the most common pitfalls and your target outcome is successfully achieved, it is crucial that detailed and holistic due diligence is performed to identify risks and synergy potentials. Two critical, yet often neglected aspects of the due diligence process are the people and organization. Even though these are not initially a focus of the financial and legal transaction, in many cases they are the true gatekeepers of value creation for the overall merger and integration.

People and organization: the true gatekeepers of value creation in M&A

Both the buy- and sell-side typically devote considerable efforts within the due diligence process to assessing the commercial, financial, tax and legal aspects of the entities involved in the deal. Yet both sides often spend only minimal effort on topics such as people, organization, IT and the environment before the transaction. While this appears to be practical at first glance, as all major financial and legal risks are still considered and the due diligence process is less time-consuming as a result, several drawbacks exist. Revisiting failed deals and common integration pitfalls reveals that a misalignment of non-financial and non-legal aspects frequently hinders value creation for the acquiring company or the merged entity. Of transactions that fail, eight out of ten did so within the post-merger period. Mismatched organizational structures, a lack of employee skills and competencies, the loss of key talent and cultural differences are often cited as the primary reasons for failure.

In contrast, organizations that already consider organizational structure, people topics and culture as part of the due diligence process can significantly increase their chances of a successful transaction and start their detailed integration planning. Organizations that define a combined Target Operating Model (TOM) early in the process and include detailed measures for retaining talent, establishing clarity on compensation levels, and promoting cultural alignment within their program management are known to be more successful in creating value during their M&A transactions. To ensure that you, too, are successful, you should stress the significance of factors beyond the financial, legal and commercial aspects in your due diligence when preparing for a deal. Including not only people and organization and operations, but also IT infrastructure and the environmental situation, will eventually provide you with a more realistic and holistic view of the risks, synergies and values contained within the deal (cf. figure 2).

Commercial
Verify commercial viability by checking business plans, strategy, sales history, pricing logic, etc.

Financial & Tax
Ensure financial feasibility by verifying margins, profitability, cashflow, debt, financing, balance sheet, etc.

Legal
Assess the legal risks by ensuring that contracts are valid, (intellectual) property rights are in place, etc.

People & Organization
Evaluate the structural and cultural fit of operating models, structures, workforce, skills, HR, etc.

Operational
Examine companies' organization, e.g. supply chain and supplier relationships, machinery, key processes, etc.

IT
Analyze the IT landscape to check for compatibility, data gaps, security risks, transfer requirements, etc.

Environmental
Evaluate the environmental impact of the deal, such as its ecological footprint, building issues, etc.

Figure 2: Typical pillars of due diligence

To ensure a fast and accurate view of a company's risks and potentials, due diligence can be performed according to predefined pillars and summarized in quantified risks and synergy scenarios. There are ten dimensions to be analyzed regarding people and organization in due diligence processes; these consider relevant internal and external factors that influence transaction success (cf. figure 3).

(Image source: istockphoto.com)

PEOPLE	**ORGANIZATION**
Labor market and labor relations Evaluation of the attractiveness of the labor market and relations with unions/ employee representatives	**Strategic alignment** Assessment of the alignment of strategy and operationalization as well as matching of KPI monitoring
Personnel costs Assessment of costs related to personnel and possible costs related to requalification, salary adjustments or severance	**Operating model** Evaluation of the overall operating model and differences between buy- and sell-side
Workforce and skills Review of workforce, key positions, skills alignment and talent retention strategies	**Organization structures** Harmonization of the operating model, definition of functional responsibilities and uniform management structure
HR operations Evaluation of the current HR processes, policies, and HR-IT support and degree of digitalization	**Business process management** Review of process structure with assigned responsibilities, operational efficiency
Leadership and culture Comparison of corporate culture, leadership and decision-making and need for stakeholder-specific integration measures	**Governance** Audit of organizational controls, decision-making & compliance with governance elements, regulations and standards

Figure 3: The people and organization dimension of due diligence

To make it more practical, for example, the dimension "Labor market and labor relations" assesses the risks and potentials related to the structural and legal labor situation. This includes the level and influence of workers councils and union activity within the organizations, the number and extent of pending labor disputes, possibilities for strikes, and all potentially associated risks and costs. Furthermore, it also assesses the external labor market, giving clarity on the availability of required employees and any risks associated with reaching the goals of the integration. Beyond this dimension, existing HR policies, compensation structures, workforce situations, organizational structures, existing business processes and governance all have a high level of influence on the speed and success probability of a merger or acquisition. It is essential that they are reviewed, risks are assessed, and scenarios for mitigation are developed. Neglecting the people and organization dimensions at the outset of a transaction often leads to pitfalls during the integration phase that can significantly reduce value. It is therefore important that you consider your "people and organization" pillar as a vital gatekeeper for creating value in your current and future mergers and acquisitions.

Aligning deal objectives with people and organization in due diligence

Along with the deal motivation (cf. figure 1), it is highly relevant to reflect on the overall transaction objectives to clearly define your due diligence process, as differing objectives can strongly impact the focus you might want to set within the process. An acquirer looking to run the acquired company as a largely separate entity will more likely focus on ensuring continued operations and the retention of employees. A buying organization pursuing a full consolidation of companies will put additional focus on culture, structures, and possible reduction measures to ensure a successful integration. The heatmap depicts the varying relevance of the people and organization dimensions based on differing deal objectives (cf. figure 4).

The greater the focus on integration as part of the deal objective, the greater the relevance of people and organization aspects in the due diligence process. No matter the objective, however, some key people and organization aspects in the due diligence process are critical to success, such as evaluating the labor market and labor relations on the buy- and sell-sides, reviewing the workforce and skills, assessing personnel costs, and ensuring governance compatibility. Especially when the M&A objective is a full consolidation, it will be impossible to have a smooth, swift and value-adding outcome if the ten dimensions are neglected during the due diligence process.

Even though the objectives and relevance of people and organization topics in figure 4 are framed from the buying perspective, the sell-side is likely to gain value from assessing similar aspects in advance of any M&A activity. Through a concise sell-side due diligence process, the vendor can assess and quantify the risks contained within the organization, giving them the possibility to initiate mitigating measures in advance in order to boost deal value and the likelihood of deal success.

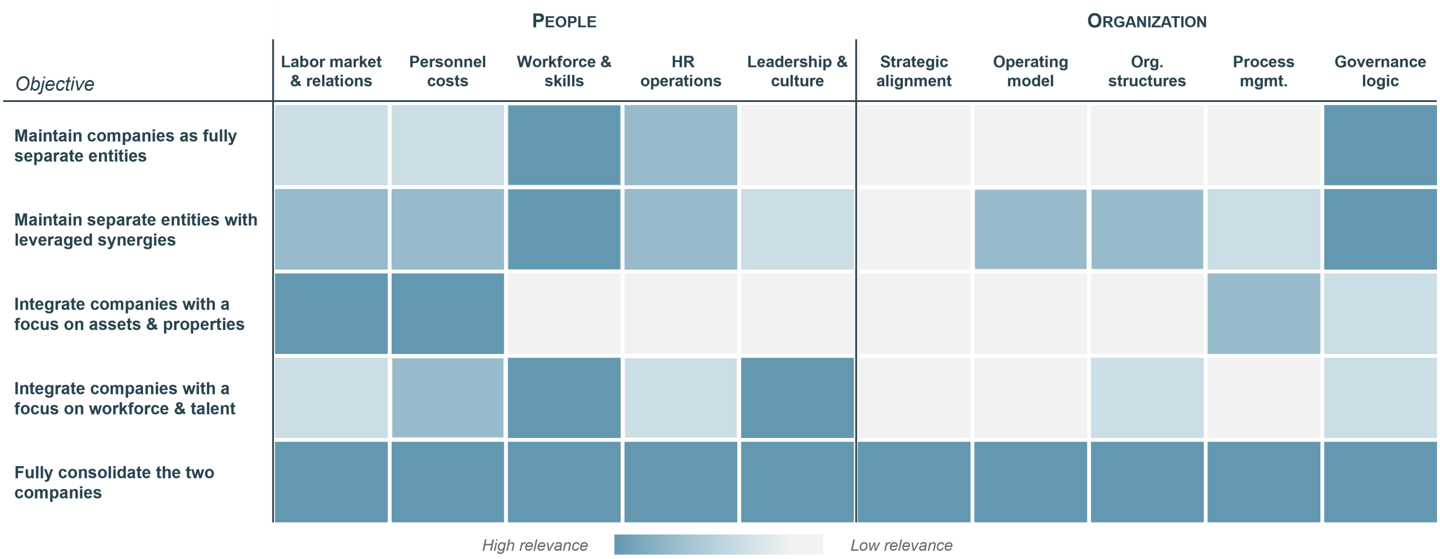

Figure 4: Relevance of people and organization in M&A transactions

Consider the people and organization in your next M&A

No matter if you are on the buy-side or sell-side in your next M&A, make sure you are not blinded by the glowing financial figures on paper. To really unlock the biggest value in your deal and ensure its long-term success, remember to look at the people and organization dimensions as early as possible.
To sum up, three takeaways are crucial:

1. **Know your transaction motivation and integration objective:** Identify the main motivation behind why you are considering M&A, what you want to achieve through the deal, and what level of integration you are striving for, as these will influence your pre-deal program management.
2. **Structure your due diligence and aim for comprehensiveness:** Set up dedicated workstreams to derive risks, costs, implications, and mitigation measures for all relevant topics – including those beyond the strategic, financial, and legal aspects of the deal.
3. **Think of people and organization aspects early on:** Keep the most common pitfalls of transactions in mind while planning your deal and consider your people and organization early on to prevent them from interfering with your deal. Organizational alignment and people matter for deal success and value!

Sources:

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