



# Can't Buy Me Love: Re-Imagining Acquisitions Where Human Capital is Key

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# What Do We Mean By Human Capital?

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- **Economic theory perspective:**

- “Stock of habits, knowledge, social and personality attributes (including creativity) embodied in the ability to perform labor so as to produce economic value”<sup>1</sup>
- Human Capital differs from other assets because returns flow both to the individual (transferable skills, talent) and the organization (productivity, creativity)

- **The business realities and M&A perspective:**

- Not an abstract economic concept but rather the actual, talented people and groups who have the knowledge, skill and culture to preserve and create value for a business
- Talent is the key asset for many businesses (and a critical asset for most businesses) to continue growth and success

# How Has This Concept Evolved?

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- **Valuation perspective:**

- Increase in relative value of intangible assets over tangible assets
- Human Capital is a growing component of intangible assets

- **Business realities:**

- Changes in the relationship between employers and their employees track broader changes in market and consumer behavior:
  - Increasingly informed, vocal and mobile workforce
  - Impact of COVID-19 and “battle tested” technology accelerating change and the literal and figurative removal of walls
- Appreciation of Human Capital as a concept and critical component in business

# Human Capital Management Industry

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- Human Capital Management industry includes the following traditional and evolving sub-industries:
  - Staffing and Recruitment
  - Human Resources (HR) Outsourcing
  - Talent and Workforce Management
  - Professional Employer Organization
  - Workforce Education and Training
- Overlay of technology and cloud solutions
- Context of COVID-19 and future of tele-commuting and remote workplaces

# Human Capital in the M&A Context

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- A “deal within the deal”
  - Identify the unique Human Capital challenges and opportunities in the business being acquired.
  - Examine solutions and approaches that buyers should consider in order to gain and retain the Human Capital assets that are driving value.
  - Timing and process considerations are important in addition to substance.
- Avoid talent loss and worse --“paying 3 times” -- and focus on how to acquire, preserve and grow a mercurial asset
  - Worst case is paying once to hire, again to retain and once again in separation.
- Heightened risk of transaction failure or lack of value-capture from using “standard” M&A diligence process, deal structure or integration approach
  - A successful Human Capital-driven transaction requires offense and defense.

# The Spectrum of M&A Situations

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- **Where Human Capital is the Business:**
  - Acquisition of a sports team, talent agency, consultancy or investment bank/financial advisory firm, IT and business consulting
- **Where Human Capital is one of Several Critical Factors:**
  - Tech and life-sciences companies that have critical IP but also key talent pools driving future R&D
- **Latent and Lurking—seemingly no reason to focus on Human Capital, except...**
  - Key contracts anchored to certain employees
  - “Keeping the band together” situations
  - “Tip of the iceberg” compliance or labor / employment-related problems

# Unique M&A and Integration Challenges

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- Valuation of Human Capital assets in an enterprise.
- Identifying critical and top performers at each level – now and in the future.
- Understanding the “secret sauce” and group dynamics that made the target a desirable acquisition.
- Considering the threats to the acquired talent meeting projected financial goals for the business; how can these been mitigated or addressed?
- Benchmarking the target business.
- Opportunities for improvement and elevating performance.
- Addressing the impediments, ranging from technology to business culture, to reaching its potential.

# Crafted Human Capital Solutions

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- **Enhanced Due Diligence**

- Information beyond the “norm”
- Validating whether there is “secret sauce” and existing compensation is consistent with contributions

- **Transaction Structure**

- Looking for win-win tax and recourse structures
- Well-reasoned restrictive covenants and appropriate IP agreements
- Closing conditions

- **Communications with Target Company Workforce**

- The value of messaging and timing of communications
- Testing the “stickiness” of key employees



# Crafted Human Capital Solutions, Continued

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- Post-Closing Integration
  - Not just an “HR function” but a business operations function.
  - Structure for target influencers to benefit from successful integration.
- Post-Closing Disputes
  - Understanding the ramifications of post-closing disputes on a working relationship.
  - Use of deferred and contingent payments and Rep and Warranty Insurance.
- Transactional and Longer-term Incentives

# Compensation and Benefit Structures in M&A

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- **The Classic Approach**

- Continue the compensation and benefit structure of the target business (if it ain't broke...)

OR

- Implement the buyer's compensation and benefit structure for the target business

# Compensation and Benefit Structures in M&A

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- **The Human Capital Approach**

- Still need to understand target's and buyer's compensation and benefit program structures
- But, consider bespoke and situational structures with a view to:
  - Facilitating successful integration and creating synergies
  - Minimizing “good reason” departures and selling culture and approach
  - Establishing incentive arrangements tied to implied projections for the valuation and driving performance by setting the “right” metrics and goals
  - Effectively communicating to employees the compensation and benefit programs (including the performance goals) and their connection to company strategy
  - Fostering culture and having compensation philosophy match culture
  - Promoting longer term “full integration”

# Compensation and Benefits in M&A - The “Levers”

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- Equity-based awards
  - Rollover
  - Cash-out
  - New grants
- Long-term cash incentive awards
  - Time horizon
  - Impact of deal
  - Will the performance metrics even work post-close?
  - Go forward long-term incentives
- Bonuses
  - Short-term cash incentive awards
  - Discretionary
  - Go forward short-term incentives
- Salary levels
- Special bonuses, payments and arrangements
  - Retention awards
  - Transaction / change in control bonuses
- Severance
  - Contractual
  - Discretionary
- Benefits and Perks
  - Executive level
  - Broad-based (e.g., 401(k), health, life, disability and other benefits)

# Incentive Structures in M&A

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- Key considerations and program design
  - Right “mix”: Long-term versus short-term; equity versus cash.
  - Right people: Cover the drivers of the business and key employees.
  - Right amount: What percentage of total should be dedicated to incentives? What amount is needed for additional retention?
  - Performance metrics and goals: Are they the correct measures? Do they drive results? Are they clear, realistic and properly communicated to employees?
  - Role of discretion: Impact of extraordinary events, unintended consequences and mid-stream adjustments.
  - Retention component and impact of different termination scenarios.
  - Forfeitures and clawbacks (*e.g.*, breaches of restrictive covenants, financial restatements and “for cause” terminations).
  - Legal and accounting.
- Evaluation of the target business to determine proper design
- Buyer self-evaluation: Did prior incentive programs motivate employees to engage in the proper behaviors and were the desired outcomes achieved? (lessons learned from prior acquisitions)

# Human Capital as a Critical Asset

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- Buyers in M&A transactions should consider whether the Human Capital component of a transaction is the key driver or at least a critical driver
- If so, consider:
  - Managing the unique challenges with Human Capital transactions
  - Modifying the acquisition approach:
    - Adapting the “regular” diligence process.
    - Key changes to transaction structure to accomplish win-win outcomes including workforce transition, practical liability recourse structures and tax efficiencies.
    - Implementing monetary and non-monetary incentives to achieve both transaction and broader buyer goals over the shorter and longer term.

# Q&A







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