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Re-Imagining Acquisitions Where Human Capital is Key

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Editor's Note: The views expressed in this perspective are entirely those of the authors.

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Human capital is increasingly both the key asset and key risk in many successful business acquisitions. For some industries, human capital is more than just important to the business—it is the business; without it, the business may be worth little or nothing. This is widely understood in traditional talent industries such as advertising, entertainment and other creative arts.

But even in businesses with more traditional assets, the value of their human capital can be critical. Indeed, almost all successful and growing businesses include groups of personnel who ultimately are critical to the operational performance of the enterprise and, in the acquisition context, critical to the transition and retention of key customers, suppliers and other personnel.

Acquiring human capital needs to be treated as an important "deal within the deal"—the people deal within the larger M&A deal, structured to do two things:

- Identify the unique human capital challenges and opportunities in the business being acquired.
- Examine solutions and approaches that the buyers should consider in order to gain and retain the human capital assets that are driving value.

Key Asset

The growing significance of human capital has become even more pronounced in recent years. It's impacting businesses across the board: software and life-science businesses with critical engineering or scientific teams, business and professional services such as consultancy and engineering firms, financial services businesses such as asset managers and investment banks, as well as aerospace, manufacturing, energy, health care, and many others.

People are even more informed, vocal, and mobile than ever before, and want non-monetary as well as monetary connections to their employers and careers. While this trend may have come to the fore during the strong labor market before Covid-19, it began building long before that as intangible assets grew in importance. At this point, the World Bank estimates that intangible capital now represents the majority of wealth worldwide.

Unfortunately, the thinking about how to acquire and keep the human capital of a business has not evolved as fast as its growing importance. The methods of transferring tangible property have matured over decades, resulting in generally straightforward processes for purchases. More recently, some have tried to adapt those tangible property processes to intellectual property. In some cases, like patents, these methods for transferring assets can work relatively well, but for many other valuable intellectual property like trade secrets and just plain know-how, confirming and transferring ownership is a real challenge which is all too often under-appreciated in an acquisition.

In large part this is because critical types of intellectual property and other intangible assets are inherent in the people involved. Often critical intellectual property is not fully documented but simply resides in the minds of individuals and groups. While it is understandable to think that research and development is all about buying or building expensive high-tech equipment, software, medical devices, and other innovations, one of the largest contributions to the R&D line item in many profit and loss statements is the compensation paid to talented developers and engineers. Preserving human capital is not just key to the development of future intellectual property, but is equally important for maximizing the value of current intellectual property.

And if the transfer of tangible property is well-defined and the transfer of intellectual property mostly well-defined, the acquisition of the other products and value derived from human capital is inherently different and difficult. Any business acquisition represents a natural career decision point for the people needed by the business: essentially, they must be re-recruited, re-hired and re-incentivized by the buyer.

Getting it right can mean a business that meets the rosy "priced in" projections of the seller. Getting it wrong is costly. A buyer may commit significant cash to induce a key talent team up front, then potentially have to restructure and offer additional compensation to the same team for retention after the closing and then, in a worst case, pay them severance.

To add insult to injury, the buyer may also suffer disruption, brain drain, competition, and opportunity cost as the business drifts while searching for new talent.

Despite the centrality, and unpredictability, of retaining human capital—which can be defined as the talented people, both individually and as groups, who possess the knowledge, skill, and culture needed to preserve and create value for a business—the due diligence, acquisition, and integration of human capital is often treated as a side show in many acquisitions and the buyer's deal team and post-closing integration team do not maximize the information and processes available for success.

While buyers often press sellers for back-up of cost and revenue projections, which is dutifully supplied, the unspoken, but unrealistic, assumption in projections is that there will be no change in the human capital of the business. Few, if any, financial forecasts assume loss of key talent or a breakdown of the culture and other workforce dynamics that were a critical contributor to the success of the business. In the end, many buyers try to avoid the complexities by either ignoring the human capital considerations: "We will just keep paying any employees we want to keep," or by treating human capital as if it is the same as tangible property: "We'll just ask a few senior people to sign employment/non-compete agreements."

Neither approach ensures the success of acquisitions where significant value resides in either intellectual property or in people's knowledge, contacts or experience. In such cases, the successful due diligence, acquisition, and integration of a business requires re-imagining the deal process to give enhanced, or in some cases primary, attention in the acquisition to human capital considerations relative to the tangible and other intangible property. Compensation is always important, but when human capital is involved and more than a short-term relationship is needed, money can't buy you love.

Identifying Challenges and Opportunities

As a part of the business and legal due diligence review of a business, buyers need a comprehensive review of the business's human capital assets. Unless the human capital is immaterial, this review should not be limited to the traditional formal review of foundational areas such as compensation structures, legal compliance, employment agreements, collective bargaining and benefit plans, and employment litigation and disputes. In addition, it requires a comprehensive and value-added approach to answer questions such as:

- What is the value of the human capital assets in an enterprise? This amount might, to some extent, be captured in accounting concepts of goodwill, R&D, or workforce in place, but a buyer should ask and try to answer this question with the same rigor it applies in valuing other assets.
- Who are the critical and top performers at each level? The current compensation may not fully reflect originators or mangers of key client relationships and the target's management may have a different perspective on this question.
- Who are the likely top performers in the future? An acquirer must consider the monetary and non-monetary costs of recruiting replacements for the top performing group should they not be retained post-closing.
- What are the individual and group drivers—monetary and non-monetary—that have enabled the target to reach current performance levels?
- What are the threats to a team meeting the projected financial goals for the business and how can these been mitigated or addressed?
- How do the target company's human capital assets compare, in value, durability, and quality, against competitor and industry benchmarks?
- What are the opportunities to elevate group performance with additional resources and personnel?
- What are the impediments, ranging from technology to business culture, to the group reaching its potential?

These issues are often underplayed in acquisitions even when they are considered, with much less attention paid than to the typical areas of focus in M&A due diligence, such as required third-party consents, litigation, and material contracts.

While there are challenges to obtaining complete answers to these questions, a human-capital oriented approach can nonetheless provide valuable information which otherwise would not be obtained. In addition, this approach provides the information needed to maximize the honeymoon of the post-closing integration period and properly implement optimal retention and performance incentives. Finally, they can be critical to getting through the period of uncertainty until employment inertia reasserts itself for most employees.

Buyers with existing industry experience naturally have operational and industry knowledge advantages in performing such diligence and analysis. Historically, this has lead the talent-based businesses being most attractive to buyers with industry knowledge. Private equity, outside of industry specialists, have been cautious with these kinds of businesses, precisely because of the nature of human capital assets and the perceived risks associated with talent-driven businesses. However, a due diligence process specifically designed for human capital assets can help, and perhaps level the playing field between, strategic and financial buyers by utilizing a knowledgeable and attentive transaction team, and the latest approaches.

For example, the growing human capital management (HCM) industry and, in particular, technology-focused HCM software solutions, can provide numerous tools and resources to assist with the due diligence process, such as background checks and employee screening. Tools also exist to help target company integration, such as training on buyer's systems, policies and procedures, and employee on-boarding and employee benefits management, and to assist with post-closing operational efficiencies and implementation of new and transitioned business processes, such as dashboard solutions to track and focus performance.

It should go without saying that even the most sophisticated HCM software is no replacement for the most human element of any human capital deal: clear, timely, and two-way communication. Incredibly valuable due diligence is often just a phone call away. The challenge, however, is structuring those communications to be most useful, while avoiding subtle pitfalls, such as initiating talks with different levels of the target's talent base too early or too late.

With the information and perspective gained from a human capital-oriented diligence review, sophisticated buyers can turn this knowledge into meaningful transaction value.

Implementing Crafted Human Capital Solutions

Although a loss of the team that created the successful business can be catastrophic to the buyer, the retention and performance incentives needed to retain that team are too often designed from the mind-set that talent, except for those executives who negotiate incentive compensation agreements, are an additional cost center with a uniform view of compensation rather than an asset with potentially differing perspectives. Most sophisticated buyers know they need to keep a key part of the organization happy, but many struggle with how to do that beyond the short term. There can be an unnerving realization when a buyer wakes up to the risk that highly important employees might not join the team, might leave before the deal, or might not stay long beyond the closing.

As mentioned, some buyers may conclude they can mitigate their exposure by ensuring key employees sign an employment agreement, invention assignment agreements, and, where available, non-competes or non-solicits. Others, going a step further toward a true retention strategy, try to address the issue using the traditional tools in the kit, such as a standard equity compensation package and cash bonuses, measured by performance or time. But all too often they impose one-size fits all metrics, undercutting the win-win program they should be aiming for.

In the rush and competition to do a deal, buyers often default to what worked in the last deal rather than crafting a customized approach reflecting individual, group and business-wide performance. For example, the value of preserving and motivating a team might justify incentives based on a matrix of individual and specific-group performance, in addition to short and long term contributions.

But for best results, buyers should invest the time and expertise commensurate with the human capital value, considering questions such as:

Transaction Structure: How can the transaction be structured to maximize tax efficiencies for not only the buyer and the sellers, but also critical talent? How do the needed human capital considerations feed into closing conditions and post-closing restrictive covenants? Non-competition and non-solicitation covenants should be carefully constructed and communicated early to ensure there is a clear understanding of those requirements and expectations. Do certain client or joint venture relationships include actual or de facto “key person” involvement where particular personnel of a target company are critical to the transfer and retention of that client? Many talent-based businesses provide opportunities for a buyer to provide win-win, creative, solutions in these areas.

Communications with Target Company Personnel: What is the messaging for the transaction and the goals of the combined business post-closing? Which talent are most likely to view the transaction itself result in a natural trigger point to decide to leave if they do not fully believe in the direction of the business post-closing, and what is the forward strategy to address this risk? Who are the key influencers within an organization? At what point should key personnel be informed of the transaction and their role post-closing and how does that affect the buyer and the seller? Sellers often want to restrict contact with their personnel, but waiting until closing may be too late—once employees start to consider their alternatives, it becomes harder to retain them.

Integration: Where are the critical human capital risks to a successful integration, and when are they most pressing? What duration of retention and incentive program best mitigate those risks? Attention should be paid not only to the acquired workforce successfully transferring over customers and other critical relationships but retaining groups within the acquired business itself. What business initiatives—or necessary pivots and improvements—would the acquired workforce be excited to pursue? How will the office locations of the buyer and the target company be integrated or continue to be separated post-closing and how will those decisions affect integration?

Longer-term Incentives: Does the buyer's ordinary course incentive plan for its existing personnel provide the optimal structure for incentivizing the acquired talent or is a unique plan required? How should the performance of the acquired business vs. the larger enterprise be considered? How much is group performance relevant along with individual milestones? How would the incentive package for the acquired personnel be perceived by the workforce of the acquiring business? Buyers who are engaging in an acquisition program can front-load some of this work prior to starting an acquisition by outlining structures that fit within the buyer's business and are consistent with prior successes, but provide needed flexibility.

Non-Monetary Incentives: What are the non-monetary incentives that have kept the team together? How does the existing business culture and operational processes of the buyer support or run counter to those incentives and processes. How can certain positive attributes of the acquired business be retained to continue the non-monetary incentives that have worked?

Post-Closing Disputes: How do the parties intend to structure the post-closing dispute process and the buyer's ability to obtain recourse from a seller? If any of the sellers will be working for the buyer post-closing, what are the ramifications of a dispute and its impact on personnel relations and incentives post-closing? Well-lawyered indemnities may prove much less useful than normal when they require taking action against valued team members. On the other hand, third-party recourse, such as representation and warranty insurance, contingent future payments and escrows are often quite useful in the human capital context precisely because they take this reality into account.

Critical to each of these factors are pre-transaction discussions and planning, a due diligence approach that enhances the review of human capital assets, and a transaction and post-closing integration and incentive plan and structure that directs every buyer's limited resources to mitigate risks and maximize success of the acquired business post-acquisition. This “Deal 2.0” approach requires an internal deal team recognizing and planning for these issues and transaction advisors who are similarly attuned to them and able to bring an integrated approach to advise the buyer and execute a winning human capital plan.

Conclusion

Identifying human capital as one of the most valuable assets of an enterprise is a trend that will continue to accelerate as economic considerations and pressure from personnel and talent will reward those businesses who are best positioned to retain and enhance their human capital assets, and thereby enjoy the associated opportunities.

In the acquisition context, buyers who pay increased attention to these issues and design thoughtful acquisition due diligence processes, transaction structures, post-closing integration programs, and retention and performance programs will maximize chances of success and mitigate risks relative to their competitors. Doing so still might not buy enduring love, but it could save a lot of heartache.

