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With merger and acquisition activity heating up, here's a due diligence checklist for regaining clarity.

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by Barry Jaruzelski, Marian Mueller, and Peter Conway

Imagine that you have just concluded a major merger or acquisition. Your organization is energized and focused by your speech, which outlined the features of the M&A deal and the potential of the combined entities. Having crossed off every item on your due diligence checklist, you expect big savings from restructuring; more importantly, you know that a year from now this newly created company will be the leader in its industry, with significant growth in revenue and higher profit levels.

Then flash forward to the first anniversary of your M&A deal announcement. The company's performance is below expectations and you're left with a nagging sense of doubt about the transaction. Wall Street analysts are questioning your firm's strategy, the wisdom of the deal, and the prospects for your stock.

We have seen this story repeated again and again after mergers and acquisitions. What goes wrong? Often, when you look closely, a common set of attitudes is at play — implicit assumptions held by the leaders who put the M&A deals together and conducted the due diligence. These attitudes fall into two broad groups. First are fallacies, misleading beliefs about the nature of M&A itself. Second are self-deceptions, the acquirers' misperceptions of their own company's capabilities and competence. By becoming more aware of them, you can raise the success rate of all your M&A deals significantly.

Five Fallacies to Avoid

M&A fallacies are often ingrained in a company's legacy practices, including the due diligence practices that have been successful in the past. It's not enough to recognize these fallacies. You must take specific precautions to keep from being blindsided by them.

1. "We can't walk away from this deal." This fallacy about M&A seems to make intuitive sense. The people who put a deal together — often the business unit general manager and his or her staff — know the target company's strengths and weaknesses and have the most at stake in the deal's success. Like all of us, however, they are subject to the vagaries of human nature. When they are too close to a deal, it clouds their ability to make an objective, unbiased decision. They are far too likely to focus on details that confirm their preconceptions and ignore details that contradict them. This is known in the field as "deal fever." It often manifests itself in statements like "We already have an agreement. Backing out would be too embarrassing to the CEO."

You can generally avoid deal fever with a layered decision-making process. The deal team, including the business leader who champions the acquisition, should

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present the case to a separate group or individual who can review its attractiveness more objectively. You must balance these prudent checks and balances against your need for speed. The most effective companies adopt "high-speed lanes" for decisions that must be fast-tracked, as well as top-layer deal review committees staffed by executives who agree to make themselves available quickly if needed. A deal committee frequently includes members of the company's capital committee, but the deal committee is smaller, enabling greater nimbleness and flexibility.

In one large industrial company, three layers of senior executives must approve a deal. The first layer consists of the president of the relevant business unit and his or her team; the second is a committee of senior corporate executives including the firm-wide CFO; the third includes the CEO and chairman of the board, plus corporate counsel and a few key advisors. Thus, the final level of approval consists of just a half-dozen individuals. Between 2002 and 2008, this company executed more than 50 transactions, and after the close, more than 90 percent of their deals either met or exceeded the performance target metrics set during pre-deal. The layered decision-making process, including efficient oversight at the top, is credited with being an important factor underlying the company's success. It means that experienced executives, who were not involved in setting up the deal, participate actively in two levels of review.

2. "Any experienced negotiator can negotiate deals." Executives often assume that all forms of negotiation are alike; thus, their commercial experience has prepared them for M&A deal making. Unfortunately, the auction-like nature of competitive deals can make mergers and acquisitions very different from negotiating a product launch or joint venture–related agreement.

For example, the acquiring management team may fall prey to a seller's overoptimistic projections or their own synergy estimates. This is especially likely to happen when there are several competing would-be acquirers, and the team feels time pressure to complete due diligence and submit a bid. It is easy to lose sight of the fact that if the price and terms aren't right, "winning" the deal can be worse than losing.

The answer is to think ahead of time about what you are willing to pay and to develop a true "walk-away" price. During negotiations, as you learn about the sellers' motivations and as new options are suggested, this preparation can help you turn down any new arrangement that doesn't give you what you need. Keep internal or external advisors in the loop to continuously check the value of the deal and provide advice on hard stops. You can also put measures in place that share some upside potential while still staying below the walk-away price. For example, you can prearrange a performance bonus for the sellers, to be awarded when agreed-upon financial milestones are reached. Be careful to make the terms explicit; even with good faith on both sides and well-thought-out milestones in place, it is possible to end up in a situation where targets are not met, and acrimony ensues.

3. "M&A performance is all in the numbers." Many executives assume that if the financial arrangements are secure, the rest of the deal will follow. But all deals have two other significant factors to consider that are often not accounted for in the numbers: the human element and the need to develop the capabilities required to succeed in the new or merged business. This is especially important if the new business model is different from the company's established model. A comprehensive due diligence process should take into account both the cultural and capability aspects of the deal.

Culture was a major potential hurdle when two large hotel and resort companies recently merged. One company had been founded by a hands-on entrepreneur who had always taken a data-driven, centralized approach to making major decisions (such as where to expand). The other company had been loosely cobbled together through past acquisitions, and left most expansion decisions to regional or local leaders. Before the merger was concluded, the senior leaders-to-be of the new entity conducted a survey of top executives across both organizations, and developed an action plan to counter the gaps in talent and skill that this survey revealed. The merger turned out to be a largely successful endeavor that brought two disparate organizational cultures into a cohesive brand and operating model.

In another case, the merger of capabilities had to be explicitly managed. A global operating company of a specialty materials group, which typically operated in business-to-business markets, acquired a maker of construction materials for consumers. Although the acquisition was relatively small, the president of the division made several trips to the acquired company's remote headquarters and spent significant time learning about the capabilities it had, as well as those that would be needed to win in the acquisition's market. This helped the acquiring company place the incoming team in the business unit that fit the team best.

4. "Information in the M&A process will naturally be kept confidential." When middle- and low-level employees get wind of a possible acquisition, leaks are possible, and they can have major consequences. Confidentiality should be taken very seriously and enforced during the due diligence process; leaks can come from a variety of sources.

A division of a global industrial concern was in the midst of negotiating a potential acquisition of a publicly traded company when a person on the diligence team leaked information about the deal to an outsider. Word spread, and the stock price of the target rose, significantly diminishing the deal's attractiveness. The person who leaked was dismissed, and a new confidentiality policy was put in place: All corporate development staff, as well as leadership team members, had to sign global nondisclosure agreements (NDAs) explicitly agreeing to secrecy on each deal to which they were privy.

Other ways of enforcing confidentiality include extending the NDA requirements to administrative staff, highlighting the importance of confidentiality during key due diligence checkpoints, prohibiting e-mail about the deal, and instituting preannounced penalties for leaks and breaches. Sometimes, key components of the due diligence process can be outsourced to a third party to reduce internal communications. These extra steps help reinforce the importance of the rules, even when the staff is already aware of the guidelines for confidentiality.

5. "There's time for detailed postmerger planning after the merger takes place." This fallacy is a comforting assumption for executives trying to rapidly conclude a detailed acquisition (while maintaining all their other commitments). However, it rarely leads to good results. Unless you define a detailed merger integration plan before the submission of the binding bid, you risk losing the momentum that you need to drive change and integrate the companies. In larger deals, in which input is required from the target to properly plan the postmerger effort, or in situations in which information is not forthcoming (such as hostile takeovers or auctions), due diligence can still identify the biggest integration risks and help you make the go/no-go decision, set your offer price appropriately, and identify initial risk mitigation hypotheses.

Identify a postmerger integration team and a leader during due diligence, as soon as it is clear that a binding bid will be submitted. This will help you identify some of the key integration risks and issues, and the resources required for integration. It will also lay the groundwork for postmerger review processes and metrics that can help hold the integration and business leaders accountable.

Self-Deception vs. Reality

Self-deceptions are often more difficult to address than fallacies, since practitioners think that they are already following the best practices. Our experience suggests otherwise.

1. "Our company's M&A process is strategy-led." Corporate leaders generally understand the importance of having a clear growth strategy before venturing into deals. Nonetheless, even in a sophisticated company, strategic definition can be surprisingly incomplete. This leads to significant delays in conducting due diligence, or to a lack of preparation in responding to deals when they become available (for example, responding to a banker's deal book).

At a large global industrial company, one division was very successful at getting internal approvals, whereas another division was not. Both divisions had good overall financial performance, but the successful division also paid specific attention to integrating its M&A plans with its organic growth strategy. The division leaders reviewed this cohesive combined strategy with the CEO every year. The result was a predisposition at the corporate level toward deals proposed by this division, even before they were presented. The other division had to go through an extensive analysis and approval process, especially for M&A deals involving adjacent or unfamiliar markets.

This is not just a matter of generating buy-in. Deals need to be generated with strategic intent, no matter how attractive the financials appear to be. This means that the acquired business should bring in capabilities that fit with the capabilities system of the larger company — or bring in new products and services for which the acquiring company's capabilities system is relevant. Otherwise, a deal may put the core business at risk or drain attention, time, and resources. In particular, mergers and acquisitions should reinforce and help build the capabilities that distinguish the core business from its competition.

2. "We have a thorough understanding of our markets." Most business leaders are predisposed to believe this. They have been involved in commercial transactions within their industries for the bulk of their careers. However, a merger or acquisition can easily bring a company face-to-face with aspects of its market that it doesn't know well.

An oil and gas equipment company was about to buy a company that specialized in innovative technologies for reading container capacity. The would-be acquirers thought they knew the market well and assumed this technology — which was most useful for partially loaded containers — would fit. But during due diligence, they discovered that in the largest markets, full load deliveries are the norm, and the technology thus had little utility. Because they weren't blindsided by their own assumptions, the company avoided making a potentially bad acquisition.

Draw on multiple perspectives, whether from inside or outside the company, to help you become aware of these sorts of issues. As you conduct due diligence, make sure you have a reasonably complete and up-to-date picture of the value chain for your target company's industry; the relevant market size, relevant segmentation data, and trends and growth drivers in each segment; customer needs by segment; customer attitudes toward the target company; current profit and profit potential by segment; technology trends and potential substitute products; geographic nuances by segment and product; competitive landscape (including as much as you can glean about products, pricing, and costs); and barriers to entry and new disruptive entrants.

3. "Our core market success is replicable in adjacent markets." The traditional definition of an adjacency is products and services that share some qualities or characteristics with your core market. For example, a manufacturer of frozen foods might think of entering the dairy business, because both businesses involve delivering precooled foods to supermarkets. In reality, however, most moves into adjacent markets are unsuccessful, especially those made through M&A. In our experience, only companies that have a well-defined M&A process that recognizes the importance of existing capabilities and the changes that will be required to evolve those capabilities have successfully executed such transactions with regularity.

Thus, when beginning an acquisition campaign, you should begin by evaluating your capabilities. Examine how well these will apply to the businesses in the company you are acquiring — and how well the capabilities you acquire will mesh with your own lineup of products and services.

The best acquirers take a strongly disciplined approach to business building, with strict criteria for acquisitions. These could include criteria related to target market size, degree of market fragmentation, gross margin targets, cyclicality and volatility, brand strength, customer concentration, and robust replacement parts or other streams of ongoing business. Such strict criteria should supplement the usual, simpler measures used by less-disciplined companies, which might be limited to target company size as well as revenue and earnings growth. When you reject target companies that do not fit your strictest criteria, you put a stake in the ground indicating that any company acquired will set up your company for above-market growth.

4. "We have a well-defined due diligence process." Many corporate leaders learn the hard way that this isn't true, particularly when their company is an infrequent acquirer or when they consider acquiring companies in different markets. They underestimate the amount of effort and time consumed by an acquisition or merger. Even when experienced senior executives are overseeing various functions, enthusiastic junior staff are executing the requisite tasks, and some due diligence processes are in place, there is still a tremendous amount of work to be done in a compressed time frame.

You may find, as you begin due diligence, that your processes are incomplete, and your team lacks the expertise to evaluate commercial prospects; technologies; legal issues; manufacturing footprints; procurement concerns; intellectual property; tax questions; regulatory issues; export controls; or issues related to health, safety, and the environment. At the least, you will need detailed standard questionnaires covering these issues; more likely, you will need to bring in experts who can answer questions with confidence.

However, this is not just a matter of finding the right people to help. One large diversified industrial company had a thorough due diligence process with pockets of expertise — but it was not well documented, making it difficult for everyone to coordinate, and for new staff to get up to speed. At one point, the corporate M&A team asked a divisional M&A team to add targets that had already been identified (by the division) as improbable candidates. Another business unit suggested a candidate that was not a good strategic match, but that was located conveniently close to the business unit's headquarters.

To avoid these types of problems, arrange regular meetings of new business development practitioners across internal boundaries. Document what went well and what did not go well following each transaction, to share with the group. Use these meetings to drive best practice development; share basic information about the market, as well as simple tips and tricks. Create due diligence templates and questionnaires, such as data request templates, so that work can flow seamlessly, even if individual staff members depart in the middle of a project.

5. "Our legacy due diligence team knows what they are doing." Even experienced due diligence staff may not have the right skills for every deal. It is important to bring in pertinent expertise to fully analyze a given opportunity, especially for adjacent markets, new geographies, and unfamiliar technologies.

In one case involving the acquisition of a technology firm whose primary customer was the U.S. government, due diligence was conducted by a team with very little experience in the defense sector. They correctly pointed out that margins on the target firm's government business were declining somewhat; however, they failed to discern a coming wave of increased government spending in the company's key business. The purchaser hesitated, opening the door for another buyer to come in and purchase the company. That competitor rode the wave of growth, enjoying high returns.

M&A is a complex process that requires significant and diverse skills and resources to execute well. By being aware of the trap these common fallacies and self-deceptions present, teams can design and execute an M&A process that is more effective and yields outcomes that consistently create rather than destroy value. +

Resources

Paul Leinwand and Cesare Mainardi, *The Essential Advantage: How to Win with a Capabilities-Driven Strategy* (Harvard Business Press, 2010): Guide to the meaning and value of coherence in strategy, with a chapter devoted to M&A principles that will produce a good fit between the two merging companies.

Gerald Adolph and Justin Pettit, with Michael Sisk, *Merge Ahead: Mastering the Five Enduring Trends of Artful M&A* (McGraw-Hill, 2009): Describes the trends affecting M&A and the ongoing strategy that a company can use to become an effective serial acquirer.

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