enews

strategy+business

Strategic Due Diligence: A Foundation for M&A Success

For further information:
Gerald Adolph, New York: gerald.adolph@booz.com
Joerg Krings, Munich: joerg.krings@booz.com
Booz & Company

09/28/2006

a strategy+business exclusive

Strategic Due Diligence: A Foundation for M&A Success

Understanding the rationale for a merger can help leaders uncover the potential value of a deal.

by Gerald Adolph, Simon Gillies, and Joerg Krings

The art and science of merger execution have made great strides since the late 1990s — a period when stock-market frenzy often led to a rush to judgment, and ultimately to buyer's remorse. Since then, a more prudent, systematic approach to mergers and acquisitions has emerged, and many companies with an articulated M&A strategy have gone so far as to institutionalize an M&A capability within their walls.

These corporate M&A groups have proven especially good at managing financial and legal due diligence — and at focusing on these critical items early in the integration process. This is all well and good; yet even the best financial and legal due diligence practices do not uncover the whole story for any given prospect, and they certainly do not guarantee success. There is a critical third component to due diligence. We call it "strategic due diligence," and it is vital to anticipating the problems that can derail a merger. Indeed, strategic due diligence is increasingly being demanded by boards of directors who want to be certain that a merger is the right choice.

What exactly is strategic due diligence? Whereas financial and legal due diligence ascertain the potential value of a deal and concern buying the company "at the right price," strategic due diligence explores whether that potential — however enticing — is realistic. It tests the strategic rationale behind a proposed transaction with two broad questions. Is the deal commercially attractive? And are we capable of realizing the targeted value? The first question requires external inquiry; the second demands an internal focus. Each question partially informs the other, reinforcing an inquiry that thoroughly plumbs the wisdom of the deal.

Above all, strategic due diligence ensures that no two transactions are treated the same way; each deal has its own value drivers, and thus the composition of each due diligence team must change. Executives should determine which areas of the organization will produce value in the merger, and draw members of the due diligence team from those areas. (See "Building the Diligence Team," page 4.) Strategic due diligence counterbalances the danger of institutionalizing and replicating a diligence capability ill-suited for the task at hand. Although some standard due diligence best practices can be adopted wholesale into strategic due diligence (see Exhibit 1), companies must tailor their process to the issues and potential integration challenges of each specific deal.

Strategic due diligence thus adds an important deal-screening filter. After all, executives must be convinced not only that the potential deal value justifies the significant investment being made, but also that the business is truly capable of realizing this value. Indeed, a sober strategic due diligence evaluation should help set the purchase price. The buyer should demand a price that is commensurate with the level of integration risk uncovered and be willing to walk away if that price isn't met.

Two Big Questions

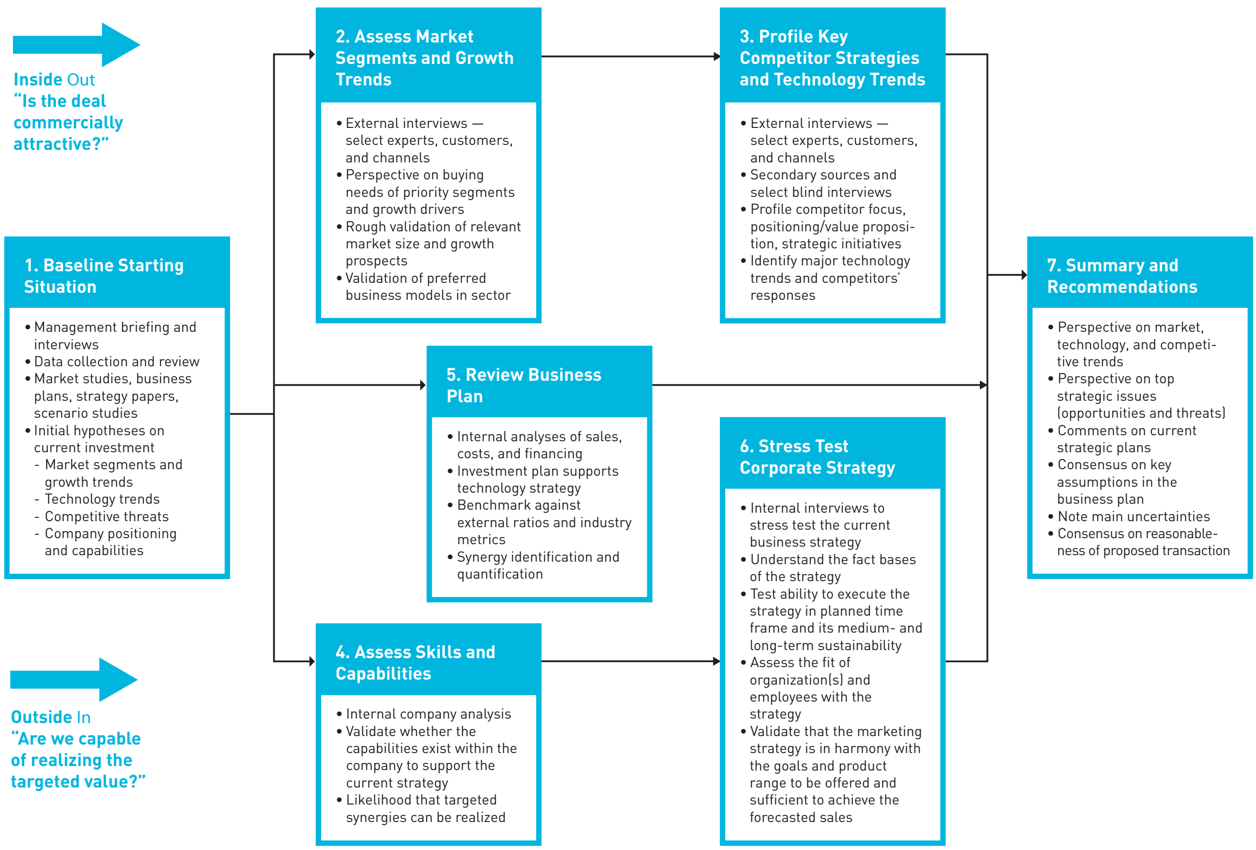
The first question, testing the commercial attractiveness of a deal, involves validating both the target's financial projections and any identified synergies using an *external* lens. Companies can achieve this by assessing overall market attractiveness and the competitive position of the target, and how these might change over time.

Whether the buyer is out-of-market (e.g., a financial buyer) or in-market (e.g., a competitor), this analysis is indispensable. However, for an in-market buyer, the commercial attractiveness issue may be more complex. The due diligence team involved in an in-market deal must gaze into the future and calculate the competitive position of the *combined* entity, including its impact on customers, competitors, and overall market dynamics. (Will the merger invite new entrants, for instance?) After all, customers and competitors will react to the merger in ways that will benefit *them* — ways that might threaten the combined businesses' value-creation assumptions.

As for the second question, a company must make a hard *internal* examination of whether the targeted value of the deal can be realized by the management team of the combined enterprise, and, if so, whether the projected time frame is realistic. For an in-market merger, it is vital that all the associated risks, in terms of customer and competitive responses, technology issues, and culture challenges, be weighed. When they have been weighed, the salient question becomes, Can these potential risks be managed? If preserving increased market share is a key driver of value, for instance, leaders had better be sure that the executives of the new company know their customers' needs, can meet them, and can fend off competitors who will surely try to pick off customers and clients during this period of uncertainty.

Although testing whether a company has the capabilities to realize projected synergies is particularly

Exhibit 1: **Strategic Due Diligence Methodology**



Source: Booz Allen Hamilton

Gerald Adolph
(adolph_gerald@bah.com) is a senior vice president with Booz Allen Hamilton in New York. His work focuses on corporate and business unit strategy, as well as merger and acquisition issues. To learn more about Booz Allen Hamilton's work in mergers and restructurings, visit: http://www.boozallen.com/mergers/.

Simon Gillies
(gillies_simon@bah.com) is a vice president of Booz Allen Hamilton based in Melbourne, Australia. He focuses on assisting Asia Pacific–based clients in corporate strategy development and implementation including mergers and acquisitions.

Joerg Krings
(krings_joerg@bah.com) is a vice president with Booz Allen Hamilton and managing partner of the Munich office. He focuses on turnarounds and profit-improvement programs for automotive OEMs, suppliers, and industrial clients.

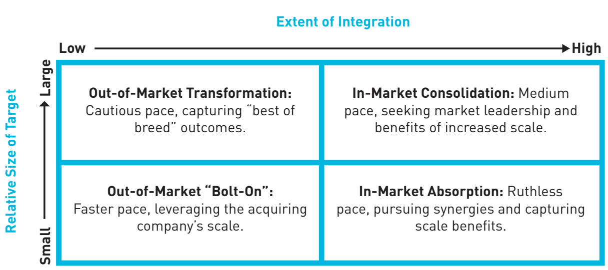
important when it involves an in-market merger, out-of-market purchasers are well served by a similar internal analysis that helps them understand the key drivers of value in the target company (people, technology, specific customers) and what the key management requirements will be in the new organization.

The Deal's Rationale

To focus strategic due diligence, it's necessary to pinpoint the value-creation opportunities of each transaction. To assist in this process, we have identified two dimensions that influence the strategic rationale and underlying value-creation focus of a deal. These two drivers are shown in Exhibit 2. On one axis, the degree of integration between acquirer and target drives the size and number of potential synergies. On the other, the relative sizes of the acquirer and target influence whether "best of breed" solutions from either company will be adopted, or whether the target will simply be absorbed into the acquirer's business model.

Mergers that are intended to strengthen current market position or that seek new growth opportunities by either entering a new market or developing new capabilities all have their own unique "degree of overlap" and "relative size," but we have found they fall into one of four categories when we perform this analysis. We have named the categories in-market consolidation, in-market absorption, out-of-market transformation, and out-of-market "bolt-on." Our four categories are broad, but we believe they are useful groupings that can serve as starting points for shaping any strategic due diligence effort.

Exhibit 2: **Value Capture**



Source: Booz Allen Hamilton

Let's take these four M&A categories one by one, recognizing that strategic due diligence always aims to validate the assumptions underpinning the strategic rationale.

The rationale for an *out-of-market transformation* (large target, low integration) is typically to transform a business by pursuing significant growth and broader capabilities in a new, attractive market. These are often "bet the farm" deals in which a company either extends the reach of its existing products or services into a new geographic market (such as with telephone and cable mergers), or diversifies into a new set of products and services (such as with a private equity group or conglomerate).

In this case, the strategic due diligence process should focus on testing the new market's attractiveness, assessing the target's competitive position, identifying critical capabilities and resources that need to be retained, judging potential market responses, and evaluating whether there are best-of-breed management practices or operating models that should be adopted across the organization. Also, those performing strategic due diligence must understand the complexities of governance where there is minimal formal integration; the systems and policies used to run the still distinct businesses should be uniform, and "legacy" people from both former companies should be dealt with consistently. Two distinctive cultures mean that cultural issues will manifest themselves in myriad ways and need to be well understood.

Experienced due diligence and integration managers must be involved in these mergers, and there must be

Building the Diligence Team

The value of strategic due diligence relies heavily on the quality of the team in charge of the process. Building a strong team is important both to ensure proper assessment of the deal and to facilitate the actual integration.

We have identified eight best practices for organizing a due diligence team:

1. Choose the right people who have time to lead the project and serve as team members. Time constraints and confidentiality will make it difficult to replace these people later in the process. Dedicate specific team resources for the due diligence period.

2. Diligence will naturally focus on certain functional areas. Human resources, information technology, finance, operations, and even R&D and marketing may all be involved. Be sure to draw team members from all of these areas of the organization. This adds valuable expertise, and it helps the team attain the buy-in from line management that can be hard to get if a key functional area is shut out of the integration process.

3. Ensure that the diligence team is co-located within a secure environment, such as a corporate headquarters. Sometimes it makes more sense to locate the team near the target.

4. Communicate to the due diligence team the strategic and financial rationale behind the acquisition. They should understand enough detail to be able to identify critical diligence issues.

5. Train the team to identify and home in on specific issues, including the analysis and data required. This ongoing checklist keeps the diligence on track and brings it to a conclusion. It thus helps to avoid the "analysis paralysis" that can result from an undirected data search.

6. Develop and communicate rules of engagement between the diligence team and the target company. This avoids cultural conflicts and ensures that the team acts in a manner that reflects the acquirer's intentions.

7. Make available analytical tools and techniques so the team can rapidly get its arms around potential synergies and integration challenges. This helps the team complete its task within the allotted time and budget.

8. There must be a healthy flow of information from the due diligence team to the integration team. Therefore, include diligence team members in the integration planning team to ensure that diligence rationale and data analysis are properly leveraged.

Although many of these best practices apply in all merger cases, there are some differences in focus depending on the nature of the merger. For example, in an out-of-market transformation, it's important that the team include those with human resources skills who can identify and retain the personnel who will drive value, as well as commercial people who can analyze product and customer profitability in these new markets. For an in-market absorption, on the other hand, human resources skills are critical to planning and coping with the impact of headcount reductions. But the diligence team must also include commercial, operational, and administrative people who can assess the potential value and timing of synergies after the merger.

high-profile, executive-level participation from both sides, especially when it is clear that the capture of "best of breed" outcomes requires culture change. A strong analytical team must drive the market and competitive assessment, and the human resources team needs to focus on organizational and cultural issues. If there are areas of consolidation, functional representation is critical to ensure buy-in from management.

The strategic rationale for an *in-market consolidation* (large target, high integration) is to create a market leader that can realize benefits by improving pricing and marketing, rationalizing operations, and leveraging assets, such as technology and skills. The acquiring company may want to increase market penetration with its products and services, and capture scale benefits within its operations. Most current mergers in the automotive and utility industries fall into this category.

For such a merger, strategic due diligence should focus on assessing potential customer value, including revenue upside and risks; validating synergies and identifying challenges when consolidating areas such as administration, operating infrastructure, and work force; determining which processes and assets are best of breed; and assessing cultural fit and integration risks, such as loss of key people in nonconsolidated areas.

This strategic due diligence team should have strong cross-functional representation from both companies involving managers who will also lead the actual integration. Human resources support is needed to manage the organizational challenges, as is analytical support from corporate headquarters. Ideally, experienced due diligence and integration managers should be involved.

The strategic rationale behind an *out-of-market "bolt-on"* (small target, low integration) is to create a new platform for growth through a relatively small acquisition. This expansion could be into a new geography — which is common among regional hospitals in the U.S. and mobile telephony — or into entirely new product or service offerings, such as a vertical integration play when a company seeks to broaden its capabilities and leverage its scale.

When geographic diversification is a factor, the rationale for the merger may involve taking advantage of deregulation, "rolling up" small players in a fragmented industry into a more coherent regional or multinational player, or expanding the scope of the business. Most likely, little consolidation will be needed beyond eliminating redundant functions such as corporate staff, information technology, and human resources. Strategic due diligence should include a focus on identifying opportunities to leverage best practices, product development, and infrastructure across the group. Even though these "bolt-ons" may operate fairly independently in the new organization, the purchaser should ask itself about its own "parenting abilities." What resources can the company use to accelerate growth while preserving the core of what it's acquiring?

Besides this parenting question, strategic due diligence for an industry buyer should focus on testing the new market's attractiveness, determining the target's competitive position, identifying what critical capabilities to retain, and addressing any cultural issues. This due diligence group should include a strong analytical team to drive market and competitive assessment, an HR team to focus on organizational and cross-border cultural issues, and functional representation in areas of coordination.

Likewise, when the out-of-market "bolt-on" involves a financial buyer or conglomerate, the same emphasis should be placed on testing the new market's attractiveness, ascertaining the target's competitive position, and retaining key personnel. Cultural differences are unlikely to need addressing beyond creating policy consistency and ensuring the interests of both sides are aligned.

The strategic rationale for an *in-market absorption* (small target, high integration) is that, by acquiring a competitor in the same market, the buyer can capture operational synergies through leveraging its existing asset base. Markets that often see in-market absorptions are U.S. retail banking, second- and third-tier auto suppliers, and technology acquisitions by the likes of IBM and Cisco Systems.

The buyer is likely to be focused on eliminating excess capacity by closing plants, merging sales, reducing overhead, improving market pricing, boosting utilization rates to increase the return on assets, and absorbing the acquired business as efficiently as possible. Therefore, the strategic due diligence focus should be on validating these assumptions, pursuing ways to accelerate synergies, and assessing potential customer and competitor responses that may impact market upside and risk.

In this case, the due diligence team should be drawn principally from the acquirer to ensure ownership of integration goals. The team should be cross-functional with a strong operational focus. Involvement of senior (or chief) human resources and information technology executives is often critical in managing work-force reduction and system integration.

Realizing Full Potential

Strategic due diligence requires an up-front investment of money as well as the time of some of a company's most capable managers — even before the deal is certain. Indeed, the team should be carefully structured to guarantee the right skill set and influence; and it should be established early enough to kill the transaction if it determines that the strategic rationale and hoped-for synergies simply are not attainable. But the advantages of strategic due

Three Common Themes of Failure

Strategic due diligence is a challenging task, to put it mildly, and there are any number of ways to veer off course if careful attention is not paid to the work. However, we have identified three "themes of failure" that most often derail due diligence.

1. Failure to Focus on Key Issues

• *Fools Rush In:* Time will be tight, but don't rush through the necessary step of clarifying the rationale for the deal and sources of expected value. This step determines which hypotheses need to be tested and avoids wasting time gathering irrelevant data.

• *Reinventing the Wheel:* Don't be so distracted by the process that the analysis suffers. When possible, use a common diligence methodology, standardized formats, and simple project management software to manage and share relevant diligence data. This will save time, keep the process focused, and thus permit a higher level of analysis.

• *Reluctance to Share:* When diligence information is not shared adequately among all diligence teams, it's impossible to focus effectively on the larger issues at hand. A clear flow of data through the use of regular (as frequent as daily) updates can quickly identify "deal killers"; it can also help the team allocate resources more effectively, and it will lead to a richer and more nuanced view of the diligence issues.

• *Analysis Paralysis:* Inevitably, some issues will remain in doubt, but the team must be rigorous about defining an end point for the analysis. Part of being focused is knowing when to check something off the list, when to report it to management, and when to move on.

2. Failure to Identify New Opportunities and Risks

• *The Unquestioned Assumption:* Although time constraints prevent any major recasting of a company's strategy, a quick stress test of management's key assumptions about its business may show opportunities for growth or a strategic refocus that may create significant value.

• *Being Afraid to Rock the Boat:* Even when a deal seems imminent, it is not too late to probe deeply into its merits. Ask the target company's management both broad and specific questions to gain a deeper understanding of value drivers and key risks. Also, identify and interview customers and the competition. This is all part of reaching sound conclusions on possible trends (such as the emergence of a substitute product or service) and risks (such as the market entry of a new competitor).

• *"It's Just an Audit":* Due diligence is more than an audit. By validating the assumptions that underpin the business plan and detecting risks or inconsistencies early, diligence aids management's long-term stewardship of the company.

3. Failure to Allocate Adequate Resources

• *Choosing the Wrong People:* The best people for the due diligence team are probably also the company's most valuable managers. Find a way to put them on the job rather than choosing people who happen to have time available. Also, make sure to choose people with the right expertise; don't overlook managers from the functional areas of the firm that will be affected by the deal.

• *Insufficient Time:* The due diligence process will be a time-crunch affair, but don't make the problem worse than it is. Give the team as much time as possible, and don't be trapped by artificial or arbitrary deadlines.

• *Insufficient Resources:* Support the due diligence teams with the resources of the firm. This includes space to work, equipment, software, staff, and access to the right data and people. And, as much as possible, relieve them of their daily responsibilities so they can focus on the task at hand.

diligence go well beyond the ability to stop an ill-conceived deal. If the deal moves forward, the full benefits of strategic due diligence will manifest themselves.

First, strategic due diligence can help set the value and purchase price of the deal. Second, it can help articulate and buttress the strategic rationale for the deal, instilling greater confidence among stakeholders that the company's claims about projected benefits are reasonable and attainable. Finally, strategic due diligence provides a strong platform for the actual integration.

All these benefits depend, however, on management's ability to approach each deal as new. The power of strategic due diligence is its focus on the specifics of the deal. We are not saying companies must reinvent the whole wheel for every deal, but they must not reuse too many old spokes. Strategic due diligence acknowledges the unique nature of every deal and offers a path to realizing each transaction's full potential. ✚

strategy+business magazine
is published by Booz & Company Inc.
To subscribe, visit www.strategy-business.com
or call 1-877-829-9108.

Originally published as “Strategic Due Diligence: A Foundation for M&A Success,” by Gerald Adolph, Simon Gillies, and Joerg Krings.