Zachary Scott
INVESTMENT BANKERS

INSIGHT
PERSPECTIVES ON THE CAPITAL MARKETS
REPRINT
FALL 2005

Making M & A Successful—Due Diligence

Due diligence by successful acquirers extends well beyond verifying data.

by William S. Hanneman

In the last edition of *Insight*, we explored the value of a clear strategic vision to the success of a merger or acquisition. If the opportunity makes strategic sense, and the initial proposal is attractive to the seller, the acquisition process moves into the "due diligence" phase. Black's legal dictionary defines due diligence as "the diligence reasonably expected from and ordinarily exercised by a person who seeks to satisfy a legal requirement or to discharge an obligation." In an M&A context, these investigations are most often designed to test the accuracy of business and financial assumptions through the analysis of a much greater level of detailed data.

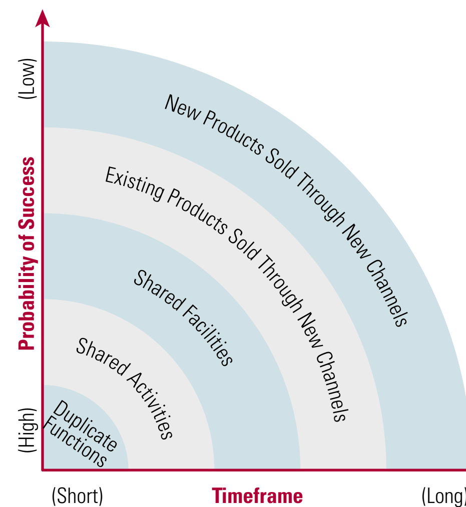
In our opinion, this definition and scope of effort is far too narrow. Due diligence undertaken by successful acquirers extends well beyond simply verifying data. In the business acquisitions in which we have been an advisor, a much more robust diligence process is sought that, in addition to assuring full disclosure, re-tests the transaction's strategic rationale and identifies the synergies likely in a business combination. Then, these findings are used to refine both the value of the target business and the deal structure. The critical element of the due diligence review is a feedback loop back to the M&A team to allow it to consider the risks and opportunities discovered in the investigation, for the purpose of determining a precise set of conditions on which to move forward or to abandon the opportunity altogether.

TEST THE STRATEGIC LOGIC

The overriding objective of a due diligence investigation is to test the information and assumptions that underlie the deal's strategic logic and to second-guess the value conclusions. The question—"just what are we really buying?"—can't be probed too deeply. Enforcing that discipline throughout the due diligence process helps to guard against pursuing a deal based on the idealized image of the target company garnered from its well-hyped public profile, the quality of its products, or its brand reputation. The due diligence investigation should dig out the real story beneath an often-varnished surface.

In a strategic review, buyers cannot rely solely on information provided by the target company, but must build their own "bottom-up" view of the opportunity and the competitive environment in which it operates. This typically means an independent evaluation of customers, suppliers, and competitors. The conclusions of that assessment must define the value drivers—revenue, cost, earnings, and capital investment requirements of the combined enterprise. It is important to avoid preconceived notions or over-confidence that often permeate M&A deal making.

M & A Synergies: What will they deliver?



WHERE ARE THE SYNERGIES?

It is almost always a challenge to be realistic about the synergies that an acquisition will deliver. Acquirers routinely over-estimate the value of potential cost and revenue benefits and downplay the difficulty of achieving them. This is a major reason why acquisitions all too frequently yield substandard returns.

The due diligence process should carefully distinguish between different kinds of synergies, the probability and speed at which they can be realized and the resources required to reap the benefits. As illustrated by the above chart, savings derived from eliminating duplicative costs through consolidation can often be won relatively quickly and easily. Farther out on the scale, the benefits from introducing new products to new distribution channels often prove to be both tantalizing and elusive. Ranking potential synergies in this way forces a distinction among possible synergistic initiatives. The potential benefits on the outer portion of the scale should be accorded a much lower value (if any) than those closer to the center.

The due diligence effort should also identify potential "negative synergies," such as loss of customers, added costs, or investments necessary to combine the businesses. In our experience, these factors are often overlooked in the exuberance of deal making.

WHAT IS THE BUSINESS WORTH?

Ultimately for the due diligence review to be useful, the information gained must be used to craft a purchase agreement that mitigates risk and sets a purchase price that is a fair measure of the risks and opportunities in the business. To accomplish this, the diligence team must communicate its findings to the negotiators working directly with the seller to structure the transaction. The challenge is to either negotiate away the unanticipated risks that have been identified or to quantify them and adjust the purchase price accordingly.

The final due diligence objective is to determine a walk-away price, which is the maximum value the buyer can economically justify for the benefits that a business combination may bring and the specific terms under which the price can be paid. To be clear, this is not necessarily the package that would be offered to the seller, but rather serves as the outer negotiation limit.

Transactions invariably gather momentum that is hard to resist. All too often, the dynamics of the process create pressure to stretch beyond the justifiable value in order to get the deal completed. The temptation is to then search for synergies that will validate the deal. Due diligence should be designed to guard against this by establishing a definitive framework for an acceptable transaction.

CONCLUSION

Based on past experience, we can say,

(continued p.2)

without hesitation, that a well-executed due diligence effort can be the determinant of M&A success and a marginal or failed endeavor. In the final analysis, due diligence is the process of confirming the assumptions that underpin the deal's strategic logic and making suitable adjustments in order to avoid paying more than the business is worth or exposure to unforeseen risks. Once the real parameters of the acquired business are clearly understood, the investment thesis and value should be fine-tuned. The final step is to document the transaction under terms that support the strategic logic and apportion the risks appropriately. But, that's a topic for the next edition of *Insight*. ❖

Zachary Scott
INVESTMENT BANKERS

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

Mark D. Working
206.224.7382
mworking@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Ray D. Rezab
206.224.7386
rrezab@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Brian J. Kremen
206.838.5526
bkremen@zacharyscott.com