Zachary Scott
TRUSTED ADVISORS

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Improving Acquisition Success Through Better Assessments: Part 1—Sustainable Business Model

Thoroughly investigating all the variables of a business may determine success in the future.

by Mark Working

The statistics on acquisition success, measured as realized return on investment relative to expected return on investment, are not good. Most of the research indicates that only about half of all deals are "successful". A recent Harvard Business Review Report claims that between 70% and 90% of all corporate acquisitions are judged as failures from a value standpoint. As advisors in mergers and acquisition transactions for more than a quarter century, we have observed that the most common villains stealing success from acquisitions fall into one of three buckets: misjudgments about the duration of the business model in its industry setting (sustainability), shortages of the necessary ingredients required to perpetuate the business under new ownership (advantages and deficiencies), and an over-optimistic view of future profits, capital and the relationship between the two (price).

No acquirer has the power to address and control all of the variables that will affect a business, but each does have the ability, with sufficient upfront investigation, to understand which variables have the greatest influence on the future success of the business.

Each business offers a value proposition to its customers, suppliers, and employees. To deliver that value proposition, the business employs capital and labor in order to produce a "profit". Almost every business is continually under attack; whether from competitors, suppliers, customers, or substitutes that can challenge the validity of the value proposition that is the basis of the business. It is in this context that acquisitions are made. Not an easy job, but the odds of success can be increased with thought and discipline.

PART I: SUSTAINABILITY: STABILITY AND LONGEVITY OF THE BUSINESS MODEL

Customers want better pricing, service and/or quality, and want it only when they need it. Suppliers want higher prices and guaranteed volumes to assure a continuous reliable supply. Competitors want your customers and at times, as a result of sub-optimal capacity utilization, may be willing to accept much less compensation to get them. In this world, employees will pursue their best options, sometimes as a result of their skills becoming more valuable in a totally different industry. In addition to the myriad of direct attacks, externalities such as new governmental regulation, currency revaluations, and economic cycles can alter the demand curve and cost structures of whole industries. If not tough enough already, substitute value propositions can emerge to redefine how customers' needs are satisfied, potentially disrupting entire industry value chains out of existence.

No acquirer has the power to address and control all of the variables that will affect a business, but each does have the ability, with sufficient upfront investigation, to understand which variables have the greatest influence on the future success of the business. In an acquisition, a buyer should evaluate expectations for value chain stability during the investment horizon of the acquirer, and determine what will be necessary for the target business to survive and thrive in that environment. This can be done by carefully considering the target's value proposition and its economic components, and how that will fare in future market conditions in which the business will operate.

THE VALUE PROPOSITION

Businesses compete by offering a product or service to their customers at a price that is lower than the perceived value received. Why did the customer make its choice, and is it repeatable? To answer that question, the ecosystem in which the business operates needs to be understood through an assessment of the market and the relationships among all the parties in the full value chain in terms of where the profits are made, capital is invested, returns earned and risks are borne.

Presumably, the target business has been successful to some degree over time. Why? What is the target's unique value proposition? Does it offer the best price, the greatest reliability, the quickest response, or the best customer service? Does it represent a geographically or logistically irreplaceable link in the value chain?

The purpose of this analysis is to determine the specific reasons for why the business has experienced success, against which future conditions can be compared. Should these reasons become more or less important, the business will likely be impacted accordingly.

ECONOMICS OF THE BUSINESS: UNDERSTANDING THE COMPONENTS

Each business has its own unique economic structure that determines the level of "profit" it generates as it delivers its value proposition. To understand how each business works, it has to be deconstructed into its component parts – the revenue stream, cost structure, and capital requirements.

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The revenue stream is a function of its individual product and customer compositions, volume, and pricing policy. Likewise, the cost structure is a combination of fixed and variable costs, some directly related to a revenue stream and some necessary to support the entire business. When deconstructed into its parts, it is not unusual to find that a business earns disproportionate amounts of profit among its products and/or customers. Similarly, some of the capital requirement is directly related to

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an identifiable revenue stream, and some are not. For instance, special treatment of a large customer might require a disproportionate amount of working capital for a dollar of sales than for other customers as a result of special payment terms or inventory to support just-in-time deliveries.

By analyzing the marginal effects of different volume and pricing changes on business performance, certain factors, often referred to as value drivers, identify themselves as the most important. Understanding these critical factors and their degree of importance to business performance helps the acquirer focus investigation on what matters most for determining the future success of the business.

FUTURE MARKET CONDITIONS

Having thoroughly evaluated the target company, the dynamics of the industry in which it operates and understanding its unique economic proposition (returns, investment requirements, and risks), consideration then turns to the future.

The demand side of the equation must be forecast. Is demand from the ultimate end user likely to change? Is it predictable? Do alternatives exist and are they taking hold? For example, there is a difference between a service required by government decree, and one that offers the lowest cost solution. In the first case, demand only changes when regulations change. In the latter, demand can be altered from the emergence of a lower cost alternative.

The stage of market evolution also makes a difference in the immediate future of the business's product or service. In other words, is the product or service relatively new with opportunities to widely expand adoption, or is the market mature? In the growth phase, the value chain tends to remain stable as focus is on producing volume to keep up with demand. As demand matures, costs become more critical and participants throughout the value chain begin to consider ways to win by gaining scale through market share, collapsing the value chain by "going direct", and by creating better mousetraps.

Understanding the structure of the industry, why it exists, and what factors hold it together allow judgments to be made on future growth, stability and longevity of the industry and the company's position within it. Overall macro demand has to be considered in light of the growth expectations for the target business and the relative success of its value proposition.

THE FUTURE IS NOT JUST AN EXTENSION OF THE PAST

Obviously, the future is uncertain. Nevertheless, the first stage to considering an acquisition is the development of an informed opinion about the dynamics of the market in which the target competes, an understanding of why the target has succeeded, the nature of future demand, and what future conditions and challenges will need to be addressed to maximize chances for continued success.

The next step, which we will cover in Part II of this series, is to identify the specific advantages and deficiencies of the target business such that an assessment can be made of the challenges to be overcome to continue the viability and success of the business following acquisition. **ZS**

Zachary Scott

TRUSTED ADVISORS

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, go to **ZacharyScott.com.**

Frank Buhler
206.224.7383
fbuhler@zacharyscott.com

Jeffrey Cleveland
206.838.5521
jcleveland@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Mike Dannenberg
206.838.5531
mdannenberg@zacharyscott.com

William Hanneman
206.224.7381
bhanneman@zacharyscott.com

Michael Newsome
206.224.7387
mnewsome@zacharyscott.com

Ray Rezab
206.224.7386
rrezab@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Mark Working
206.224.7382
mworking@zacharyscott.com