The Role of Strategic Due Diligence in the Acquisition Process

Creating value through acquisitions has proven to be a perilous strategy. Often, the seller knows more about the business and its markets than the buyer. This asymmetrical knowledge can cause the buyer to overpay and result in the destruction of large amounts of shareholder value. How does one avoid costly strategic misreads when completing acquisitions? The answer lies in recognizing what you are buying, understanding how it fits into your overall strategy, and carefully developing your post-acquisition plan. The objective of this article is to outline a strategic due diligence process that will help you maximize the probability of achieving a value-creating acquisition.

Due Diligence Defined

Due diligence is the process by which buyers investigate and evaluate a potential acquisition. The broad term is used to describe activities in a variety of disciplines including law, accounting, environmental, human resources, and others. Of these different due diligence activities, the three that generally receive the greatest attention are accounting, legal and environmental assessment (usually for manufacturing businesses).

These three activities are extremely important in helping to ensure the completion of successful acquisitions. Typically, companies will rely on professional service firms with specialized expertise to perform an objective appraisal of these due diligence areas. The findings from the legal, accounting, and environmental reviews can result in renegotiating the transaction price or, in some cases, abandoning a transaction.

We caution executives to recognize that the information garnered from these assessments represents just the tip of the iceberg as to whether a potential acquisition will be successful. Legal, accounting, and environmental audits are fundamentally backward-looking reviews. Their principal focus is to evaluate a company’s historical actions or to uncover past problems that the buyer does not want to inherit or wants to receive compensation for in return.

We are not suggesting that these historical issues are trivial or unimportant, but the one-time costs associated with fixing identified problems from the past are often minor compared to the overall economics of the transaction. The key driver of the merit of a transaction is the expected value of the future cash flows attributable to the acquired company. Typically, the future value of items such as revenue growth, gross margin improvement, cost synergies, and balance sheet efficiencies dwarfs the cost of settling an outstanding legal claim or resolving an environmental problem.
Additionally, the information disclosure requirements in the nonstrategic due diligence areas are much better defined. For example, public companies must have independently audited financial statements. This can make major accounting problems easier to identify. Similarly, regulations require the disclosure of known environmental issues when properties are exchanged. In our experience, it is unusual for a seller to deliberately violate these rules, as they can often be held liable for nondisclosure. In summary, rigorous accounting, legal, and environmental due diligence are key reviews for any acquisition. However, the expectation should be that the results will confirm what was previously disclosed by the sellers.

Strategic due diligence, on the other hand, reveals the most important insights regarding a company’s future value. Broadly defined, it represents the set of activities involved in evaluating a target company’s markets, customer relationships, competitive position, and strategic direction. The knowledge gained from this evaluation becomes the critical input into determining the target’s value to the acquirer. This information can then be leveraged to drive the bid and negotiation strategy to ensure that the largest portion of the value created from the transaction is captured by the buyer’s shareholders.

Strategic due diligence is typically organized into two distinct phases, each of which involve three activities:

**Phase One: Analysis of External Environment**
- Market Assessment
- Customer Analysis
- Competitor Analysis

**Phase Two: Valuation and Negotiation**
- Valuation Analysis
- Sensitivity Analysis
- Negotiation Strategy
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to forecast the expected growth in the businesses of the target's value can be based (see below). The three activities in Phase One are typically performed concurrently as they are complementary and, in some cases, overlapping. For example, customers are often the best sources of information on competitors, and hence, the interviews performed in the customer analysis will provide important insights into the key competitor analysis questions.

Market Assessment
The objectives of market assessment are to establish the current market size and to forecast the expected growth in the segments relevant to the target company. The first part of this activity is to construct the appropriate strategic segmentation of the market given the target's business model. A strategic segment is that portion of a market that requires a defined set of competencies, assets and geographic presence in order to compete. Hence, a strategic segment will often have a common set of competitors, customers, service requirements or technological capabilities. Strategic segmentation can take several forms as the following examples illustrate:

- End-user: many manufacturing businesses are aligned based on the end-user’s industry (e.g., telecommunications, automotive, computers) since the supplier requirements differ by industry.
- Geography: this is the most common strategic segmentation for service businesses, as a local presence is often required.
- Price Point: price is a common means of segmenting many consumer markets (e.g., automobiles, residential housing, clothing) as many factors including product quality, service levels, and sales channels can differ markedly by price point.
- Technology: technological capabilities are frequently the appropriate segmentation in industrial markets where competing approaches can serve the same customer need (e.g., plastics vs. metal, automated vs. manual).

Once the strategic segmentation for the target's market is determined, the next step is to ascertain in which segments the target competes today and where it has the capabilities to compete in the future. We have seen situations where an acquisition candidate attempts to position its upside opportunity by referencing the size and growth prospects of an entire market, when in fact it can only compete in a small portion. As a buyer, you should not pay for this upside unless the acquisition provides a clear means of entry into a new segment that would otherwise not exist for the buyer or would be more costly to achieve by other means.

The final activity in this step is to forecast the growth of the relevant strategic segments as a means of setting boundaries around the target's revenue upside potential. This is performed by using multiple sources of market information including industry reports, interviews with experts, government sources, competitors’ literature, and feedback from customers. It is important to consider the negative influence of factors such as substitute products/technologies as well as the positive influence of factors such as expected growth in the businesses of the target's customers.
The output is a robust market model defining the size of the relevant market segments; this will serve as an important input to the revenue forecast in the valuation of the target.

**Customer Analysis**

Customer analysis can provide the most important insights into an acquisition, since it takes into consideration customers’ perspectives on their future buying behavior and the target’s ability to meet changing needs. L.E.K. typically begins by identifying customers according to the strategic segmentation developed in the market assessment, and then selecting a representative sample of the key customers to be interviewed from each segment. The number of customer interviews to be conducted is a function of the concentration of buyers within the target’s markets and the diversity of the responses received in the initial interviews. The more concentrated the customer base and the less variable the responses, the fewer are the number of interviews that need to be performed and vice versa.

The interview content should be designed to probe for insights on current buying criteria, how customers expect these to evolve, how the target company has performed on the criteria versus the competition, and what it will take for the target to win a greater share of business going forward. For fast-changing industries, it is particularly important to focus the interview on the future, as these insights will be the most relevant to the forecasting of cash flows of the target. We recommend speaking to both ex-customers and non-customers of the target to supplement the interviews with current customers. It is these interviews that often provide the best insight into a target’s true competitive position.

**Competitor Analysis**

The objective of competitor analysis is to gauge the acquisition’s value based on its strategic position vis-à-vis existing and future competition. The focus of this analysis is on current, direct competitors, but you need to also consider the barriers to entry for new competition, the likelihood of new entrants, and the threat imposed on the target by competitive entry. Once the competition is defined, your goal is to benchmark the target’s relative strengths and weaknesses in meeting customers’ needs. Several sources can be utilized, including competitors’ published materials, customer feedback, industry sources, general literature searches, and interviews with competitors directly. The ultimate goal is to define the competitive threats and opportunities for the target that can then be quantified in the valuation analysis.

One question often asked by our clients is “How thorough do we need to be in these first three steps of strategic due diligence?” The answer depends on two considerations:

- How well you know the target and its markets
- How large the transaction is in absolute terms and relative to your company’s resources (see figure below)

All other things being equal, the further the target company is from your core business in terms of product/service offerings, customers, competitors, or geography, the greater the required level of strategic due diligence. Similarly, the larger the financial commitment that you are making of your shareholders’ and investors’ resources to complete the acquisition, the greater the level of required strategic due diligence.
For acquisitions that are very close to your core business, are participating in a familiar geography, and involve a relatively small financial commitment, the work in Phase One may be minimal.

Valuation and Negotiation

The objective of Phase Two, Valuation and Negotiation, is to utilize the strategic insights from Phase One to determine the true value creation potential of an acquisition and to make informed decisions in the negotiation process. There are three distinct activities in this phase.

Valuation Analysis

The easy part of valuing a target acquisition is building the discounted cash flow (DCF) model to project the income statement, balance sheet, and cash flows. The difficult part is developing the assumptions that drive the key lines of the valuation. The results from Phase One can provide the intelligence to reduce the guesswork normally associated with this task. For example, a thorough understanding of customers’ future buying behavior and competitors’ relative positions allows you to make educated hypotheses regarding an acquisition’s future market share in each strategic segment. This forecasted market share, along with the predicted size of each market segment, enables you to forecast the target’s revenue with reasonable confidence.

A similar process applies to the cost side of the income statement. If customers characterize their supplier choice as principally driven by the suppliers’ ability to introduce new technologies, you will likely need to maintain or increase the present R&D budget in the forecasts. The key is to allow the qualitative information from Phase One to drive the quantitative assumptions in the valuation model. If you are unable to make an educated estimate as to the forecast for a key income statement or balance sheet item, you need to perform more research.

In valuing the target, two separate analyses should be performed. The first is to forecast the stand-alone value of the target, assuming that the company is operated as is; this value represents the seller’s minimum price for divesting the business. The second analysis is to add revenue, cost, and balance sheet synergies associated with your ownership of the target to the stand-alone value. The one-time costs associated with completing the transaction are then subtracted from the synergies to determine the target’s full synergistic value to you. This value represents the maximum price that you are willing to pay in order to acquire the target; if you were to pay above this level, you would be destroying value for your shareholders by completing the transaction (see figure above).

Sensitivity Analysis

Once both the base-case stand-alone value and synergistic value of the target have been established, the next step is to perform a series of “what if” analyses around the key assumptions driving the valuation. No matter how thorough the strategic due diligence and no matter how strong your knowledge of the target, there will always be some uncertainty regarding a few of the key assumptions.

We deal with this uncertainty by conducting sensitivity analysis, or varying the key assumptions around the range of uncertainty and measuring the impact on the target’s value.
Sensitivity analysis is an important tool for three reasons. First, it highlights for your senior team the most critical factors driving the valuation of the target; often the dozens of assumptions made in determining the value of a target company can be boiled down to five or six critical considerations. It is precisely these items on which you need to spend the majority of your attention in the last hours before reaching a final bid decision. Second, sensitivity analysis helps to quantify the size of the economic risk that you are taking in deciding to either bid or not bid on a particular property. Often these decisions are made on gut instinct or intuitive feel, but experience shows that the analytical rigor of sensitivity analysis can lead to considerably more accurate conclusions. Third, if the transaction is completed, this analysis can serve as a focus for post-acquisition integration (see figure above).

**Negotiation Strategy**

The last step in the strategic due diligence process is to determine the price to bid for a company within the value creation range. As discussed in valuation analysis, the stand-alone value of the target is the seller’s minimum price and represents the bottom end of the range; the synergistic value of the target minus acquisition costs represents the upper end of the range. We consider several factors in recommending a specific bid strategy within this range as follows:

- **Your confidence in the base-case assumptions.** As a general rule, the less sensitive a target’s value is to the range of uncertainty surrounding the key assumptions, the higher you should bid. This would not be true, however, if the uncertainty distribution curve were skewed toward the favorable range.

- **Competing bidders.** The more common the synergies to be realized among likely competing bidders, the more likely it is that you will have competition on the high end of the bid range. Hence, a higher bid may be necessary.

- **Alternative valuation techniques.** Other bidders may use alternative valuation techniques to set their bid, such as multiples analysis (see side box). Depending on the value for the target calculated by these techniques, the higher or lower you will need to bid within the value creation range.

- **Strategic implications of not doing the deal.** This represents the opportunity cost associated with the transaction. The value of the acquisition needs to be compared to the value associated with the next best use of the allocated capital. The less favorable the risk-return trade-offs associated with the competing options, the higher your appropriate bid range.
1. Mitigating risk for your shareholders. Purchases are made with cash, stock or a combination of the two. In a cash transaction, your shareholders reap the upside if the forecasted synergies are realized and will bear the loss if they do not materialize; hence, the acquirer bears the entire risk burden of the transaction. In a stock transaction, those risks are shared with the seller’s shareholders. Therefore, in a stock transaction, a higher bid can often be justified as:

1) The seller has greater incentive to ensure optimal implementation; and

2) The overpayment risk for your shareholders is reduced.1

Benefits of the Systematic Approach

Applying a systematic approach to strategic due diligence can yield huge returns to companies considering acquisitions. Among the many benefits, consider the following:

- Without market, customer and competitive analysis, revenue forecasting is unreliable at best and guesswork at worst. How can a target’s revenue be intelligently forecasted without understanding the company’s competitive strengths and weaknesses and customers’ future buying behavior? Simply basing future projections on historical growth curves will produce unreliable forecasts and can result in a grossly under-or over valued target.

- The careful forecasting of the key revenue, cost and balance sheet line items results in establishing specific commitments on the part of the acquiring company’s management team. This allows management to know what it is “signing up for” before the deal is closed, and provides the opportunity to change assumptions and the final bid price if concerns are raised.

- An analytical approach to establishing a target’s stand-alone and synergistic values helps remove the emotional element associated with trying to win a bidding war. A robust valuation model supported by the appropriate strategic information will prevent buyers from over-paying in the excitement of final negotiations and under-bidding for valuable strategic properties. Not paying more than the present value of the incremental cash flows associated with the acquisition represents a win for the potential acquirer’s shareholders.

- The results from the strategic due diligence process provide the acquiring company with the strategic information it will need to manage the target company. For example, understanding how customers’ needs are evolving or identifying the most important competitive threats will be critical to guiding the combined company’s strategic direction going forward. Strategic due diligence accelerates this learning process and expedites the achievement of the long-term goals.

In summary, a thorough and systematic strategic due diligence process in combination with legal, accounting, environmental and other due diligence efforts will greatly enhance your ability to create shareholder value through acquisitions. “Look before you leap,” as the saying goes, is the best way to land safely.


Why would L.E.K. consider a non-DCF approach to valuation?

To longtime readers of Shareholder Value Insights, it should be clear that L.E.K’s approach to valuation is firmly based in applying discounted cash flow (DCF). DCF provides a clear, analytical framework for understanding the true value of an asset considering both cash flow potential and systematic risk elements. Why “then” would we consider a competing valuation methodology like multiples analysis (e.g., price-to-earnings, price-to-sales, price-to-cash flow ratios) in formulating bid strategies? The long-term value, many analysts and firms continue to use it as their primary valuation tool. Hence, in order to develop an efficient bid strategy where the objective is to bid below the synergistic value of the target company but just above the second-highest bidder, the use of multiples analysis can provide some important insights. Competing bidders’ valuation approach may well be based on the utilization of current trading ratios or recent transaction multiples within the target’s market segment. Hence, the result of a multiples analysis valuation may provide an important clue as to how far below your reservation price you can bid while still winning the auction.
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