

M&A Due Diligence Checklist and Precautions

Julia Ryan

Corporate due diligence teams usually have four-inch-thick binders or “playbooks” to guide them through the mechanics of due diligence. But that alone will not guarantee successful execution of a corporate merger-and-acquisition (M&A) strategy. A merger or acquisition is more likely to be successful if leaders provide direction at key junctures to ensure the deal rationale is sound, the deal value can be secured, and the postclosing integration runs smoothly.

During the *pre-diligence analysis*, *diligence research*, and *postclosing planning*, a company leader can ask probing questions about why the deal fits, what the key drivers are for deal success, and how the integration can be as seamless as possible.

PRE-DILIGENCE ANALYSIS

Pre-diligence analysis can provide a context for the proposed merger or acquisition. While **Exhibit 1** shows this happening sequentially before the diligence research phase, it can be part of a continual feedback loop, shaping strategy throughout the company on a regular basis.

Sector M&A Analysis Can Provide Valuable Insight

M&A research is filled with gloomy statistics about the inability to achieve shareholder value from an acquisition or merger. As investors have long memories, the company’s long-term reputation and credibility are at stake.

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A study of other sector M&A deals can help a company develop a list of “lessons learned” (based on others’ mistakes). Deals are all different; thus, there may not be a perfect corollary to the target acquisition, but thoughtful research may yield valuable clues.

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Shareholder value is measured by increased earnings, stock-price appreciation, and growing dividends. Shareholder value can come from expanding market share, developing new service or product offerings, increasing margins, implementing operating efficiencies, and lowering costs.

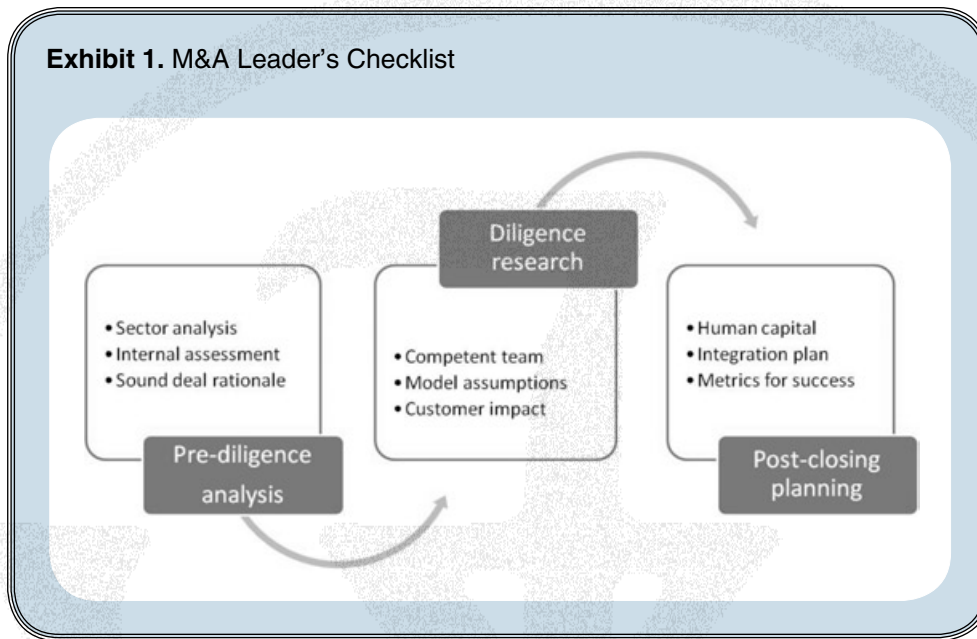
Internal Assessment of Strengths and Weaknesses Is Critical

Leaders must understand their company’s weaknesses, before contemplating a new transaction. Further, the acquirer’s leaders must understand the root of those weaknesses. With that insight, it is easier to ascertain whether the target company will help address deficiencies or compound them.

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If a weakness is an internal structural issue, it may be necessary to address it before proceeding with the M&A strategy. Or it may be that a target acquisition can address the weakness, perhaps through its superior market positioning, innovative technology, or customer-care approach. In this case, careful thought should be given to preserving that value and adopting it into the acquirer post-closing.

Exhibit 1. M&A Leader's Checklist



If a weakness comes from external factors, the M&A strategy must be looked at through a different lens. Perhaps the target company experiences the same challenges. In this case, consideration should be given to whether or not the addition of the target company will diminish the threat or increase the acquirer's exposure.

Conducting an inventory of the acquirer's strengths has several benefits. First, the acquirer is better prepared to articulate to the target company the assets it brings, helping the target company envision how its business could grow exponentially with the support of the acquirer. Second, the acquirer can more effectively communicate how the transaction will leverage its existing strengths, hopefully making the transaction more appealing to stakeholders.

Transaction Must Have a Compelling Rationale

An acquisition or merger is a company-changing event, and one that should not be entered into lightly. It distracts management, puts stress on the organization, and places the company in the limelight. Therefore, there should be a very compelling strategy to justify the cost and angst of any acquisition.

Too often companies engage in M&As as a means to escape their current reality. That is not a sufficient enough rationale; leaders must identify sustainable value arising from the acquisition. M&A strategies are chiefly about growth, not trading water.

Let us take the example of a transaction driven by a customer acquisition strategy. An acquirer may view a target company as a means to accelerate customer acquisition. A compelling rationale would be that the target company had unique strategies for profitable customer growth or innovative customer retention tactics. A less compelling rationale would be to acquire a peer company's customer base for the purpose of synergy savings. Unfortunately, synergy savings are often hard to achieve, or come at some opportunity cost. Moreover, they may not be repeatable.

DILIGENCE RESEARCH

The acquirer's due diligence team will typically conduct extensive due diligence in financial, regulatory, legal, operational, environmental, and market factors. A leader can contribute to their success by focusing on: (1) the composition of the diligence team, (2) the assumptions used to justify the transaction, and (3) the transaction's impact on customers.

Competent Team Is Necessary

The first step is to appoint an experienced project manager. The project manager should be able to focus full time on the project, free of other responsibilities. The project manager should have a strong working knowledge of the acquiring company's operations and culture, as well as of the industry. The project manager should have very strong people skills, as this person will be the acquirer's ambassador to the target company.

He or she should be well organized; be adept at managing large, complex projects; and have previous acquisition experience. Strong leadership capabilities and the ability to navigate smoothly through the process are also critical traits.

Leaders can trust the project manager to select an appropriate due diligence team. But it can be valuable for the leader to review the areas of expertise within the team, to understand the use of external resources, and to allocate resources for the team to effectively conduct its diligence.

The use of consultants or external advisors to supplement the skill sets and experience of the internal team members is quite commonplace. However, some companies make the mistake of bringing in too many external advisors. Additionally, advisors can be very expensive; thus, the project manager may benefit from the leader's guidance about how to coordinate their assignments.

Due diligence teams are often so enthusiastic about the project that they are unlikely to raise deal-breaking issues or concerns. Hence, a leader has a unique opportunity to instill a culture that rewards critical thinking.

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The team may perceive that the acquisition is of great personal interest to the leader, and it would be unwise to appear unsupportive of the transaction. In their fear to raise issues, a flawed transaction could move forward. Or the team may presume that the leader has special insight to the transaction, making their concerns frivolous or naïve. Ironically, the opposite is likely the case: through the team's diligence, it will probably uncover new information, unknown to the leader. To prevent either circumstance, leaders can encourage team members to raise concerns.

Key Valuation Drivers Should Be Vetted Internally

Leaders can prevent their company from falling into the trap of "over-promise, under-deliver." Very often, transaction analysis incorporates some level of savings from cost cutting ("synergy savings"). But before taking that path, a leader should encourage analysis of the trade-offs of pursuing

synergy savings too aggressively. For example, perhaps there is greater long-term value to operating the acquired company without changes for the first year. Because synergy savings are only one side of the equation, equal or greater consideration can be given to the ability to deliver increased sales, higher margins, more products and services offerings, and similar positive possibilities. Pushing too hard on synergy costs may not allow the newly merged entity to achieve growth targets.

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Leaders may fear that failure to achieve synergy savings immediately will be viewed negatively by the investor community. But taking a different perspective, if an acquirer demonstrates a sophisticated understanding of the target company, investors may have greater confidence in the acquirer's management team.

Financial models rely greatly on assumptions—the old adage "garbage in, garbage out" holds very true in this case. Therefore, the leader will want to probe the model assumptions. Overly aggressive assumptions will result in forecasted margins that may be hard to realize ultimately. Company leaders should ask about the financial forecast's assumptions to understand the model's bias.

It is human nature to assume that the acquisition or merger strategy will work out as anticipated. Additionally, company leaders may want to request alternative model scenarios or use a Monte Carlo approach to see where the greatest drivers to value creation lie and to understand what could happen in an alternative reality from the base-case assumptions.

Customers Are Important Stakeholders in the Transaction

Traditionally, M&A strategy focuses on creating shareholder value, and surprisingly, customers can become an afterthought. But customers are the lifeblood of most companies. Therefore, leaders can provide significant value by inquiring about the potential impact the proposed acquisition may have concerning customers.

Customer impact analysis (**Exhibit 2**) subtly probes the impact to customers of the M&A transaction.

Customer interface refers to the company's "touch points" with customers. Leaders can inquire about how that will change following the closing of the transaction. For example, if customers are used to manned service centers, and the integration plan is to move them to a new electronic portal, it is important to consider how customers will react to the new interface technology.

Customer care focuses on how the company will address customer concerns, answer customer questions, and resolve customer problems. Customers may be especially sensitive to customer care issues as a result of the press or media attention relating to the transaction. Vigilant review of customer care systems and processes can help identify potential areas of customer dissatisfaction.

Brand value, defined as the positive manner in which customers view the company, may be an important element of the transaction. Trial tests and market research may help the acquirer understand the brand value of the target company, as well as its own company. The acquirer will also want to think about how to market or "brand" the new entity, post-closing.

Customer perception may be the most subtle aspect, but also the most powerful. Careful thought should be given to how the customers will perceive the new acquisition or merger. Customers are a very important stakeholder group both before the transaction closes and afterward. Understanding customers' perceptions can help the acquirer structure the marketing and sales strategy post-closing.

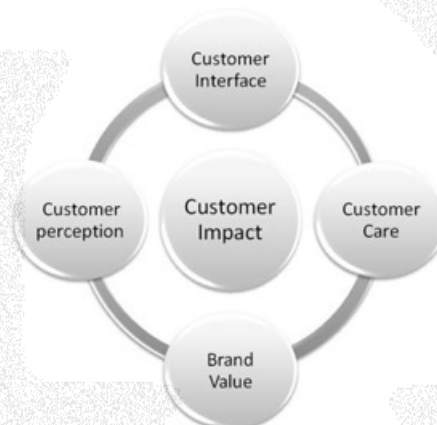
There are a series of questions that a leader could pose to the team, to foster a better understanding of potential customer challenges of the newly merged entity.

- How will the manner in which we serve customers change?
- How will our interface with our customers be altered?
- What is our marketing campaign to address customer concerns?

POSTCLOSING PLANNING

A smooth transition following the closing of the transaction may be the most important factor in protecting value for shareholders and customers. Transition challenges can arise in the areas of human capital, technology, and operations.

Exhibit 2. Aspects of Customer Impact



Intellectual Capital Is Often a Material Part of Transaction Value

Many companies ascribe their success in large part to the people in the firm. For instance, the target company may be proud of their unique culture that has enabled them to attract and retain professionals critical to their success. Failure to recognize and protect that culture might result in significant loss in value.

Culture differences can be subtle and should not be too quickly discounted. They may relate to business attire, work hours, telecommuting, job sharing, workspace, geographic location, community activities, benefits, training opportunities, and more. If the target company's culture cannot be maintained within the newly merged entity, serious consideration must be given to the resulting implications.

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Compensation can be a cultural issue to the degree it motivates employees in different ways. Compensation plans may be very different between a high-performance growth company and a mature, large business. Frequently an acquiring company insists that the employees of the target company change their compensation plans to mirror those offered employees in the acquiring company. In fact, its unique compensation plan

may have actually contributed to the success of the target company, and restructuring it may be akin to cutting off a limb.

A common mistake is that the acquiring company may not offer enough high-level positions to the leaders of the target company. Too often the majority of premier positions are staffed by the acquirers' executives. Not only may this trigger an exodus of senior people, but it may cause up-and-coming stars in the target company to depart as well.

The manner in which the acquirer manages culture issues and protects human capital has a long-lasting impact. Managed well, the newly merged company will have an innovative and dedicated workforce. Handled poorly, the firm may have a passive-aggressive workforce as well as suffer from reputation loss.

To preserve the human capital in both organizations, company leaders of the acquirer and target company need to work together to empower all employees, to instill pride in the newly combined company, and to avoid an us-versus-them culture.

A Thoughtful Integration Plan Preserves Transaction Value

Integration planning is as important as the diligence research. Smart leaders can make certain that integration is not an afterthought but rather a distinguishing success factor. The integration plan should be even more detailed than the diligence plan, because the focus is on business continuity. Therefore, in addition to focusing on the areas of change, integration planning additionally focuses on preserving what is already in place.

It can be challenging to preserve value identified in diligence. One mitigation strategy is to develop strong communications between the due diligence team and the integration team. It may also be appropriate to deliberately design some overlap between the teams, so that certain individuals are common to both teams.

Another success factor in successful post-closing integration relates to effective communications strategies with internal and external stakeholders.

Large M&A activities create uncertainties among both workforces; thus, it is invaluable for leaders to provide frequent, content-rich internal communications. One of the most important topics is how company operations may

change, and more specifically how employees are affected. Once employees understand their roles, they can support the vision and more efficiently manage through the integration.

External stakeholders also want to be informed of news concerning the acquirer and target company. Meaningful communication can go a long way to alleviate concerns. In the absence of strong communications, customers may shift their business to a competitor. Community leaders may be agitated, worrying about the company's presence in the community. Competitors may be hoping for a misstep that will yield them new market opportunities. And regulators may worry about compliance, safety, or service disruption if they do not receive reassuring communications from the acquirer and target company.

Identification of Key Metrics Leads to Success Post-Closing

Company leaders can ask their team to define metrics for success, and memorialize these for future reference. The metrics should extend beyond financial measures to additionally include operational performance metrics. Some examples could include customer satisfaction, customer retention, customer additions, reduced lost work time, higher employee satisfaction, shorter development cycles, lower cost per unit produced, and other productivity measures.

Companies often feel defensive when a merger has failed to yield tangible results, and they may search for metrics to justify the acquisition after the fact. By establishing metrics beforehand, leaders build credibility with investors and other stakeholders. Additionally, articulating success metrics early in the process helps employees understand what performance targets are important to achieve.

CONCLUSION

Successful M&A work takes much more time and resources than companies initially estimate, as well as greater planning and patience. Company leaders can help ensure success by allocating appropriate resources, empowering the diligence and integration teams, and taking time to understand the risks and opportunities associated with the acquisition or merger. In this way, company leaders can provide guidance to the diligence and integration teams, ensuring that the major value drivers are understood and protected. 