

A Newsletter
for the
Professional
Intermediary

M&A Today

Volume 9
Number 1

January 2000

The Value of Market Due Diligence

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Market due diligence of an acquisition candidate is an underutilized process, even though it often yields considerable value to both strategic and financial buyers, whether operating companies or investment firms.

A properly executed market due diligence program can alert the prospective buyer to possible problems before the business is acquired or it can identify opportunities which make the acquisition even more attractive than initially contemplated; market due diligence can help confirm that the transaction pricing is fair or it can provide evidence for modifying the pricing or terms of the deal. Independently conducted market due diligence also can help give your Board, your shareholders, and your bankers greater confidence in the transaction.

In light of these benefits why isn't professional market due diligence an integral part of every acquisition? Why isn't it assigned the same value as financial, environmental or legal due diligence? Why is it often conducted in a relatively superficial way, often just before the closing?

There are undoubtedly many reasons why market due diligence is underutilized and each buyer and each situation is different. But to a large extent, I suspect market due diligence is not emphasized because buyers

feel that the results will not add significantly to their knowledge of the acquisition candidate and will not change their decision to make the purchase.

Based on my experience conducting hundreds of market due diligence investigations, I can point to numerous examples in which market due diligence had a major impact on the buyer's decision. And even if the buyer proceeded with the original deal, the knowledge gained from the market analysis proved extremely useful after the purchase.

What is market due diligence?

In its basic form, market due diligence involves an assessment of the markets in which the acquisition candidate participates, and an appraisal of the candidate's current status and future outlook. Since the buyer has, to a large extent, based its interest and its valuation on a forecasted stream of topline and bottomline results, market due diligence also plays a vital role in determining or confirming realistic revenue and profit projections.

To provide these results, a properly conducted market due diligence investigation requires discussions with a cross-section of market participants -- current and former customers of the candidate; sales prospects and lost

accounts; specifiers of the products; distributors, reps, and other sales channels; suppliers; and competitors. These discussions must be detailed and open-ended so that interviewees are given the opportunity to raise new issues and express candid opinions regarding the market and candidate.

While market due diligence can be effective if conducted on a blind basis -- without any reference to the acquisition candidate -- the results are generally richer if interviewees, other than competitors and competitors' agents, are informed that the program is being conducted on behalf of the candidate, which obviously requires the latter's permission.

Lessons from Market Due Diligence

Based on my many due diligence experiences covering a vast array of products, services, markets, and industries, certain lessons for buyers have become evident. These lessons hopefully illustrate the value market due diligence provides and how it can help buyers make better investment decisions.

(1) Beware of industry experts spouting conventional wisdom.

In many instances a buyer's market due diligence only consists of talking to "industry experts" -- securities analysts, market researchers, trade magazine editors, and the like. While these "experts" can provide useful, general information, they often are so involved in a particular market that they lose objectivity and draw incorrect conclusions.

For example, a client was interested in acquiring a company that produced specialty software for the callcenter market. The industry's leading market researcher, the "industry expert", felt that this firm was at

a severe competitive disadvantage because it did not also make continuous recording equipment, while its competitors did. However, when we talked to potential customers we found that fewer than 10% needed continuous recorders and for the bulk of the market, the candidate was not at all disadvantaged. Our client disregarded the "expert's" advice and acquired what has become an outstanding company.

(2) Sellers always understand their businesses and markets better than buyers.

This requires that a buyer become a "quick study." Not only does the buyer need to quickly obtain an understanding of overall market dynamics, the competitive environment, and the like, but knowledge of less obvious issues often can be critical.

For example, we evaluated a fractional horsepower motor manufacturer which appeared to be a fine company -- excellent reputation, good products, well respected by customers. However, in looking more closely at the competitive environment we found that the candidate's leading competitor had recently been acquired by a large manufacturer of larger motors. This gave that competitor enormous purchasing leverage for key components, such as lamination steel and copper wire. Through further investigation we learned that the competitor intended to use its new cost advantage to gain market share through aggressive pricing. Obviously, this was likely to have a major adverse impact on the acquisition candidate's projected revenues and profitability, and it led our client to revise its offer.

(3) There is usually an overriding business reason why a company is being sold at a particular time.

Although owners of privately held companies may indicate that they are selling for estate planning

and/or retirement reasons, and public companies may claim that they are selling divisions which are no longer strategic, we have found that there are often fundamental business/market reasons which are driving the sale. Market due diligence helps buyers uncover these “real” reasons.

(4) When it comes to revenue growth and profitability, the past frequently is not a good predictor of the future.

Markets can change dramatically, even during stable economic times, and individual companies often can decline faster than they grow. In our rapidly changing environment, extrapolating from the past to forecast the future can be dangerous. Even in relatively stable markets, a buyer needs to have a detailed understanding of a candidate’s competitive position to forecast accurately.

For example, a client was interested in acquiring a company which manufactured specialty transformers for the electrical utilities industry. Over the previous 5 years this firm grew at close to 10% annually versus an underlying market growth of 3-4%. Could this growth rate be sustained? The candidate’s management believed it could and expected to be paid for that growth. However, as a result of the market due diligence, we showed that above average growth wasn’t sustainable for a number of reasons, and that the purchase price should be based on the market growth forecast of 3-4%. We also determined that the market was about to experience a temporary decline which could put added pressure on the new buyer. As a result of these findings, our client postponed the transaction and avoided overpaying.

(5) The seller always “dresses” its business for sale. The question is to what extent.

Just as we might paint, fix leaks and otherwise tidy up our home when we put it up for sale, so does an owner dress up his business in anticipation of selling it. This “dressing” often takes the form of cutting selected expenses in order to enhance the business’ bottom line without adversely impacting the top line in the short term. For example, RD&E expenses might be reduced, the customer service department might be downsized, or programs in support of distributors might be cut back.

Market due diligence can usually uncover these changes. Customers and sales channel participants are quick to complain about declines in support and assistance; and a comparison of the candidate’s financial statements with those of its major competitors is often very revealing. And once the extent of this “dressing up” is understood, buyers can factor corrective actions into their pro forma projections.

(6) Since markets can evolve rapidly, be sure the candidate is serving the right customers and addressing real market needs.

This lesson is particularly relevant in industries undergoing rapid technological change or global evolution. It also can impact any firm seeking to differentiate itself and gain share by offering a “better” solution for a currently served or new market segment.

For example, we evaluated a firm which produced a line of commercial refrigeration equipment. This company was a technical innovator emphasizing energy efficiency and product reliability, and it focused its selling efforts on store operations and engineering personnel. Unfortunately for this firm, the food retailing industry was changing. Supermarkets’ merchandising and marketing people had become the decision makers, and they were concerned with displaying food in a way that

enhanced the customer's shopping experience, not the energy efficiency or reliability of the equipment.

(7) Understand the leverage in a market and how it will impact the acquisition target's business model

The acquisition candidate's market includes its competitors as well as the industry's suppliers, the sales channels utilized, and the range of customers. In most markets, one of these groups has leverage over the others and this influences pricing, terms and conditions, etc. For example, in the personal computer market, key suppliers such as Intel and Microsoft, have considerable leverage. In many auto parts categories the Big 3 auto makers still have considerable leverage, while in many consumer products the big box retailers such as Home Depot, Best Buy, and Wal-Mart have enormous leverage over manufacturers.

It is critical that a buyer of a business know where the leverage in the served market currently resides and how that might be changing since it will greatly influence the candidate's ability to maintain margins and implement price increases, and it will dictate the firm's business model going forward.

In many markets, particularly business-to-business, the Internet will have a major impact as it enables highly fragmented groups of customers to join together to exert influence on suppliers. In virtually all markets the Internet will make customers much more knowledgeable, less reliant on suppliers for assistance, and better able to compare each supplier's value proposition.

(8) While buyers should generally move as quickly as possible to close a transaction, sometimes slowing the process can be beneficial.

In most instances, buyers benefit from moving each step of the acquisition process along as rapidly as possible. Whether it's identifying the prospect, negotiating the deal, signing the letter of intent, or closing the transaction, faster is generally viewed as better for the buyer.

However, I can think of many situations in which moving the process more slowly benefited the buyer. Typically these situations involved acquisition candidates which were having difficulty achieving their strategic or financial objectives. Delaying the closing by a month or more often made these shortfalls apparent giving the prospective buyer the opportunity to reassess the pricing and terms of the transaction. In several instances this led to adding a performance-based payout to the transaction whereby both the buyer and seller shared the identified future risk.

(9) Beware of the overly helpful - or overly protective - seller

While a buyer should expect a reasonable amount of assistance from the seller in facilitating and conducting the market due diligence, one should be wary of either too much or too little help.

If too much help is forthcoming it might indicate that the seller or his representative is trying to speed the due diligence so that key issues are missed, or is attempting to direct it towards certain conclusions. If too little help is forthcoming it suggests that the seller is trying to prevent the buyer from getting at critical issues, usually problematic ones.

To minimize either possibility, the buyer's market due diligence team should request specific information from the seller and be very insistent that the request be fulfilled completely. A dose of skepticism and

“trust but verify” should be the guidelines of the market due diligence team.

(10) Be certain that the business being acquired is consistent with your strategic intent and marketing orientation.

A successful acquisition requires compatibility between the buyer and the acquired firm. This is not only true for issues such as culture and vision but also for tactical issues such as a marketing orientation and growth programs. An important role of marketing due diligence is to help the buyer understand how well the acquisition helps it achieve its goals and how well it fits the buyer’s business model.

For example, a Fortune 500 client generally serving stable, low growth markets sought opportunities in high technology in order to spur growth. As we investigated one particular acquisition candidate it became clear that the need for high levels of R&D expenditures, even during a market downturn, was a significantly different business model than our client was comfortable with. As a result, the client chose not to proceed with this opportunity but instead sought other acquisitions in somewhat more stable sectors of high tech.

Another client’s strategy is to buy a “core” business and then add complementary acquisitions to achieve above average growth. Therefore, as part of the due diligence of a prospective “core” company, we evaluate the possibilities for complementary acquisitions. If few are obvious the client is likely to pass.

Summing Up

The value of marketing due diligence cannot be underestimated. It not only provides the acquiring company with insights that could kill the deal or modify

the valuation, but it also can identify areas that will require additional investment after the closing or opportunities which can enhance the business under the new owners.

While some buyers conduct market due diligence with internal staff, we have found that the results are much more valuable when the investigation is conducted by an outside firm which brings objectivity and, in many cases, specific industry experience to the assignment. The results are even more useful if the outside market due diligence professional is a regular member of the acquisition team, similar to outside accounting and legal professionals.

Regardless of how and by whom it is undertaken, market due diligence should be an integral part of your acquisition process.

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