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Using Knowledge as a Competitive Advantage in M&A Transactions with Data and Strategies Group

EDITOR'S COMMENT:

One of Data and Strategies Group's (DSG) disciplines is market due diligence in mergers and acquisitions transactions... perhaps one-third of its total business which also includes marketing strategy, product planning, competitive intelligence, customer satisfaction, etc. The question M&A Today poses is 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? M&A Today believes the answer to this rhetorical question is that the potential client (usually the buyer) falls into one or more of the following categories:

- *does not know or appreciate the benefits of market due diligence*
- *perceives that there isn't enough time to conduct this service pre-losing*
- *believes that his company thoroughly understands the*



Gene Briskman

specific market, the target company, and its competitors,

■ *that the extra money spent for this due diligence is not worth it.*

Overview

Before we discuss the benefits of market due diligence, let's dispel several myths about the cost and the time to conduct this service in the context of a relatively small middle market transaction. Let's assume that the proposed purchase price is \$10 million and the esti-

mated closing costs are as follows:

Investment Bank	\$350k
Attorney	70k
Other	30k
Due diligence	50k

TOTAL	\$500k
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The above represents 5% of the purchase price. It should be noted that the buyer may not be represented by an investment bank and DSG's fees as well as the attorney's fees could be higher or lower. The estimated time for DSG to conduct the market due diligence would range from two weeks to two months.

Reasons why

Let's discuss a few scenarios:

SCENARIO #1

You are a strategic Fortune 1000 buyer and you believe that you are very knowledgeable about the industry, the players, the trends, the opportunities, the threats, etc. You have been appointed by the CEO as the champion of this deal. In other words, your butt is

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Using Knowledge as a Competitive Advantage

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on the line... if the acquisition is successful, you are a winner, but if the acquisition fails you will be held accountable. Regardless of your industry expertise, sellers always understand their businesses and markets better than buyers. There is usually an overriding business reason why a company is being sold at a particular time and there are often fundamental business/market reasons that are driving the sale. Market due diligence helps buyers uncover these “real” reasons. As the champion for the acquisition are you going to risk your career on this acquisition decision without consultation with a third party, non-partisan professional, or are you going to rely on your conventional wisdom?

SCENARIO #2

You are an operating company desirous of diversifying in an aligned industry, but you are not that familiar with this particular industry. Over the previous five years, the target company grew at close to ten percent annually versus an underlying market growth of three to four percent. Can this growth rate be sustained? The target management believes it can be sustained and expects to be paid for this growth. What if you retained DSG, for example, and they 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. Would you be compelled to try to renegotiate the transaction so at least the higher growth, if achieved, is based on an earnout or royalty basis?

SCENARIO #3

Finally, let's assume you are a private equity group which probably means you have the least amount of industry knowledge unless it is an add-on to a portfolio company. While buyers should generally move as quickly as possible to close a transaction, sometimes slowing down the process can be beneficial. Delaying the closing by a month, often using the legitimate reason of completing the due diligence process, will give you the opportunity either to become more comfortable with the deal, to give you a “heads-up” as to what you are facing, to make certain adjustments are in the Purchase & Sale Agreement, or to abort the deal.

Data and Strategies Group

Gene Briskman is Managing Director of DSG which he founded in 1988 as a business development consulting firm. By way of background, Gene received his MBA from MIT's Sloan School in 1966. Immediately thereafter, he worked in corporate development for Sylvania, a division of GTE, responsible

for bringing military technologies to commercial markets. Gene later founded Identicon Corporation, a pioneer in the barcode scanning industry. He then spent several years at another consulting firm, Technical Marketing Associates, before starting DSG.

According to Gene: “Marketing due diligence of an acquisition candidate is an underutilized process. Based on my experience of conducting hundreds of investigations, I am able to point to numerous examples in which market due diligence had a major impact on the buyer's decision. Even if the buyer proceeded with the original deal, the knowledge gained from the market analysis proved extremely useful after the purchase. In its basic form, the process involves an assessment of the markets in which the acquisition candidate participates, and an appraisal of the candidate's current status and future outlook.”

A properly conducted market due diligence investigation requires input from a cross-section of industry participants — current and former customers of the target, sales prospects and lost accounts, product specifiers, distributors, sales representatives and other sales channels, suppliers, and competitors. These industry participants can

be approached in one of three ways, based on the client's (and target's) preference:

Blind Approach: “We are conducting a market study and are calling to find out what is happening in your segment of the market.”

Direct Approach: “We are conducting a study on behalf of XYZ Company (the target) in order to help them do a better job serving you.”

Open Approach: “We are conducting a due diligence study for a client that is investing in XYZ Company.” (If the impending deal is generally known in the industry.)

Case Studies

Perhaps the best way to describe the potential impact of market due diligence is with several examples:

FRACTIONAL HORSEPOWER MOTOR MANUFACTURER

DSG's private equity client had just signed a Letter of Intent to acquire a leading manufacturer of fractional horsepower motors sold to OEMs for selected high volume applications such as refrigerator icemakers. According to Gene Briskman: “The target appeared to be a fine company — excellent reputation, good products, competitive prices, well regarded by customers. However, during the due diligence, as we looked more closely at

competition, we found that the company's major competitor had just been acquired by a much larger manufacturer of larger motors. This gave that competitor enormous purchasing leverage for key components such as lamination steel, copper wire, etc. As we investigated further, we learned that the competitor intended to use its newly obtained cost advantage to gain market share through aggressive pricing. Obviously this would have an adverse impact on the target's top and bottom lines, and it led our client to revise its offer."

SUPERMARKET REFRIGERATION EQUIPMENT MANUFACTURER

Gene Briskman continues: "Another private equity client planned to acquire a producer of supermarket refrigeration equipment. The target was a technical innovator emphasizing energy efficiency and high reliability. Their selling efforts were focused on store operations and engineering personnel, and these folks were uniformly very pleased with the company and its equipment. Unfortunately for this firm, (but fortunately for our client) our due diligence identified a fundamental change in the food retailing industry whereby supermarket chains' merchandising and marketing people were becoming the specifiers of in-store equipment, and they were concerned with displaying food in a way that enhanced the customer's shopping experi-

There is usually an overriding business reason why a company is being sold at a particular time and there are often fundamental business/market reasons that are driving the sale.

ence, not the energy efficiency or reliability of the equipment. So here again, market due diligence prevented an acquirer from making a serious mistake."

SPECIALTY SOFTWARE SUPPLIER

In this third example Gene states: "Still another client was in the process of acquiring a supplier of specialized training software to the call center industry. The target company had created this market niche and was still the leading supplier, but was facing market share erosion as manufacturers of related hardware systems began to bundle the specialized software with their hardware. As a result of these competitive threats, the target company was interested in joining a parent that could help finance the necessary hardware development.

DSG began the due diligence by surveying major customers and we found that less than 20% had any interest in bundling the hardware and software. The majority did not really need the hardware, and were planning to continue to buy the software as a stand-alone product. This finding made the deal much more attractive to our client, who now could postpone (or forego) what was expected to be a major

investment program."

The Added Plus

Besides conducting marketing due diligence for buyers, DSG occasionally works directly for sellers in a very focused effort to identify attractive acquirers that are potential strategic buyers, fit the seller's criteria, and have the financial capability to do the deal. And, as Gene states: "If the sellers are really smart, they will hire us to see what the buyer's due diligence will turn-up... so our client can go about addressing some of these issues before they initiate the selling process."

Post acquisition, DSG is often asked to provide additional support such as:

- Sales channel analysis and restructuring, particularly if the acquisition is an industry add-on to an equity firm's portfolio company in the same industry or is a strategic acquisition by a corporate buyer
- Branding strategy to determine which brands should be emphasized, the role of each brand, and the channels through which each brand should be marketed. This is particularly important when a client acquires previously competing businesses.

■ Product and technology planning to identify the most attractive new product opportunities and determine how the company's technology resources need to be enhanced to address the product development effort.

■ Diversification planning including identifying new market opportunities and potential additional acquisitions.

Conclusion

More than ever before, CEOs or private equity firms can not afford to make mistakes with acquisitions, especially if it means spending \$100,000 or less to verify a target company's markets, products, technology, pricing, competitive position, etc. Knowledge often provides the competitive advantage that sets successful acquirers apart, ensuring they make the right deals at the right prices. While DSG's clients could attempt to do market due diligence projects themselves, information that is imperfectly gathered or inadequately analyzed is of little benefit. And the value of an independent professional providing objective input is often critical in resolving internal ambiguity.

Gene Briskman can be reached at Data and Strategies Group, Inc., 190 North Main Street, Natick, Massachusetts 01760 (508-653-9990), or by email at briskman@dsggroup.com. Their web page is www.dsggroup.com.