Due diligence

By Philip Atkinson & Dara Clarke

How strategies of soft due diligence can leverage the rewards of mergers and acquisitions and business expansion, part I.

Soft due diligence – Only 20% of M&A activities achieve the synergies for which they were created

How many business people would buy a used car or a house without spending some time checking them out first? Very few of us would commit to such an investment without some form of thorough examination. Change the scenario to the context of M&A. How many apply different rules and logic when they buy or acquire a company? You cannot tell everything about the company from the balance sheet or the profit and loss account.

Much of what drives most businesses is the intangible element of 'human capital and the culture reflected in performance levels, which is the cause that drives financial performance.

> **The world is getting smaller and the competition for the best businesses is underway**

Without harnessing the potential of its people, a company is worth nothing. Unless someone makes a sale there is no business. People cause events and businesses to bloom. You would be forgiven for not thinking this is the case, when we traditionally value the worth of potential business acquisitions with the sole focus on strictly financial measures. We argue that to make a deal work you have to shape the culture of the organisation to deliver outstanding value and return for the investors.

In reality, sometimes the nearest a management group get to understanding the dynamics of a newly acquired business is opening the 'books' on day one after acquisition or merger.

Due diligence

I know that the corporate lawyers and the key investors, accountants and various auditors will have examined the financials, but have they really grasped a picture of what makes the company tick? To illustrate this point, I was working with a large automotive group headquartered in the USA who were buying up suppliers all over the world. At that time, the group had not undertaken much analysis of a potential business capability beyond financial the considerations. For instance, could existing manufacturing machinery be adapted to the product range?

What is the current level of investment in manufacturing systems and robotics? How well does this match the rest of the group? To what degree are strategies, policies, systems and processes of the potential acquiree aligned with their suppliers? Can their suppliers be neatly tailored to work together? What about the suitability of distribution and logistics? Will current distribution channels in the other business replicate our existing logistics? With this aid or confuse our customers? Has the soon to be acquired company the ability to deliver JIT with suppliers, or are they operating on a much more immature model of customer-supplier relationship?

In the case illustrated above, it was only after much debate from the manufacturing strategy VP and each of the operational facilities in several geographies, that is was agreed that a manufacturing engineer join the due diligence group. Up to this time it had been composed of accountants and lawyers. Now due diligence would have to ensure that potential new acquisitions conformed to a whole raft of capabilities which went well beyond financial analysis and even focus on 'cultural fit'.

Nightmare partial integration through IT

What may appear on company balance sheets to be naturally synergistic can be a nightmare to align together. Our understanding is that the 'norm' in integrating businesses is that not much effort will be devoted to integrating two or more cultures and effort often is expended on IT to the detriment of the culture.

We are aware that some companies undertake a significant technology audit of IS/IT but not all companies move to that level of analysis. The audit may uncover several conflicting systems connected by a series of 'black boxes'. This may ensure suppliers and staff are paid on time and that payments can be processed internationally, but there are much bigger issues to bridge.

Is IS or IT the enabler or driver to business solutions? Does IS/IT in both organisations occupy the same strategic position? Is IS/IT seen as a core competence or, rather, a means to an end to process and transfer information for decision-making? Is one company technology leader in driving change and the other the equivalent of an IS Luddite in terms of scope and innovation?

Key strategic questions

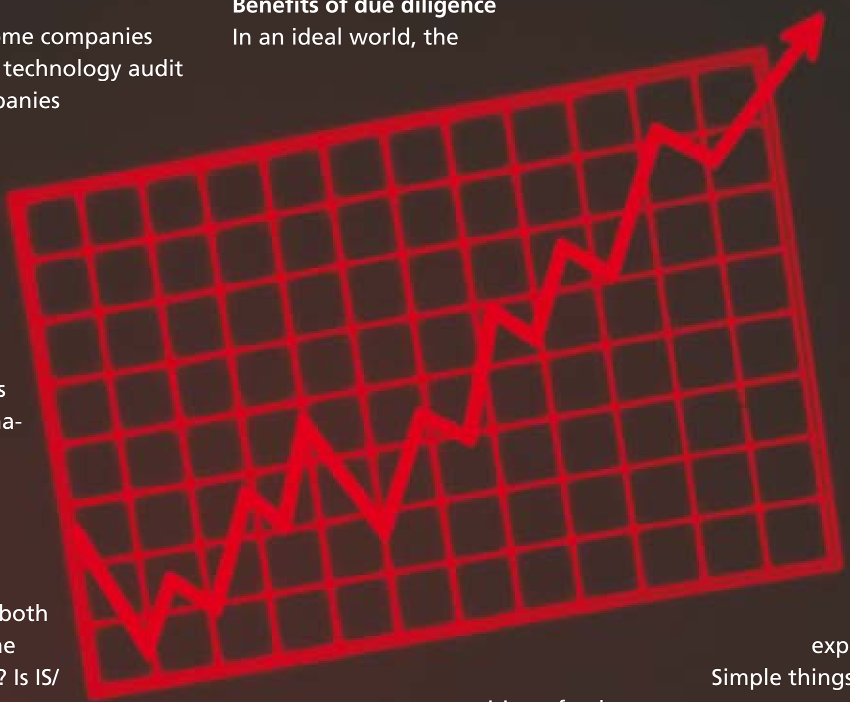
Key strategic questions arise that may not be apparent to the business leader who wants the acquisition or merger to go ahead speedily. Although natural synergies may appear to arise from a new acquisition, joint venture or merger, the scope of investigative work is mostly undervalued and simply left to chance.

It is at this stage, prior to purchase, that we must ask, have the right questions been posed. However, often their inclusion is seen as not helpful in supporting decisive actions. M&A or joint ventures and the creation of new entities is often conducted in less than a conducive environment. Hostility may comprise part of a takeover or merger and too much prevarication on the part of the hungry CEO wanting to shape a new business, detracts from just doing the deal.

'Deal making' is not always conducive in an environment when trying to attempt an informed, accurate and speedy investigation into potential synergies whilst identifying opportunities and threats.

Benefits of due diligence

In an ideal world, the composition of a due diligence team far surpasses the group of investors, financiers, bankers, accountants and lawyers. The bill for this variety of 'due diligence' latterly comes to millions in terms of fees. To include other professionals requires a substantial investment in research but delivers a huge return on investment. This strategy works because it is investing in prevention. Please remember that roughly only 20% of acquisitions or mergers actually achieve the synergies for which they were originally created.



Soft due diligence

The term focuses more on the hard financials and PE ratios etc. 'Soft due diligence' takes account of measuring the cultural landscape of the potential acquired partner or business. Further, this must be compared with the existing business to examine complementary synergies and those that will act as a brake or barrier on business performance. This soft due diligence is not hand holding and measuring 'organisational climate', but focusing with precision on those areas that can make the deal worthwhile or leave the acquisition and the new business entity floundering, directionless and without drive or energy.

This becomes even more critical in the scenario where there are cross border implications. What are the geographic barriers to integration? Are there any major cultural trends in a geography that would hinder growth or expansion in another culture? Simple things such as religious beliefs may act as a stopping point. A company with western type policies and management styles may have difficulty operating in a predominantly Muslim country.

To make a deal work you have to shape the culture of the organisation to deliver outstanding value and return for the investor

Culture consequences

IBM recognised the cultural divide many years ago when, in the 1960s, they commissioned research to understand the broad cultural differences that exist in other countries. These extensive and largely secretive findings and analysis helped IBM enormously in creating new partnerships and their own divisions and manufacturing capabilities in more than 60 countries throughout the world. Other companies, such as General Electric, Motorola etc commit to this process. Benefits can accrue to all businesses and in all sectors.

Beware, the cultural divide between some countries could create major

issues that hinder business integration. There are no impossible scenarios – just situations which require more work.

For instance, how is it that the entity created between a largely US, fast changing, technology driven company committed to aggressive growth, creates a new entity with a Japanese business renowned for their patience in R&D, quality improvement and commitment to JIT with a solid supplier base?

The two cultures may appear to be so different that you may think the new business entity could not possibly work. It will not if the analysis of soft due diligence is not incorporated into the post acquisition integration strategy.

Okay, we are not saying in the example that this business venture will not work – rather that the two partners have to make it work and invest time and energy in creating the culture for the new entity. It will not happen or evolve by accident.

Simple things such as religious beliefs may act as a stopping point

Diagnosis – soft due diligence

Without drilling down into the detail, the diagnostics that support this level of analysis have to be both precise and strategically focused at the same time. Further, if data collection and diagnostics take months to process and analyse this time of indecision could inhibit the success of the potential business, or open up opportunities for competitors to either stalk the potential partners or even act quickly in the market to set up a rival bid or venture. Speed of decision making can create the 'barriers of entry' that the partners may need to keep others at bay. Indecision and poor analysis get the new business off to an extremely bad start.

Summary thoughts

In the world of mergers, acquisitions, joint ventures and business expansion, it is clear that Investors need to be aware that they can often make the wrong decisions. Invariably, such decisions are based on inaccurate data. In too many cases, the data is focused solely on trading agreements, legal documents, tax possibilities and basic financials.

To make M&A activity and business expansion powerful, profitable and purposeful, we have to get the right picture of the culture of the business. This goes far beyond IS/IT considerations, manufacturing strategies and capabilities, marketing mixes, product portfolios, sale strategies, innovation and new product development, country culture, organisational cultures and politics, country values and management style.

It is easily possible to develop a solid picture of opportunities for the business, predicting areas of risk and closing these quickly, but this can only be achieved through viewing the whole creation of the new entity adopting the soft due diligence business model and diagnostics outlined here.

Conducting a preacquisition investigation

Soft due diligence is an indepth intervention, enquiring and investigating the relative health of an organisation. Our diagnostic skills are concerned with investigating disease and finding cures for what ails the body corporate. As corporate surgeons or diagnosticians are deciphering cause-effect relationships, within the business, it is vital to create prescriptive measures and regimes which when applied will generate wealth and health.

Traditional due diligence, whether undertaken by investors, lawyers or accountants is time consuming and much that is analysed, studied, discussed and debated is strictly legally bound by contractual documents of 'non-disclosure' and 'confidentiality agreements'. Most acquisition or business expansion is commercially sensitive, which others can use to their advantage so it is not surprising that assumptions are made and trade-off is taken. Risk is what business expansion is about, whether it be organic or acquired business expansion. However, the risk is reduced substantially by undertaking some cultural analysis as well as pure financials.

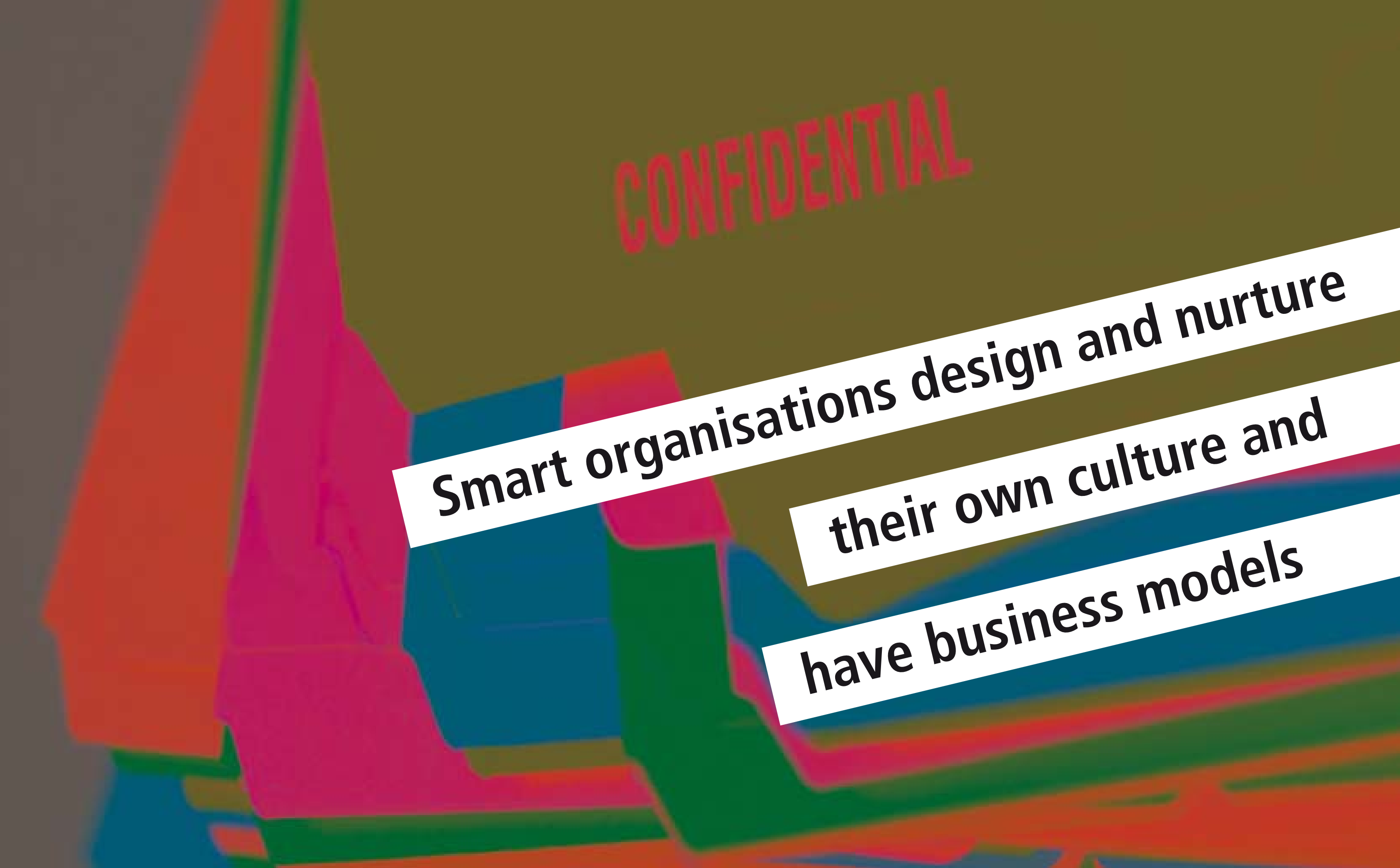
Confidentiality and need to know

The benefits of working in creating a new entity commercially will have an impact on the share price and investment decisions of all partners to the transaction, so all parties have to consider 'what if scenarios' and won't wish to advertise too much or show too much interest in their partners, their quest or their prey! Frequently, only the CEO and Chairman of the two or more businesses will know what is happening at any one time.

Thin on the ground: Methodologies for soft due diligence

Surprisingly few companies have set in place a discipline and a methodology for diagnosing the ills, opportunities and hazards that are likely to mature in potential commercial partnership. Often, decisions that drive acquisitions are based purely on numbers and optimistic and unrealistic assumptions. Some others have argued that the ambitions of key CEOs are the driving force for business expansion.

Key dealmakers want to dominate the market and make a difference to trading and performance. Key players like this can make a significant impact on the performance of their businesses and will probably benefit substantially from taking the right decision or the right calculated risk.



Smart organisations design and nurture their own culture and have business models

Strategies for soft due diligence
Very few businesses have in place strategies for soft due diligence and those which do, are usually renowned for their extensive acquisitions as a key component of their overall corporate business strategy. Two companies immediately leap to mind. Jack Welch, CEO, led the ever-powerful General Electric (now run by Jeff Emmelt) to create the acquisition fever for which GE is renowned. In the GE empire very few days go past without purchasing, merging or divesting one of its businesses. GE has a powerful set of processes in place to undertake both soft due diligence and post acquisition Integration. They commit to them every time. The same performance is mirrored by Fred Goodwin, CEO of the Royal Bank of Scotland. In his hands, the business has grown to become the sixth biggest bank in the world.

The business models that both businesses employ are well tested and fit neatly into a series of soft due diligence and post acquisition strategies that can slot into place, depending on the size, the type of business and the geographic culture or cross border deal that is taking place.

As most organisations focus more on the hard areas such as strategies, systems, processes and technology, companies like RBS and GE also commit greatly to investigate how businesses are managed.

Cultural audits

Every organisation has a culture. Smart organisations design and nurture their own culture and have business models to achieve this. Few organisations commit resources to this formally and most cultures unfortunately evolve due to the wins and the whims of their key players, and the charisma and vagaries of key personalities as they emerge in the business.

A great deal of culture may be based on the personality and styles of key top people. The trouble is, if this is the default model, then when a key person move onwards or out, the culture has nothing with which to hold itself together, apart from a belief in the 'old leader or warrior' which fails to sustain the business model.

Philip Atkinson and Dara Clarke will conclude this feature in the Summer edition of Management Services Journal.

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The early methods pioneers judged that there was "one best method" for carrying out a task and in particular it was F.B.Gilbreth who held and practised this belief. Today the UK MTM Association still practises the concept that there is one best method in the use of resources and from that is derived the most economical time for the job in hand. This takes account of all resources, human, material, machines and workplace layout. Our name has a specific meaning, in that the concentration upon the best working method and its derivation by a recognised MTM system will provide the best solution in terms of time and therefore cost. Where work is performed that contains a manual input, there will be an MTM system suitable for your needs whether the work is short-cycle and highly repetitive, or is based around small-batch manufacture.

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