

Voice of the Marketplace in Acquisition Due Diligence

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The Problem

Why is it so difficult for companies to achieve their strategic goals through acquisition? Research has consistently shown that most acquisitions fail to meet expectations. It is typically not because of poor legal or financial due diligence. Yes, integration problems certainly account for a major share, but a less recognized killer of acquisition success takes place much earlier, in the due diligence process – lack of a deep understanding of the target’s market and its position in the marketplace. Traditional due diligence is too often inwardly focused on historical financials, operations, legal liabilities, precluding a forward-looking analysis of the future success factors. In almost 20 years of providing due diligence services to strategic buyers, we’ve heard all the post-acquisition laments. The market wasn’t growing as fast as we thought it was. The new technology had a much greater and quicker impact. We didn’t see the price war coming. We didn’t know how vulnerable the key accounts were. And many more. All problems that could have been identified by investigating the target’s ability to navigate future marketplace issues.

As a strategic buyer, how do you identify the critical problems before it is too late? The very nature of the process is designed to control the information flow and keep you in the dark. The deadlines are tight and most due diligence takes place in a two to three week period. The target’s job is to put only its best foot forward. And we all know, the financial advisor works for the target. Their job? To paint the target in the best light to drive the deal price higher. Neither is motivated to

identify the pitfalls likely to be encountered once the deal is closed. Traditional due diligence, while necessary, needs to go beyond the historical and examine the target’s potential in the context of its future marketplace. M&A is truly a situation where *caveat emptor* has to be the operating philosophy.

A Solution

In a perfect world, a full 360-degree market and competitive due diligence is always the way to go. In the real world where time and resources are often constrained, the one component of market due diligence you must not do without is the *customer*. Quickly accessible, unbiased, and possessing the answers to address your concerns, customers are the window to the target’s (and your) future success. At a minimum, good customer due diligence illuminates the target’s market position, identifies potential threats, assesses the strength of key account relationships, and tells you where the market is going – providing deal leverage in the process (see Sidebar 1). It can also prevent you from making a big mistake (see Sidebar 2).

When you boil it all down, the customers are one of the main reasons why you are buying the company, and when you are looking for the insight on the market – they are the market. They are your *Voice of the Marketplace*. Who has a better feel for the market’s and your target’s future growth prospects? And here is the amazing part. Research indicates less than one-third of acquirers include customers in the due diligence process¹.

SIDEBAR 1: Smelling Sweet

A provider of brand name personal care products had engaged us. The client’s strategy was to expand into household products to leverage its relationships with supermarket chains and mass merchandisers. Attracted by the extraordinary growth of the category, our client was considering the acquisition of a leading provider of simmering potpourri.

Our interviews with category buyers at leading supermarket chains and mass merchandisers confirmed that simmering potpourri was a “hot” category and the target a well respected leader. However, further probing indicated that they believed the current high growth was more of a consumer fad that would not last more another year to eighteen months.

Result

This insight allowed the client to re-structure their offer to provide an adequate return based on more rationale forecasts, and once acquired, to develop strategies for product and channel development for their new simmering potpourri division.

Those conducting customer due diligence may engage a third party for their expertise and easier access to the customers or use internal personnel. It has been our experience that many acquirers who do customer research in-house often use methods that actually prevent customers from sharing all that they know. The following are three key lessons we have learned over almost two decades that will help acquirers who want to conduct their own customer due diligence better harness

the *Voice of the Marketplace* in acquisition due diligence.

Lesson #1: Use Senior People

Acquirers who conduct their own customer due diligence often use the wrong personnel. Addressing strategic issues that predict your future success is not the job of a beginner or the MBA interns. A 2006 survey by McKinsey & Co. found that the more successful acquirers used M&A teams with longer tenured personnel as opposed to recently hired ex-investment bankers, etc². These personnel benefited from a deeper knowledge of the acquiring company and what it wanted to achieve through acquisition. The same concept holds true in conducting the customer due diligence. Senior staff will have greater success at gaining access to the customers and the insight they gather will carry more weight in the decision making process. Not to mention the important side benefit of senior people wrestling with objective data to counterbalance the tunnel vision that often grips M&A teams. However, the key elements senior people bring to the process are a better understanding of the strategic issues and the ability to converse at that level with executives from the customer organization.

Lesson #2: Cover the Customer Base

“Touching base” with a few key customers does not constitute customer due diligence. A typical due diligence effort should include a minimum of 20 to 30 customer organizations depending upon the number of distinct market segments in which the target competes. A good rule of thumb is five to six customers in each segment. Across the segments, the 80/20 rule usually holds true for most companies and 20 to 30 of the biggest customers should represent a significant portion, if not the majority, of the target’s revenue base. Obviously you want to talk to as many of the key customers as possible. Not only is it critical to assess the strength of these relationships and the security of the future revenue stream, but also the

leading customers are often the largest players in the industry and their actions and perceptions are the most influential in shaping the future. Lost customers are an excellent source of information on the target’s weaknesses as well as the intensity of current and emerging competitive threats. As the target strives to put its best foot forward, lost customers are often overlooked. All companies lose customers and strong resistance to providing access to them is a potential red flag.

Lesson #3: Have a Conversation

Probably the most important lesson we have learned over years of conducting research through direct interviewing is the power of the conversational format. Conversely, using a survey format is a good way to reduce your ability to achieve meaningful insight. The goal is to have a strategic conversation and surveys with their yes or no questions and short-answer formats stifle verbal interaction. It may sound like advice from a marriage counselor, but the secret to good interviewing is listening. Always ask open-ended questions. Asking “how do you decide on the number of vendors to use” is going to elicit a more thoughtful response than “how many vendors do you use” which will get a one-word answer.

The pace and structure of the conversation should be based on the interviewee’s responses. Listen carefully to the responses and ask questions for elaboration and to control the flow of the interview. While you should always have an outline of the topics to be covered, let the conversation dictate the topics. In other words, don’t follow your outline in a strict order asking question A, then B, then C. If in addressing topic A, the interviewee mentions C that is the perfect segue to C. Look for an opportunity to come back to B later. It is the same methodology used by professional journalists and is, importantly, a lot more engaging and interesting to the person you are interviewing. A fair number of our conversations begin with the interviewee stating, “I can only

give you 10 or 15 minutes” and 45 minutes later they continue to voluntarily drive the conversation well past the original list of questions often raising issues unforeseen by the acquirer providing even more insight into your target’s future.

Understanding the target’s competitive position and where the market is going is vital to your decision on whether and how to proceed with the acquisition process. If you are successful in acquiring the company, the value of in-depth customer due diligence does not end at the closing table. If done correctly, the knowledge gained will help you address integration challenges, that other great hurdle to acquisition success.

A carefully structured analysis is a baseline to aid in building the business plan going forward. It will point out areas for improvement from product features to service delivery, identify personnel critical to retain, and determine opportunities for the new parent to create synergies.

The due diligence check-list is long. Time permitting, a comprehensive market due diligence that includes customers, competitors, suppliers, and other industry stake-holders will insure a greater probability of achieving your objectives. If, for whatever reason you can’t do it all, choose the customers. Whether contacted directly or indirectly (as is sometimes necessary), customer due diligence is a critical tool that most acquirers ignore. In fact, given the number of acquirers who actually use it, customer due diligence may be more appropriately considered a “secret weapon.” If done properly, interviewing the target’s customers offers an expedient and unbiased source of answers to key issues that will determine your ultimate acquisition success.

SIDEBAR 2: Losing Power

Our client, a specialty rubber products manufacturer, was in negotiations to acquire a company that made rubber battery separators. This highly specialized product was typically used in large back-up power systems for nuclear submarines, power generation facilities and other high-end applications. The target had a dominant market share in this niche and the enviable margins to go along with such a market and positioning.

Our interviews with back-up power systems manufacturers and the U.S. Navy indicated the customers were well into the approval process for a competitive product, a polymer-based replacement separator that provided significantly better performance at a much lower price. The last hurdle in the approval process was a two-year field test to prove the new product's durability. Many customers viewed this last component as a formality.

Result

Ignoring vehement protests from the target regarding our data and insight, the client passed on the deal. Nearly two years later, the client called to thank us. They had recently been contacted by the target in what would be characterized as a "very flexible negotiating posture" having recently lost their marquee Navy contract to the new separator product.

About the Author

Matt Paumen is a managing partner with Krill Northgate, LLC in Ponte Vedra, Florida. The firm specializes in providing research and analysis to support its clients' strategic decision-making. With more than 18 years of experience, Matt has advised clients on 200+ M&A transactions as well as other corporate growth initiatives including new market entry, new product development and international expansion.



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Quick and discreet, we can complete most projects in three weeks or less.

¹Avoiding the Perils of Traditional Due Diligence, Michael May, Patricia Anslinger and Justin Jenk

²Habits of the Busiest Acquirers, Robert N. Palter and Dev Srinivasan