

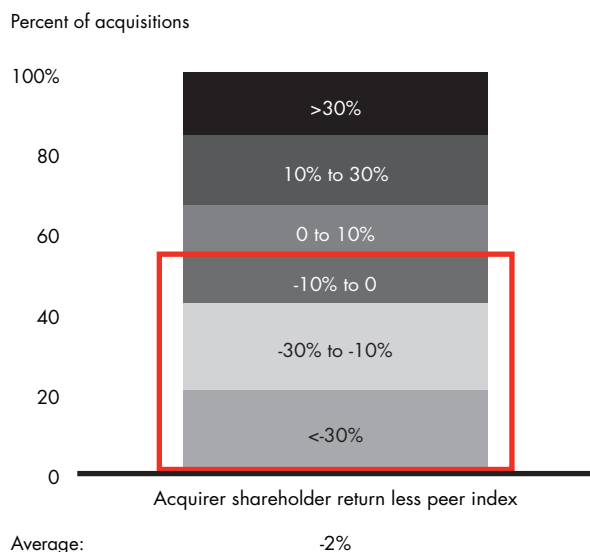
## Deal making: Using strategic due diligence to beat the odds

It may come as a surprise in an M&A landscape struggling to recover, but executives are getting better at deal making. From 1995 to 1998, only one out of every four acquirers beat their peer index by more than 10 percentage points, according to Bain & Company research. From 2002 to 2005, the success rate had nearly doubled, to 45 percent or about one out of every two acquirers.

What's behind the improvement? In our view, shaped by working on more than 1,800 M&A projects worldwide with corporate acquirers and more than 4,000 due diligence engagements for PE investors, the most salient factors are increased discipline at opposite ends of the deal value chain: Companies are completing deals with sounder strategic rationales, and they are executing more effectively on merger integration.

Even with these improvements, however, about half of deals larger than \$250 million fail to deliver the promised returns. The problem lies in the middle of the deal value chain: commercial due diligence. Only one in three business development executives we surveyed said they are satisfied with how their firms manage deal diligence.

About half of large deals fail to deliver the expected returns



Note: Time period is 20 days before announcement to 12 months after announcement.  
Source: Bain US and European Acquisition Success Study (2007)

Too many executives treat diligence as an audit to confirm what they think they know, rather than a solution to the problem of “I don’t know what I don’t know.” The focus on getting the deal done leads to reliance on conventional wisdom that flows from off-the-shelf information or standard industry research. In fact, diligence is a critical step to test and quantify what seems like a good idea.

The key to effective diligence is recognizing that you are making an over/under bet versus the conventional wisdom. The most successful acquirers consistently uncover a deal’s hidden upside, which allows them to bet the “over.” But they are also careful to fully anticipate the downside, making sure potential risks are well understood. With that understanding, they can calculate when to bet the “under.”

The leading private equity firms are among the best practitioners of strategic diligence in the world. Their business models are built on identifying the hidden value in assets that are being thoroughly shopped. The top-tier firms know when to reach and outbid rivals and when to walk away.

Corporate deal makers face a different set of diligence challenges. Most private equity transactions are set up as auctions, complete with data rooms and well-defined processes for selling the assets. Corporate deals are more often private, requiring the bidder to make educated guesses about the asset they are buying. Yet, while the deal processes are different, the diligence tools used by private equity firms are equally valuable in both settings. In all cases, it’s essential to formulate a strong, well-articulated deal thesis in advance and to concentrate analysis on proving it from the bottom up. All deal theses should answer the question: “How will buying this business make my existing business more valuable?” If a potential transaction has strategic value, the assertion needs to be backed up with customer input, competitor insight, new industry data and analysis about how profit pools are likely to evolve. In many corporate cultures, incentive systems that bias individual managers to make, not avoid, investments create additional deal risk. The best defense is a truth-seeking culture fostered by a rigorous deal-review process. It helps to set a walk-away price and make a concrete list of strategic benefits up front as part of the broader deal logic.

Efficacy flows from asking the big questions about a deal from conception and focusing analysis on the few things that truly drive value. What factors result in superior performance and competitive advantage, and are these forces likely to stay in place during the foreseeable future? How dependent is the earnings stream on the existing management team, and what happens if they leave or their incentives change? Has the asset been dressed up for sale? What is the potential exit strategy if things go wrong?

An essential part of this process is knowing what you don't know about a target and being diligent in understanding why a business is, or isn't, attractive. Predicting financial outcomes, especially over the long term, is inherently stochastic and frequently depends on assumptions that are foreign to an executive's past experience.

One trap, however, is relying on the target for intelligence. Forecasts supplied by management and secondary sources should be viewed with circumspection. Selling executives and many industry analysts have their own natural inclination to put the best spin on information. Build your own proprietary view from the bottom-up and outside-in by spending time in the field interviewing customers, suppliers and competitors. No single element of business diligence is more important than plumbing these sources for business intelligence about the target.

Beware also the allure of expected synergies. Executives tend to have strongly held views on their industry and often bias their thinking by imagining how much cost

can be wrung from rationalizing duplicate operations. Extracting value from combining complementary businesses is more elusive than most people think, both in terms of the actual potential and the work required to achieve it. The key is to ensure synergies work for you, not against you. Remember, research shows that 90 percent of merged firms lose market share in the first year after a deal closes.

That said, the first day of due diligence is really the start of merger integration. It is an opportunity to chart a course early and set a plan to capture as much value in the business combination as possible. Especially if you are targeting a competitor, due diligence can be the first inside view of a company, shining a light on where synergies exist and where they don't. Above all, diligence should confirm whether a deal is truly scale or scope. The answer to that question will guide the subsequent merger integration and management of the acquired business, which follows a very different course, depending on whether it is a scale deal or a scope deal.

Finally, be prepared to walk away at any point if that's what makes business sense. In our experience, successful deal makers turn down many more opportunities than they pursue. There's nothing glamorous about stepping on a landmine.

#### **Key contacts in Bain's Global Mergers & Acquisitions practice are:**

- Global:** David Harding in Boston ([david.harding@bain.com](mailto:david.harding@bain.com)), Ted Rouse in Chicago ([ted.rouse@bain.com](mailto:ted.rouse@bain.com))
- Americas:** Laura Miles in Atlanta ([laura.miles@bain.com](mailto:laura.miles@bain.com))
- Europe:** Axel Seemann in Frankfurt ([axel.seemann@bain.com](mailto:axel.seemann@bain.com)), Arnaud Leroi in Paris ([arnaud.leroi@bain.com](mailto:arnaud.leroi@bain.com))
- Asia-Pacific:** Satish Shankar in Singapore ([satish.shankar@bain.com](mailto:satish.shankar@bain.com))

#### **Key contacts in Bain's Private Equity practice are:**

- Global:** Hugh MacArthur in Boston ([hugh.macarthur@bain.com](mailto:hugh.macarthur@bain.com))
- Americas:** Bill Halloran in San Francisco ([bill.halloran@bain.com](mailto:bill.halloran@bain.com))
- Europe:** Graham Elton in London ([graham.elton@bain.com](mailto:graham.elton@bain.com))
- Asia-Pacific:** Suvir Varma in Singapore ([suvir.varma@bain.com](mailto:suvir.varma@bain.com))

For additional information, please visit [www.bain.com](http://www.bain.com)