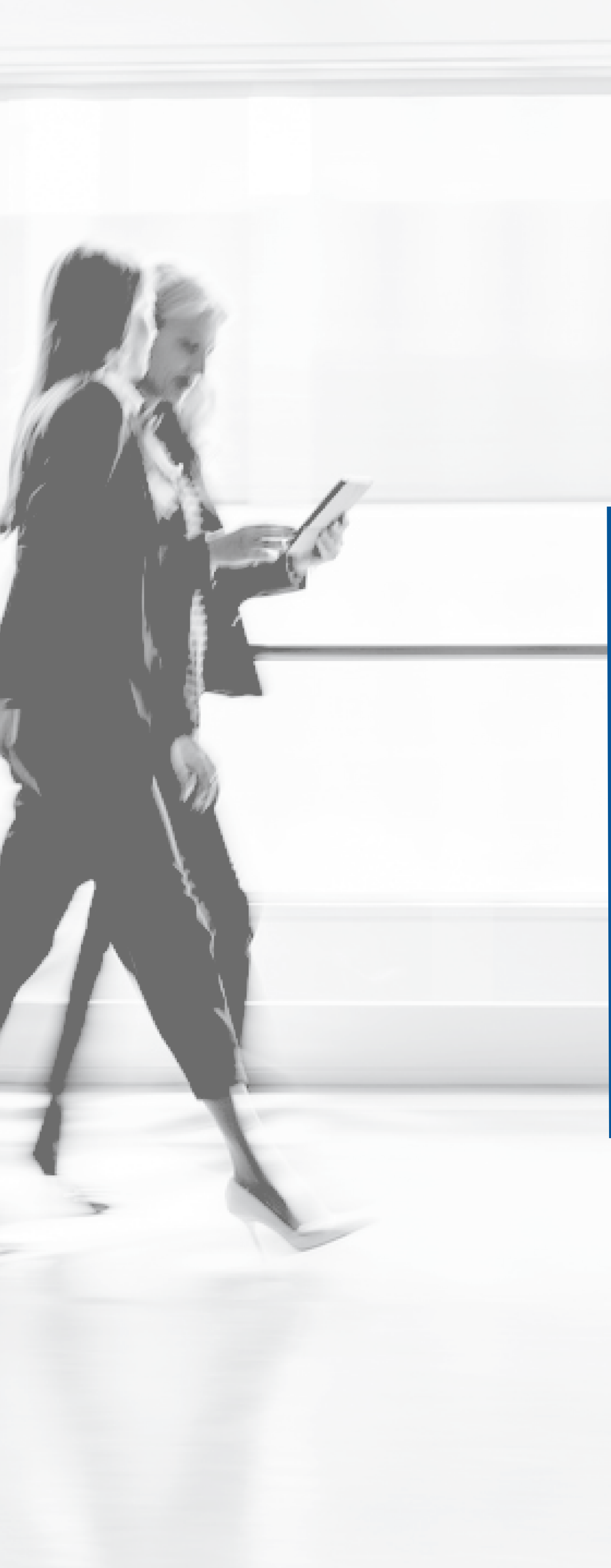
M&A DUE DILIGENCE
FOR THE 21ST CENTURY

CLARKSTON CONSULTING

Global mergers and acquisitions (M&As) are expected to hit a record $3.2 trillion in 2018 after hitting $2.6 trillion in 2017, with the healthcare, consumer goods and technology sectors seeing the most deal action this year. Mergers and acquisitions have not seen such an uptick in activity since the economic crisis of 2007.

Forget all the M&A failure postmortems, self-help articles, blogs and books. The facts are clear – typically 70% to 90% of acquisitions fail. Looking historically, the M&A failure rate has held constant for almost 100 years. That's not to say there haven't been successful M&A - Exxon/Mobile, J.P. Morgan/Chase, and Disney/Pixar are just a few examples of success.



The dismal overall performance record described above provides enough evidence to predict a history that investors can't ignore. These failures can cause serious damage to companies and their boards of directors, devaluation of stock price, or loss in confidence by company shareholders.

When seeking growth, modern business leaders tend to pursue two strategies:

1. Grow your revenue and profit from within by cultivating and growing demand for products and services, or
2. Merge with or acquire another company.

There are many reasons deals fail, from culture clashes, hidden liabilities, poor planning, or simply inadequate expertise, but these issues point to the predominant reason for acquisition failure – lack of strategy. Should M&A be considered your growth solution, considering how it fits into the organization's overall long-term strategic vision is critical to success of the deal and potentially the success of your business. Acquisitions, when closely married to long-term strategy, can ensure sustainable market presence, optimized product or service portfolios, and improvements to profitability and other key performance metrics.

Here are a few valuable questions that your organization can consider during the pre-merger due diligence phase, to determine whether a target company is a suitable candidate for a merger & acquisition and some of the factors to consider building into the business case to proceed;

1. How can we assure ourselves that a merger or acquisition is going to create shareholder value?

When companies merge, most of the shareholder value created is likely to go to the seller and not the buyer, as some would believe. On average, the buyer pays the seller all the value generated by a merger, in the form of a premium of 10 to 35 percent of the target company's calculated market value. The due diligence team sould try to anticipate common "dis-synergies", such as the loss of customers, and consider raising their estimates of one-time costs associated with the proposed M&A.

Answering this question will also include vetting assumptions about pricing and market share, benchmarking in your industry to deliver cost savings, and realistic assessments of the timeframes required to capture synergies.

2. As the acquiring company, what should we "give" to create a successful transaction and achieve the anticipated benefits for our long-term vision?

When companies focus solely on what they are going to get from an acquisition, they're less likely to succeed than those that view it as a bilateral transaction, with give and take needed on both sides. When an acquirer is in "take" mode, the seller can elevate its price to extract all the future value from the transaction, especially if another potential buyer is in the equation.

If, as an acquirer, you have something that will help the

selling company become more competitive, the picture changes. If the selling company is unable to make that enhancement on its own, you rather than the seller, will earn the rewards that flow from the transaction.
An acquirer can improve its target's competitiveness in four ways:

1. providing growth capital;
2. providing better managerial oversight;
3. transferring valuable skills; and
4. sharing differentiated capabilities.

3. What are the resources and the resulting budget required to build into the business case to successfully merge the acquired company into ours?

The resource effort should be bottomed out during the due diligence phase rather than after. If the costs are too great, it will be another factor in the decision as to whether to proceed with the merger or acquisition.
It has been proven too many times over the last decade that companies underestimate the resources / human resource budget required to support a merger or acquisition. Cost and resource estimates must be built into the business case in the due diligence phase.

M&A can often fail or not achieve its full potential due to staffing issues. When mergers are understaffed, employees in both merging companies face the pressures of their own selection process, having to perform their day to day responsibilities, and accommodate the necessary data and information requests to support the integration teams.
Evidence suggests that many key integration roles should be pulled out of the business and backfilled. When integration teams run out of budget, activities are cut short and the result is sub-optimal processes to operate the new business.

4. From an IT perspective, in what condition is the target company's technical architecture?

Answering this question requires a thorough review of component technology, standards compliance, data structure design, code structure, and at least a half-dozen other items. Internal experts should assess the scalability of systems and any performance issues. Consider the following questions during due diligence in order to optimize IT integration;

- **Infrastructure** – Does their infrastructure allow for scalable growth? Does the IT team have the right development hardware and software? (If not, what CAPEX or OPEX will be required to achieve sustainability?

- **IT Support Staff** - Does the target company's technical support group have sufficient staffing? Is their hardware and software functional and reliable?
- **Network Security** - Is their network secure? What is the complete IT security profile at the target company, from anti-virus protection and firewalls to proper password protocols? What are their off-site backup and recovery capabilities in the event of a disaster?
- **IT Development** – What is their structure for development? Do they have the right people, the right processes, and the correct documentation for development?

5. What questions will be asked by regulators from a compliance perspective?

If regulatory approval is needed for this transaction, you should anticipate detailed questions from regulators and plan the appropriate answers. Some of the common questions asked by regulatory bodies include:

- Why did the buyer select this specific target company?
- What is the transaction's structure?
- Is the buyer paying fair market value?
- Are there market share issues that could conflict with the Federal Trade Commission?

In deals that present antitrust issues, the government's approval of the transaction will depend on if, in their view, the transaction would have pro-competitive or anti-competitive effects on the relevant market(s). The parties' success in meeting their objectives will depend largely on the planning that occurs at the very earliest stages of consideration of a deal.

Obtaining antitrust approvals as quickly as possible is critical to success. Although both parties will want

to consummate a contemplated merger as quickly as possible, the parties often select a drop-dead date that is far into the future so that there is sufficient time for obtaining antitrust approvals.

6. From a commercial perspective, do we ensure that we know what we are buying when considering an acquisition?

In this, the devil is certainly in the detail. Not all pre-close due diligence can flush out this information, which can have a direct impact on the projected profitability models. There have been multiple M&A examples where significant changes in revenue and market trends within a target company's major product lines were discovered during the pre-close due diligence phase, resulting in clear and direct impacts to the proposed purchase price. The output of the confirmatory due diligence process should:

- Determine whether to go through with the deal
- Confirm the purchase price based on identified risks and the quality of financial statements provided by the potential partner
- Confirm the transaction's structure
- Address how to handle any post-closing issues that arise
- Begin to plan for an integration strategy with the seller
- Create action to form the rest of its transaction advisory team (including members from organizational areas such as legal, accounting, regulatory, operations, reimbursement, quality, insurance, human resources, benefits, and tax).

What's becoming clearer each year is that traditional due diligence approaches do not work, no matter how good they appear to be. The acquiring company should ensure that due diligence efforts go beyond financials to include industry specific strategy, people, technology, human resources, and organizational design expertise.

In the wake of year-end US tax legislation, conditions are ripe in 2018 for a surge in M&A activity. With a large reservoir of repatriated tax dollars at their disposal, life sciences and consumer products companies will be navigating new opportunities for growth and revenue, chiefly through targeted M&A. Businesses in the consumer products and life sciences industries will utilize M&A to enter new markets and offer differentiated value to their core constituents but these benefits will only be realized through a thorough, modern approach to M&A due diligence.

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