M&A Due Diligence
What Corporates Can Learn from Private Equity
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While many factors influence the success of a corporate merger or acquisition, the quality of the due diligence is one of the most critical (Figure 1). However, performing good due diligence is challenging for even the most experienced serial acquirers. The time table is compressed and driven by the needs of the vendors rather than the needs of the bidders. Key information is often made available late or not at all. And with a range of parallel due diligence work streams to manage, there is a logistical challenge as well.

Why, then, do private equity firms go from one due diligence to another with an apparent grace that most corporations only dream of achieving? In this article, we identify four distinct actions private equity firms take that can help corporations streamline the due diligence process, make due diligence more effective, and ultimately enable better M&A decision making.

FIGURE 1. Key M&A success factors

<table>
<thead>
<tr>
<th>% of Respondents who identified this as one of the top three success factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Planning and executing the integration process</td>
</tr>
<tr>
<td>Conducting due diligence</td>
</tr>
<tr>
<td>Understanding cultural issues</td>
</tr>
<tr>
<td>Identifying, screening and prioritizing targets</td>
</tr>
<tr>
<td>Developing M&amp;A strategy early</td>
</tr>
<tr>
<td>Achieving optimal price</td>
</tr>
<tr>
<td>Negotiation process</td>
</tr>
</tbody>
</table>

Source: Accenture & Economist Intelligence Unit 2006 Global M&A Survey
Any private equity deal maker can testify that one of the key drivers of the bid for an asset is future growth and stability of cash flows, as they determine both the asset’s value and the appropriate degree of leverage. This is validated by Accenture’s shareholder value analysis research, which shows that a significant part, in many industries the majority, of the average public company’s enterprise value is based on expectations of increased future cash flow growth over and above the current level (Figure 2).

However, traditional due diligence tends to be backward-looking, concentrated on validating historic performance and identifying potential liabilities and risks. While it is certainly important to understand that an acquirer is actually buying the assets it thinks it is buying, focusing on the current rather than the future only addresses a minority of the acquisition target’s enterprise value.

Therefore, to reflect the real value relationship, the bulk of the due diligence effort needs to focus on helping the acquirer understand the target’s future prospects and how those fit with the acquirer’s strategy. This can require a disproportionate emphasis on at least two due diligence work streams: strategic and operational.

Strategic due diligence involves validating the acquisition target’s fit with the acquirer’s strategic rationale for the acquisition, and understanding the target’s market position and outlook to inform the price offered.

A strategic fit assessment typically covers an in-depth analysis of whether the acquisition target enhances the acquirer’s competitive position and explores areas where synergies could be realized. These synergies should be quantifiable, where possible, so the acquirer can evaluate the additional value the combination could create. A market assessment and future outlook is equally important to this effort because it can enable the acquirer to assess whether the acquisition target has a realistic management plan. A thorough review of assumptions underpinning the management plan—and, more importantly, comparison with market dynamics, competitive position and operational capabilities—often can highlight discrepancies in the target’s management plan. To address this, acquirers can apply sensitivities—in other words, change assumptions—to make the management plan more realistic and value the business appropriately. Strategic due diligence also can highlight potential restructuring opportunities to create further value and identify bolt-on acquisitions that can accelerate growth.

Operational due diligence involves understanding the operational characteristics of the target (for instance, organization structure, IT systems, and culture) and hence the integration approach and timeline that will be required, as well as validating the target’s operational and capital expenditure outlook to inform the price offered.

An operational due diligence assesses whether the acquisition target’s capabilities, operations and infrastructure support the delivery of the target’s management plan. We believe acquirers should consider resisting the temptation to perform such an exercise for each functional area, and instead focus on developing a tailored approach for selected areas that may be critical to measuring the success of integration. For example, an IT due diligence could uncover the material risks an acquirer must address when migrating the target’s infrastructure and applications onto the acquirer’s IT platforms. In addition, it behoves an acquirer to understand the future outlook for IT costs, how they can be managed and whether opportunities exist to generate operational cost savings. Similarly, HR issues can be an important factor to consider, particularly in the case of cross-border acquisitions.

For example, when pursuing a foreign acquisition, a large state-owned oil corporation identified the retention of critical talent as key to measuring the success of the integration. To develop an HR retention and cultural integration plan, the acquirer collected relevant HR information from both public and acquisition target sources during due diligence. By analyzing the skills and experience of each individual alongside his or her existing position (and future potential) in the target organization, the acquirer was able to identify key individuals it should retain. The acquirer then developed a retention plan that included both monetary and non-monetary incentives prior to deal announcement, and subsequently communicated with key employees soon after deal announcement. This approach helped enable the acquirer to minimize unwanted attrition during the integration phase and, thus, retain a key driver of the deal’s value.

In contrast with the financial and legal varieties, high-quality strategic and operational due diligence do not generally require an army of specialist advisors. Rather, the due diligence work streams can be staffed by the acquirer’s own people, selectively augmented with advisors who bring targeted insights, such as independent perspectives on the market outlook or an in-depth assessment of the timeline and cost to get to a common IT platform.
## FIGURE 2. Current versus future value by industry

<table>
<thead>
<tr>
<th>Industry</th>
<th>Companies included</th>
<th>Total EV (USD bn)</th>
<th>Total FV (USD bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fabless Semiconductor</td>
<td>Qualcomm, Broadcom, AMD, nVidia, MediaTek, Marvell, LSI, Xilinx, Altera, Omnivision, Novatek, Mstar, CSR, Realtek, Cirrus Logic</td>
<td>175</td>
<td>115</td>
</tr>
<tr>
<td>Financial Services</td>
<td>UBS, CS, DB, JP Morgan, MS, HSBC, Barclays, Citibank, BofA, SocGen, Santander, Unicredit, JuliusBaer</td>
<td>1,336</td>
<td>862</td>
</tr>
<tr>
<td>Auto</td>
<td>Volkswagen, Toyota, GM, Daimler, Ford, Fiat, Honda, BMW, Nissan, Hyundai, SAIC, Peugeot, Audi, Renault, Kia, Tata Motors, Suzuki, Dongfeng, Great Wall, Gelly</td>
<td>1,756</td>
<td>1,046</td>
</tr>
<tr>
<td>Oil &amp; Gas Services</td>
<td>Schlumberger, Halliburton, National Oilwell, Baker Hughes, Weatherford, Technip, Cameron, Aker, FMC, Oil States, Weir Group, Dril-Quip</td>
<td>304</td>
<td>157</td>
</tr>
<tr>
<td>CPG</td>
<td>P&amp;G, J&amp;J, Unilever, L'Oreal, Henkel, Colgate Palmolive, Reckitt Benckiser, Estee Lauder, Beiersdorf, Clorox</td>
<td>923</td>
<td>360</td>
</tr>
<tr>
<td>Chemicals</td>
<td>BASF, Dow, LyondellBasell, DuPont, Sumitomo, Akzo Nobel</td>
<td>322</td>
<td>123</td>
</tr>
<tr>
<td>Telecom</td>
<td>AT&amp;T, Verizon, Telefonica, Deutsche Telekom, Vodafone, France Telecom, Telecom Italia, VimpelCom, Telenor, KPN, TeliaSonera, MTU, Rogers, Swisscom, Tele2, TDC, Elisa</td>
<td>1,343</td>
<td>439</td>
</tr>
<tr>
<td>Consumer Tech</td>
<td>Samsung, Apple, Panasonic, Sony, Toshiba, LG, Canon, Nokia, Sharp, Acer, IBM, Nikon, HTC</td>
<td>705</td>
<td>197</td>
</tr>
<tr>
<td>Software</td>
<td>IBM, Microsoft, Oracle, Symantec, VMware, CA, Adobe, Intuit, Citrix, Autodesk, BMC, Red Hat</td>
<td>727</td>
<td>178</td>
</tr>
<tr>
<td>Oil &amp; Gas</td>
<td>Shell, ExxonMobil, BP, Total, Chevron, Hess, Suncor, Murphy, Occidental, Husky, Apache, Cenovus, Marathon, Chesapeake, Canadian Natural, Anadarko, EOG, Devon, Talisman, Canadian</td>
<td>1,892</td>
<td>104</td>
</tr>
</tbody>
</table>

**Notes:**
1. Enterprise Value = Sum of Market Capitalization, Net Debt (total debt less total cash) and Unfunded retirement liabilities (if any)
2. Current Value = Present value of current operations, based on NOPAT divided by the WACC
3. Future Value = Enterprise Value less Current Value. Numbers may not add up due to rounding
4. For financial services industry, Enterprise Value = Market Capitalization + Current Value = EBIT excl. unusual items * (1-Tax Rate) / Cost of equity; future values shown here are weighted by enterprise value. Numbers might not add up due to rounding
5. Analysis from financial information July and August 2013

Source: Bloomberg, Annual and Quarterly Reports 2012 and 2013, Accenture Analysis
Focus on the key value drivers

A deal’s ability to deliver future value will typically depend on a limited number of drivers, and the private equity approach to due diligence reflects this. Each due diligence work stream is given a clear set of value drivers and risks to assess, and only once there is clarity on the most important issues will the due diligence focus shift to the next set of issues. This approach includes two key benefits: A strong hypothesis about how well the target stacks up to the original investment rationale is consistently in place and is gradually refined throughout the due diligence process; and due diligence costs can be minimized as the degree of effort is ramped up or down depending on the attractiveness of the target and the importance of the remaining issues.

Corporate acquirers, on the other hand, face the temptation of curiosity. Due diligence is often seen as a once-in-a-lifetime opportunity to take a close look under the bonnet of a major competitor, or perform a case study on a successful peer in another market. Instead of focusing on the target’s most important facilities, the operational due diligence work stream performs risks turning into a “grand tour” of peripheral operations to see what the acquirer can learn from the way the target company performs its business (all without a clear link to the deal rationale or the valuation). Similarly, the strategic due diligence work stream might put disproportional effort into assessing the market outlook of a minor part of the target’s activities—not because it has material impact on value, but because it is a segment the acquirer itself is considering entering. As a result of this lack of focus and discipline, due diligence can become an expensive, draining exercise, and the key issues are often lost in the reams of data produced.

To resist this temptation, corporate acquirers can take a page from the private equity due diligence playbook. Rather than asking the due diligence work streams to develop their own lengthy check lists that they then go through from top to bottom, the deal leaders can provide each work stream with a set of key issues that are directly linked to deal rationale and valuation. Once there is clarity on those key issues, leaders can decide whether the due diligence work stream has completed its mission, or whether there is another set of issues to investigate.
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Rigorously revisit the synergy case

Synergies are a primary area where corporate bidders have a leg up on private equity when competing for an asset. Because corporates have them while private equity firms don’t, all other things being equal, synergies can allow corporate acquirers to bid more money than private equity. However, being able to incorporate the value of synergies into a bid also increases the risk of overpaying.

In our experience, most corporates enter due diligence with synergy expectations that are too optimistic. Therefore, it is critical to come out of the due diligence process with a more robust set of synergies. How? By using three key levers.

First, in line with the preceding recommendation about focus, due diligence activities might be structured so that they expressly validate the expected synergies. Second, consider using the data made available in the due diligence to further break down the initial assumptions on expected synergies as a way to create more granular estimates for both the value of the synergies and the timing. This can be a very efficient approach to increase the robustness of synergy estimates as it is intended to relentlessly flesh out unrealistic assumptions. Third, take a step back from the hour-by-hour due diligence frenzy to revisit the synergy case and deal rationale in light of the new insights gained, and incorporate those insights into the valuation.

For example, when a European mining company was looking at an acquisition in Latin America, it began due diligence expecting synergies to come from two principal areas: applying the European company’s best-practice production methods to the Latin American assets, and optimizing logistics across the combined portfolio of mines and customers by supplying customers from the mine closest to customer sites.

However, operational due diligence revealed that the Latin American company’s mining operations were on par with those of the European company’s mines, thus there were very limited opportunities to apply best practices. Hence, the valuation was revised downward to incorporate this insight. On the other hand, this was partly offset by the findings from the strategic due diligence: the Latin American company derived a much larger share of its revenues from long-term contracts with European customers than expected, resulting in a much greater opportunity to optimize logistics.
Consider the integration roadmap

Private equity firms build a detailed financial model incorporating the financial impact and timing of initiatives to accelerate revenue growth and improve operational performance to get an accurate forecast of future cash flows and exit valuations. Corporate acquirers could take the same rigorous approach, even if the ownership horizon in this case is perpetuity, and that they would take into account opportunities for synergies in addition to stand-alone growth and operational performance initiatives.

A key to getting an accurate picture of what stand-alone improvements and synergies to expect, as well as their timing, is having a clear view of how the acquirer will integrate the target company. This can require creating a high-level integration road map designed to identify key milestones for each functional area across the targeted integration timeline. With the information made available during due diligence, an acquirer might be better able to get a sufficiently detailed picture of the target company to understand the issues that will likely have a fundamental impact on how much value the integration can generate and at what rate integration can take place. Three such issues are how the combined company and the integration program should be organized; how quickly cost synergies can be realized; and what it takes in terms of integrated sales forces, offerings and systems support to generate revenue synergies. The resulting outputs could be modelled at least on a quarterly basis and used as an input to valuation. This work is important enough that many successful acquirers turn it into a due diligence work stream in its own right.

For example, when a leading emerging-markets telecom operator performed due diligence on a competitor, it tested two integration detailed scenarios: one selective and one comprehensive. The selective scenario focused on integration in a limited number of areas, whereas the comprehensive scenario covered full integration of both operators. After assessing what synergies could be realized in the two scenarios and weighing the risks of each, the company decided to base its valuation on the selective scenario to avoid ending up using synergies that would be very challenging to realize to shape its bid for the competitor.

Another potential benefit of developing an integration road map during due diligence is that it can allow the acquiring company to accelerate its integration planning. This can have benefits both in terms of the time value of money from earlier synergy realization from the core integration activities, as well as being able to swiftly execute the keep-the-lights-on integration activities required on the day the transaction closes and when ownership changes.
Conclusion

With due diligence being one of the most critical drivers of M&A success, acquisition-minded corporations could benefit from taking steps to enhance the way they conduct due diligence to help ensure they get the most out of every deal.

By taking a page from private equity and adapting the four principles discussed to their own due diligence activities, corporate acquirers can be better positioned to overcome the challenges inherent in the process and more efficiently, completely and accurately determine whether they should proceed with a deal and, if so, what they are willing to pay.
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