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Top tips to make the best acquisition, or not

Knowing when to walk away from one deal and how to pursue another is key to success, say **Graham Elton** and **Rolf-Magnus Weddigen**

TALKING HEAD

Getting a good deal has never been easy. But with more than $250bn (€195bn, £132bn) of uninvested private equity capital worldwide – and prices rising to what Blackstone Group head Stephen Schwartzman calls "nose-bleed territory" – picking the right acquisition target is doubly challenging these days.

Corporations are also flush with cash on their balance sheets, with 61 publicly traded companies worldwide each reporting more than $10bn in cash, further fuelling the M&A boom.

All that ready money is placing an even higher value on a key ingredient in the success of private equity firms: the discipline to walk away.

Indeed, executives say that knowing when to walk away from a deal is one of the most difficult responsibilities to execute.

When Bain & Company surveyed 250 senior managers with M&A responsibilities, half said their due-diligence process had overlooked significant problems, and half found that targets had been dressed up to look better for deals.

Two-thirds said their approach routinely overestimated the synergies available from acquisitions. Overall, only 30 per cent of executives were satisfied with their due-diligence processes. A third acknowledged they had not walked away from deals despite nagging doubts.

To address these common shortcomings properly, acquirers can start by ridding themselves of their assumptions.

When senior executives begin to look at an acquisition, they quickly develop a mental image of the target company, often drawing on its public profile or its reputation within the business community.

That mental image shapes the entire deal-making process – it turns into the story management tells itself about the deal.

Private equity firms tell us their advantage lies in being industry outsiders. They force themselves to ask basic questions about how an acquisition truly will make money for investors.

That circumspect app-roach has helped to fuel a surge in acquisitions involving private equity firms, which have closed deals worth $462bn globally in the first three quarters of 2006, more than double the amount of $230bn for the same period a year earlier, according to Thomson Financial.

How do private equity firms hone their deal-making acumen?

Rather than rely on secondary sources and biased forecasts provided by the target company itself, the most effective acquirers build their own proprietary, bottom-up view of the target and its industry. They form investment committees that test the deal thesis, the attractiveness of the opportunity and then take a final decision.

Private equity firms commonly focus their due-diligence on four interrelated areas that some players call the four C's: customers, competition, costs and capabilities.

To arrive at a business's true stand-alone value, all accounting idiosyncrasies must be stripped away. In most instances, the only way to do that is to look beyond the reported numbers by sending the due-diligence team into the field. Equally important, putting a team into the field is often the best way to assess a target's future prospects.

Successful acquirers begin by drawing a map of the target's market – its size, its growth rate and how it breaks down by geography, product and customer segment. This allows private equity firms to analyse a target's customer segments – their profitability potential and where they are vulnerable.

Next, they compare the target company's industry presence with that of competitors. How does it stack up in terms of customer feedback, market share, revenues and profits by geography, product and segment? By looking at the pool of available profits, companies can determine whether the target is getting a fair (or better) share of industry profits compared with its rivals.

Then they run the expense numbers. Do competitors have cost advantages? Why is the target performing above or below expectations? When considering post-merger opportunities for reducing costs, firms can assess whether the benefit of sharing costs with other business units will outweigh the lack of focus that can arise from spreading costs across multiple businesses.

Successful acquirers are not looking to buy just a P&L, a balance sheet and a cash flow; they also want capabilities such as management expertise.

Capabilities may not be easy to measure, but taking them for granted can be too large a risk.

In the end, effective due-diligence is about balancing opportunity with informed scepticism. It is about testing every assumption and questioning every belief. It is about not falling into the trap of thinking you'll be able to fix problems after the fact. By then it is usually too late.

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