PART One

Planning

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CHAPTER 1
Introduction

OVERVIEW

Mergers and Acquisitions: A Way of Corporate Life

Consider the following scenario. You take an end-of-weekend look at your e-mail, only to find a message from your division's CEO about a certain company that is in play . . .

> *. . . The company's founders have apparently decided that it's time to sell their business and have retained a broker to advise them on their strategic alternatives. The broker contacted me and outlined the auction process that will be conducted. An offering memorandum will be distributed upon execution of a nondisclosure agreement. Participants will have two weeks to review the offering materials, after which nonbinding offers are expected. A selected group of bidders will be invited into the second round, which will consist of a management presentation and access to a data room, after which definitive offers are expected.*
>
> *We have to move quickly in order to have a chance of acquiring this property. Three activities should be initiated immediately:*
>
> 1. *The legal department should review and negotiate the nondisclosure agreement terms in order to receive the offering materials.*
> 2. *Business development should draft a briefing document for the corporation regarding the company: who they are, the market segment in which they operate and its attractiveness, how the*

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acquisition would help us, and how an acquisition by one of our competitors would hurt us. They should work with finance to prepare an initial valuation for sizing. We have to get the corporation up to speed and excited about this market segment and the company fairly quickly because, not surprisingly, the broker has established an accelerated timetable for this deal.

3. *The data room will be open in approximately three weeks. Business development, legal, and finance should assemble a due diligence team, making sure that the necessary internal experts and external advisors are lined up and ready to hit the ground running.*

I hope your weekend was restful—we have a lot of work ahead of us.

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If this scenario sounds familiar, it is because mergers and acquisitions (M&A) have become a way of corporate life. During the last five years, over 46,000 transactions were announced in the United States.[1] This statistic, however, does not take into account the many prospective transactions that progress far past an initial evaluation and never come to fruition. If 46,000 transactions were completed and announced, it is probable that corporations spent significant time and resources working on several hundred thousand potential transactions over the same period.

Why have there been so many acquisitions? The answer is relatively straightforward. Corporations compete to provide shareholders with a superior return on investment. Executives of publicly traded corporations, in particular, feel pressure to generate and sustain growth in earnings, the factor upon which corporate valuations are typically based. Earnings growth is derived from three main sources:

- Revenue from existing and newly developed products and services
- Mergers and acquisitions
- Productivity increases and cost reduction initiatives

[1] *Mergerstat Review* 2007 (Santa Monica, CA: Factset Mergerstat, LLC, 2007), 8.

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While productivity and cost reduction represent important drivers of profits, in the absence of increasing revenues, these types of initiatives cannot produce sustainable, year-on-year earnings growth. As a result, revenue growth tends to dominate the agenda of corporate leaders, with internal (organic development) and external (acquisitions and alliances) growth strategies competing for priority and capital allocation. Further, as corporations grow, mature, and capture an ever-larger market share, organic growth produces diminishing returns and executives find themselves increasingly reliant on external options such as acquisitions to boost revenue growth.

Contrary to the impression fostered by the extensive media coverage of high-profile takeovers of publicly traded companies, the majority of acquisitions occur without much fanfare. Over 95 percent of transactions involve "below the radar" acquisitions of privately owned companies. Further, with an average transaction value of $66 million, many of these deals tend to involve comparatively small businesses, as shown in Exhibit 1.1. Indeed, many corporations view the smaller, more agile businesses in their markets as incubators for new ideas that, if proven successful, can then be swept up into the acquirer's portfolio of products and services.

The good news for acquirers is that there is seemingly no shortage of such acquisition targets because small businesses represent a significant part

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EXHIBIT 1.1 Number and Size of Announced M&A Transactions

Year	Total Transactions	Number of Nonpublic	Percent Nonpublic	Average Value of Nonpublic ($ millions)
2002	7,303	6,892	94.4%	$61.4
2003	7,983	7,520	94.2%	$55.8
2004	9,783	9,411	96.2%	$66.8
2005	10,332	9,884	95.7%	$64.6
2006	10,660	10,172	95.4%	$77.6
TOTAL	46,061	43,879	95.3%	$66.1

Source: Mergerstat Review, 2007.

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of the U.S. economy and generate a disproportionate share of its growth. More specifically, small firms:

- Employ about half of all private sector employees
- Generate about half of the gross domestic product
- Created 60 to 80 percent of the nation's net new jobs[2]

As a result of the high volume of deals, the acquisition process has become a routine business activity within many corporations, supported by a staff of full-time business development professionals and subject to formal acquisition policies and procedures. The high level of acquisition activity has also required the regular involvement of a broad array of executives and managers from across corporate departments. In large corporations, it is not uncommon to see executives spending almost as much time scouting smaller businesses for potential acquisition as they do tending to their responsibilities for ongoing business operations.

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Mixed Results

Despite the well-established role that acquisitions play within their overall growth agenda, corporate acquirers have generally not achieved good results. In fact, the business literature has consistently stated that, on average, mergers and acquisitions have failed to achieve their acquirers' objectives. A sampling of typical findings presents a bleak picture:

- More than three-quarters of corporate combinations fail to attain projected business results . . . most produce higher-than-expected costs and lower-than-acceptable returns.[3]
- Fully 65 percent of major strategic acquisitions have been failures . . . resulting in dramatic losses of value for shareholders of the acquiring company.[4]

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[2]U.S. Small Business Administration, Office of Advocacy, "*The Small Business Economy: A Report to the President*" (Washington, DC: U.S. Government Printing Office, 2009). Available at www.sba.gov/advo/research/.

[3]M. Beth Page, *Done Deal: Your Guide to Merger and Acquisition Integration* (Victoria, BC: Authenticity Press, 2006), 6.

[4]Mark L. Sirower, *The Synergy Trap: How Companies Lose the Acquisition Game* (New York: Free Press, 1997), 17.

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- According to a PricewaterhouseCoopers survey, up to 80 percent of merger and acquisition transactions destroyed or failed to create value.[5]
- Thirty years of evidence demonstrates that most acquisitions do not create value for the acquiring company's shareholders . . . recent research shows that acquisitions in the 1990s have just as poor a record as they did in the 1970s.[6]
- Numerous studies demonstrate that, on average, M&As consistently benefit the target's shareholders, but not the acquirer's shareholders.[7]

This is hardly new information; documentation of acquirers' overall record of failure stretches back decades. But a high rate of failure certainly does not suggest that all deals fail. In fact, the literature covering mergers and acquisitions is replete with case studies of individual deals whose results fall everywhere within a broad spectrum bounded by clear failures and unqualified successes. Outcomes of individual transactions across, and even within, organizations vary widely. And in practice, a track record that includes at least a few solidly performing acquisitions may convince organizations that, while difficult and perhaps uncommon to achieve, success is possible.

As a result, this history of mixed results has not caused corporations to turn away from acquisitions as an important part of their growth strategy. In fact, the pace of transactions, despite the risks, continues seemingly unabated. The practical question that corporations face, then, is not whether to continue to pursue acquisitions, but what can be done to increase their odds of success.

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Acquisition Risk and Due Diligence

Other aspects of the scenario presented in the previous sections should sound familiar: the prospective buyer's mobilization of a due diligence effort, often in the context of a competitive auction.

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[5]Alexandra Reed Lajoux and Charles M. Elson, *The Art of M&A Due Diligence* (New York: McGraw-Hill, 2000), xi.
[6]Robert G. Eccles, Kersten L. Lanes, and Thomas C. Wilson, *Harvard Business Review on Mergers and Acquisitions* (Boston: Harvard Business School Press, 2001), 46.
[7]David M. Schweiger, *M&A Integration: A Framework for Executives and Managers* (New York: McGraw-Hill, 2002), 4.

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As the business literature makes clear, acquisitions are inherently risky investment decisions. One factor contributing to this risk is acquirers' lack of detailed knowledge about the businesses they pursue. Although a general level of familiarity may exist, crucial data about targeted companies is often beyond the reach of prospective acquirers, buried in books and records, or residing in the experience of the target company's management team. This forces organizations to make their acquisition business cases dependent on *assumptions* about the condition and future prospects of targeted businesses; and faulty assumptions may mean the difference between success and failure. Consequently, corporations are generally unwilling to make an acquisition of any magnitude without the opportunity to first take a closer look—to gain comfort that a target business is what it is represented to be, to validate key assumptions, and to mitigate the risk that an acquisition will bring unwelcome surprises.

This closer look that potential buyers take at targeted businesses is referred to as *due diligence*. Due diligence, as a general concept, is a familiar one in business. The term has its roots in common law, and its usage in the United States dates at least as far back as the U.S. Securities Act of 1933, which required certain parties involved in a security offering to conduct an investigation into the company as a way to defend against accusations of inadequate disclosure to investors. Over time, the term has come into use in a number of other settings, including the investigation of potential mergers and acquisitions. In the context of mergers and acquisitions, due diligence traditionally encompasses those activities:

- Performed by a team of internal experts or external advisors
- Performed during a specified period of time in a transaction when the seller provides access to the target company
- Performed when the team strives to discover as much as possible about the true state and future prospects of the business
- That inform decisions the acquirer must make about the deal
- That, by validating key assumptions, search for previously undisclosed risks, support or alter the valuation, and provide input for the negotiation of the definitive purchase agreements

Driven by this focus on validation and risk mitigation, due diligence teams typically include contingents of legal and accounting professionals,

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along with selected corporate managers and executives, who scrutinize key aspects of target business, such as:

- *Financial*. Financial statements and tax returns, assets and liabilities, and debt and credit arrangements
- *Legal*. Corporate documents, contracts and agreements, ongoing, pending, and potential litigation, environmental matters, legal and regulatory compliance, and international transactions
- *Business*. Strategy and plans, customers, products, and markets and competition
- *Operations*. Technology, property plant, and equipment, facilities, real estate, and insurance coverage
- *Human resources*. Organization, management, personnel, employee benefits, and labor matters

Due diligence teams also provide a critical intangible benefit to acquirers, acting as a needed voice of skepticism within acquiring organizations, counterbalancing the potentially blinding enthusiasm exuded by deal champions. In making decisions about potential acquisitions, corporations rely on the performance of due diligence to function as a key gating factor, to ensure that both positive and negative factors are evaluated and weighed.

Recognizing the legitimate concerns of potential buyers, sellers customarily provide some level of access to target companies' business and financial information and senior management personnel before definitive offers for acquisition are expected. It should be kept in mind, however, that sellers are focused on their own interests, including:

- Creating a competitive field of multiple potential acquirers while minimizing disruption to the target business
- Ensuring that the sale process is fair—that all potential acquirers have access to the same information
- Protecting competitively sensitive information, especially from the majority of bidders (who will ultimately be unsuccessful)
- Maximizing the value of the sale

Sellers normally bring businesses to market through auction-style sale processes, managed by professional business brokers or investment bankers.

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Although auctions usually accommodate acquirers' need to perform due diligence, their fundamental purpose is to optimize the transaction for the seller, putting into play a clash between buyers' concerns and sellers' interests. In fact, sellers often use the competitive leverage provided by auctions to constrain the level of due diligence performed by potential acquirers. They accomplish this by limiting access to a predefined period when target company leadership is showcased through management presentations and detailed information is provided via actual or virtual "data rooms." Sellers limit buyers' access because they see more downside than upside in providing greater access. If a target business is optimally presented within its marketing documents (typically its offering document or prospectus), by definition, due diligence will offer little prospect of further enhancing its image (and value). At best, favorable aspects can be confirmed and, at worst, unfavorable aspects can be unearthed. As a result, sellers normally attempt to push participants to complete their due diligence rapidly and control the amount of information made available, creating an environment of dynamic tension for buyers, and further adding to acquirers' existing risk.

Looking at the intrinsic risk of acquisitions and the difficult environment within which they take place, it is understandable why so many transactions fail. But many acquirers also succeed or fail for reasons that are within their control. We strongly believe that *a soundly planned and well-executed due diligence review* remains the best way to make a major difference in an acquisition's results. Such a due diligence process leaves a potential acquirer much better positioned against other bidders, mitigates acquisition risk, and increases its odds of success. Likewise, an organization that gives insufficient attention to the critical but frequently overlooked details of due diligence does so at its peril. Our goal in writing this book is to present and discuss a comprehensive, step-by-step guide for performing due diligence based on practices and principles that we observed to be most effective in practice.

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PREVENTABLE CAUSES OF FAILURE

We begin by examining some of the potential causes of acquisition failure that can be attributed to poor execution by the acquirer. Our intent here is not to provide an exhaustive study of every possible reason acquiring businesses can be unsuccessful, but to focus on a number of preventable causes of failure and then to outline a due diligence approach that we believe

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will lead to better results. An acquisition team's errors can be grouped into several categories, namely:

- Myopic approach to due diligence
- Reacting to deals
- Compartmentalized behavior
- Inactionable findings
- Exclusive focus on risk mitigation

Myopic Approach to Due Diligence

A critical mistake that acquirers can make is to view due diligence too narrowly; that is, as an exercise compressed into the period when the seller makes its books, records, and people available to prospective buyers. This perspective can have potentially disastrous consequences: The due diligence team may be assembled too late, disbanded too early, and operate in a manner that is disconnected from other acquisition activities. Perhaps worst of all, this narrow window of time might become the only period during the transaction when acquisition team members think about a deal's potential risks.

Risks exist throughout the entire transaction cycle. The root cause of a poor due diligence process may exist early in the development of an organization's growth strategy. Likewise, a postacquisition integration that does not translate due diligence findings into action can completely undermine the benefits of sound preacquisition analysis. Exhibit 1.2 illustrates the risk factors faced throughout the acquisition process. Note that "poor management of due diligence—overlooking something important" is only one of many potential risks that an acquiring organization faces.

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Reacting to Deals

To some extent, mergers and acquisitions are inherently reactive because buyers have little control over owners' decisions about whether and when to sell their businesses, but this does not excuse a lack of planning. Organizations that do not give advance consideration to those market areas and the kinds of prospective acquisitions that best serve their interests are poorly positioned to respond to deals when they materialize. We illustrated just such an organization in the scenario in the section titled "Mergers and

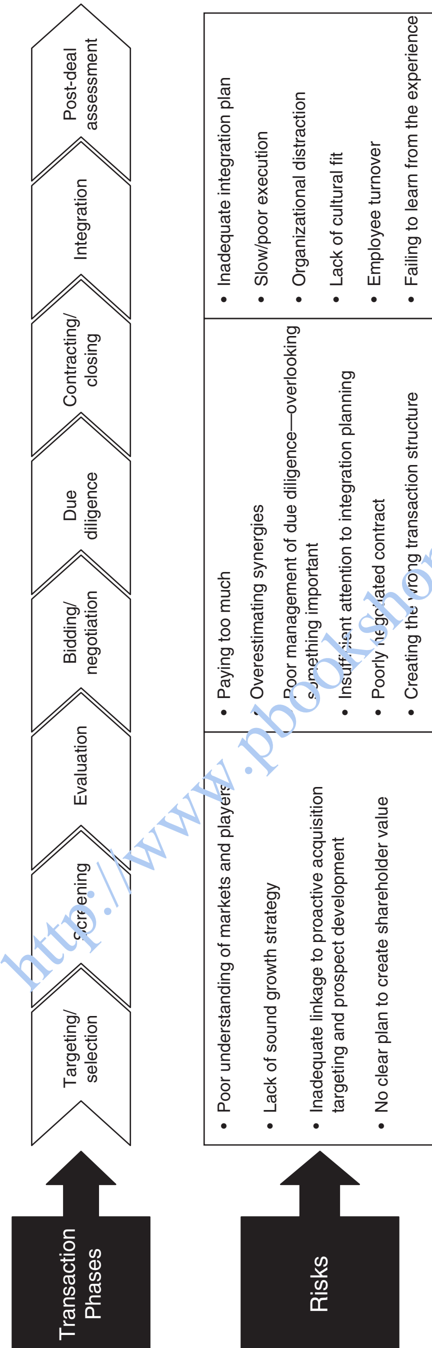

EXHIBIT 1.2 Risks Exist throughout the Entire Acquisition Process

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Acquisitions: A Way of Corporate Life." One may have wondered why the division needed to introduce corporate management to both the candidate and to the market segment in which it operated. This organization faces an uphill battle in terms of its internal decision making, and the acquisition team may confuse justification of the transaction with analysis of its merits.

The launch of a particular deal should not mark the occasion of the first conversation within the potential acquirer about its growth strategy. If organizations are continually reacting to deals as they are brought to market, they run the risk of being enticed into randomly acquiring businesses unaligned with their organizational goals and objectives.

Compartmentalized Behavior

As mentioned in the section "Acquisition Risk and Due Diligence," due diligence teams can consist of an eclectic group, including specialists such as legal, tax, business development, and accounting professionals, along with corporate managers who provide expertise in areas such as technology, human resources, operations, sales, and marketing. The benefit of involving multiple parties is that a thorough examination of an acquisition target can be conducted within a reasonably short time span, especially if the seller's data is made available for simultaneous electronic access.

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There is, however, a related risk of bringing too many perspectives to the due diligence review: It can cause the process to become compartmentalized and allow important items to be overlooked. By definition, specialists tend to look at issues through the filter of their training. For example, if a due diligence team relies on its legal experts to review customer contracts in an asset purchase, it can rest assured that the key terms will be reviewed and abstracted and relevant legal issues, such as assignability provisions, will be studied. But without coordination across the team, the contract review may not address other issues of business significance, such as the target's approach to pricing and its implications for competitive positioning and profitability. Larger, cross-functional, deal-impacting questions may thus fall victim to the minutia of specialist scrutiny.

Inactionable Findings

Perhaps the most relevant question for a due diligence team to answer is whether it has discovered any reason why a potential acquirer should not

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proceed with a transaction. The objective of finding potential "deal breakers" is so important that some organizations may believe that if none are found, all that remains of due diligence is for the team to document its findings that support the decision to proceed. Although negative assurance (i.e., "no reason not to proceed") is the most critical finding of a due diligence team, it also provides an acquiring organization with no road map for action other than to go ahead with the transaction. Additionally, limiting the mission of a due diligence team to this one question squanders the potential value of this assemblage of expertise. Due diligence should do more than act as the brakes on a train; it should also help to choose the right track.

Exclusive Focus on Risk Mitigation

Even in situations where an acquisition target is fully supportive of the strategy articulated by the acquirer and the risk mitigation focus of the due diligence team results in the acquisition of a good business, there is still a risk that the investment may be a bad one. This is because an acquisition of a good business is still a failure if it destroys shareholder value—if the price paid for the business exceeds the total value of the deal to the acquirer. So risk mitigation is a necessary aspect of due diligence, but it is not sufficient. There must be two essential objectives for the due diligence team: risk mitigation and value creation.

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KEY SUCCESS FACTORS

The identified areas of failure can be translated into a set of operating principles that comprise a due diligence approach that better serves the acquirer's interests. These principles, or key success factors, are illustrated in Exhibit 1.3 and discussed in the sections that follow.

Holistic View of Due Diligence

An acquisition team's chances of identifying and mitigating risks are best if it looks broadly across the entire transaction continuum and methodically addresses the areas where risks can occur.

In our view, the scope of due diligence should be broad—to identify and address the full range of risks and opportunities that exist throughout

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Causes of Failure		Key Success Factors
• Myopic approach	⇒	• Holistic view
• Reacting to deals		• Growth strategy
• Compartmentalized behavior		• Integrated management
• Inactionable findings		• Purposeful action
• Exclusive focus on risk mitigation		• Value orientation

EXHIBIT 1.3 Translating Causes of Failure into Key Success Factors

the transaction cycle. We will use the term *holistic due diligence* throughout the discussion to emphasize this point. Specifically, holistic due diligence should follow a sound growth strategy, inform the decision to acquire and the terms and structure of the transaction, and then guide the actions to be taken before and following the transaction.

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Growth Strategy

As mentioned, an organization's decision to pursue an acquisition should be an outgrowth of a sound strategic planning process. Having such a process would provide an acquiring organization with an agreed-upon strategy for a particular market segment and, ideally, a related acquisition target list, facilitating a clear and quick assessment of the strategic merits of a given acquisition candidate. This process also provides the due diligence team with a well-thought-out set of key variables and critical assumptions to be validated during its investigation. We further discuss the linkage between strategic planning and acquisitions in Chapter 2.

Integrated Management

Methodical coordination, communication, and information sharing are essential in the management of due diligence activities. Foundational to effective cross-team management is a top-down assignment of due diligence objectives based on a transaction's particular risks and opportunities, a topic discussed in detail in Chapter 4. We also address methods and techniques for communication and information sharing in Chapter 5.

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Purposeful Action

Due diligence teams should be presented with a challenge far greater than playing a key part of the go/no-go decision. Their work should also ask: What actions should the acquirer take leading up to and following the transaction to mitigate the full range of risks it faces and to fully exploit available opportunities to create shareholder value?

This notion carries into the conduct of due diligence itself. Rather than being led by the information requested and received from the targeted business, the conduct of the entire due diligence examination should be objectives-driven. Further, due diligence cannot end with the creation of a static findings report. Those findings must be expressed in terms of actions that must be taken both before and following the deal, including the negotiation and structuring of the transaction and the planning and implementation of postacquisition integration, which we address in Chapters 6, 7, and 8.

Value Orientation

To ensure that a transaction results in both the acquisition of a good business and in a profitable investment for the acquirer, due diligence must focus equally on risk mitigation and value optimization. The due diligence team should approach the process with the mentality of an investor as well as that of an auditor and use value creation as a guiding principle for many of its activities. In the next section, we will further address this notion of due diligence and value creation.

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DUE DILIGENCE AND VALUE CREATION

Plan to Create Value

An organization needs more than the intention to generate a return to make an acquisition successful. Two influential authors, David Harding and Sam Rovit, point out that many companies are "terrifyingly unclear" to themselves and investors about why they are making an acquisition, and advocate that every transaction start with a clear statement of how that particular deal would create value for the acquirer.[8] We think this idea is fundamental to a

[8]David Harding and Sam Rovit, *Mastering the Merger: Four Critical Decisions That Make or Break the Deal* (Boston: Bain & Company, 2004), 50–51.

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successful acquisition, and our guide for the conduct of due diligence builds on the requirement to develop what we refer to as a "plan to create value," in which the prospective acquirer states explicitly *why* it intends to make an acquisition and *how* it proposes to generate a return. This plan serves as a framework for the acquirer's acquisition team, to ensure that actions taken from due diligence through integration are consistent with its purpose. A plan to create value, as we define it, includes the following elements:

- *Strategic purpose*. A compelling reason to pursue the acquisition, including both a sound strategic rationale and an explicit depiction of the increase in value expected from the transaction
- *Value drivers*. An assessment of the magnitude and variability of the sources expected to generate the increased value, framing the key assumptions to be validated in due diligence
- *Key risks*. A comprehensive examination of a deal's inherent downside risks, outlining the most important issues to be mitigated before or after the acquisition

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Strategic Purpose An organization's plan to create value should begin with an explicit statement about how a given acquisition would further an organization's progress toward its strategic goals and objectives. We discuss this concept at length in Chapter 2. For now, suffice it to say, an acquisition needs to have a clearly communicated strategic rationale. This way the organization (both executive management and the deal team) knows why it is embarking on a transaction, and that the essential reasons for the acquirer's interest can be fully vetted in the due diligence team's investigation. For example, if the primary reason a corporation is interested in a particular acquisition is to acquire a certain technological capability, a fundamental goal of the due diligence team should be to validate the key assumptions made about the technology (e.g., to make sure that the target has full and unencumbered ownership rights to the technology, that it has been properly maintained, that the competitive and financial advantages afforded by the technology are sustainable, etc.). Absent a clear strategic rationale, the due diligence team might conclude that the target is a generally good company, but might not investigate certain matters to the level of depth necessary to ensure the acquisition's ability to fully deliver on its expectations.

Another critical element of the plan to create value is a calculation of the increase in value expected from the transaction. The acquirer's business case for the transaction would normally include a financial forecast showing

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a rate of return that exceeds the corporation's "hurdle" rate, resulting in a positive net present value for the investment. In our view, this forecast needs to be supported by the specific assumptions and actions that will *create* the return on investment, so that these can be validated during due diligence and acted on following the close of the transaction. A tight linkage between the financial drivers of value, key assumptions, required actions, and the implications for due diligence and integration planning is critical to an acquisition's success. For this reason, we now elaborate on each component of value. Exhibit 1.4 presents a visualization of the sources of value created by an acquisition investment.

The exchange between acquirer and seller can be broken down into several components:

- The acquirer delivers the *purchase price*, which consists of the *stand-alone value* of the target business, plus an *acquisition premium*.
- The acquirer receives in return the *combined value*, which is the *stand-alone value* of the target business plus the *synergy value* resulting from the integration of the target with the acquirer.

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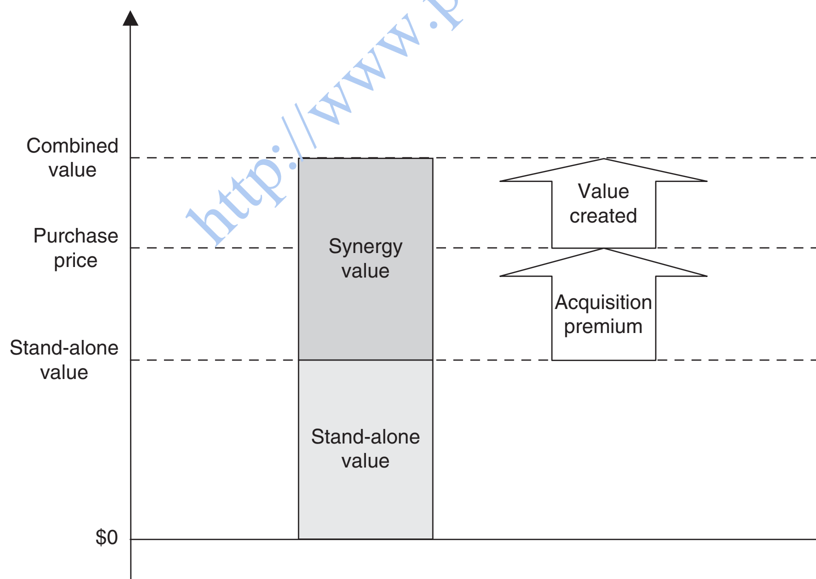

EXHIBIT 1.4 Sources of Value Created by Acquisition Investment

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- The deal's success for the acquirer is measured by the *value created*, which is the *combined value* minus the *purchase price*.

A description of each term follows:

- *Stand-alone value*. Represents the potential acquirer's estimated value of an acquisition target as managed by its current ownership. If the target is a privately held business, the acquirer will need to calculate this number as the starting point for determining its bidding strategy. It is also important to calculate a stand-alone value even if the target is publicly traded in order to estimate how much future growth the market has *already* factored by into the target company's share price. The stand-alone value can be determined by calculating the present value of forecasted revenue, income, and cash flows over a 5- to 10-year period, based on factors such as:
  - Historical financial results
  - Current market position
  - Organizational strengths and weaknesses
  - Existing growth strategy
  - Projected ceiling for sustainable market size, growth, and share
  - Assessment of whether the target can attain this potential on its own
  - Assessment of key obstacles to achieving the future growth potential

  The more detailed and explicit the potential acquirer can make its assumptions in support of the forecast, the more effectively it can then validate those assumptions during due diligence. In order to ensure that the calculated stand-alone value is reasonable, it should be compared with the market value of comparable businesses.
- *Acquisition premium*. The acquisition premium represents the amount required to induce ownership to sell. If the target is a publicly traded company, the acquisition premium can be readily computed as the difference between the sale price and the market capitalization of the target preceding the acquirer's offer. If the target is privately held, the acquisition premium is the amount by which the purchase price exceeds what the acquirer thinks the business is worth on its own.
- *Purchase price*. This is whatever value is negotiated between the buyer and seller, though, as stated, it can be thought of as the stand-alone value plus the acquisition premium. It is useful to think of the purchase

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price as consisting of these two components because it helps to illustrate some of the contrasting perspectives shared between the parties during price negotiations, and it underscores the direct relationship between the acquisition premium and risk. Acquirers are normally reluctant to offer more than what they view as the stand-alone value for a business (i.e., an unwillingness to pay for value that would only be created by their prospective ownership) because any acquisition premium reduces the value creation opportunity and increases the acquirer's level of risk.

Conversely, sellers expect the purchase price to include an inducement to sell, because at the stand-alone value they are theoretically and, if well-advised, practically content to hold onto their ownership stake.

- *Synergy value*. Synergy is the term commonly used by prospective acquirers as they contemplate the financial benefits of combining with the businesses they target. The synergy value of an acquisition is normally envisioned to be attainable from one of several sources:
  - *Revenue synergy*. Additional revenue growth spurred by activities such as joint product development and marketing, or cross-selling
  - *Cost synergy*. Cost reductions driven by actions such as sharing organizational infrastructure, streamlining redundant operations, or achieving economies of scale.

  The synergy value is a potentiality unique to the combination of two specific organizations, and it is produced only as the result of the postacquisition integration activities planned and implemented by the acquiring organization.
- *Combined value*. Represents the total incremental value received by an acquirer, including both the stand-alone value of the targeted company, plus full realization of the synergy value resulting from the combination of the two organizations. The combined value is best thought of as a maximum potential number.
- *Value created*. Represents the incremental value created for the shareholders of an acquirer as a result of its acquisition investment, calculated as the difference between the combined value received and purchase price paid.

Value Drivers By making explicit its calculation of the sources of value envisioned from an acquisition investment, a prospective acquirer can clearly see which key assumptions underlie the valuation of a target business. This sets the stage for conducting a comprehensive examination of the possible variability in an acquisition's key assumptions. We use the term *value driver*

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to describe each key assumption addressed in the analysis to emphasize two points:

1. The analysis should be shareholder value-oriented. The focus of the analysis should center on the assumptions that have the largest bearing on the combined value of the transaction to the acquirer.
2. The analysis should be biased toward action: key assumptions to be validated in due diligence, and actions to be taken before and following the close.

We now reexamine the sources of value in an acquisition by looking at each component as a value driver:

- *Stand-alone performance*. As illustrated in Exhibit 1.5, the stand-alone value of an acquisition should not be perceived as a fixed, or "given," amount. It is dependent on the how the target business performs under

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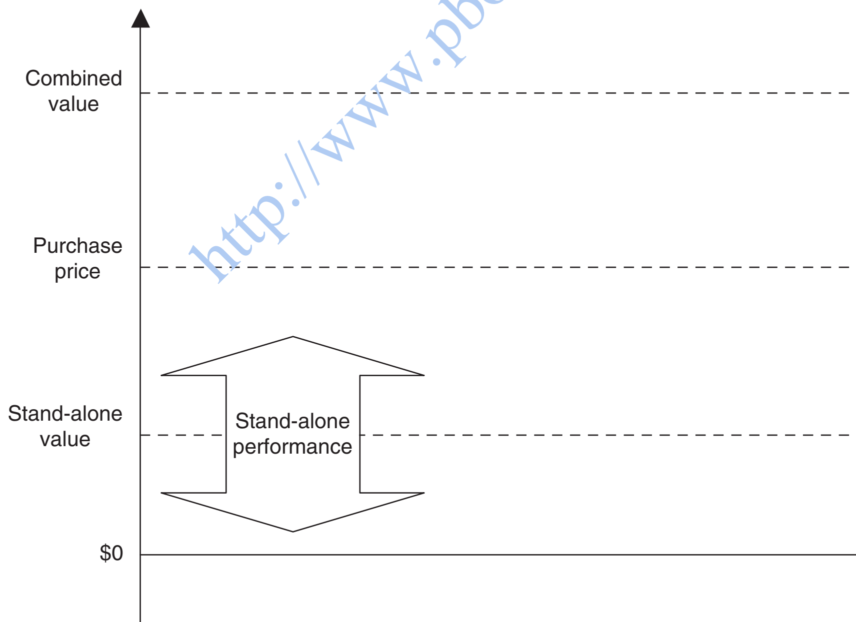

EXHIBIT 1.5 Stand-Alone Performance (and Value) Is Not a Given

the ownership of the acquirer, which has a lot to do with whether the acquirer's key assumptions about the business and its markets turn out to be correct, and how well the business is managed by the acquirer.

- *Acquisition deal structure*. It is useful to consider the purchase price to be a variable amount as well. Acquirers can and should seek to optimize all of the elements of the acquisition deal structure, not only the headline purchase price, but also the contractual terms and conditions, which can shift risk and value back and forth between buyer and seller, and even the tax structure of the transaction, which can also gain or lose value for the acquirer. This idea is illustrated in Exhibit 1.6.
- *Synergy opportunities*. The term *synergy opportunities* emphasizes that the synergy value is an amount that will accrue to the acquirer only if everything goes right with the acquisition and integration—it is a potentiality, far from a given. The acquirer will not realize the synergy value

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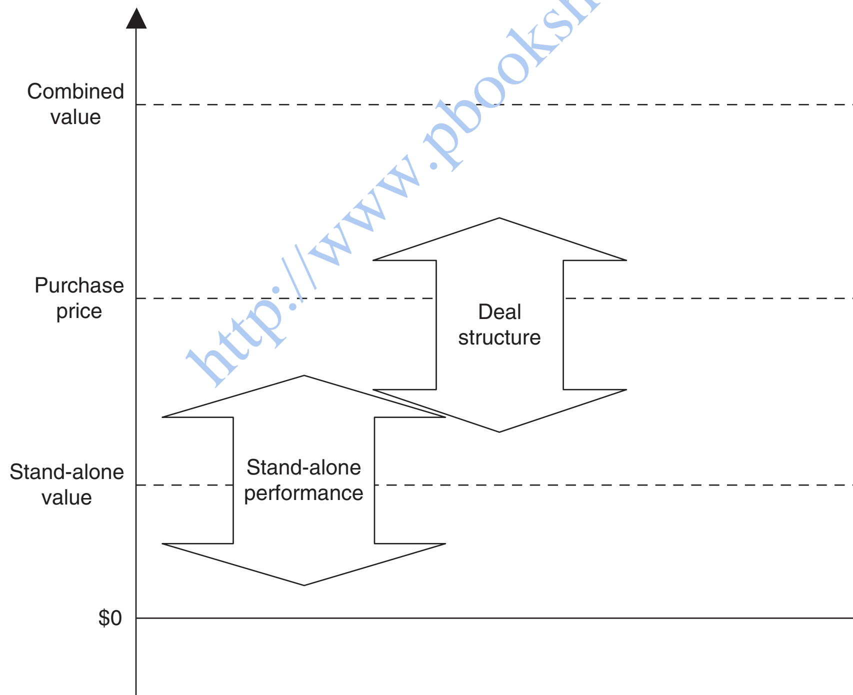

EXHIBIT 1.6 Deal Structure Can Increase or Decrease the Purchase Price

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without intensive planning and well-coordinated action; and not all synergies will deliver to the full level of their potential. This area should be a major focus of both the due diligence review and the integration plan.

Exhibit 1.7 highlights the importance of synergy opportunities in value creation.

Key Risks As discussed in the section "Myopic Approach to Due Diligence," there is a wide range of potential risks to an acquisition, either inherent in the acquired business or borne out of integrating the operations of a target business with those of the acquirer. Any number of these risks can conspire to undermine a lot of hard work and value created from synergy. Yet an acquirer is not a passive witness to the things that may or not happen to its acquired business. While it cannot control all key factors, it can influence many of them by directing its actions in a way that mitigates the downside risks inherent in a given transaction. Critical to this process is

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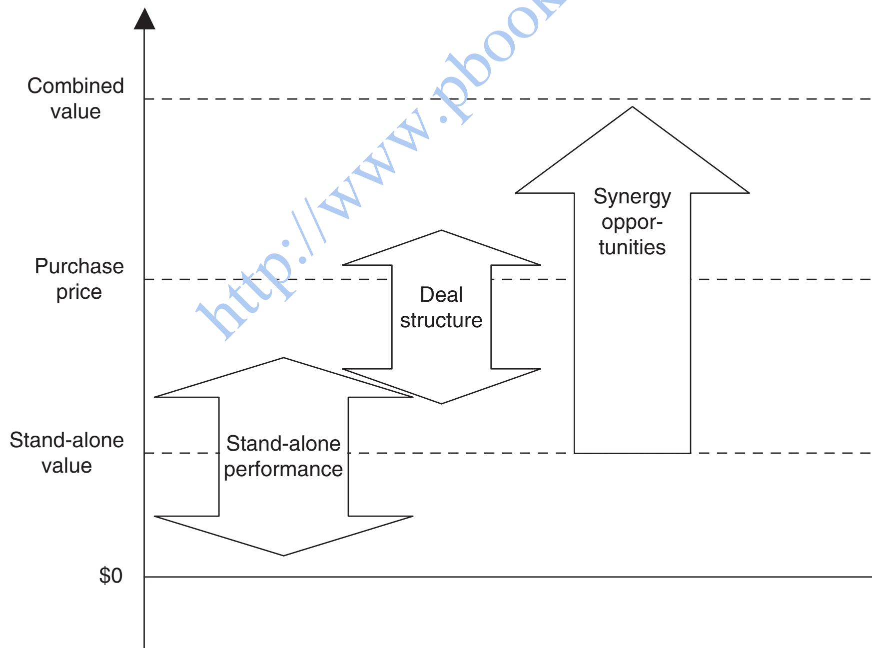

EXHIBIT 1.7 Importance of Synergy Opportunities in Value Creation

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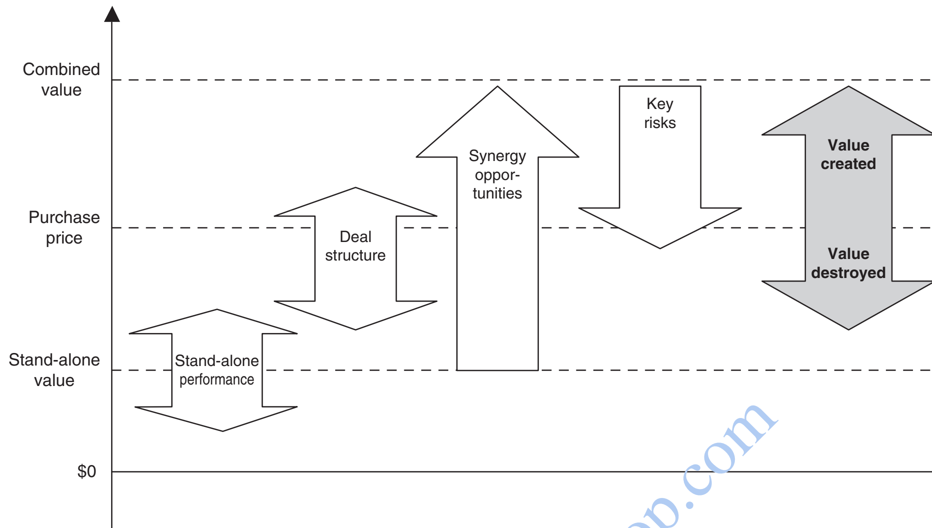

EXHIBIT 1.8 **Management of Opportunities and Risks Can Mean the Difference between Value Creation and Value Destruction**

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assessing the full range of risks, determining which ones are most significant to the value expected from the acquisition, and methodically creating plans to mitigate the risks.

Exhibit 1.8 displays the interplay of all the key value drivers and risks and dramatizes their combined potential to either create or destroy shareholder value.

Purposeful Behavior

By preparing a plan to create value, an organization creates a solid understanding of what it hopes to achieve from a given acquisition, as well as a deep awareness of the factors that could truly make a difference to the transaction's success. This insight then needs to form a guiding framework for purposeful, proactive behavior on the part of the acquisition team to mitigate the identified risks and to optimize the value drivers of the acquisition. Absent a sound plan and a tight linkage to action, the acquiring organization risks seeing its team buffeted by the moment-to-moment events of the

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transaction, unsure of whether the things that absorb its time are the things that should.

Since the risks and opportunities inherent in an acquisition span the entire transaction cycle, as discussed in "Myopic Approach to Due Diligence," it follows that close direction of the acquisition team should not end with the creation of the due diligence report. As we will discuss further in Chapter 3, the plan to create value should influence action during three critical time periods:

1. *Before acquisition*. Issues requiring specific focus during the conduct of due diligence, plus items requiring resolution before the acquisition closes
2. *At acquisition*. Items that must be resolved within the acquisition transaction structure and underlying legal agreements
3. *Following acquisition*. Items that should be incorporated into the postacquisition integration and contingency plans

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Key Points

1. Acquisitions have become a way of corporate life, most commonly involving small, privately held businesses. ("Mergers and Acquisitions: A Way of Corporate Life")
2. Results for acquirers have been mixed. The risk inherent in acquisitions has given rise to formal preacquisition due diligence investigations. ("Mixed Results" and "Acquisition Risk and Due Diligence")
3. Risks and opportunities exist throughout the transaction's lifecycle, necessitating a broader view of due diligence. ("Myopic Approach to Due Diligence")
4. Acquiring a good business does not guarantee an adequate return on investment. We believe that acquisition teams should possess the perspective of both an auditor and an investor in order to achieve two critical objectives: risk mitigation and value creation. ("Exclusive Focus on Risk Mitigation")
5. Holistic due diligence, a cross-transactional perspective, is required to address a transaction's full range of risks and opportunities. ("Key Success Factors")

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6. We advocate a plan to create value to serve as the framework for purposeful behavior leading up to, during, and following the close of the acquisition. The plan to create value includes the following elements ("Plan to Create Value"):
   - Strategic purpose
   - Value drivers
   - Key risks

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