# THE FIVE DRIVERS OF PRE-LOI MARKET DUE DILIGENCE

*Private equity groups are investing time and money on external pre-LOI market diligence. By external, we are referring to outsourced "Market," "Business," "Customer," "Competitor," "Supplier" or "Commercial" due diligence (hereafter referred to as "market diligence.")*

*There are five main influencers driving increased demand for market diligence prior to submission of a Letter of Intent.*

## 1. Investment Banker Processes

Bankers are intentionally reducing the window of opportunity for conducting formal, post-LOI diligence. In response to speedier processes, private equity buyers are conducting more diligence activities before the deal is formally signed up. The compressed timelines simply do not allow for sufficient opportunity, in many cases, to conduct thorough diligence after the period of exclusivity begins.

Finally, the bankers wish to speed up the time to close, and often look favorably upon bidders that commit to conducting some diligence early (and commit to wrapping up diligence quickly) so as to reduce the time period until closing occurs.

## 2. Positioning with the Sellers

In competitive auction processes, it can be worthwhile to distinguish one's interest, purposefulness and seriousness from other bidders. Investing time, energy and financial resources at this early stage not only distinguishes your firm, but can also foster the relationship-building process, as well. "We are conducting diligence on your market. As we uncover interesting findings on growth opportunities, we may want to bounce some ideas off of you to see whether you agree and to hear your perspective on these trends and dynamics."

## 3. Risk mitigation

Front-loading key market diligence items could curtail or reduce the need for costly full-blown diligence activity that occur post-LOI. Conducting the most critical aspect of external research *up front* in the process can eliminate the expenses associated with all the other aspects of diligence if the pre-LOI market diligence reveals significant problems.

To the extent that you can identify potential deal-killers relating to the external market environment, you could preclude unnecessary expenses. For example, if, during the pre-LOI stage, you diligence three deal-killing external, market concerns and one of them comes back as a legitimate, real threat to the business, there is no need to proceed any further – with any type of diligence. You could confidently walk away from the deal at a pre-LOI stage because of a market finding. The deal is off, and dead-deal costs are spared.

Examples of external dal killers would include the Company overstating market growth, false assertions about customer preferences, the emergence of an 800 pound competitive rival, an imminent (undisclosed) regulatory threat, etc. It is obviously advisable to thoroughly identify and evaluate red flags that could materially impact the bid or even kill interest in the deal.

## 4. Justification of Higher Multiples

On the other hand, pre-LOI market diligence may uncover hidden opportunities that would justify a robust, winning bid. Often the winner in an auction process can offer a higher multiple than others because they are aware of market or competitive opportunities not uncovered by others. The discovery of these opportunities changes assumptions about growth prospects for the Company.

## 5. Value and Return on Investment

Given the short timeline, limited scope and reduced staffing requirements of pre-LOI market diligence, these projects are inexpensive. Yet, they can be exceptionally revealing and hence valuable. Simply put, the ROI of these projects can be significant.

Without spending a great deal of your time, resources, or capital, it is possible to confirm or refute a limited number of key points of attraction to the deal, or, on the other hand, concerns about the Company, its market, customer/prospect buying behaviors or competitive dynamics. Pre-LOI market diligence typically lasts only a few days to perhaps two weeks and focuses on addressing issues and finding answers that will have a material impact on your bid.

## Why not Conduct this Work In-House?

Outsourcing the market diligence work to a third-party is beneficial for several reasons: 1.) *Expertise* - Outside experts are experienced at gaining actionable insights based on market research – this is what they do for a living. 2.) *Time* – Outsourced consultants save you valuable time and effort – they are efficient and can do this work in a matter of days. 3.) *Cost* - Pre-LOI market diligence is inexpensive. 4.) *Candor* and objectivity – By making industry contacts as a private equity investor, you may bias the contacts somewhat, or worse, you may alert the industry that an acquisition process is underway and create some speculating on who the target may be. On the other hand, consulting firms typically call the industry experts, competitors and customers under the guise of conducting a very broad, 30,000 foot industry overview ("and now we are dipping our toe into this little, obscure niche that we had not been familiar with…Educate me about your little slice of the market….")

## Why Do Consulting Firms Take on these Relatively Small Scope Assignments?

Some consultants (Acclaro included!) are excited about pre-LOI work, and sometimes will even take it on pro-bono, because of the likelihood that they will earn the right to be the first choice for the full, post-LOI assignment (should the client win exclusivity and choose to outsource this diligence work). Who better to do the full-blown study, than the team that just finished researching the market in the pre-LOI stage?

## Who Conducts the Work at the Research/Consulting Firm?

The same team that will conduct the full post-LOI, market diligence is the proper team to conduct the pre-LOI work. At Acclaro, this typically means an Operating Executive (who thinks like the client and keeps the team focused on the issues of highest priority to make the work as actionable as possible); a Project Manager (who is the central clearinghouse for all data and communications -- internal and with the client -- throughout the project) and several consultants (who handle the research and aid in the analysis of the data).

## How is the Research Conducted?

Without access to management, customer lists, or confidential company information, how can the research take place? Since a typical market diligence exercise only relies to a limited extent on internal company information, it is not as difficult as it may sound. The primary tool that researchers use to conduct market due diligence is the telephone. Qualitative and quantitative primary research largely involves speaking with competitors, industry experts, customers/prospects, trade associations and other industry stake holders.

## Conclusion

Conducting third-party pre-LOI market diligence is a cost-effective way to gain a more thorough understanding of opportunities and threats to the target -- before submitting a bid. Investing a limited amount of capital up front can ultimately pay significant dividends. And it is appreciated not only by the potential acquirers, but by the bankers and sellers, as well.

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