THE INCREASING IMPORTANCE OF MARKET DUE DILIGENCE

As the M&A market heats up again, there are obvious difficulties in selecting the best deals for which to submit IOIs. Getting comfortable with today's high valuations can be a tall order. Meeting the expectations of bankers running quick processes is trying, as well. And while debt is flowing, lenders seem to have become more discerning in terms of their expectations for data.

The risks of doing deals are higher than they have been in recent memory. As a result, buyers are even more apt to utilize outsourced pre- and post-LOI market due diligence to augment their internal efforts. (*Note: We refer to our work as "market" due diligence; some clients use the terms "customer" or "business" synonymously with "market" due diligence. And in other regions of the world, market due diligence is referred to as "commercial" due diligence*.)

What is Market Due Diligence, Then?

Market due diligence, unlike other aspects of diligence, does not base its findings on information provided by the company. Instead, market due diligence involves gathering data from industry experts, competitors, customers, and sometimes suppliers and other third-party market participants. In niche markets, it is essential to gain the perspective not only of customers, lost accounts and prospects, but third party market experts, and, most importantly, direct and indirect competitors.

Market due diligence therefore provides a "more accurate, independent, future-centric, and ultimately more reliable view of the…prospects of the business." ("Counsel: Commercial Due Diligence and Acquisitions", *The Edge Malaysia*, Issue 759, Marcus van Geyzel, June 15, 2009).

While there is an unlimited number of issues that could be studied in market due diligence, most studies include these primary questions:

Customers:
- Are customers satisfied?
- What is the threat that customers will seek another source of supply?
- How does the target stand up against each buyer's acquisition criteria?

Competitors:
- Is the target well-differentiated against competitors, in ways that are meaningful to customers?
- Are the competitors' strategies, intentions, and capabilities viable threats?

The Market:
- Is the market as attractive as the target claims that it is?
- What are the most attractive segments from a growth and profit standpoint?
- Are market trends threatening or creating opportunities?

Suppliers:

- What are the chances that a leading supplier might try to forward integrate and enter this market?
- What are the supplier's perceptions of the target and its competitors?

Strategy:

- Does the strategic direction of the company make sense, given internal competencies, and external market trends, customer needs, and competitor capabilities and intentions?
- What should be the critical components of the company's growth strategy, moving forward, based on the external research as well as an understanding of the Company's strengths relative to its competitors?

Sincere Interest?

Bankers running the sales processes have reported that conducting market due diligence (particularly at the pre-LOI stage) does help differentiate the highly sincere and serious prospective investors from the rest of the field.

Historically, sell-side intermediaries were somewhat leery of investigations that would involve contacting customers. However, as the process has become more routine, efficient and valuable for the Company (particularly in terms of post-close strategic planning), many bankers and intermediaries are accustomed to the practice and are advising sellers in advance of this requirement.

Busy, Busy, Busy

While the old mantra regarding market due diligence was "that is our job," more private equity groups today are recognizing that premise as short-sighted. They do not have the time to thoroughly conduct all aspects of diligence.

And they probably do not have the expertise. The easiest calls to make, the customer calls, represent only one part of the full picture of market due diligence that needs to be conducted. Competitor calls, for example, can be tricky. Skills and experience are required. As private equity groups realize that they should be outsourcing this critical task to the experts who conduct market due diligence on a regular basis, the frequency of conducting full-blown market due diligence will increase.

Lender and LP Concerns

Lenders and even LPs are increasingly requiring market due diligence. Lenders, previously reluctant to interfere with the due diligence process of sponsors, are increasingly asking lead equity sponsors to hire third-party market due diligence professionals. In some cases, they are even specifying particular firms. Several years ago, in an issue of *Mergers and Acquisitions Journal*, Danielle Fugazy wrote that LPs want "to make sure their money is spent on viable companies… Lenders are also pushing for more due diligence to ensure they are making sound investment decisions at a time when debt providers are being super careful about which deals they'll back."

They may even want to be on the phone during weekly conference call reviews between the third party market diligence provider and the sponsor.

Most Sellers Today Have Experienced Recent Problems with Their Businesses

It is hard to find sellers today with a track record, over the period of the recession, demonstrating consistently exciting operating results. So it can be difficult to differentiate between those suffering from the macro effects of a poor economy and those whose business models, operations, human capital and/or strategies were simply underwhelming.

Acquirers recognize that there are more risks associated with today's deals. They wisely want to know about all of the skeletons in the closet (and how to remove them) before they decide on closing the deal or not. The poor quality of some of the recent deals has increased the demand for market diligence.

Conversely, it can be difficult to distinguish between extremely hopeful and aggressive forecasts and those actual, credible scenarios in which a target is truly poised for impressive growth and profitability. According to one private equity sponsor, "We are still having our greatest difficulty getting new deals done because of the divergence between our expectations of the next couple of years of performance versus those of the sellers. Ours, of course, is more pessimistic -- which creates all sorts of valuation and financing issues."

Higher Equity Component of the Deal Structure

When deals consisted of only a 20 percent equity check, the private equity sponsors had less at stake on every deal. Seller expectations have involved a higher allocation of equity, so recent buyers have increased their use of equity in financing deals. This has caused larger equity funds to swoop down into the lower middle market. A differentiating factor has become increased utilization of equity. The result is a heightened level of risk on every deal. One way to mitigate this risk is to utilize market due diligence on every deal.

Growth strategy decision-making

Today's higher valuations can mean higher risks. Many private equity groups are becoming more hands-on at the earliest possible moment in the ownership of the company, or even before they take over. There is simply much more uncertainty in the market today; mapping out the low hanging fruit for management and helping them select a direction to embark upon is a necessary, defensive maneuver.

Understanding, planning for, and taking advantage of growth opportunities begins on day one. One critical component of business due diligence involves determining if the company is headed in a sustainable, viable direction that makes sense based on its internal capabilities and the external (customer, competitor, supplier and market) opportunities it faces.

Therefore, business due diligence should include an evaluation of Company strategy. It may uncover that the Company has a low opinion of planning, or that it has a limited vision of the future. Or, the research could show that the company developed a strategy without gathering facts about the current state of reality with customers, competitors, or its market. The assessment could show that the Company never considered Wildcard scenarios that may shake their basic assumptions of the business. Finally, the investigation may reveal that the Company did develop a fine strategy, but it is not executing effectively, or it is under-resourced in some way.

Market diligence insights are instructive in pointing out a potentially new strategic direction for the Company, post-closing. The ability to gain access to a vast array of market experts (customers, competitors, third-party market participants) is one of the key benefits of outsourcing market due diligence. Good business diligence can help ensure a solid Return on Investment.

Conclusion

Market due diligence is a critical aspect of the due diligence process. It is useful for Go/No Go decisions, valuations based on growth expectations, and for carving out a strategic path for the newly acquired entity. For a number of reasons, the frequency of use of full-blown market due diligence studies is increasing – and rightly so.

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