

THE SOFTER SIDE OF DUE DILIGENCE

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For a CEO, soft, qualitative information can be as critical to an acquisition as any hard numbers you might insert into a spreadsheet. Nearly every merger or acquisition assignment I have completed over the years for a company's executive, was driven by either the soft data or heavily influenced by it.

A CASE IN POINT

A business services firm with an international reach delivered an array of services except for one very lucrative niche. A half-dozen other firms, also with an international customer base, had managed to grow this single portion of the market. Senior management very much wanted to capture some of this market's revenue, but felt that it would cost too much to build its own service. Instead, it elected to either buy or ally (form an alliance).

Generally, all those involved — the VP Strategy, CFO, VP Marketing — all understood the numbers involved in the decision. Revenues for all the major players were fairly well known. Everyone also had a sense of each firm's profitability. What management lacked was the softer aspects of due diligence: the intelligence that reported on another company's management style and operating approach.

STRATEGIC AND CULTURAL FIT

Attempting to identify the most important criteria by which it would measure likely success with any other partner in this category, management decided it needed to include answers on softer matters. Strategic or cultural fit between the two companies was the most important criteria. In addition, we examined how the companies would

strategically and culturally fit in these categories:

- Does the sales force follow an approach that would complement that of the client's?
- How committed is the potential partner to this sought-after niche?
- Is it a long-term set of objectives, or just a strategic experiment?
- Has the prospect successfully delivered on its promises?
- How deep is its intellectual bench?
- How well does it use the internet to retain customers?

After conducting dozens of key interviews with industry insiders, management identified subtleties in the interplay of all the players who either compete or act as distributors in this market, subtleties often missed in the

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general and trade press. Each of the criterion above, including the approach of the sales force, partner commitment, and so on, received a weighting factor.

Some criteria had a greater impact than others on the list. Each softer acquisition characteristic received a scoring value, based on a simple ten-point scale (with 1 as a low or no match to 10, representing a perfect match). The strategic assessment team chose the scoring scale based on its past experience.

After running test scores against each of the target companies, all but

two categories proved rational and reasonable. The two that did not, failed because the scores were either too high, too low, or were unusable. After tallying all scores for all criteria, one company rose to the top of the pile. The scoring placed the *winner* a good twenty percentage points above the nearest other candidate.

EXAMINING THE FUTURE THROUGH SCENARIOS

But that alone was not enough. Management developed a series of scenarios, potential future outcomes for the other players and the direction these companies would likely take in the marketplace. (See Sawka, this issue.) The what-if scenarios examined what the competitive market would look like if the company allied with each of the players. Creating the scenarios allowed the company to test the various alliance or merger combinations, almost akin to the way a grade school student would crosscheck an addition-subtraction or division-multiplication problem. The crosscheck in this instance confirmed the original recommendation.

The company now knew what made this likely candidate such a good fit with its own strategy and management culture. Undeniably, the numbers — sales, profitability, and cash flow, among others — remain in the forefront of any acquisition or alliance strategy. Yet so many deals fail for reasons that fall outside the margins of the spreadsheet. The ones that succeed seem to do so because those in the deal match both fiscally and culturally.

The above example is just one of many competitive situations requiring soft intelligence. Each merger or alliance assessment is inherently

SIDEBAR 1: DUE DILIGENCE: 'SOFT ISSUES' CHECKLIST	
DUE DILIGENCE CATEGORY	SAMPLE OF IMPORTANT "SOFT" FACTORS TO EXAMINE
General Information	<p>Historical review of recent parallel acquisitions, noting successes and failures.</p> <p>Review and verification of stated industry trends, comparing to statements made by the client.</p> <p>Competitor response modeling to identify likely competitor and marketplace reactions to the acquisition.</p> <p>Scenario analysis of possible merger outcomes.</p>
History and Background	<p>Organizational analysis: assemble and verify general organization structure and assess the efficiency of the organization, including analysis of decision-making procedures.</p> <p>Failure/success verification: verify reasons for XYZ's past failures and successes in acquisitions.</p>
Sales/Customers	<p>Customer valuation analysis: determine subset of most valuable customers.</p> <p>Analyze customer commitment: to purchase XYZ's products and services.</p>
Assets	<p>Intangible assets valuation: review XYZ's intellectual asset management.</p>
Suppliers	<p>Supply chain analysis: review supplier relationship, and efficiencies or deficiencies of XYZ's supplier strategy. Determine if potential problems exist with continued or increased supply. What do suppliers think of XYZ's business proposition? Are alternate suppliers committed to competitors?</p>
Markets, Products, Competition	<p>Scenario planning: conduct long-term review of XYZ's plans, and its likely success in evolving markets.</p> <p>Value-chain analysis: identify where XYZ falls within the profitability/value chain line, as well as a particular competitive advantage (or disadvantage) it may have as a result of its position.</p> <p>Competitor profiles: include strengths and weaknesses.</p> <p>Competitive product/service comparison: examine the breadth of XYZ's offering in contrast to those of rivals.</p>
Human Resources	<p>Benchmark organization structure against similar corporations, examining organization environment compared to rivals. Examine decision-making hierarchy, ability to respond to rival's actions, etc.</p>

different. Over the years we have developed our own due diligence checklist for senior management. Sidebar 1 highlights some of the criteria from the softer side of due diligence you may want to consider.

Remember, many so-called spreadsheet-induced mergers or acquisitions have failed over the years because the soft issues made them fail. CEOs need to recognize this failure and

desperately need to understand the psyche of a future partner, as well as the underlying characteristics that give this potential partner its inherent strength, or its weakness.

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