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Acquisition Surprises: Best Practices for Preparation and Risk Management

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Acquisitions are among the most far-reaching, ambitious business decisions that senior executives may face in their leadership of a company. And while the opportunities enabled by acquisitions are often compelling, the effective management of an acquisition process and realization of value depends on anticipating and preparing for post-closing surprises.

Of course, eliminating uncertainty and surprise is impossible, but anticipating and preparing for what may lie ahead is not. From the perspective of a CEO or CFO, such anticipation and preparation requires looking beyond diligence checklists, beyond inflexible integration plans, and beyond the false security of a single representation of how the future combined business will perform and evolve.

This overview of acquisition surprises and "best practices" for CEOs and CFOs also suggests opportunities for important observations and client advice for valuation professionals involved in acquisition-related assignments.

Beware of Checklists!

Evaluation of potential acquisitions involves a wide range of audits, assessments and analyses that are intended to inform a prospective buyer's consideration and to prepare for the days and months of post-closing integration work. While some executives may reflexively reach for due diligence checklists, certain areas of greatest potential for post-closing surprises, notably those related to people, customer relationships, and cultural aspects simply aren't conducive to checklists.

Confirmatory due diligence assessments, including valuation inputs to quality-of-earnings reports, often have potential to serve as "red flags" that anticipate post-closing surprises of keen interest to an acquiring company's management. For example, a firm's management of its manufacturing assets provides leading indicators for its future capacity, maintenance capital expenditure requirements, product quality levels and trends, and flexibility to meet projected customer needs. Indications of under-investment in asset maintenance may go far beyond risks to the value of the equipment on a stand-alone basis, rather risks to the capacity and cost structure of the go-forward business. Similarly, the quality of receivables, inventory and payables may be indicative of compelling insights into relationships with key customers and strategic suppliers.

As such, beware of checklists! And expect that most acquisitions will encounter the unexpected after closing. Savvy acquirers may increase their effectiveness in handing those surprises through scenario analyses and pre-closing preparations for areas of greatest uncertainty.

Organizational Surprises

"Talent assessment ranks among the top challenges for companies making acquisitions. In the best of circumstances, it's difficult to determine whether key managers will be successful in the new organization," counseled a Senior Vice President of Human Resources with two decades of acquisition diligence and integration experience.

Acquiring a business often reflects the assessment that the target company's leadership and organization have operated effectively, and can continue to do so in support of future growth and value to the acquirer. Recognizing that post-acquisition ownership may bring new expectations, different priorities, and often an accelerated plan for growth is important in anticipating potential surprises. Further, the acquired company's management may have been well-suited to an earlier phase of its existence, while ill-suited to managing as part of a larger enterprise.

Start Integration Planning Early... Very Early

Getting an early start with integration planning may be helpful in reducing the risk of surprises and better preparing a company to face surprises encountered.

For example, involving sales, marketing, and operations executives in certain pre-closing activities can assure operational input into the deal valuation and key operational risks. Market-facing executives often have relationships with companies that may be interesting acquisition targets or have insights regarding companies whose market position or business practices would make it unattractive.

Further, operations executives will add value to scenario analyses and planning to consider the range of post-closing outcomes for related to customers, strategic suppliers, and competitors. Supply chain and sourcing analyses may require assessment of both third-party relationships and internal capabilities. Insights into such operational integration challenges can begin with audits of plant and equipment, performance metrics, rated vs. actual capacity, and other assessments, whether done by an acquirer's internal executives or third-party experts such as valuation firms.

Be Careful with Year One Projections

Acquisition valuations require thoughtful financial projections, and the "Year One" projections face particular risks, whether based on factors related to the transaction itself or factors related to external business relationships impacted by the acquisition.

Factors directly related to the acquisition may include: (a) seller's projections may be overly optimistic, (b) organizational transition may impact results, or (c) anticipated synergies may be realized over time, perhaps far beyond Year One.

Key customer and supplier relationships may disrupted by the acquisition in unpredictable ways. Many prospective sellers limit direct access to customers or strategic suppliers during a sale process, whether for competitive reasons, toward minimizing disruption of ongoing business relationships, or reflecting limited knowledge of their internal organization to the pending consideration of a sale. Also, customer or strategic suppliers may be prompted by the change in ownership to seek new pricing, consider competitive offers, or perceive new risks in their relationship with the target.

And finally, the "Year One" projections will be highly scrutinized by investors and an early (perhaps premature) sign of the deal's potential, so appropriate care is prudent.

So What?

Pre-acquisition diligence involves studying a mix of "facts and figures" as well as far more subjective aspects of a business, such as people/culture, customer relationships, and the broader market in which a company operates. Even experienced CFOs can risk relying on the black-and-white security of checklists.

For valuation professionals, looking beyond the checklists and comfort of a fixed-number valuation may lead to observations and recommendations with significant impact to clients anticipating, preparing for, and (sometimes) avoiding surprises.

Joseph Feldman is President of Joseph Feldman Associates, a Chicago-based corporate development consulting firm founded in 2003. Joseph Feldman Associates provides acquisition and other strategic transaction consulting for growing companies and their investors. For more about acquisition surprises, download *"Middle Market Acquisitions: If I Had Only Known"* at www.josephfeldman.com.