Anticipating Acquisition Surprises

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.

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 will describe the benefits of an acquisition due diligence campaign driven by areas with greatest potential for surprise. This approach to due diligence provides more actionable input to deal evaluation and integration planning, as such better preparation for the inevitable surprises from acquisitions.

Confirmatory due diligence ≠ due diligence

Evaluation of potential acquisitions involves a wide range of audits, assessments and analyses that are intended to inform a prospective buyer's decision-making 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 company culture, simply aren't conducive to checklists.

Confirmatory due diligence assessments, including quality-of-earnings reports; review of accounting, tax, and legal records; and environmental studies often have potential to serve as "red flags" for valuation of a transaction or as inputs to contractual negotiations for indemnifications or disclosure obligations. However, diligence efforts must also include more subjective and dynamic areas such as strategic sourcing relationships, operating capabilities, customer relationships, company leadership, organizational strength, and competitive response. The more subjective of areas of due diligence may be more inherently more challenging to assess, though these are often essential to the anticipated value of the acquisition.

In a recent study by Joseph Feldman Associates of middle market acquisitions, interviews with nearly ninety company executives and advisers identified post-closing surprises as more typically found outside of typical confirmatory due diligence areas. Over reliance on diligence checklists may under-emphasize important pre-closing diligence in areas with highest surprise risks, such as talent/organization, customer/market, and integration-focused operations assessments.

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 more deliberate pre-closing diligence in areas of inherently greatest uncertainty.

Organizational surprises

"Proper assessments of people who aren't your employees may be impractical. That said, acquirers should temper their optimism that the target's management will be just fine. Planning for more changes, perhaps many more changes, in the target's team would be sensible in most cases I've worked with," counseled a Senior Vice President of Human Resources with two decades of acquisition diligence and integration experience.

Over 80% of those interviewed in our research indicated that all or most senior management of the acquired firm was retained post-closing. Yet 40% of those interviewed encountered "organization and people" post-closing surprises following the acquisition.

As a middle market company Board of Directors member reflected, "…we found out after the acquisition that the management team did not talk to each other. During negotiations they had presented the team as a tight group, and in reality they had very diverse views regarding the future of the company."

Acquiring a business often reflects the assessment of whether the target company's leadership and organization have operated effectively, and the outlook for their doing so in support of future growth and value to the acquirer. It is important to recognize that post-acquisition ownership may bring new expectations, different priorities, and often an accelerated plan for growth, any of which may lead to organizational 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. The leader of a manufacturing company described the management team of an acquired business as "totally competent in running the business; totally incompetent in doing things differently to grow it."

Customer and market-related surprises

Establishing a clear understanding of a target company's customers and market position is critical to assessment of value and risk. However, that clear understanding may be elusive for several reasons inherent in an acquisition process, thus potentially leading to post-closing surprises.

First, many prospective sellers limit direct access to customers during a sale process, whether for competitive reasons, toward minimizing disruption of ongoing business relationships, or reflecting limited internal disclosure to their sales organization of the pending consideration of a company sale. The "acquired company did what they could to keep the acquiring company from talking with customers in detail," reported a C-level executive in the home services industry. This common constraint on diligence may lead to unexpected outcomes post-closing.

Second, certain customers 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. Clear determination of the risk of such potential actions may be speculative in advance of a transaction.

The CEO of a consumer products company encountered a major customer loss shortly after an acquisition closed. While this possibility was considered for integration planning and valuation purposes, the impact required a few years to recover. The CEO identified two notable learnings: "first, we hadn't adequately tempered our projections for Year One post-closing to account for the unknown; doing so would have been prudent vis-à-vis our investors, without needing to ease expectations from our sales team or retained management; second, for product line acquisitions, the right transition time for our key sales relationships is immediate; individual accounts matter too much to defer integration."

Finally, the target company's unique vantage point in an evolving market may be simply beyond the view of a potential buyer, notwithstanding careful interviews with management or outsiders with perceived expertise on relevant trends.

Scenario analyses
As described above, the risk for major post-closing surprises may be highest in more subjective business areas such as related to organization, customers, competitors, and broader market conditions. Such surprises are far beyond the scope of checklists that may provide a false assurance that all the bases have been covered. How can an organization contemplating an acquisition do better at anticipating the wide range of possibilities that might happen?

For many companies, the use of scenario analysis can provide a planning tool that overcomes fundamental uncertainty or ill-preparedness ahead of completing an acquisition. In brief, scenario analysis prompts a company's leadership to think about those important aspects of the future, especially considering factors over which the firm may have little or no control. These might especially include competitive response to the acquisition from suppliers, customers, government, and individuals whose careers may be impacted by the deal.

Imagination becomes an essential ingredient to effectively considering a range of alternative futures that might require action by the company. And while scenario analysis may be a routinely useful exercise, the greater uncertainty and newness associated with acquisitions may make such "what if" thinking far more critical to a company's success.

According to Patrick Marren, Principal of the Futures Strategy Group, LLC, a leading scenario-planning consultancy, "Scenario planning can help organizations identify key market fault lines, critical success factors for acquisition, and potential 'rogue waves' coming from outside their accustomed context that could disrupt their entire industry. It also allows them to 'rehearse the future' in a far deeper way than merely going down a checklist ever could."

Finally, scenario planning can be used in integration implementation as a team-building exercise to bring key people from an acquired entity swiftly up to speed on the acquiring organization's strategic vision of the future.

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 certainly value to scenario analyses and planning to consider the range of post-closing outcomes for related to customers, strategic suppliers, and competitors.

Summary
"Great strategy, planning and integration execution are essential, but not sufficient to ensure success with acquisitions. There will be surprises", reflected the chief executive officer of an industrial products company.

And while unforeseen developments may sometimes limit an acquisition's impact, other surprises can also prove quite positive as previously unforeseeable opportunities are realized.

Acquiring firms are advised to take a broad view of pre-closing diligence, considering both traditional "confirmatory" diligence along with more subjective efforts to understand an uncertain future. After all, companies prepared to consider acquisitions among their options may thereby achieve growth and competitive position that is otherwise unachievable.

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