CICERO GROUP / STRATEGIC DUE DILIGENCE

STRATEGIC DUE DILIGENCE: THE FOUNDATION FOR DEAL SUCCESS

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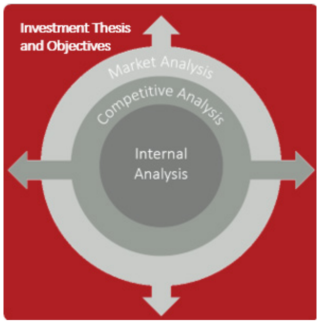
Strategic due diligence is a critical component of deal analysis which investigates the commercial attractiveness of a deal and its likelihood of achieving success. Different from financial and legal due diligence, which center on determining a deal's correct price and structure, strategic due diligence centers on determining whether a deal's value is adequate, realistic, and attainable. It does so by first understanding the overarching deal thesis and objectives and then assessing the deal against those objectives. The target organization's market and competitive landscape are then systematically analyzed to understand the size of the opportunity and how to effectively compete. Finally, the target is evaluated on its internal ability to execute necessary strategies. Consideration is given not only to overt aspects of a target's strategy, but also to the underlying strategic drivers. Strategic due diligence also builds a strong platform from which effective integration and portfolio management strategies can be launched.

Ultimately, strategic due diligence will provide a data-driven perspective for investors on whether the deal is likely to achieve success and on the strategic steps that should be taken to optimize value and post-deal integration effectiveness.

INVESTMENT THESIS AND OBJECTIVES

Strategic due diligence begins with forming a clear understanding of the investment thesis and objectives. Understanding these elements ensures all subsequent analyses tie back to the overarching desired outcomes for the deal. Also, different strategies apply to different categories of investments. For example, an industry buyer may justifiably take a different approach than a purely financial buyer, and a deal focused on expansion into new products or markets may have different demands than a deal focused on industry consolidation and scale benefits.

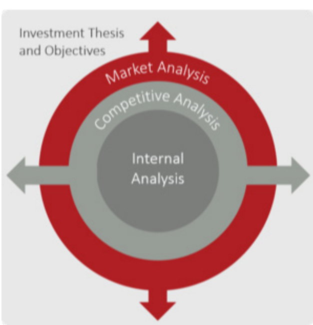


Consideration must also be given to the level of operational influence the investor will have on the target after deal completion. Critical questions that ensure alignment with objectives must be asked and may include, is this a scale acquisition? A scope acquisition? Will it expand capabilities, or are there other strategic considerations that play a significant role? How will current investors, customers, and competitors react? For institutional investors, does it fit within the portfolio? What is the overall strategy? Does the organization require a controlling interest? What efficiencies are we looking for? What level of operational control will we exercise and what portfolio management support can we provide?

Answers to the above questions help inform the strategic rationale for a deal. This rationale is then broken down into component value drivers that are investigated and pressure tested across multiple scenarios and throughout the ensuing market, competitive, and internal analyses.

MARKET ANALYSIS

Determining the commercial attractiveness of a deal begins with performing a rigorous and data-driven market analysis. Market analysis centers on understanding the customer, current and prospective. Customer demand drivers, trends, preferences and jobs-to-be-done are ultimately what create a market opportunity. The analysis must also consider how these trends or preferences are likely to shift over time.

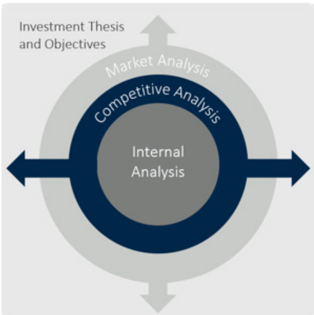


Thorough market analysis also considers legislative, political, regulatory, economic, social, technological, environmental, and legal trends that may impact demand and market size over time. Many markets rapidly shrink and others expand during periods of economic recession. The last two decades have produced droves of new regulation that have stymied some markets while bolstering others. Generational social preferences must also be assessed against the product or service being offered inasmuch as tastes can vary widely by generation and can rapidly expand or contract a market. Barriers to entry, structural stability, cyclical resilience, and secular tailwinds are additional market factors that must also be analyzed.

With customer and external market considerations understood, a data-driven approach can now be applied to sizing the market. Total addressable market, serviceable addressable market, and share of market become quantitative and informative measures against which deal potential is evaluated. Differing scenarios should be modeled and analyzed reflecting various market dynamics and outcomes. These scenarios should also address the possibility of major market disruptions as well as changes in market dynamics due to deal closure.

COMPETITIVE ANALYSIS

The next step in evaluating the commercial attractiveness of a deal is to perform a thorough competitive analysis. This phase begins with identifying current and potential market players that present a competitive dynamic. This includes both direct and indirect competitors and players in adjacent markets that could easily shift into the target company's market.

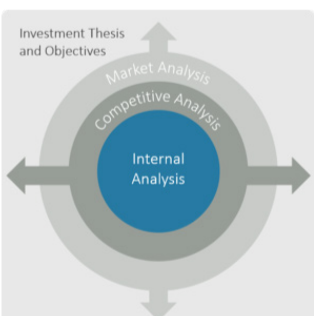


Each competitor is then analyzed and plotted on a matrix that portrays both strength of strategy and ability to execute operationally. Scoring in these two main areas is built from rankings across several sub-categories such as strength of value proposition, pricing, selection, differentiation, marketing, technology, funding, leadership, reputation, and others. This process also uncovers industry best practices that inform the strength of the target company and potential post-deal strategies.

The competitive analysis continues by deploying tried-and-true frameworks such as Porter's Five Forces and competitor SWOT analyses. A robust analysis will also take into consideration what actions competitors may take in response to the deal. Failing to consider how the competitive landscape may shift after completing the deal can leave investors and managers unprepared to respond strategically.

INTERNAL ANALYSIS

Once a clear view of the market and competitive landscape is obtained, the diligence is ready to shift to arguably its most critical phase – internal analysis. Internal analysis ultimately assesses whether the target company can effectively compete in the market and competitive landscape and achieve the desired value in both the short- and long-term. Operational capabilities, leadership strength, financial strength, and cultural considerations are evaluated against best practices to determine likelihood of success.



Management team skills and capabilities are a material factor when considering the target's ability to achieve deal objectives. Whether the management team can effectively be retained post-deal is also important to assess inasmuch as many acquisitions struggle when otherwise highly competent leaders exit after the transaction is completed.

At this point in the analysis, the target can be evaluated against the industry best practices that were identified during the competitive analysis. This can highlight potential deal risks as well as assist in the crafting of strategies and integration plans that will better position the target company to succeed. Potential synergies and dis-synergies, such as cultural frictions and loss of customers, are also identified, quantified, and analyzed.

Finally, pro forma financial projections are validated and updated as necessary to reflect key factors stemming from the market, competitive, and internal findings. It is not uncommon for existing projections to have forgotten or overlooked material factors uncovered in the preceding analyses. The target's financial health is reviewed by looking at things such as revenue stability, concentration and historical growth, as well as trends in working capital, EBITDA, and cash flow. Having a comprehensive view of the market and competitive landscape now allows for more robust and reliable financial projections to be developed.

CONCLUSION

All too often, financial and industry buyers are overly focused on financial and legal due diligence whilst forgetting to address the critical components of strategic due diligence. This is commonly a product of resource and time constraints. Many investors, including industry buyers and financial buyers, purposefully hire independent consultants to perform strategic due diligence as a means of ensuring key strategic questions are answered and not forgotten in the myriad moving parts of a deal. Strategic analysis can also identify risk-mitigation tactics that can optimize deal outcome pre- and post-deal execution. Ultimately, strategic due diligence is the foundation upon which deal rationale is validated and deal success is achieved.

Deals happen fast, and due diligence needs to be strategic and accurate. With time or resource limitations, it is often useful to bring in outside help with all or part of the due diligence process. Cicero Group provides a wealth of understanding and experience in supporting operating organizations or investors with strategy formulation, target identification, strategic due diligence, and post-merger integration.

ABOUT THE AUTHOR

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Chris Speer is a Senior Engagement Manager in the Salt Lake City office of Cicero and a leader in the firm's Strategic Due Diligence practice area. He has over 14 years of experience across roles in finance and investment banking, private equity investments and operations, and management consulting.

Prior to joining Cicero, Chris co-led a boutique Denver-based consulting firm focusing on strategic due diligence, post-merger integration, and organizational transformation. Chris began his career in management consulting at McKinsey & Company. Previously, Chris was an analyst for Goldman Sachs and an operator for a private equity portfolio company.

Chris holds an MBA from the University of Chicago Booth School of Business and a Bachelor of Science in Finance with High Honors from the University of Utah David Eccles School of Business.

ABOUT CICERO GROUP

Cicero Group is a premier management consulting firm focused on implementing data-driven strategies for a broad mix of private, public, and social sector organizations across the globe.

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