DEAL SUPPORT

DEAL ORIGINATION AND COMMERCIAL DUE DILIGENCE – IMPLICATIONS FOR INVESTORS AND SELLERS

What should investors expect from Commercial Advisers?

With the collapse in leveraged finance and concerns about corporate performance, Merger & Acquisition activity has declined significantly, particularly amongst the Private Equity community. Nevertheless, deals are still being done – trade acquisitions, corporate recoveries and equity funding – and latest figures suggest a recent upturn in activity. And there is continuing interest and opportunity around the following:

Commercial advisers support investors' 'origination' processes by identifying attractive markets and potential targets.

We will see increasing investment interest as the economy picks up … and a focus on different and new sectors

1. "Counter-Cyclical" Products and Services .
2. Longer term, lower growth but more resilient businesses – pharmaceutical, energy/renewables /and other utilities (eg Nuclear), healthcare/employee services, travel.
3. Specialist Niche Businesses – digital marketing businesses and related IT services, producers of critical components and owners of real Intellectual Property or innovations.
4. Application of new business models to old sectors (eg online) and vice versa
5. Continued rise of online – boosted by growth in mobile broadband and related applications.
6. Venture Capitalism (given an improved regulatory framework) and opportunities for growing established smaller companies.
7. Social Enterprise
8. Rescue of struggling businesses.

In the meantime, the tools and techniques employed at SEMPORA in support of deals are also valuable to investors wishing to understand how to improve their current investments and support strategic decisions. These might include customer review and analysis, market research, regulatory review, consumer trend analysis, market sector reviews and competitive analysis. Understanding the competitive set has always been a key part of any strategic review, and is especially important in the current climate. The most important element remains understanding the customer.

> The role of Due Diligence

Commercial Due Diligence or Review – a branch of strategic marketing consulting that combines detailed analysis with macro and strategic review - is normally completed within a very short period of time compared to many consulting assignments.

Conducting due diligence is a balancing act of assessing risk and opportunity – the classic strategic dilemma. One of the dominant sentiments to arise from the recessionary environment is uncertainty – for businesses, for individuals and for consumers. We are faced with extra difficulty in projecting and planning for the future.

The reality is that whatever the scope and business situation, an external view will always reveal something helpful – whether a hidden threat or an unexplored opportunity.

Good commercial review can identify additional potential

Reviews do often uncover additional 'upside' and project experience shows that a review can identify such significant additional potential that it has led to an increased revaluation. More often the projections have had to be reviewed more harshly, or at least with a degree of healthy scepticism, but to a point where the plan is realistic and achievable and is therefore one to which everyone can reasonably commit.

As lending picks up there will be a requirement on lenders to expand the risk analysis, perhaps moving closer to the original meaning of due diligence, and potentially separating this from the commercial and strategic review, which of course remains essential in the investment decision. The adviser will also have to provide exceptional value for money by making less ambiguous assessments – for example, reporting conditions as 'challenging' whilst suggesting that opportunities can provide some 'upside' stops short of providing good value from the exercise. Good commercial review should as far as possible be scoped to help the new owners with ideas and recommendations on strategy and tactics.

It is fair to say that many business plans have a certain degree of reasonable optimism although project work has shown a number of plans that happily projected more than a doubling of sales over the next three years, with little substance behind them. Current economic conditions also show that maintaining the status quo in terms of sales and profit or even simply remaining in business can be a 'result'.

Plans are not about overpromising and…

Clearly stated conclusions are essential, even if they do not make particularly comfortable reading.

At SEMPORA we are often told that one of the most important criteria in acquiring a business is 'the management' – indeed a buy-in, where incumbent key management are not directly involved as owners / in the purchase i.e. as an MBI, is likely to be one of the least successful forms of acquisition.

Eventually we will see the return of leveraged transactions and resultant increase in demand for advisory services and transaction support. It is likely though that the scope of these services will change not just in the content, with more emphasis on:

- **Strategic Fit –** including analysis pre-deal – to assess synergies and opportunities and – and involvement afterwards to ensure that synergies can be realised as well as any rationalisation implemented.

Commercial review is also about support on strategies and tactics

- Emphasis on **Strategic Review,** especially regarding customer relationships/contracts and the customer engagement and fulfilment processes, and Competitive Analysis.

- **Practical** and **real suggestions** for helping the new regime succeed – a focus on the potential as well as the risks.

A review can be broken into four core headline topics: Market (how attractive is it? where are we in the 'cycle'), Customers (who are they, how do they behave and what do they think?), Competition (what is the basis of competitive advantage – is the company or product a 'winner'?), and Projections (are they realistic and achievable?). Extending these themes a little requires:

Important main topics are:

Market
Customer
Competition
Projections

- More concentration on the competitive situation. It is still remarkable that many businesses seem to know so little about their competition.
- Better understanding of what drives profitability and the factors that may change those drivers.

- Key success factors: the customer and end-consumer – crucial for all businesses, understanding the end-user / consumer is critical to future success but particular important for any kind of distress purchase – what was the reason for the demise, for example?
- Understanding the stocking cycle in relation to the market cycle.
- Regulatory affairs – what will the political scenery be and how will that effect public spending and industrial policy; especially around elections, budgets and spending reviews.

Lenders will as ever require answers around:

- Accurate, quantifiable market sizing and growth forecast
- Uniqueness/Competitive Advantage
- Business plan growth
- Market consolidation
- Concentration of competitors
- Scalability – can we do more than organic growth?
- Exit prospects – who are potential buyers?
  Will competitors be looking to do the same? When?
- Bolt-ons or additional services. Any opportunities identified?

> Everyone gains from the process

Opening a business up to analysis is daunting for any management team – and with an emphasis on risk appraisal for the investor it can be seen as focusing on negative aspects. Whilst the temporary pain might be offset by the gains of selling the business or securing an increased shareholding, ultimately everyone is interested in the continued success of the business.

A good 100-day plan is a key element of a successful deal process

A good review at the deal stage can set the groundwork for further improvements, whether part of a 100-day plan, subsequent review during the course of the investment and advice on any further fund-raising, re-financing or vendor/exit process.

With the lack of debt finance and fear of over-valuation – based in some cases on harsh experience – the due diligence exercise becomes ever more valuable. It is also possible to see that there would be a toughening of deal terms and warranties.

A different approach to commercial due will be needed

The approach to commercial due diligence will change in some respects since many business plans have relied heavily on organic sales growth projections, and a key element of due diligence has been to establish how realistic these are at the top line level. Now that we are in periods of low growth and the base assumption of ever expanding market demand is unsound, the review focus sales has to be as much on market resilience, cyclicality and above all niche marketing.

Certainly it places more importance on analysing core profitability and the ability to generate cash (or not consume it quite so quickly if there is a problem) – and profit and cash are no more or less important at these times – but it is the sales-driven assumptions that need to be rigorously tested.

Without a sound, thorough and professional Commercial Due Diligence process the investment risk can become even less manageable than in the past.

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