

Strategic Due Diligence – The key to unlocking a deal’s full potential



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Executive Summary

The key to unlocking a deal's full potential is a rigorous and comprehensive strategic due diligence. While legal and financial due diligence focus on determining the correct price for a company, strategic due diligence focuses on whether the value of the deal is realistic and attainable. Strategic due diligence not only assesses the commercial attractiveness of an investment, but also assesses the likelihood of success. It does so by objectively and thoroughly analyzing the market, competitive landscape, and the target company's ability to execute needed strategic actions. Also, as many mergers and acquisitions fail due to unanticipated cultural and operational challenges, a rigorous strategic due diligence establishes a strong platform from which an effective integration can take place.

Strategic due diligence begins by thoroughly vetting the investment thesis and desired objectives of the deal. Identifying these objectives is followed by dissecting the strategic rationale and underlying assumptions for the investment. All identified value drivers, including potential synergies, are then assessed, investigated, and pressure tested. This allows the critical next steps of the diligence to be informed by and tested against the deal's objectives and reasoning.

Once the investment thesis, deal rationale, value drivers and underlying assumptions have been mapped, a thorough and data-driven market analysis is performed. The market analysis begins with understanding the customer. Needs and trends among customers are analyzed to determine demand scenarios and market size. Demand forecasts are created for various economic conditions and market dynamics. Other trends and risks that may affect the market outlook, such as technological, political, regulatory, environmental, and social, are also evaluated.

Next, a rigorous competitive analysis is performed. All major and relevant competitors and potential competitors are identified and evaluated based on their respective strategies and execution abilities. Strategic due diligence considers not only the current competitive environment, but also the anticipated changes that may follow deal completion. Strategic actions of competitors in response to the deal are anticipated and incorporated into the analysis. Each competitor's strengths and weaknesses are assessed and best practices are identified and reviewed.

Finally, the strategic due diligence takes an in-depth look at the target company's capabilities and culture. Whereas the prior analyses are focused on determining the commercial attractiveness of the deal, this step focuses on the likelihood of achieving success. The management team is evaluated against their ability to execute strategic initiatives. Potential frictions arising from integration challenges and cultural issues are considered and reviewed for mitigation strategies. As part of the internal analysis, financial projections are carefully scrutinized and tested against market and competitive dynamics. Synergies from scope or scale are uncovered along with the requisite actions needed in order to achieve them. Also, internal operations and processes are evaluated against identified best practices.

Strategic due diligence will ultimately provide a data-driven opinion on whether the deal will lead to a company that is capable of outperforming competition and capturing an attractive market position. Risks are properly weighed and balanced and mitigation tactics are crafted. Anticipation and evaluation of potential integration challenges carve a path for managers to ensure deal success after closure. Most importantly, a rigorous strategic due diligence allows investors to thoroughly understand the risk-reward tradeoffs of the deal and what strategic steps should be taken to achieve success.

Exhibit 1 – Summary Components of a Strategic Due Diligence



Investment Thesis and Objectives

Undertaking strategic due diligence should begin with a clear understanding of the investment thesis and objectives. Different strategies can apply to different types of investments. For example, is this an acquisition focused on expanding into new products or markets, or it is part of an industry consolidation effort? Is the investment being made by an industry player or a financial buyer? Each of these circumstances and variants thereof require a slightly different lens to be applied to the due diligence.



Deals focused on expanding into new products or markets should be evaluated based on the strategic rationale for the expansion. Are the new products or markets adjacent and complementary to those in the current portfolio and is there strong justification for the need to expand? To what extent will the target company be integrated and do operations need to be improved or consolidated? What is the target's competitive position in the market and how might this change after the deal?

Deals focused on industry consolidation efforts should be evaluated largely for potential scale benefits and cost synergies. Will the value of increased market penetration and revenues be realized through reducing operating costs and eliminating redundancies? How might customers and competitors respond to the consolidation and how could this impact the integration strategy?

Another consideration is the level of operational influence and involvement the investor will have. Purely financial buyers may have somewhat less flexibility in facilitating strategic and operational changes. Hands-on or industry buyers looking to expand product offerings or move into new markets may have increased ability to make changes but may be subject to cultural frictions.

Each of these investment scenarios will have several underlying assumptions, value drivers, and desired outcomes which should each be pressure tested and framed. This will lay the foundation for performing the market and competitive analyses and will have major implications for the internal analysis.

Market Analysis

The first critical step in assessing the commercial attractiveness of a deal is performing a data-driven market analysis. Market analysis must first identify who the customer is for the target company's products and services. Customer demographics, needs and desires, and behavioral trends all inform the level of demand in the market. It is not enough to consider the current trends. A proper analysis will consider how these trends may shift or change over time. Henry Ford once stated, "If I had asked people what they wanted, they would have said faster horses." Ford first understood the fundamental problem that his customers were trying to solve for – faster and more efficient transportation.



An effective market analysis will also consider trends in the technological, political, regulatory, environmental, and social realms which may impact demand forecasts over time. Economic recessions are a recurring reality and can have material impacts on business performance. Further, we have repeatedly seen the huge implications of evolving regulations on the market for services such as ride sharing, financial services, and countless others. Social generations also often have different priorities and focus areas which must be considered, as evidenced by the varying tastes among Baby Boomers, Gen-X'ers, Millennials, and the rising Post-Millennials. Market sizes and opportunities can rapidly expand and contract according to such shifting tastes.

Once the customer needs and market trends are well understood, a quantitative approach can be taken to size the market and determine current and prospective market share. Multiple scenarios reflecting various market dynamics should be developed to paint a holistic picture of market attractiveness. Investigation of potential market-disrupting factors and their implications should also be incorporated.

Finally, a robust market analysis will also evaluate potential shifts and changes in the market environment due to the deal's closure. Many mergers and acquisitions have struggled in the face of market criticism or skepticism of the transaction. The post-deal environment should be evaluated for such risks.

Competitive Analysis

The next critical step to assessing the commercial attractiveness of a deal is performing a rigorous competitive analysis. Competitive analysis starts with identifying all major and relevant competitors in the market. This may include prospective competitors as some companies may be operating in adjacent markets and have the ability to rapidly shift into the market of the target company.



Once relevant competitors have been identified, strategic due diligence looks at each of them closely to determine the strengths and weaknesses of their respective strategies and execution capabilities. It is often helpful to chart the competitors on a matrix in which strength of strategy is on one axis, and ability to execute is on the other. The scoring in these categories is comprised of a ranking across several sub-categories. These sub-categories include elements such as pricing, selection, differentiation, value proposition, marketing, funding, technology, management team, reputation, and others. This approach not only allows competitors to be ranked but also allows best practices to be discovered across all facets of the business that can be referenced in the internal analysis.

In addition to a review of each key competitor in the market, it is important to assess the overall competitive landscape using frameworks such as the Five Forces model developed by infamous business strategist Michael Porter. Porter’s model evaluates the threat of new entrants and substitutes, supplier and buyer power, and competitive rivalry. Each of these elements is critical to understand the competitive dynamics and risks within a market.

Finally, strategic due diligence considers what competitors may do in response to the deal. It is not uncommon for other industry players to respond with strategic actions of their own after a deal has been completed. An assessment of these potential actions is key to predicting changes in the landscape and crafting response tactics. This improves the reliability of the deal’s projected outcomes. Having assessed the commercial attractiveness of the deal from a market and competitive perspective, the analysis shifts inward to evaluate the target company’s capabilities and likelihood of achieving success.

Internal Analysis

The final and perhaps the most critical component of a strategic due diligence is the internal analysis. The primary purpose of the internal analysis is to objectively assess whether the target company is capable of achieving the desired outcomes of the deal. This step involves looking at strategic and operational capabilities as well as organizational culture. Financial projections are also carefully scrutinized and evaluated against the findings from the market and competitive analyses.



The skills and experience of the management team of the target must be weighed to determine the likelihood that they will be successful in achieving desired outcomes. It is also important to consider whether or not said management can or will be retained and for what duration after the deal is executed. Many mergers have struggled after otherwise very capable managers exited the target company soon after the transaction.

The operational capabilities and business model of the target must also be carefully analyzed. The competitive analysis likely identified a variety of best practices that can be used in this step. Evaluating each component of the business against these best practices can not only inform risks and opportunities but also help in the development of a strong integration plan.

Also, the internal analysis focuses on identifying and validating potential synergies that are to be realized through the deal. These may include scope, scale, cost, cultural, and other synergies. These are important to quantify as part of validating the overall financial attractiveness of the target. Potential dis-synergies such as loss of customers or cultural frictions should also be researched and addressed with mitigation tactics.

Finally, financial projections are carefully scrutinized as part of the internal analysis. Each of the other components of the strategic due diligence serves as an important contributor to the validation of financial forecasts. It is not uncommon for existing projections to have ignored important market and competitive dynamics uncovered in the prior steps.

Conclusion

Without a strategic due diligence it is unlikely that investors will fully understand the potential risks, benefits, and opportunities of a prospective deal. Financial as well as industry buyers often place much emphasis on financial and legal due diligence whilst forgetting the major implications of strategic due diligence, which is key to determining whether the value expected from a deal is realistic and attainable. This is a material contributing factor to many failed mergers and acquisitions and private equity investments.

Strategic due diligence can not only validate a deal's rationale but also substantially improve the likelihood of its success by creating a solid platform from which post-deal integration strategies can be formulated. It does so by carefully analyzing current and forecasted market and competitive dynamics and by objectively evaluating the company's ability to execute the strategic actions needed to achieve investment goals. Potential synergies and dis-synergies that could impact the deal's success are assessed and validated. Strategic due diligence can also identify potential integration challenges and cultural frictions which can then be hedged with mitigation tactics.

There is no question that strategic due diligence is critical to unlocking a deal's full potential. It will not only inform the validity of the deal's rationale but also highlight whether the target company is likely to successfully compete in the market and achieve the desired value. Strategic due diligence should be included in any comprehensive assessment of an investment opportunity.

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