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Creating Value Through Improved Decision Making and Effective Execution (SM)

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## M&A - Asking the right questions before the deal!

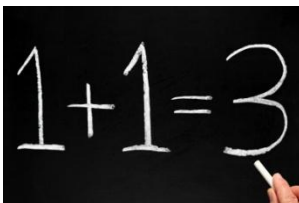
The questions asked are often as important as the answers given. Warren Buffett recently learned this the hard way and will undoubtedly ask better questions the next time a subordinate suggests an acquisition target.



M&A activity is up and valuations are rising. According to The Wall Street Journal, total announced US M&A deal value is up 30%, to \$499B, from this time last year, while the number of deals is down 13%. Microsoft is buying unprofitable Skype for ~10x sales or \$8.5B; current speculation is that Facebook's rumored 2012 IPO will sport a \$100+B valuation with a 50+ EBITDA multiple. Lastly, the executive grumbling, "I can't believe the high multiple they paid for that...the math doesn't work", is back. These points suggest that it is time to revisit a few questions that acquisition-minded executives and boards should ask themselves.

I hope that you find the following brief list of M&A-related questions useful. They are intentionally structured in a digital, yes/no format to facilitate their use in a check-list should the reader so desire.

## M&A questions to ask and answer before doing a deal.



**Do we know why we are interested in this target?** For a **strategic buyer**, the answers to this question include access to raw materials or markets, an enhanced pipeline of new products, additional manufacturing capacity years ahead of what the permitting and construction process will allow, the synergies of consolidating redundant capabilities, alignment with macro trends and unmet needs such as infrastructure investments in developing economies and Japan, and the growing affluence of BRIC consumers. For a **financial buyer**, the answers to this question include taking advantage of an underleveraged balance sheet, a sum-of-

the-parts is greater-than-the-whole valuation, backing a business with solid management and growth prospects that has been ignored by its current owner, and the turnaround upside of a poorly-managed company. Carefully answering this question is important because it is possible, in a bidding war and the subsequent pursuit of synergies, to destroy the key reasons that made the target attractive in the first place!

**Do we know (a) how we will make money from this acquisition, (b) how much money we will make, and (c) when we will make this money?** Buyers should know, in some detail, how they will make money from an acquisition before they submit their first round bid. They should be able to convincingly state the value drivers that need to be enabled, nourished, and maintained and the value destroyers that need to be minimized or stopped. Buyers should also define their "walk-away" price. This last point is crucial to ensuring that the buyer doesn't get caught up in the acquisition process, overpay, and then face the common "Winner's Curse" where the acquisition doesn't create the hoped for value. "When" the money will be made is key as buyers search for a timeframe to make money along the continuum between "accretive next quarter with a 1 year payback" and "all the money is in the terminal value."



Category creation and evolution occur at a relatively moderate pace in many industries. This pace tends to give strategic buyers a relative advantage over financial buyers in that strategic buyers have both the information and the time to study potential targets and define how, how much, and when. The unpredictability of industries with faster category dynamics, such as mobile connectivity (think the 30+% decline in BlackBerry's North American smartphone market share since 2009), social media, and related consumer hardware/software (think iPad), can prove challenging for both strategic and financial buyers.

Faster category dynamics make the answers to how, how much, and when all the more important as the climb to recover from mistakes can be quite difficult. Business simulation with scenario planning can be an important tool to help buyers identify, understand, develop contingencies for, and value the various outcomes, upsides, downsides, optionality, and decisions they will face given category creation and evolution.

**Are there other ways to achieve the strategic vision? Is the strategic vision viable?** Strategic buyers can become fixated on a specific target or targets - "either we buy X or bust" - either overpaying to secure the target or fumbling going forward when the acquisition doesn't occur. It is very important for companies to think through multiple routes to reach their desired strategic vision. Having a "first choice" acquisition target shouldn't mean an "only choice" path to growth.



Strategic visions so narrowly defined as to allow only one or two acquisition targets with minimal alternative routes (e.g., joint venture, internal development) to achieve the vision may be unachievable given the probability of acquisition success. Viable strategic visions should (a) result in value creation for the firm and (b) be achievable via multiple paths.



**Is there a good cultural fit between the buyer and target?** It's a given that firms must learn to work effectively with people around the world; the locations of customers, suppliers, talent, and regulators necessitate a global perspective. Separate from this, the cultural fit between buyer and target organizations is very important for synergy realization and the

ongoing viability of the merged organization. The many facets to consider when assessing cultural fit include:

- **Business model** (e.g., product, service, "razor and blades", licensing)
- **Compensation and benefit systems** (e.g., variable pay, equity incentives, holiday/vacation/sabbatical policy, flexible hours and location)
- **Decision making processes** (e.g., hourly "2 minute management meetings to touch base", annual 1,000 page "Strat Package" review)
- **Financial** (e.g., frequency, quality, and time horizon of forecasts; project accounting)
- **Organization norms** (e.g., definition of business casual, class of air travel)
- **Organization structure** (e.g., matrix, global business unit, regional leadership)

**Does the acquisition move the needle?** This question is not an endorsement of large, transformational acquisitions over smaller, bolt-on acquisitions. Rather, this question is an endorsement of investing resources in deals that create material value for the buyer's shareholders.

**Do we have an integration plan and the talent to execute the plan?**

It is one thing to know how, how much, and when value will be created; it is another to achieve value creation. The detailed integration plan and the talent to execute it should be in place at deal closing. Buyers should be realistic about the quantity and quality of talent which will be necessary to achieve a successful acquisition integration that delivers synergies while keeping the pre-acquisition businesses of both buyer and target running smoothly.



**Do we have a clear, easy to communicate, rationale for the acquisition that important stakeholders will understand and support?** There are many stakeholders in an acquisition - investors, boards of directors, management teams, regulators, creditors, employees, customers, financial analysts, media, suppliers - several of whom can stall an acquisition or limit value creation should the acquisition proceed. The buyer should identify the most important stakeholders for a particular acquisition and have a rationale and method of communication that obtains sufficient stakeholder support.

**Conclusion**

In many business situations, the questions asked are as important, if not more important, than the answers given. This is particularly true in M&A, where many deals fail to create the desired shareholder value for buyers. Correctly done, M&A is a powerful tool that allows buyers to achieve growth, position themselves for the future, and create value for their shareholders.

Sincerely yours,

## Hal Craig

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