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Getting Due Diligence Right

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Effective due diligence is one of the most important tasks in negotiation and there are a few traps that deal makers must avoid

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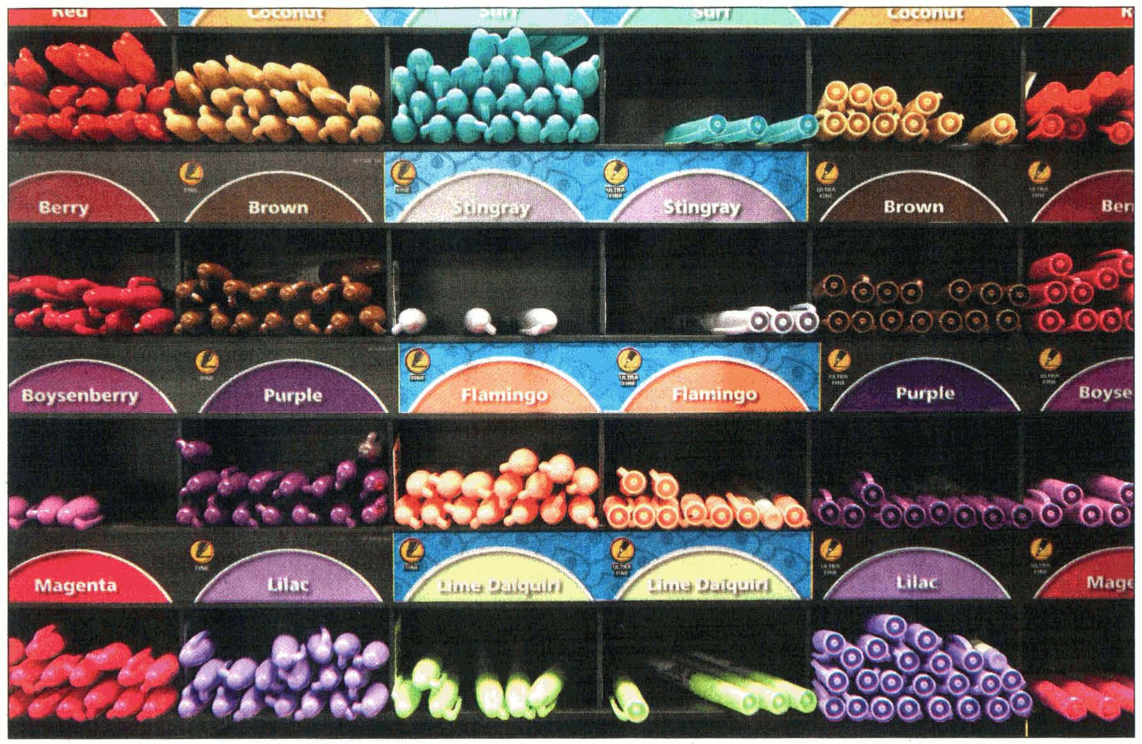

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True colours: *Newell Rubbermaid Sharpie markers sit on display at an Office Depot store. Under time pressure, Newell had raced through the due diligence process and failed to discover that Rubbermaid 'perfumed' itself*

AMONG the serially successful deal makers are Bain & Company, a top-tier private equity firm; Cinven, a leading European private equity firm; Teva, an Israeli generic pharmaceutical company; and Nestle, a Swiss conglomerate and textbook acquirer. These companies know how to avoid the traps of poor due diligence, have a disciplined due diligence process, and know how to create value through superior negotiation capabilities.

However, the industrywide record of creating value through mergers and acquisitions is poor. A study by KPMG International in 1999, for example, looked at shareholder returns on mergers relative to the performance of other companies in the same industry one year after the announcement of the merger. Using this commonly used standard of success, they found that "83 per cent of mergers failed to unlock value". Clearly, there are many reasons as to why deal makers fail to create sustainable value.

In this article, however, I will focus only on a few traps of due diligence that apply to all types of negotiations and how to avoid them.

Hubris

Hubris or overconfidence is a cognitive bias that can influence decisions. Overconfident CEOs, for example, are prone to information judgment error.

They believe that they hold more information than they actually have, consider their own information more valuable than external information, and make decisions based more on subjective judgment than on objective information. Consequently, they pay higher premiums for their deals and end up with more value-destroying deals.

Hubris also drives deal makers to overestimate the future benefits and underestimate the future costs of transactions.

A study by McKinsey & Company found that the average acquirer materially overestimated the synergies that come from economies of scale and scope, best practices, or sharing capabilities, and ignored dis-synergies arising, for example, from loss of customers.

In negotiation, what you do not know may be often more important than what you know. Thus, negotiators should restrain the ego and value more valid data.

Information availability bias

Negotiators tend to collect information from easily available sources and do not invest enough resources in collecting information from not easily available sources of information. Consequently, they make decisions that are based on a limited subset of information.

In contrast, effective deal makers, such as John Connaughton with Bain Capital, recognise the limited value of secondary and easily available information.

He said: "We throw away the secondary research and build our point of view from the bottom up."

Similarly, Cinven also builds its point of view from the ground up by using its own team of analysts to collect information from primary sources of information.

For example, prior to acquiring Odeon Cinemas, Cinven sent its teams of analysts to "hang out at the movies" and collect information from the field on each theatre site. It was not the typical "data room" analysis. This clearly gave Cinven a better understanding of Odeon.

In negotiation, valid information is king! Deal makers must be willing to invest resources in getting information from easily and not easily available sources of information.

Confirmatory bias and deal fever

Some negotiators fall in love with a deal well before it was analysed. Consequently, the rigour of the analysis is compromised by using optimistic assumptions and underestimating the downside risk.

But not Benoit Bassi, the managing director of Bridgepoint Capital in Paris. He never falls in love with the companies that he targets for acquisition. In a typical year, Mr Bassi reviews about 150 investment ideas and filters them down to just a few.

In a good year, he ends up acting on two good investment ideas. He does not hesitate to walk away even from the companies that initially seemed like great investments.

For example, after courting FruitCo, a European company for months and subjecting it later to a rigorous due diligence for several weeks, many worms were found. Mr Bassi walked away and killed the deal himself.

In negotiation, negotiators should restrain their pre-conceived beliefs and not fall in love prematurely with the wrong deal.

Time pressure

The more time a buyer has to investigate the deal, the more skeletons the buyer will find. Sellers, therefore, use time pressure to limit the due diligence process.

For example, Rubbermaid's executives gave Newell an exclusive right to acquire Rubbermaid, as long as the deal could be done in three weeks. Newell, which already fell in love with Rubbermaid, accepted the condition.

Under time pressure, Newell raced through the due diligence process and failed to discover that Rubbermaid "perfumed" itself: it stuffed its distribution channels by offering heavy promotions and deep discounts. It was only later that Newell discovered that Rubbermaid had a poor customer service record and weak management.

In negotiation, time has a strategic value. Negotiate realistic time frames for any task related to the negotiation, especially due diligence.

Narrow focus

In mergers and acquisitions deals, for example, the due diligence effort tends to focus on the past and the present of the four Cs of competition: customers, competitors, cost and capabilities.

The competitive analysis, almost exclusively, is limited to financial, legal, and operational issues. The critical cultural, human resources and strategically forward-looking issues take a backseat. For example, in 1998, Safeway, a leading grocery chain in the US acquired Dominick's, a regional grocer in Chicago for US$1.8 billion.

The strategic fit and synergy between them was questionable because the grocers are different. Safeway is a generic grocer focusing on store brands and disciplined cost management. Dominick's, in contrast, focused on prepared foods, in-store cafes, and product variety.

Once Safeway took over, implemented aggressive cost cutting measures, and introduced its private labels goods, Dominick's started to lose market share. Safeway could not resell Dominick's for a fifth of what it had paid.

Critically important cultural and human "soft" issues are also ignored, even though as a study of 125 mergers and acquisition between 1996 and 2000 and greater than US$1 billion suggested, cultural integration issues can make or break deals.

Successful deal makers clearly recognise that in negotiation, effective due diligence and comprehensive planning are perhaps the most important tasks which should never be underestimated. Complex deals are multi-dimensional and should be studied as such.

Perhaps a useful motto for effective preparation and planning is: "In God we trust. The rest bring valid data."

The writer is an associate professor of organisational behaviour and human resources practice at Singapore Management University and teaches negotiation. He is the author, co-author, and editor of several negotiation books, including his newly published 'Negotiation Excellence – Successful Deal Making'