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Ten Questions to Ask Before Pursuing an Acquisition

Corporate acquirers can benefit from asking the same questions private equity firms ask themselves before pursuing acquisitions.

Most mergers unfortunately fail. Looking at Quaker's purchase of Snapple or the merger of AOL and Time Warner, mergers regularly expose executives to insurmountable culture clashes, integration challenges, or even biases that make them fall in love with a deal and drastically overpay. As my colleague Jay Kim shows in **his research**, desperation can also make executives throw the kitchen sink at a deal, with dire consequences for the long-term plans of the business.

Corporate acquirers pursue acquisitions for many reasons from gaining access to complementary resources and capabilities to increasing their size and economies of scale; the hunt for synergies is the key term. Private equity funds on the other hand have a different mandate when it comes to acquisitions or investments. They have a clear end goal in mind: improve or transform the portfolio company and sell or exit the investment. The ability to exit is vital in Private Equity (PE) and the implied measure of success, makes for an interesting study for the benefit of all acquirers.

In the Private Equity elective, part of the INSEAD EMBA programme, we give the students detailed documentation of various acquisition opportunities and ask them to prepare a pitch for the investment committee of a mid-market buyout fund. When vigorous debate inevitably gets underway, we always find one key question bubbling to the surface: What's different about the way PE players approach a deal to the way corporate acquirers do; what can we learn from their ability to capitalize on the opportunities? As Graham Oldroyd, former Partner at Bridgepoint, and I argue in the class, PE players ask themselves ten questions in regard to every proposed acquisition. Corporate acquirers can benefit by asking themselves the same questions too. In the main, each will have similar desired answers. There are, however, some subtle but important differences. Many acquisitions are contested, and corporate acquirers may frequently find themselves competing against PE bidders. It is then helpful for corporate acquirers not only to ask the same questions but also to understand where there may be different considerations being applied by PE.

1. Why invest in this company?

PE buyer considerations: Can this be positioned as a compelling opportunity to investment committee colleagues and to investors in the PE fund?

Corporate acquirer considerations: Will this be compelling when described to the holding company board, key shareholders and other stakeholders?

2. Is this in line with the investment strategy?

PE buyer considerations: Does the investment fit the fund mandate? Is it in the right geographic region? Does the transaction fall within prescribed enterprise value and equity investment size limits? Is it in a target sector? Is it at the correct growth stage (start-up vs. early stage vs. growth or established business)? Is it a 'good to great' or 'turn-around' investment? Is there development potential and market opportunity? Is the management of the right quality? Having bought and developed the target company, will there be a ready exit through IPO or sale?

Corporate acquirer considerations: Does the acquisition fit or conflict with the acquirer's published acquisition strategy and/or previous statements by the Group Chairman or CEO to investors? If the acquisition takes the acquirer group in a new direction, can this be readily explained and justified?

3. Are reputational issues addressed?

PE buyer considerations: Are there reputational, ethical, environmental or other issues affecting the investment, and, if so, have they been priced in, and are they being fully, responsibly and satisfactorily addressed? Does the target carry out activities excluded by certain PE fund investors (e.g. armaments, tobacco, etc.)? Will the acquisition require Competition Authority or other regulatory or government approvals?

Corporate acquirer considerations: Are there reputational issues affecting the investment, and, if so, have they been priced in, and are they being fully, responsibly and satisfactorily addressed? Will this be seen to be the case by stakeholders? Are any risks so large that, however well managed, if things still go wrong they could potentially threaten the whole Acquirer Group? Will the acquisition require Competition Authority or other regulatory or government approvals?

4. What is the quality of the earnings?

PE buyer considerations: Is the current and projected future profitability on which the investment case is based sustainable? What is the extent of cyclical exposure? Does the target have earnings resilience, pricing power, sustainable competitive advantage?

Corporate acquirer considerations: As for PE, and: What synergy benefits exist and how certain are they?

5. Is there an opportunity for good returns?

PE buyer considerations: Is the expected purchase price reasonable and within relevant benchmarks? Is an appropriate level of debt funding available? Do projected potential equity returns meet PE fund requirements? Is the investment characterised by unlimited, strong potential upsides through multiple possible routes, and limited or moderated downside, or the reverse?

Corporate acquirer considerations: Is the expected purchase price reasonable and within relevant benchmarks? Will it be earnings dilutive or accretive? Is finance available internally or at a reasonable cost as new funding? Do returns depend on synergies? If so, how certain are they and how is the projected value shared between Acquirer and Seller? Will the acquisition block other expansion options?

6. Realism of plans and projections?

PE buyer considerations: Has the target company demonstrated past forecasting/budgeting accuracy; solidity of assumptions; contracted future earnings; cyclical exposure; quality of management, etc.? What is within the target company's control, and what is outside? Are there any key dependencies (e.g. suppliers, customers, third parties)?

Corporate acquirer considerations: As for PE.

7. Management?

PE buyer considerations: What is the existing management team's track record? Is the team capable of delivering the projected turn-around/revenue and profit growth, and running a larger, expanded business? Are there any existing gaps or team members leaving post-acquisition? Can these gaps be filled? Do key customer, supplier or other relationships depend on individual management team members? Is management ready to invest personally in the acquired company? Were any key functions fulfilled by the Seller, and, if so, how will these be handled once ownership changes?

Corporate acquirer considerations: What is the existing management team's track record? Do they share the same culture as the Acquirer? Is the team capable of delivering the projected revenue and profit growth, synergies, and running a larger, expanded business? Are there any existing gaps or team members leaving post-acquisition? Can the Acquirer cover this? Do key customer, supplier or other relationships depend on individual management team members? Were any key functions fulfilled by the Seller, and, if so, how will these be handled once ownership changes? Will management be happy with incentives in the Acquirer Group?

8. Exit opportunity, ease and timing?

PE buyer considerations: Having bought the company, how easily will the PE Fund be able to sell it at the end of the investment period? If so, when and how – IPO, trade sale, timing, etc.? Are there obvious future owners?

Corporate acquirer considerations: Is the aim to merge the acquisition with other Acquirer Group companies or run it as a free-standing entity? In either case, if the acquired business at some point in the future becomes non-core, can it readily be resold? Would such a sale expect to attract a premium or discount to the acquisition pricing?

9. Matters requiring further due diligence investigation?

PE buyer considerations: Do we know the company, the sector and the management? Have we taken references? What are the key assumptions underpinning the investment case? How can these be tested? Have potentially disruptive new technologies, market or regulatory changes been assessed? Are there any key customer, supplier or other dependencies? What are the potential 'left-field' risks? In addition to 'standard' due diligence (accounting, tax, pensions, commercial, legal, environmental) what specific further issues need investigation? Any potential issues under UK Bribery Act 2010 and US Foreign Corrupt Practices Act 1977?

Corporate acquirer considerations: As for PE.

10. Competition to buy the business?

PE buyer considerations: Do we know competing bidders? Can we expect to win, and will the Seller sell at the purchase price assumed?

Corporate acquirer considerations: As for PE

So what can corporate acquirers learn from the way PE firms execute acquisitions? In summary, given that PE firms are directly measured by and succeed or fail based on their investment performance, they are more selective about the acquisitions they make and more financially disciplined post-acquisition. They're also more open to the type of acquisition as long as there is clear potential for the target, whether in growth, turnaround or development potential. Given the importance of making an exit, PE firms are focused on immediate improvements and are willing to invest in making such improvements; culture is less important as long as the management shows potential.

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