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MIND THE GAP

Accelerate M&A Returns by Neutralizing Three Insight Gaps

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Every experienced practitioner in M&A can relate at least one cautionary tale of a deal gone bad, an acquisition that was transformed overnight from a synergy machine into a toxic spill. In some cases, the acquirer ignored alarms that should have become deafening, brushing aside concerns as warrantless fears. Just as often, though, the acquirer implemented an appropriate acquisition process, but failed to adjust for the limits of that process.

All humans are vulnerable to these limitations, because we see what we see. Too often, we fail to search for The Missing Guest, the factor or information that should be there, but isn't. As the flow of data turns into a flood, it is particularly counter intuitive to ask for more. Once we've decided which information we will collect, though, we have also made a largely unintentional decision about what we will ignore.

Three insight gaps are firmly embedded in the acquisition process itself. These gaps are particularly challenging, because the due diligence process can convince a buyer, wrongfully, that the gaps have been closed. This misperception is always aided, of course, by confirmation bias - the tendency to interpret information through a filter that supports our pre-existing perceptions/goals/needs.

The Seller's Secret

The first gap is the best known, although there is a large difference between the number of people who recognize the issue and those who address it effectively. This gap is the simple fact that the seller always knows more about what he is selling, and why, than the acquirer knows about what he is buying. Hidden weaknesses, looming threats and the daily tap-dancing that keeps the wheels moving can be invisible to the buyer and often undiscovered during due diligence.

At one client company, for example, the president of a large division was a great operator and a poor mentor. Rather than teach his team how to schedule production, he shuffled the deck of orders himself each week. When he left the division, production efficiency plummeted and orders were delayed. At another company, the founder had a close relationship with a major customer, but that customer was about to hand over the reins to his son. The son had a less favorable view of the vendor than his father did, which made the tenure of the account less likely than the owner believed.

In both of these examples, the risks would probably be missed in a normal process of negotiation and due diligence. This doesn't suggest fraud on the part of the seller. Especially if

the seller is also the founder, many of the idiosyncrasies of the business might seem to be normal practice. Even when seller recognizes an issue that is outside the norm, he is unlikely to describe it in terms that might scuttle a deal.

Due Diligence Limitations

The limits of due diligence create the second insight gap. Due diligence is essentially a risk management tool. Even when customers are interviewed in advance of a transaction, the process seeks to identify potential loss and, less frequently, fraud. Due diligence does little to assess core competitive competencies of the target company, especially as those competencies are seen through the eyes of key customers.

Due diligence, like an audit, is often backward-looking and risk-focused, while the post-acquisition emphasis will be forward-looking and opportunity-focused. Too frequently, acquirers will accept the due diligence conclusions as more all-encompassing than is, in fact, the case.

Due diligence might fail to identify the true source of customer retention and loyalty, product/service components that deliver customers to the highest value opportunities, counterproductive incentives for employees, and legacy products that only appear to make a contribution to profitability, among other issues. While the review might confirm the patterns of order flow, the question of why is frequently The Missing Guest of due diligence.

Corporate Myths and Legends

The third and most confounding of the insight gaps is misperceptions held by the seller. While the seller will know more than the buyer about the company in play, the seller will almost invariably hold beliefs about the company that are simply wrong. If the seller is the founder, these might be perceptions from the time of the company's founding; even though the reality is much different for customers and operations originated in the past several years. At times, the seller and executive team that meet with the acquirer will share beliefs that flow from a business that does not exist today.

In a recent engagement, a client expressed the view that customers recognize his firm as the low-cost provider and feel secure with the knowledge they will reduce total costs by working with his team. Interviews with customers failed to confirm that hypothesis, however, and we learned that loyalty and referrals flowed from other sources. Armed with this insight, the client could reorient sales scripts, web content, targeted customer groups, employee incentives and other tools for acquiring and retaining clients. Without this insight, the client and anyone who acquired his firm would achieve lower growth and retention than customers were willing to offer.

The fact that the selling group holds some skewed perceptions does not necessarily pose a major threat. Often, the differences are relatively minor or the beliefs are true for the customer group (larger, longer established) most likely to get the attention of senior management.

It would be overreaching to suggest that a seller is out of touch with reality. However, there is almost always a disconnect between the perceptions held by long-term staff members and less - tenured employees. Often, significant cultural differences might separate the senior team from the staff below. Thus, when the senior management team meets with the acquirer's team and explains how the business works, it might not be obvious to anyone in the room that inaccurate - but fully believed - assessments are being delivered.

ROI Reduction Process

Combined, these three insight gaps can create a significant gap for the new owner of a business. The acquirer will have internalized inaccurate beliefs about the company, believe more insight has been obtained independently than is truly the case, and rely on a management team that might, itself, be the source of misperceptions.

Keeping the former management team in place does not close the gap, because the retained leaders will be unaware of their own misperceptions. Their insight gaps might prevent them from bringing the company to the next level - and getting to the next level is the source of ROI for the acquirer. To paraphrase Green Bay Packers legend Vince Lombardi, that's not the most important thing. It's the only thing.

Post-closing Assessment Tools

Acquirers can reduce the impact of these insight gaps by conducting a post-closing assessment that identifies the missing pieces and creates a rapid and corrective response. This rapid response can preempt the disappointing stream of surprises and detours that can follow any transaction.

The key for successful acquisitions is to implement the assessment immediately after the transaction closes, minimizing the likelihood that the insight gaps will create problems. Any assessment must address the issues that will drive return on investment on a sustainable basis. In the Quadrant Five process, for example, we focus on the answers to three critical questions:

1. What does the company do better than its competitors? Competitive strength and profit potential come from the differences, not from the commonalities with competitor offerings. By identifying the true sources of competitive advantage, the acquirer can narrow the focus for strategic initiatives or investment.

> **2. Do A-list customers believe the company excels in these areas?** A-list customers are the ones who could or should be responding to the competitive edge. These might not be the largest customers today, but they will be the ones with the strongest potential for profitable, sustained growth and reduced turnover. If they don't believe the competitive advantages are real, the management team is either mistaken in its beliefs or ineffective in communication.
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> **3. If the A-List customers believe it, will they pay for it?** Payment can come in the form of a premium price or a larger share of the customer's orders, higher retention rates or faster payment. Whatever the form of payment, this is the return that the company seeks from its competitive edge.

Implemented effectively, a post-closing assessment will identify the strongest opportunities to be tapped and to reveal any misperceptions that limit the company's potential to capitalize on these opportunities. The insight gaps will be covered as the acquirer achieves three key goals:

1. Identify the hidden insights or drivers that the seller understood far better than the buyer before the transaction closed.

2. Shift the research/assessment process from risk management (due diligence) to sustainable, profitable growth.

3. Avoid unprofitable investment or dead-end initiatives that can result from any misperceptions shared by the management team still in place at the acquired company.

In the best of cases, the acquirer will learn that all is well, no hidden issues are about to surface in the post-closing environment, and the management team is truly in touch with all the critical issues. In tougher situations, the acquirer will gain valuable insights immediately, rather than suffering through on-the-job training in defective operations.

Either way, the post-closing assessment is a relatively inexpensive way to preempt problems and accelerate returns. Insight gaps cannot be avoided in the acquisition process. They are innate components of both human nature and negotiation, which means they are always to be expected as potential roadblocks. When acquirers recognize that these gaps exist, however, it is a relatively simple process to identify and overcome the challenges, and to both assure and accelerate the rate of return.

About the Author

Michael Rosenbaum is founder of Quadrant Five (www.q5works.com) and a highly experienced consultant to corporate management teams. His newest book, Six Tires, No Plan, chronicles the life and management style of Discount Tire Company founder Bruce Halle.

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