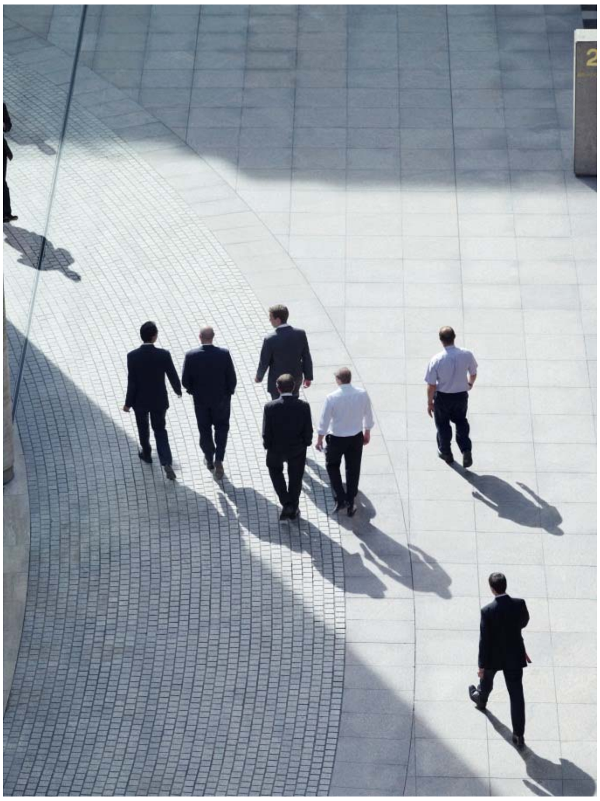
Unlocking the M&A value through commercial & operational due diligence

Consulting analysis



www.pwc.hr/consulting

In times of economic and business uncertainty several types of companies can be distinguished; those that face the crisis unprepared and generally lose their market share, those working on their restructuring and internal efficiency in order to defend their profitability, and those that think about ways, and are able to take advantage of the crisis for better positioning and growth. Such companies, having a clear strategy and vision of their position in the long term, often use the market crisis for further growth and consolidation through acquisitions.

When a corporate client, "private equity" fund or a third party considers acquiring a company, it often enters into a due diligence process. Depending on the market complexity and the target company, the due diligence may include various components such as a financial, commercial, operational, tax, legal, technical and other due diligence, depending on industry specifics.

Since nowadays the investor's focus is mainly directed towards the financial and tax aspects, the commercial and operational due diligence is often unjustifiably omitted. This is caused by the investor's perception that he has sufficient information about the company's business operations and market conditions. As a result, there may be a risk of an inadequate valuation or incorrect understanding of the target's direction in its market environment. Additionally, in the case of acquisitions that extend beyond the investor's domestic market to new geographical areas or parts of the value chain, it is critical that the investor gets an understanding of the trends and opportunities that these markets offer and how they will affect the target's performance and profitability. It is also common practice for the new management of a company to request a due diligence in order to familiarise with the entity as soon as possible.

During the transaction process, it is necessary to have a clear understanding of the market dynamics and the consequences it may have on business operations. Safe investment decisions are made only after gaining maximum understanding of the business context in which a target company operates.

It must be emphasized that external factors often affect a company's revenues and profitability more strongly than factors that can be interpreted using empirical (historical) financial indicators. As a result, the commercial aspect provides a deeper insight into a company's operations and adds significant value to the investor.

During the transaction process, it is necessary to have a clear understanding of the market dynamics and the consequences it may have on business operations. Safe investment decisions are made only after gaining maximum understanding of the business context in which a target company operates. Knowing the risks that affect or may affect business operations is a key component in the success of the transaction process, which is often full of non-transparencies.

While the commercial due diligence primarily relates to the market environment and competition, the operational due diligence focuses on internal performance indicators, particularly in the domain of technology, people, processes, efficiency of the organisation, the operating model, etc. On the other hand, the identified potential synergies or cost reduction opportunities in the due diligence process give the investor insight into the company's future potential.

Due diligence assignments are usually quick and intensive projects, which in the entire transaction process have duration of one to two months. Depending on the depth of the required analysis, activities may include the following:

- insight into the company management profile
- analysis of the specifics and trends of the overall market and individual market segments
- analysis of the company position in the value chain
- strategic analysis of the competition
- sustainability of the current competitive advantage (direct impact on revenues)
- insight into strategic market opportunities
- benchmarking with similar industry players
- analysis of revenue and profitability drivers
- analysis of customer/user profiles and satisfaction
- productivity or performance of parts of the organisation compared to the industry average
- synergy potential or room for savings
- testing the attainability and the reality of the business plan (direct impact on valuation)
- insight into the risks affecting the achievement of business plans and identifying risk mitigation activities, etc.

In case investor requests financial and commercial projections, besides pure historical data, they must be based on elaborate inputs arising from the commercial and operational analysis and understanding of market trends impacting target dynamics, and as such they can directly affect the valuation. The impact on the valuation of the target based on the stated inputs is sometimes measured in multi-million amounts, depending on the size of the transaction. Additionally, depending on the availability of information, the due diligence process reaches into the depths of business operations where potential opportunities and risks of the transaction are trying to be identified. Risks might be identified from the tax, financial and legal due diligence aspect and as such they are embedded in the SPA (Sales and Purchase Agreement).

The fees that investors allocate for the due diligence in the entire transaction process are marginal compared to the transaction value, since the results of a comprehensive due diligence can greatly reduce the risk of making wrong investment decisions and greater adverse financial effects. Thereby, investors should realise multiple returns on investment (ROI) which they gain with the commercial and operational due diligence services.

Commercial due diligence inputs can impact valuation result in multi-million amounts, and significantly influence investment decision. Thereby, investors should realise multiple returns on investment (ROI) which they gain with commercial due diligence services

Case Study Example

Commercial due diligence stream had a task to provide midterm forecast on target and market performance. Based on historical dynamics, target performance projection was just a bit below official Management business plan which was provided to bidders. Once commercial and operational due diligence team finalised analysis of the recent and upcoming market developments it was clear that target's Management made several poor business decisions which will negatively impact market share and performance in upcoming period. With that insight, valuation team adjusted company's value and provided investor much more clear picture and standpoint on investment decision.

Our regional due diligence and strategy consultants with deep previous experience in some of the regional leading companies can enable rapid diagnosis of key deal issues. Each member of the team can draw on the extensive expertise and the resources of PwC's worldwide industry networks.

We regularly work alongside our financial due diligence teams to share findings and conclusions. As a result, PwC's conclusions are based on well-researched and integrated views on all aspects of the transaction.

For further information please contact:

Dejan Ljuština

Director, Consulting Leader

Phone: +385 1 6328 888
Mobile: +385 91 4920 782
e-mail: dejan.ljustina@hr.pwc.com

Mislav Slade-Šilović

Senior Consultant, Strategy & Operations

Phone: +385 1 6328 888
Mobile: +385 99 2671 877
e-mail: mislav.slade@hr.pwc.com

www.pwc.hr