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Operational Due Diligence

Value found – Value delivered

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Executive summary

Operational due diligence is a bespoke, continuous and iterative process of formulating and testing the investment thesis in an effort to co-create an actionable value creation plan. As a primarily forward-looking and opportunity-focused process, operational due diligence therefore complements other risk-oriented forms of due diligence to maximize the return on M&A investments.

Some key words in the above definition need further elaboration:

The primary objective of operational due diligence (ODD) is to provide input for the value creation plan. The scope of an ODD is therefore by definition bespoke, as each deal is unique. The scope is tailored to the rationale, structure, industry and company-specific operational risks of the respective deal. There is no standard set of procedures in a typical ODD, unlike the fairly uniform scope and process of financial due diligence (FDD) or legal due diligence (LDD).

ODD is a continuous process, which does not stop at the end of the due diligence phase. Operational due diligence procedures begin during the target selection phase and continue throughout the deal cycle, up to and including the first 100 days post-closing. Whereas FDD and LDD findings offer key inputs for further negotiations and the SPA draft, it is essential to continue processing ODD findings in the value creation plan as more access is granted. This will help secure buy-in from the management of both the target and specialist division.

The iterative aspect relates to the hypothesis-based approach used in ODD, responding to the question, "How can we best create value with this transaction?" An ODD starts with a hypothesis, which is tested and reformulated until it reaches a conclusion. ODD demands creativity, relies on multiple information sources and allows for interaction between stakeholders. An inductive and iterative approach will achieve the best results, with a focus on providing actionable insights that are presented in a concise equity story.

Developing an effective value creation plan requires co-creation rather than a report authored by the buyer's advisors alone. In testing the investment thesis, the ODD team needs to work closely with the management team responsible for implementing the plan post-closing. A proper value creation plan comprises:

- a prioritized set of value creation opportunities (synergies and stand-alone performance improvement initiatives), as well as

- a plan of action, describing how to capture the upsides and to mitigate the execution risks.

Commercial due diligence (CDD) assesses how attractive the target's market is and how strong the target is at present compared to its competitors. As in FDD, the as-is assessment of CDD provides important input for ODD in response to the question, "What do we need to change about our operations to create more shareholder value?" Translating these facts into an action plan is at the heart of ODD and what makes it a forward-looking process.

ODD can help buyers see their risks through a different lens – if they take a balanced approach. When risks are well understood and managed, it can inspire buyers to leverage opportunities for growth. On the flip side, every opportunity will pose certain risks. Operational due diligence can help stakeholders see both sides of the coin. In the current competitive M&A market, deal teams need to strike a balance between an issue and a risk-based approach to due diligence, focusing on identifying and substantiating the upsides. ODD as part of the overall due diligence process changes the lens from 'due diligence to lose' to 'due diligence to win'.

The above definition calls for a comparison of ODD with other forms of due diligence, such as financial, tax, commercial and legal due diligence, which are focused on establishing the existing economic value of the target and on defining the terms for the Share Purchase Agreement (SPA):

Tab. 1 – Overview Due Diligence Types

	FDD, CDD, Tax DD, Legal DD	ODD	Chapter of this thesis
Orientation	Backward-looking	Forward-looking	1. Main objectives of ODD
Objective	Protect value	Create value	2. How companies create value through M&A
Focus	Risk-focused	Opportunity-focused	3. How to balance risks and opportunities
Process	Completed process	Continuous process	4. How does ODD fit into the M&A process
Scope	Standardized	Bespoke	5. Breadth and depth of ODD
Who	Independent	As co-creators	6. Roles and ownership
How	Sequential	Iterative	7. How to perform an ODD

Based on the above description, ODD comprises: 1) the development of a value creation plan, 2) un-biased advice on the strategic fit of the transaction and 3) efforts to obtain buy-in from target management. The entity integrating or acquiring the target company bears responsibility for a robust ODD, but that is impossible without involvement from target management. External ODD advisors can provide additional specialized expertise and significantly increase the quality of the operational analysis, but they are no substitute for the required ownership.

Main objectives of ODD

The term due diligence is used by the M&A industry in a broad sense and can cover financial, legal, operational, commercial, tax, HR, IT, pension and technical issues. The scope of a due diligence investigation varies, as many internal and external factors influence the depth and breadth of due diligence, such as:

- availability of information in the data room
- existing acquirer's knowledge of the target company
- estimated risks and risk appetite
- time available for due diligence
- restrictions on data sharing imposed by competition authorities

Due diligence findings are typically used to shape the following deal documents:

"The basic function of due diligence is to assess the benefits and liabilities of a proposed acquisition by inquiring into all relevant aspects of the past, present and predictable future of the business to be purchased."

According to "The Art of M&A" by Alexandra Reed Lajoux (McGraw-Hill Education, 1989)

Fig. 1 – Due Diligence Focus Areas

Investment thesis	Valuation	SPA	Integration plan
Scope, area, breadth, depth			

focus ODD (dotted boxes: Investment thesis, Integration plan) focus FDD, LDD (solid boxes: Valuation, SPA, Scope, area, breadth, depth)

Looking backward

Financial due diligence is an assessment of the current financial position of the target. As such, it might indicate that the target exceeded its sales goals for the previous two years. It would also explain that this was due to market improvements, or because flaws in the company's sales process produced incorrect sales projections. Financial due diligence is primarily backward looking and provides a detailed assessment of the current situation as well as input for the valuation and price mechanisms in the SPA.

Buyers conduct legal due diligence to assess the legal status of the business by exploring all relevant legal issues at that time. It would include any outstanding claims relating to ownership, pending legal actions, outstanding rulings, liabilities, employee actions, insurance claims, intellectual property rights, professional licenses and so on. Legal due diligence is key for drafting the share purchase agreements (SPA) to ensure that the buyer will indeed become the legal owner of the target company he believes is for sale and to provide protection against known liabilities.

Similarly, tax, HR, IT, pension and technical due diligence are largely focused on looking backward and understanding how the business is performing at present based on its past performance.

Looking forward

Identifying operational weaknesses and risks can often provide good reasons for investing. If, for example, you identify that the target business has a weak sales structure, the investment plan could include providing additional funds for the sales department after the acquisition. If the sales team is only strong in a certain region, merging with a company that has a national footprint might unlock significant value. It is the task of the ODD to identify unrecognized potential in the target business.

ODD procedures focus on assessing whether a business is capable of sustaining its operations into the future and on outlining the actions and investments that are needed to accelerate business growth. The ODD provides a roadmap to delivering positive returns on the M&A investment.

Conclusions

The objectives of an ODD are to:

- Assess whether the target's operations are sustainable over the long term, without additional investment on top of management's business plan
- Identify those actions and investments that the target management has not yet discovered or considered and that will accelerate value creation moving forward
- Advise the deal team on the strategic fit of the proposed transaction
- Help secure buy-in from all stakeholders for the proposed changes

While financial, tax and legal due diligence provide the basis to assess the current economic value and to draft the SPA to protect the purchase price, ODD is more forward looking and responds to the question, "What are we going to do with the target when it becomes ours?".

Example

Valued at $47 billion based on its latest funding round, WeWork became one of the world's most valuable private companies in 2019. Public investors were ultimately reluctant to invest, and the WeWork IPO failed, resulting in an 85% value impairment for the main financial sponsor Softbank. What went wrong?

Basically, WeWork engages in ‘rent arbitrage’ by signing long-term leases at one rate, generally for 15 years, and then subleasing the space to SMEs and enterprise members for shorter durations. While the cost per desk is lower for members, the higher density means that WeWork receives a higher aggregate rent for the space. This practice obviously creates a duration mismatch, which leaves WeWork exposed to market fluctuations in the event of a downturn. With the relatively short terms of the subleases, WeWork bears the risk that tenants might abandon the space on short notice and leave WeWork liable for the master lease obligation. They are also exposed to the credit risk of the SME subleases.

A significant advantage of the WeWork business model is the fact that even though tenants are crammed into smaller spaces, WeWork maintains they pay lower costs overall for their space services. The lower rent expense for tenants is one of the key drivers of the business model.

However, the downside to the WeWork business model is that it is expensive. The cost of providing the space is significantly higher than that of a traditional office. There is also the higher cost of the physical improvements to the space to provide the signature WeWork look. Industry estimates indicate that the aggregate rent for WeWork has to be roughly twice the market rate for the entire subleased space to cover the increased operational costs and the non-economic space of the communal areas.

So, does the business model make economic sense when compared to the traditional office market analytics? The Company has been losing money at the same rate as its top line revenues are increasing. WeWork has never been profitable but Adam Neumann (founder and ex-CEO) points to Amazon and the years it took for them to cross over into profitability.

WeWork focuses on different metrics to track their performance. The first important metric WeWork tracks is the growth in new membership (desks rented). This is akin to the concept of ‘eyeballs’ or ‘clicks’, which tech companies use on the theory that the more views you have, the more likely you are to make a sale. Indeed, Neumann has put WeWork on par with tech companies in corporate presentations due to their incredible growth in memberships.

Neumann claims that WeWork’s model is ‘asset light’ and that they are service providers more akin to Uber or Airbnb. Based on its membership growth, WeWork believes they will achieve scale and become the dominant global leader in the co-working space. He believes the WeWork brand will be the default choice for global enterprises requiring multiple locations and increase the value of the buildings WeWork occupies.

However, unlike Uber or Airbnb, WeWork has assets – lots of them. It has leases or assets valued at roughly $15 billion and rental obligations or liabilities at about $18 billion, which basically offset each other. More importantly, the company has approx. $7 billion in property and equipment, from desks and chairs to copy machines, barista equipment and more.

Companies like Uber and Airbnb do not have the corporate overheads that WeWork does. Uber works with drivers as independent contractors and Airbnb does not own the properties rented on its platform. In contrast, WeWork employs thousands of people who provide numerous services. They have employees on-site and at their corporate headquarters directing new acquisitions, overseeing the tenant improvements and managing the actual operations at their facilities. Providing consistent, exemplary service to the clients is a really difficult, time and resource-intensive endeavor. Just ask any hotel manager. While staff are not technically assets, they represent a significant expense not found on the balance sheet of a typical tech firm.

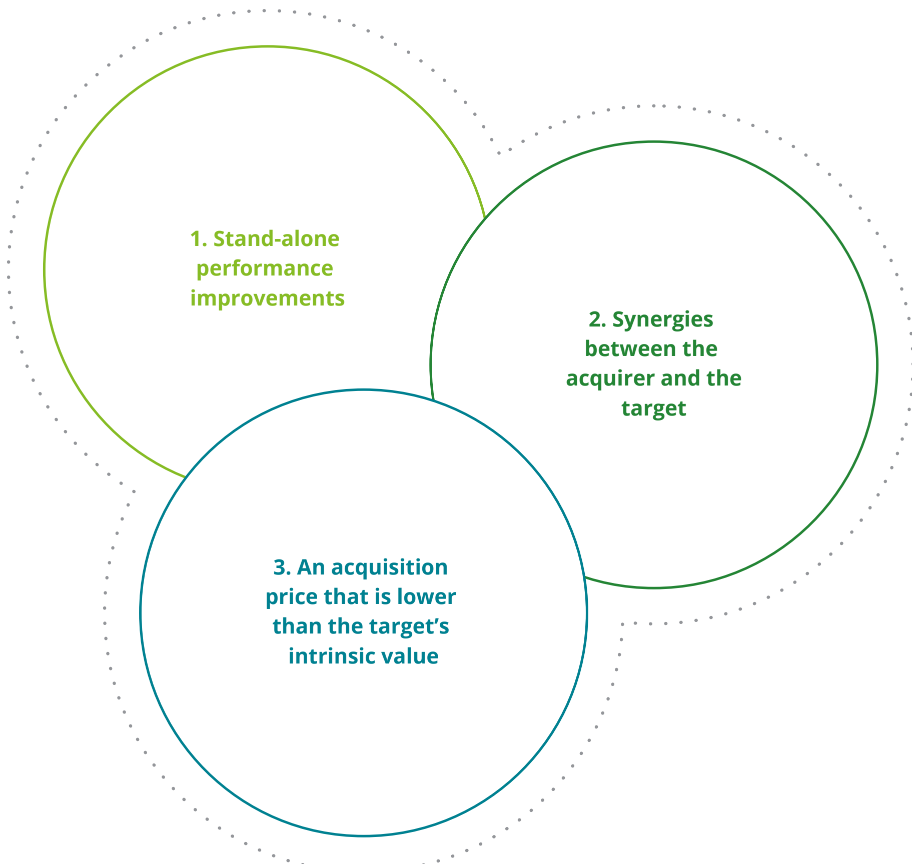
Operational due diligence could have revealed the true economics of a business like WeWork and the flaws in its KPIs. ODD would also have provided Softbank with guidance regarding a more rational value creation plan.

How companies create value through M&A

1. Stand-alone performance improvement

Generating value through initiatives to improve stand-alone performance is an avenue typically exploited by private equity, but which is also available to strategic buyers. Improving the target's performance beyond the business plans of the existing management requires a holistic approach. This not only has to cover all four financial value drivers of equity value (see graphic), it must also strike a balance between short-term actions and long-term value drivers to secure the company's future.

Fig. 2 – From the acquirer's point of view, a transaction can create value through

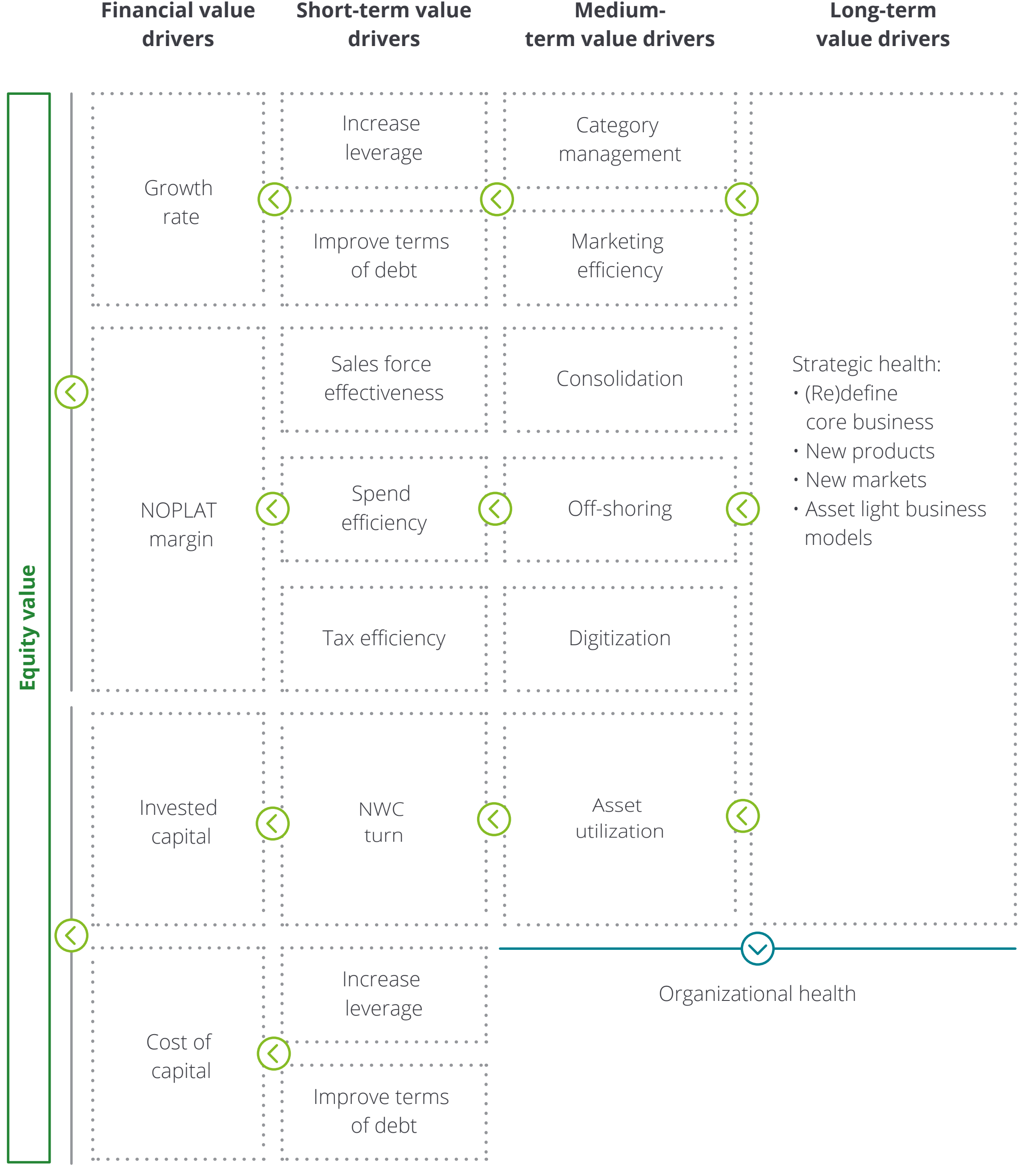


Short-term value creation
During the first year of ownership, acquirers typically seek to improve business performance and generate cash to fund more structural improvements with the following initiatives: enhanced pricing and sales force incentives to push the topline, cost base rationalization, improved inventory turns and shorter average DSOs as well as re-financing options to reduce the cost of debt. Our private equity clients in particular use financial disciplines and proven tools to secure these benefits.

Medium and long-term value creation
The medium to long-term initiatives typically generate significant returns but are more difficult to capture. In order to safeguard the target's structural health over the long-term, acquirers need to align the more fundamental changes to the operating model with the long-term strategy.

Deciding on the sequence of initiatives and the risk profile is one of the deal team's key responsibilities during the operational due diligence process.

Fig. 3 – Overview Value Drivers



2. Synergies between the acquirer and the target

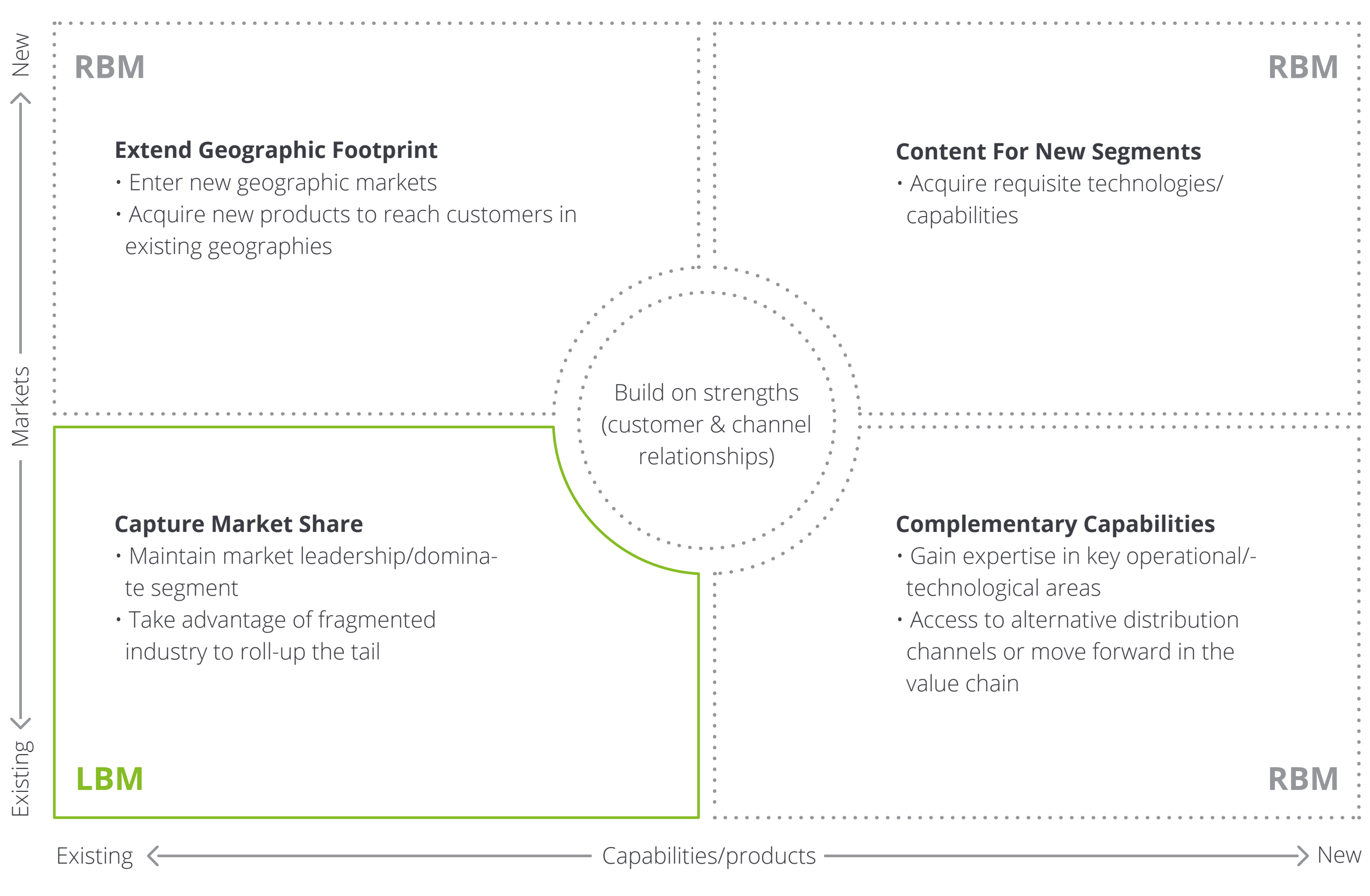
Broadly speaking, there are two strategic motivations for a merger. The most common is to boost the acquirer's current performance in terms of capabilities and products, which will help the company either to maintain its premium position or to cut costs.

The second reason to acquire a company is to accelerate growth by entering a new market or to gain expertise from the acquired company and reinvent the parent business model (Christensen, 2011). See also the M&A strategic gameboard below and the two strategic reasons marked in two shades of blue.

To correctly select, price and integrate acquisitions, acquirers need to understand the strategic rationale behind the acquisition. The best way to achieve this is to think of the target in terms of the customer value proposition, profit formula, resources and processes.

Under the right circumstances, acquirers can extract resources from an acquired company and plug them into the parent's business model to boost performance. Resource-focused deals like these are called "leverage my business model" (LBM) acquisitions. A different strategy to grow the business involves buying another firm's business model, operating it separately and using it as a platform for transformative growth. We call this a "reinvent my business model" (RBM) acquisition.

Fig. 4 – M&A Strategic Objectives Gameboard



Deals to boost the acquirer's current performance by cutting costs or maintaining a premium position

Deals to accelerate growth by entering new markets or reinventing the parent's business model

"Leverage my business model" (LBM) examples
When ASML, a manufacturer of lithography machines, acquired HMI, the market leader in wafer inspection technology, the deal offered nice cross selling synergies. It also secured vital technological expertise and a team of dedicated HMI engineers for ASML's continued quest to produce more patterns on silicon at nanoscale and maintain its leading market position.

The market consolidation strategy pursued by Dutch grocery retailer Jumbo in 2009 involved first acquiring Super de Boer, and then later C1000 and Emté. This demonstrates the power of M&A in markets where fixed costs are key (for grocery retail: store rent, transport, distribution center costs, marketing and branding).

"Reinvent my business model" (RBM) example
Oil majors like Shell and Total are considering entering the utility market in order to disrupt their existing oil-based business models and ride the wave of electrification.

Tab. 2 – Deal Types

Deal type	Strategic reason	ODD Focus area
LBM	Acquiring resources to command premium prices	Unique technology and ability to maintain critical staff
	Acquiring resources to lower cost	Compatibility of resources (input and processes)
RBM	Accelerating growth by entering a new market	Quality of product and market position relative to peers
	Acquiring to learn and reinvent parent business model	Unique business model and ability to preserve

Conclusions
Companies turn to acquisitions to meet goals they cannot achieve internally. But buying another company is not a magic wand:

- Companies can acquire targets that allow them to command higher prices, but only for the same reasons that they could have raised prices all along: by improving products that a majority of customers feel are sub-par.
- Companies can acquire targets to cut costs, using excess capacity in their resources and processes to serve new customers, but again, only to the extent that they already could have done by finding new customers or increasing capacity on their own.
- Companies can acquire targets to gain new business models that provide a platform for transformative growth, which they could have developed in-house.

At the end of the day, the decision to acquire depends on whether it would be faster and more economical to buy something that you could, given enough time and resources, make yourself. With mergers you buy more time, but you are only buying time if you are able to maintain the know-how, resources or business model the target company is offering in the post-deal period. Acquirers should therefore plan the scope of an ODD to focus on assessing whether the target does indeed have valuable resources, know-how or business models and whether they can sustain them post deal.

The scope of an ODD investigation should also be geared toward testing the investment thesis, which requires a deep understanding of how to create shareholder value with the proposed transaction, either standalone and or through synergies.

How to strike a balance between risks and opportunities

As discussed in earlier chapters, the objective of most forms of due diligence is to protect value and keep deal risks within an acceptable range. We can see this as a 'play not to lose' focus. Based on many stories of failed mergers and declining post-deal earnings from avoidable corporate missteps, risks are considered a negative that must be managed.

This is, of course, true, but it is just one side of the coin. Risks, such as the allure of disruptive technologies or the potential in an aging population also represent business opportunities that can become a competitive edge. In fact, companies that take risks tend to prosper, but they can lose money if they fail to properly manage these risks.

Balancing risks and opportunities
Being able to see both risks and opportunities is like being able to see both the vase and the two faces in the optical illusion on the right.

To cultivate the ability to recognize both risks and opportunities, companies need to change their due diligence mindset and their ideas about the type of analysis required.

Regardless of whether an acquirer is focused on protecting deal value or winning the deal, taking a structured approach to mapping, quantifying and managing deal risks and opportunities is essential for good deal-making. Finding the balance between risks and opportunities, or vice versa, follows a logical order:

- Identifying risks and opportunities
- Managing risks and opportunities
- Evaluating risks and opportunities

1. Identifying risks and opportunities

Risks are often placed into four categories: strategic, operational, reporting and compliance. They tend to vary from deal to deal and can be identified in different ways (e.g., learning from the past, learning from others, market scanning, scenario planning, etc.).

Opportunities are typically grouped into two categories. Opportunities within the organization, e.g., supply chain optimization and improved service offerings, and opportunities outside the organization, e.g., shifts in customer behavior or changing legislation.

2. Managing risks and opportunities

During the due diligence phase, deal teams develop a comprehensive inventory of the key risks and an initial view of the opportunities. A structured approach to assessing the magnitude of risk and opportunity is often lacking, as is the ability to identify ways to mitigate those risks.

Risk appetite is generally defined as the amount of risk exposure or the level of adverse impact that an organization is willing to accept. Once the acquirer has reached its risk appetite threshold (also known as risk tolerance), negotiations around various deal mechanics can bring the exposure back within the accepted range and match risk exposure to risk appetite. Risk appetite can also be described as intelligent risk taking, coupled with disciplined risk management.

The ability to quantify potential benefits and impacts is particularly relevant for understanding, measuring and managing risks and opportunities. Often when risks are well managed, opportunities that initially appear too risky become more attractive. In addition, companies with experience in M&A understand that the better you are at identifying and mitigating risks, the more likely you are to capture opportunities that target management or rival bidders cannot.

As a rule, we can use traditional methods to assess the potential benefits of opportunities (e.g., the projected increase in market share or profits from increased economies of scale). Measuring risks is a five-step process:

- Quantify the risk impact
- Assess the probability of risk impact for the company
- Quantify this impact on the combined group (Impact) x (Probability)
- Analyze the cost/benefit of mitigating actions
- Rank risks according to priority to understand which are most critical

3. Evaluate risks and opportunities

As part of the deal process, acquirers have multiple options to mitigate risks, such as risk sharing (e.g., agreeing to structure the deal as a joint venture, rather than a full share purchase), transferring risks (e.g., through RWI insurance) or reducing risks by becoming more agile in responding to risks (e.g., by ringfencing or separating high-risk activities from the combined group).

Conclusions

Finding upsides above and beyond the target management's business plan can make or break the prospect of winning the deal. Earlier, we described this as 'due diligence to win', a strategy with the explicit goal of unlocking value upsides not seen by others as a justification for raising the bid for the target company. When our clients have a 'due diligence to win' mindset, they understand that they have to invest in changes to the technology, products and business model beyond what target management believes is achievable. These changes come with additional risks for deal implementation.

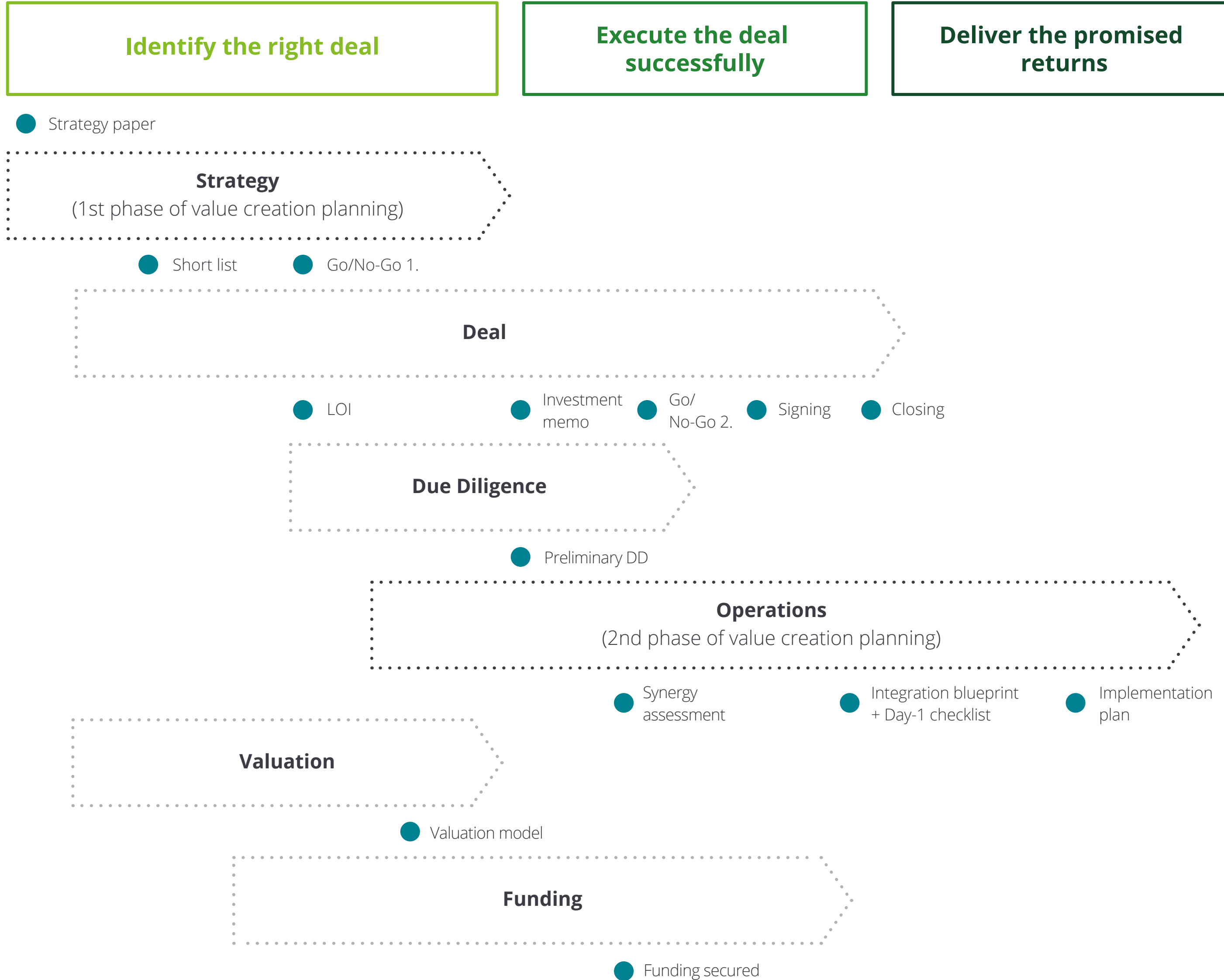
Fitting operational due diligence into the overall M&A process

The term “due diligence” is used by lawyers to indicate the period between signing a Letter of Intent (LOI) and signing the SPA draft. In practice, due diligence starts the moment that a buyer even considers a deal.

In this chapter, we outline the entire end-to-end M&A process. It starts with Phase 1: Identifying the right deal, which comprises M&A strategy development and target screening. Based on the results of the target screening, the buyer signs a LOI, which triggers Phase 2: Executing the deal. This phase includes the due diligence process and results in a Share Purchase Agreement (SPA), which triggers Phase 3: Delivering the promised returns from the deal.

As we describe the 3 phases, it will become clear how vital it is to embed ODD throughout the M&A process.

Fig. 5 – ODD Phases



Phase 1: Identifying the right deal

Predeal efforts are focused on identifying the right deal. This typically starts with a strategy paper as a basis for discussions about the portfolio, gaps in the portfolio and strategies to close these gaps, either through organic or inorganic growth.

The decision to pursue inorganic growth starts with a long list of acquisition candidates, which is condensed into a short list through initial screening and then an even shorter list after more detailed screening and high-level integration and synergy planning. The buyer then calculates initial valuations, selects a preferred acquisition target and signs the LOI, which triggers Phase 2: Due Diligence.

ODD in phase 1

In the pre-deal phase, ODD enables the acquirer to assess its own operations in the context of its overall strategy. Benchmarks and an in-depth understanding of the key risks and opportunities of the business plan can be helpful in this process. ODD is also useful for gaining an operational perspective during the target screening process.

Phase 2: Executing the deal successfully

A key component in this phase is the financial, tax, HR, IT, pension and technical due diligence process, which provides a better understanding of historical business performance and assesses key transaction risks. CDD and ODD should also be used to test the assumptions in the management's business plan.

During Phase 2, the acquirer should also assess if all the target activities are truly core activities, or if some activities should rather be characterized as non-core when they run counter to the corporate strategy. The due diligence outcomes and the core/non-core evaluation are factored into the valuation and the funding requirements.

A key outcome of Phase 2 is a signed SPA, which reflects the key due diligence findings.

ODD in phase 2

ODD plays a key role in this phase. By testing whether the management's business plan is robust, the acuquirer can validate the underlying assumptions and determine whether they align with its strategy. This helps identify upsides and risks to the business plan as well as establish potential synergies. The upsides, risks and synergies identified lead to further adjustments in the valuation model.

Another ODD outcome in Phase 2 is a more refined integration plan, which serves as a basis for the detailed integration/planning of Phase 3.

Phase 3: Delivering the promised returns

The focus post-announcement is to deliver the promised returns. This starts with the integration planning phase, which includes day-1 preparations, development of the operating model and the integration blueprint. The acquirer must consider customer, market, product and organizational strategies in designing the integration blueprint. In anticipation of closing the deal, the deal team may want to set up a clean room to frontload synergy capture and to validate synergy assumptions. It is essential in this phase to address any human resources and corporate culture issues.

Once the deal has been closed and the day-1 plan has been successfully implemented, it is time to execute the integration plan. The focus is now on realizing deal synergies and maximizing the value potential by retaining customers and employees, leveraging economies of scale, integrating systems, etc. It is essential in this phase to manage and coordinate the individual workstreams of the integration plan.

ODD in Phase 3

The focus here is to validate the operational assumptions that have been made in Phases 1 and 2. To speed up the value capture process, acquirers may set up a clean team to handle the organization. All the upsides, risks and synergies that have been identified will necessitate further adjustments to the valuation model and the integration blueprint.

As the integration/separation phase plays out, ODD is focused on ensuring operational stability and continuity as well as on capturing deal value.

Conclusions

The due diligence activities prior to signing the LOI are primarily commercial in nature. How attractive is the market the target operates in? How well is the target positioned and what are the growth prospects? Once more access to the target company is granted, we typically start addressing the operational issues. This should happen at the latest after the first analysis of the financial deal mechanisms (e.g., normalized EBITDA, net debt and normalized working capital) to test whether the deal can be achieved financially.

In contrast to financial and commercial due diligence, ODD plays an even more significant role after the SPA has been signed, as it provides key input for the integration blueprint and the day-1 checklist.

Breadth and depth of operational due diligence

The more common forms of due diligence (financial, tax, HR) have a standardized scope and a standardized set of information requests.

ODD is a completely different process that cannot be standardized, as risks and value drivers vary significantly between acquisitions. The scope, resources and information requests for ODD must be tailored to the deal in question. In doing so, the deal team is responsible for:

- Assessing the information required to facilitate proper decision-making for the proposed deal
- Deciding on the necessary expertise of the due diligence team members
- Allocating the various due diligence issues to different team members and aligning the insight gathered by all into one coherent conclusion

ODD investigations typically answer one or more of the following three questions:

1. Are the target's operations robust?
2. What are the operational upsides and what is the full potential of the target?
3. Which post-merger synergies can be expected?

1. Are operations robust?
In order to assess whether the target company's operations are robust, the deal team conducts site visits, interviews operational management and benchmarks the KPIs. ODD practitioners call this due diligence phase 'kicking the tires', as sellers will often limit interaction with operational management and make sure the machinery is polished before a site visit. However, this thorough as-is assessment of the target's operations provides the foundation for all other layers of ODD. Typical due diligence questions are:

a. What level of investment has been made in the business (no investment backlogs, latest technology in place)?
b. Is management tracking the right KPIs and is it performing against benchmarks?
c. Are the cost savings reported in the past actually structural savings?
d. How achievable are the projected savings from performance improvement?

2. What are the operational upsides and what is the full potential of the target?
In contrast to most due diligence processes, upside analysis requires acquirers to project future financial performance of the target company based on the following 4 key steps:

a. Baselining key financial and operational historic data
b. Developing a hypothesis
c. Testing the hypothesis against internal and external data points
d. Financial modelling of validated hypothesis in mini business cases

Making hypotheses and quantifying upsides based on assumptions and estimates can feel uncomfortable – particularly in M&A processes where investors are trying to minimize risks. In order to ensure the deal team has all the available information about the target's real value creation potential, it is advisable to invite a challenge from non-business owners. This will help overcome hidden bias.

3. Which post-merger synergies can be expected?
Assuming the deal team conducts an indicative synergy planning exercise during the target identification phase, synergy work during the due diligence phase is primarily focused on making the existing plan more robust. The task here is to find proof points and flesh out the details of the implementation effort, based on these key questions:

a. What proof points can we find to support the estimates and assumptions made in calculating the synergies?
b. Is the implementation plan sufficiently detailed?
c. To what extent are the synergies dependent on third-party cooperation (e.g., clients, suppliers)?
d. What is the plan B to capture the expected synergies?

Conclusions
Establishing the right scope for ODD requires experience. A proper risk assessment at the start of a project will focus the due diligence efforts and often provides a better return on ODD. There are literally thousands of due diligence questions people could potentially ask; selecting the right questions is an art.

The ability to provide actionable insights and a robust roadmap for change could make the difference between 'due diligence to lose' and 'due diligence to win'.

Roles and ownership

There is a small mountain of books and articles on M&A by academic researchers and consultants. Research consistently shows that roughly 67% of mergers and acquisitions deliver zero shareholder value. Although you could argue about the statistics used in these analyses (e.g., including only large deals of listed companies and leaving out small, private equity deals), the academic consensus is that the typical merger and/or acquisition is a bet against the odds.

However, a study covering a decade of deal-making (McKinsey, 2011) showed that it is primarily the large deals that destroy value, and that serial acquirers have a 64% better chance of creating a shareholder return than their peers. McKinsey's conclusion is based on research into both large and small deals of the 1,000 largest companies in the western world. The following are a few of the reasons serial acquirers succeed:

- A more disciplined decision-making process, in which strategy is linked to target selection
- A more systematic method of integration planning and execution, starting in the due diligence phase
- M&A is an integrated part of the company's operating model, including performance measures, incentives and governance processes

Role of the M&A department

As part of their 10-year study into merger failures, Haspeslagh and Jemison (1991) concluded that value creation through M&A requires a distinct decision-making process. Establishing a distinct process is key, because merger decisions are different from regular investment decisions for the following reasons:

- Merger opportunities are often coincidental
- Business managers (often) lack M&A experience
- Mergers are opportunistic by nature
- M&A requires faster decision-making
- Access to relevant information is limited
- It is an 'all or nothing' decision
- The inherent risk of a merger is higher when you buy people and processes, not just assets

In order to protect the company from deal failures, CEOs of large corporations establish standalone M&A departments. The typical roles of an M&A department are as follows:

- Designing and implementing a distinct M&A process
- Stimulating M&A as a key lever for growth
- Acting as the first point of contact and filter for investment banks offering acquisition opportunities
- Providing expert advice during the deal-making process, including contracting external advisors

Role of the deal team

The managers of M&A departments assemble deal teams for individual acquisition opportunities. The primary objective of these teams is to assess whether a merger opportunity is attractive and to draft a post-deal action plan focused on creating shareholder value. Typically, a deal team should consist of:

- A general manager capable of overseeing all functions, including strategic fit. The general manager is in charge of the deal team.
- A deal team should also include a manager responsible for leading the acquired company post deal, including post-merger integration.
- Team members with previous M&A experience, so that experience can be shared across M&A opportunities.
- Team members who understand that they are part of the M&A team and are committed to the team objective of assessing the strategic fit, instead of acting as representatives of their discipline.

The deal team is typically involved in assessing synergies, conducting an operational review to identify and quantify investment needs, as well as in drafting an initial integration plan. Deal teams are typically multidisciplinary and sourced from departments like HR, IT, Operations, Finance and Sales & Marketing.

Role of external ODD advisors

Working with external ODD advisors provides additional specialist capacity to analyze the available data, perform site visits, conduct interviews, quantify review findings and report on the results in a concise, bankable manner. External advisors also help to provide further benchmarks and external proof points, to ensure an un-biased view, to accelerate delivery and to limit internal coordination efforts. However, it is no substitute for the commitment needed from the business owners to make the M&A a success. Developing a value creation plan is therefore always a co-creation between the specialists in the deal team and the ODD advisor.

Degree of involvement

Developing a value creation plan takes a lot of work, so deal team managers tend to involve more people as the deals grow larger or as they progress. However, the more people you pull into a process, the more difficult it becomes to achieve an artful balance of (often) contradictory objectives. Small teams may lack breadth, but they are likely sufficient to produce at least a rough valuation, which will allow planning to move ahead.

Taking a more inclusive approach to evaluating potential synergies can create more value and promote a culture of shared accountability and buy-in. But it also requires the deal team manager to put more effort into coordination to keep everyone aligned and focused on the team objectives rather than individual and disciplinary priorities.

It is important for deal team managers to promote transparency and confidentiality, while also embracing skepticism, championing the shared vision and keeping a ruthless focus on efficiency.

Buy-in creation

In our experience, deal teams achieve the best due diligence results when they involve specialist business managers on a topic-specific basis and allow them to collaborate with a dedicated (external) team to perform the required analysis. The business managers can help articulate the risks of cutting too deep or too quick, for example, or identify opportunities that build on the existing transformation program. Getting their input early in the process creates a shared understanding of the final synergy targets.

These dialogues do not need to take a lot of time. A facilitated workshop and a straightforward information request can dramatically increase the level of insight during the due diligence phase. The deal team can secure additional buy-in for the value creation plan between signing and closing, or during the first 100 days post-closing with target management.

Conclusions

It is the role of the M&A department to establish a distinct screening process for the acquisition target and to keep the organization disciplined in adhering to the decision criteria for the proposed deal.

The M&A department's management is responsible for assembling the right deal team and deciding on the balance between external advisors and internal ownership. Making sure that M&A deals create value is as much about knowing who to involve – and when to bring them on board – as it is about knowing how to capture synergies.

Keeping your deal team small ensures confidentiality, but you will need to bring more people on board to identify synergies. The bigger the team is, the more distractions there are in the day-to-day business, which may jeopardize confidentiality and increase the level of internal noise about the deal's strategic fit.

External ODD advisors can provide additional specialized expertise and significantly increase the quality of operational analysis. However, they cannot replace the sense of ownership that the in-house M&A team bring to the table. As a result, when external contractors are involved in the ODD process, it must ultimately be a co-creation between the advisors and the business owners.

How to perform operational due diligence

The more common forms of due diligence rely on a linear approach, whereas ODD is based on an iterative, structured and inductive approach.

Linear, more standardized approach
Financial, tax, legal and HR due diligence, rely on a set of practice standards provided by their respective external advisors. Financial due diligence engagements are typically structured based on procedures that have been agreed upon in advance, detailing the specific analyses to be performed. The client is responsible for deciding on the analysis required, while the report produced by the due diligence provider contains only factual findings. Due diligence providers do not provide an opinion on the attractiveness of the deal. Its procedures are not designed for that purpose and therefore do not form a sufficient basis.

As these engagements are straightforward in nature, the advisors execute them in a linear fashion:

Fig. 6 – ODD Approach

Scoping	Analyze	Synthesize	Report
• Agree on the specific analysis to be performed with client	• Perform the agreed analysis as described	• Summarize findings based on available facts	• Present findings in bankable report • List analyses which could not be performed due to data omissions

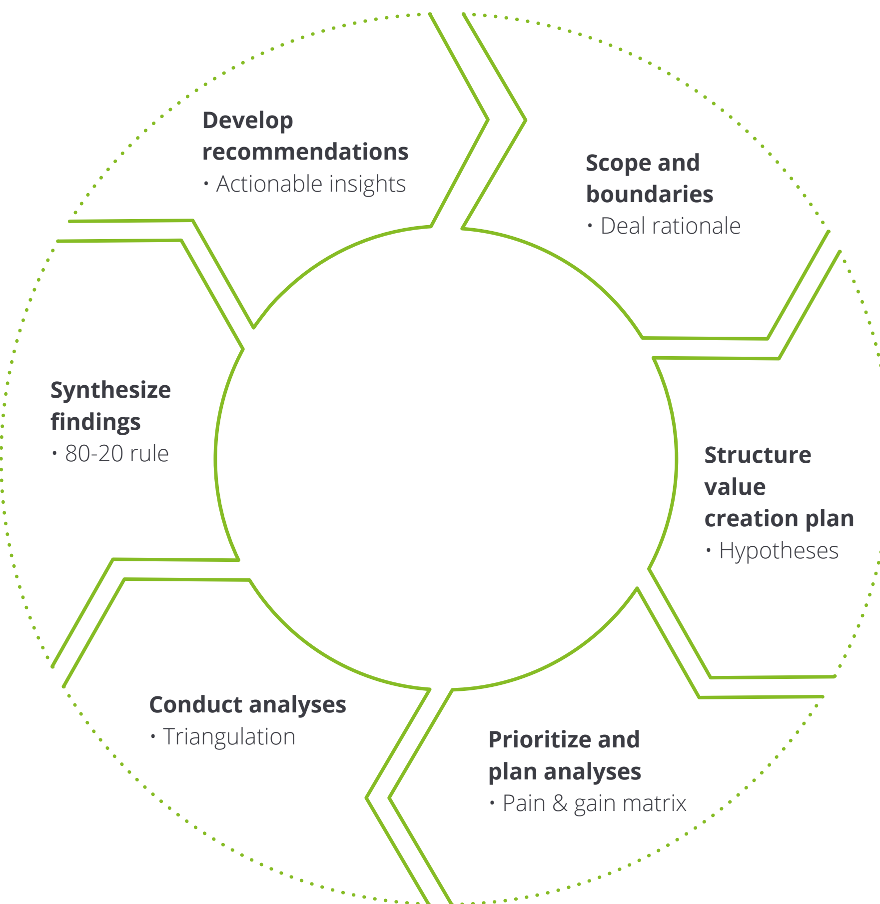
Iterative, structured and inductive approach

The ODD process, by contrast, is designed to determine the optimal solution in terms of value creation and to provide input to the value creation plan. This requires a more explorative, investigation process.

The best ODD providers are those that develop innovative, impactful and actionable insights on a continuous basis and that deliver comprehensive, fact-based, accurate, flexible, creative, and pragmatic input. Deloitte deploys the following structured, inductive approach:

1. Agreeing on scope and boundaries
2. Structuring the value creation plan
3. Prioritizing and planning analyses
4. Conducting analyses
5. Synthesizing the findings
6. Developing recommendations

Fig. 7 – Iterative ODD Process



1. Agreeing on scope and boundaries
In our approach, we start by gaining a full understanding of why our client is interested in acquiring the target company, and how it fits into their group strategy. Sometimes it is tempting to skip this step, because the deal rationale seems so obvious, or the deal timeline is pushing us to move on. However, factors such as ongoing projects, promises on employment and autonomy, planned add-on acquisitions, etc. are important boundaries for the value creation plan.

In our experience, this step is crucial for the deal team, including its advisors, but also extremely valuable for those who ultimately decide on the final investment. This is particularly key, as the deal rationale, risks and implementation boundaries are often not very well-defined at the start of many M&A projects.

2. Structuring the value creation plan
Once we have defined the scope and boundaries, the ODD process proceeds with a series of rapidly iterated steps, buttressed by active and ongoing communication. Communications are focused on structuring the research, prioritizing issues, planning and conducting analyses, synthesizing findings and developing recommendations.

For the sake of simplicity, we have presented ODD here as a linear process. In reality, however, it is not actually linear. A key element of operational due diligence is developing and then iterating an early version of the value creation bridge and implementation plan. The diagram above illustrates this process with a looping arrow. The early version of the plan will typically be a "Week 1" draft storyline, which is revisited and reiterated at least weekly to reflect hypothesis testing and adjustments in each phase of the process. Regular, thoughtful iteration with the deal team saves time and creates stronger buy-in. Hypothesis trees are a helpful technique in structuring value creation plans. This technique disaggregates the primary research question into a cascade of hypotheses that, when addressed, will combine to answer the primary question. For example, let's assume the primary question is, "How can we improve the target's EBITDA by €20m over the next two years?" A hypothesis tree might break it down as follows: "Target EBITDA is expected to grow organically by €5 million", "Target can stimulate an additional €5 million in EBITDA growth from current business", and "Target has opportunities to capture €10 million in growth through synergies." We then break these hypotheses down further into different issues or hypotheses at the next level of the tree.

The goal of this stage is to structure the problem in discrete, mutually exclusive segments that are small enough to accommodate an analysis and that, taken together, are exhaustive (MECE: mutually exclusive, collectively exhaustive). The art lies in identifying an efficient and effective structure, which takes only a minimum number of steps to complete and yields a sound, relevant answer. Acquiring and mastering this art comes from apprenticeship and practice.

We prefer to work with hypotheses, because it makes ODD and the entire operational due diligence process dramatically more efficient. Quickly developing a powerful hypothesis tree or drafting a storyline enables us to develop impactful solutions on a tight timeline.

It is important for teams with less M&A experience to be aware that hypotheses and early storylines may appear premature to their clients. It is not unusual for business leaders to mistrust something that looks like an answer hastily reached after just 24 hours and to request a comprehensive underlying analysis. That's why it is so important to explain your approach in advance (most importantly, that a hypothesis is not a final answer) and its benefits (a successful operational due diligence process always starts with a good hypothesis and keeps the deal team from becoming overambitious). Deal teams should also be aware that a hypothesis tree approach can trap you in a restrictive mindset by reinforcing beliefs that have no basis in fact, thus reducing the chances of an "outside the box" solution.

3. Prioritizing and planning analyses
It is a common practice to use a two-by-two matrix to prioritize and plan the work, e.g., a matrix featuring "value impact" and "ease of implementation" as the two axes. This matrix is also called a pain and gain matrix. Other prioritization criteria include urgency (but beware of the danger of being lured into firefighting), strategic alignment, operational risks and day-1 issues.

4. Conducting analyses
ODD projects largely consist of gathering facts and conducting analyses to support or contradict the hypotheses. If the facts prove that an individual hypothesis no longer holds true, you have to rewrite the hypothesis so that it is once again plausible. Then, you need to go back to the process of prioritizing and planning your work again.

At this point, we aren't going to explain the different types of analysis used for value creation. However, it is worthwhile to reiterate how important proof points are. Any solution that is not supported by quantitative facts bears a heavy burden of proof. Where proof points are not readily available, in the data room or with the acquirer, you need to collect evidence elsewhere. Alternative sources of evidence and investigations used in ODD range from interviews, recalculations and models to benchmarking and observational studies (during site visits). The deal team compares and triangulates direct and indirect evidence to ensure that the facts consistently support the hypotheses. A mix of data points from different sources collected using different techniques will build strong hypotheses, which can survive the scrutiny of management from the target and the deal team.

5. Synthesizing the findings

Synthesizing findings is perhaps the most delicate task of the value creation process. After spending a certain period immersed in the details, it is crucial to step back and distinguish between what is important and what is merely interesting. Although, formally speaking, synthesis is the penultimate step of the process, it should ideally happen daily, or any time the team makes any analytical progress. This will remind the team of the hypothesis they are trying to test, help them prioritize the tasks, highlight logical links in the value creation plan and ensure that they have a story ready to articulate at all times during the planning process.

6. Developing recommendations

In the reporting step, we address the deal team's primary question: "What do we need to do to create value, and how will we do it?". Elegantly synthesized, analytical solutions rarely answer the how. They explain what needs to change but not how the change will come about. The value creation plan is therefore incomplete until we have made actionable recommendations, established a plan and secured commitment for implementation. The essence of this step is to translate the overall solution into the actions required to deliver a sustained impact.

The deal team needs to develop and communicate a pragmatic action plan that is acceptable to the organization. First, it must include the relevant initiatives, along with clear chronology, timing and mapping of the individual actions required to realize them. This should not merely take into account the need for sustained impact, but also the effect of visible 'quick wins', the resources available and any competing priorities. Second, it must assign clear owners for each initiative. Third, it must identify the key success factors and challenges involved in delivering the initiatives, including, for example, identifying change agents and change blockers.

Conclusions

The primary objective of ODD is to answer the question, "How can we best create value with the proposed transaction?" The right due diligence process is one that welcomes creativity, relies on multiple information sources and allows for interaction between stakeholders. A traditional, standardized linear approach is not fit for this purpose. ODD achieves the best results when it is structured as an inductive and iterative process, focused on providing actionable insights and presented in a concise equity story.

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M&A services: Deep capabilities in every phase of the deal
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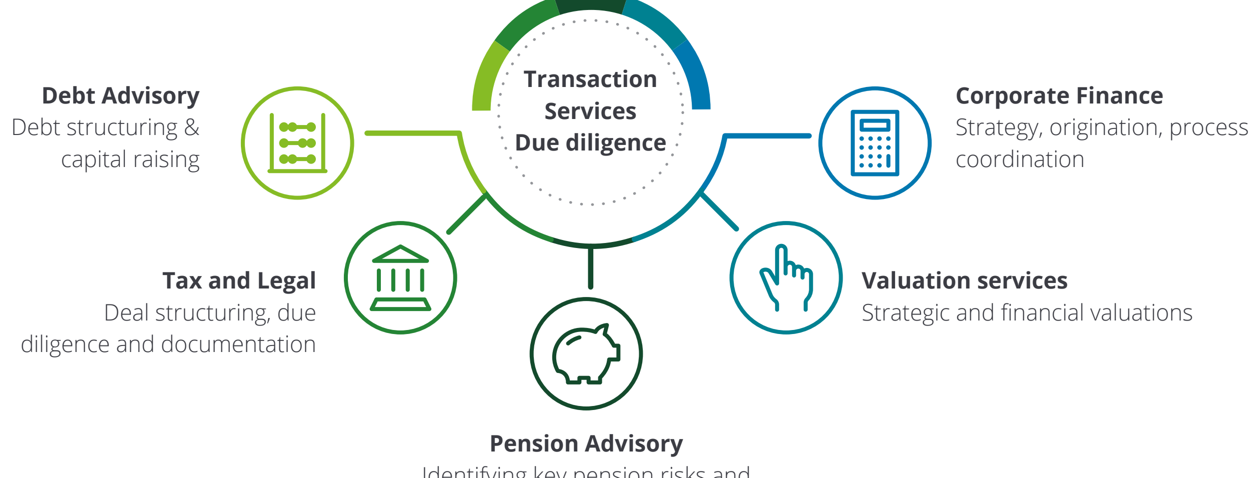
How M&A services can help
M&A is not for the faint of heart: M&A deals are demanding, the risks can be daunting, and the stakes are usually high. With more than 16,000 Deloitte M&A professionals serving clients in more than 150 countries, M&A Services can help you move forward with confidence through every step of the M&A lifecycle – from strategy and due diligence to integration or divestiture. Our M&A Services team has the depth of resources and breadth of capabilities to bring you the unique combination of skills your deal requires – experienced specialists in business intelligence, buy side, sell side, finance, human capital, risk management, valuation, industry and many other areas of specialization. We deliver these services with a risk-intelligent, integrated approach, anywhere in the world you need us – and we are always working toward achieving the outcomes you envision for your deal.

Fig. 8 – M&A Services



M&A Tax services

Tax due diligence
- Identify key tax issues
- Assess impact on cash flows
- Provide SPA impact

Tax Structuring
- Advise on tax efficient structure
- Maximize use of tax attributes
- Reduce cost of transaction

Structure exit ready

M&A Legal services

Buy-side support
- Legal due diligence
- Transaction documentation (SPA)

Integration & Separation
- Integration, separation and transitional arrangements
- Legal restructuring

Vendor assist
- Legal vendor due diligence
- Transaction documentation (SPA)

Transaction services

Financial due diligence
- Highlight key business drivers
- Identify upsides & downsides
- Analyze working capital
- Identify price negotiation options
- Identify SPA impact
- Pre-analysis (i.e., red flag analysis)

Integration & Separation
- Develop integration/separation blueprint
- Set up program management office
- Benefit tracking

Vendor assist
- Analyze/challenge financial data
- Prepare a data book and data room
- Identify separation issues
- Analyze the upsides
- Prepare a financial fact book

Benefits & Pension advisory

Identify key pension risks, including future (cash) funding and impact on valuation

Provide specialized SPA input from a pensions and benefits perspective

Perform broader HR due diligence procedures, including financials, HR operations, culture and people
Prepare HR function for day-1 after signing the deal

Debt advisory

Sounding and pre-analysis
Determine financing alternatives
Arrange acquisition financing

Assist in re-financing Dividend recaps
Benchmark analysis

Arrange stapled financing
Pre-pack funding

Corporate Finance

Buy-side support
- Identify acquisition targets
- Manage acquisition process
- Assess potential synergies & value
- Advise on bid strategy
- Negotiate best deal

Sale Advisory
- Manage sale process & deal issues
- Prepare sale documentation
- Identify and warm-up potential investors

Valuation services

- Strategic and financial valuations
- Appraise sensitivities and risks
- Dispute valuations

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