

DRAFT

GETTING DUE DILLIGENCE RIGHT

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The record of mergers and acquisitions investments, from the perspective of the corporate acquirer “has been dismal” (Aiello & Watkins, 2000: 101). A study by KPMG International in 1999 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, the study found that “83 percent of mergers failed to unlock value” (Harding & Rovit, 2004: 51). Despite the grand promises of the “transformative” mega merger between America on Line and Time Warner, for example, “some \$200 billion of shareholder value had vanished” (Munk, 2004: xiii). In the \$5.8 billion acquisition of Rubbermaid by Newell which was described by *BusinessWeek* as the merger from hell, Newell’s shareholders lost 50% of their investment, and Rubbermaid shareholders of a further 35% (Harding & Rovit, 2004). After the acquisition, Newell’s former CEO admitted that Newell had overpaid. In another transaction, Quaker Oats also overpaid when it acquired Snapple for \$1.7 billion. Some industry analysts estimated that the breakfast food giant paid as much as \$1 billion too much. Indeed, twenty eight month later Quaker Oats sold Snapple to Triarc Companies for less than 20% of what it had paid (Eccles, Lanes & Wilson, 1999).

Clearly, there are many reasons as to why such transactions fail. It seems, however, that the main reason is related more to failures in due diligence than to other lapses in the other part of the deal process (Aiello & Watkins, 2000). In a recent survey, two hundred and fifty global executives involved in mergers and acquisitions admitted that there were breakdowns in their due-diligence processes, of which half reported that important issues were not detected (Harding & Rovit, 2004).

But not all companies perform as dramatically poorly as AOL and Time Warner, Newell and Rubbermaid or Quaker Oats and Snapple. A research based on a sample of 1,700 mergers and interviews with deal makers showed that the executives who led high performing mergers conducted effective due diligence (Harding & Yale, 2002).

Successful deal makers have a disciplined due diligence process and a clear *negotiation thesis*. They know precisely what value they must get from the deal, how the

deal-design would create that value, and thus focus like a laser beam on negotiating that value. Once the due diligence does not confirm the expected value, the deals are off. This is what Benoit Bassi does.

Benoit Bassi, the managing director of Bridgepoint Capital in Paris never falls in love with the companies that he targets for acquisition. In a typical year Bassi reviews about one hundred and fifty investment ideas and filters them 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 warms were found. Bassi walked away and killed the deal himself. “When we got in there to do our due diligence,” Bassi said, “what we thought we knew turned out to be wrong” (Harding & Rovit, 2004:61).

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.

Due diligence is broadly define as a data collection and analysis activities design to determine the value of assets or services in preparation for a transaction between negotiators. The purpose of this paper is to identify the factors that contribute to poor preparation in the pre-negotiation phase of potential transactions.

Traps of Due Diligence

Secondary Sources of Information

The primary purpose of due diligence is to collect reliable information from reliable sources in order to make sound decisions. Often, however, negotiators fail to invest sufficient resources in collecting valid information from primary sources of information. They tend too often to rely on information from secondary sources.

John Connaughton, a managing director with Bain Capital had observed that often management teams of the targeted acquisitions tell him that their industry is growing while it is, in fact, declining. Thus, he said, “We through out the secondary research associated with the outlook for the business and build our point of view from the bottom up” (Harding & Rovit, 2004:65). Cinven, a leading European private equity firm, takes a similar approach. They take a critical view of the targeted companies for acquisitions by using their own analysts. Prior to acquiring Odeon Cinemas, a United Kingdom theater chain, Cinven sent its teams of analysts to the field – to “hang out at the movies” -- and collect information on each theater site. It was not just the typical macro analysis back in the “data room” but rather a ground-up micro analysis. By using this approach Cinven had a better understanding of Odeon and its current and potential value (Harding & Rovit, 2004: 78).

Information Availability

In the preparation stage and during pre-negotiation phase, some negotiators differentiate between information that is easily available and information that is not easily available. Subsequently, this bias limits the negotiators information search to easily available information from easily accessible sources which naturally produce a limited subset of information.

Effective negotiators, similar to investigative journalists, detectives, spies, assume that information is available without making the distinction between available and not available information. This is what Sumner Redstone did in 1987; he acted like a detective. To acquire Viacom International, a multimedia company, he had to compete against Terrance A. Elkes, the chief executive officer of Viacom and his management group. They wanted to takeover Viacom and make it a private company. Elkes and his group, the insiders, clearly had information advantage and were not about to share much with Redstone. Facing information asymmetry disadvantage, Redstone acted:

I decided to go around them [Elkes and his group]. I met with Bob Pittman, who had helped to create MTV [a business unit of Viacom]...and picked his brain. He told me MTV had become a very unpopular place to work in the year since Viacom had bought it. Morale was extremely low and people were leaving in droves (Redstone, 2001:125).

Through Pittman's connections, Redstone got to meet Tom Freston, co-president of MTV [after Pittman left MTV], and Geraldine Laybourne, president of Nickelodeon [a business unit of Viacom]. In a dinner with Freston and Laybourne, Redstone asked a lot of questions and got important and specific inside financial information such as, "MTV business was just getting started and was making \$15 million on \$80 million in revenues" (Redstone, 2001:126).

Hubris

Hubris or overconfidence is a cognitive bias that can influence decisions (Khaneman, Slovic, & Tversky, 1982). It is generally defined as exaggerated self confidence (Hayward & Hambrick, 1997) in regard to one's judgment. Prior studies found that overconfident CEOs, for example, are prone to information judgment error.

They believe that "they hold more information than they actually have" (Li & Tang, 2010: 4), consider their own information more valuable than external information (Bernardo & Welch, 2001), and make decisions based more on subjective judgment than on objective information (March & Shapira, 1992). Consequently, they pay higher premiums for their acquisitions and end up with more value-destroying mergers because they underestimate the resources required to embark successfully on strategic initiatives (Hayward & Hambrick, 1997; Malmendier & Tate, 2006).

Hubris, drive deal makers to overestimate future benefits and underestimate future costs. A study by the McKinsey & Company found that the average acquirer materially overestimated the synergies that come from economies of scale and scope, best practice, or sharing capabilities, and ignored dis-synergies arising, for example, from loss of customers (Christofferson, McNish, & Sias, 2004).

Exaggerated self-confidence, however, is not unique to CEOs. It is also prevalent among members of the armed forces (Hazard & Peterson, 1973) and the Central Intelligence Agency (Cambridge & Shreckengost, 1980), and negotiators. Shimon Peres, President of Israel, have been negotiating diplomatic and political deals for 60 years. Aware of the negotiator's overconfidence bias, he suggests that negotiators are prone to make two types of mistakes: either overestimating or underestimating their counterpart negotiators. If a negotiator is to make a mistake, it would be better, President Peres

suggests, to underestimate oneself and overestimate the other side (personal communication).

Terrance A. Elkes, the chief executive officer of Viacom International in 1997 was overconfident and underestimated Sumner Redstone who was at that time a theatre owner and minor share holder of Viacom. Redstone believed that Elkes and his management group attempt to take Viacom private amounted to stealing the company too cheaply and decided to oppose Elkes and his group. He entered the bidding and won. Reflecting on this competition years later, Redstone wrote: “I was unknown, just some theatre owner who had struck it rich with a couple of stock purchases. Elkes and his group didn’t know me and they never took the time to find out who I was. I believe,” Redstone continued, “they underestimated me, never for a minute took me seriously.” That, Redstone concluded, “is a grave negotiating flaw and a cardinal mistake” and suggested: “Always do your research” (2001: 121-122).

Confirmatory Bias

“Someone at the top falls in love [with a deal], and the word comes down, ‘We are going to do this deal.’ Once the decision gets made, the guys doing the deal just want to get it done. They start stretching the operating assumptions to make it work” (Aiello & Watkins, 2000:102) and the rigor of the risk analysis is compromised, particularly the downside analysis by using optimistic assumptions (Eccles, Lanes, & Wilson, 1999). The pre-transaction pressure to justify deals drives deal teams to overvalue confirming information and devalue or ignore disconfirming information. This is *pre-transaction confirmatory bias* – justifying potential transactions well before they were thoroughly studied.

Professionals in the intelligence community are also aware of the hazard the self serving *confirmatory bias*. In a private meeting, the former head of the Israeli internal intelligence, Yaakov Perry, was asked: “What did you learn from your personal experience combating terrorism in the last 30 years?” Mr. Perry instantaneously replied: “Do not hate your enemies, the terrorists. If you do,” Perry explained, “you will not be able to understand how they think, what makes them tick, or how to recruit some of them.”

The *pre-transaction confirmatory bias* has, it seems, has an enduring transformative power from *pre-transaction* to *post- transaction confirmatory bias* - justifying transactions after they were executed. A study KPMG International found that 83 percent of the mergers in 1999 failed to create value. However, when the managers who were involved in these acquisitions were asked to evaluate their performance, 82 percent were convinced that their acquisitions were successful (Harding & Rovit, 2004: 5).

Time Pressure

Kirk Kerkorian, ready to sell Metro-Goldwyn-Mayer and United Artists (MGM/UA), called Ted Turner, the founder of CNN, and told him that he is planning to put MGM/UA up for auction in two weeks. However, he would give Turner the first right to buy it for \$1.5 billion, if Turner closed the deal in ten days. Turner, eager to get the deal, rushed to meet the tight deadline and signed a purchase agreement at full price, \$1.5 billion.

Turner, according to industry analysts, overpaid by 200 to 300 million dollars. In the rush to close the deal, not all the legal issues were uncovered. On August 4th, 1985, just two days before Turner signed the purchase agreement; MGM/UA had signed a contract with Rainbow Services and locked up all cable rights. In addition MGM/UA had already contracted with HBO to buy several movies at a very advantageous rate” (Goldberg & Goldberg, 1995: 355) It took many months and costly resources to sort out these issues out.

The more time an acquirer has to investigate the target, the more skeletons the acquirer will find. Sellers, therefore, use time pressure to limit the due diligence process. Rubbermaid’s executives gave Newell an exclusive right to acquire Rubbermaid, as long as the deal could be done quickly, in three weeks. Newell, under time pressure “raced through the due-diligence process” (Harding & Rovit, 2004:73), and failed to discover that Rubbermaid “perfumed” itself. It stuffed its distribution channels through heavy promotions and deep discounts. Only later, Newell discovered that Rubbermaid had poor customer service record and weak management.

Agency

Do agents, hired by principals to represent their interests, act in the principals' best interests? Not always. Investment bankers, acting as financial agents, encourage their clients to pursue "acquisitions that are driven by overly optimistic projections" (Kosnik & Shapiro, 1997: 7). For example, Rawson Food Services, acting on the advice of its financial agent – Prudential-Bache --, paid about \$40 million to acquire 43 supermarkets from Pantry Pride Enterprises, Inc. Shortly after the acquisition, Rawson filed for bankruptcy reorganization and sued Prudential-Bache. Rawson argued in court that Pantry Pride was worth substantially less than what it had paid for it. The Florida state court found Prudential-Bache guilty of negligence and awarded Rawson \$26.3 million in punitive and compensatory damages (Kosnik & Shapiro, 1997).

In virtually every complex transactions, deal makers do not have the necessary expertise to conduct a sophisticated financial, legal, or technical, due diligence. They are dependent on the expert-agents and have to hire them and monitor them. The problem is how does a principal monitor an expert-agent when the principal lack such expertise? In many cases they can not and thus take the agents' advice.

However, the core of the agency trap is not just in expertise asymmetry, it is in the faulty compensation structure. Agents such as investment bankers or real estate, are paid agency fees that closing of deals, regardless of their future outcomes. In the failed Campeau' acquisition of federated Department Stores in 1998, First Boston, received a \$12 million agency fee for closing the deal (Kosnik & Shapiro, 1997). Less than two years later, in January 1990, Campeau declared bankruptcy (Bazerman & Neale, 1992).

The impossibility for individuals or organizations to conduct well informed due-diligence was most evident in the sub-prime mortgage crises. The French pension funds, the banks in Iceland and Japan, or the German investors in Dusseldorf to could not determine whether the mortgage backed bond that they purchased were indeed triple-A-bonds. The bonds were as triple-A by the rating agencies, Moody's, and Standard and Poor (S&P). But, in fact, they were not.

The rating agencies are "trusted" agents of the investing public. But, they "were paid fat fees by Goldman Sacks and other Wall Street firms [the bundlers of millions of

mortgages into bonds] for each deal they rated, pronounced 80 percent of the new tower of debt [the low rated and risky bundled bonds] triple-A” (Lewis, 2010: 73).

Strangely, the “independent” rating agencies, responsible for protecting the interests of investors, did not have their own independent model of rating bonds; they relied on Wall Street firms that packaged the bonds and “send over their own model...[and] somehow, roughly 80 percent of what had been risky triple-B- rated bonds now looked like triple-A-rated bonds” (Lewis, 2010: 76).

The financial instruments – the collateralized debt obligation (CDOs) bonds and the credit default swap (CDSs) were extremely complex, most individuals and firms on Wall Street did not understand them. Wing Chau, who had run Harding Advisor, did not either. He purchased collateralized debt obligation bonds, however, without buying insurance -- credit default swap (CDSs). His investors and others around the world lost billions of dollars.

Deal Fever

Members of Wall Street – individuals and firms, including the rating agencies – were stricken by deal fever. The greater the number of deals the more they benefited. Wall Street was a deal making machine with neither unlimited nor monitored appetite. But, deal fever is not limited to Wall Street.

Robert Kohlhepp, the vice chairman and former CEO of Cintas, highlights the dangerous tendency of organizational units (e.g., the internal merger and acquisition groups) to produce many deals because they are evaluated on the basis of the number of the done deals. The operation people too like to make many deals because they want to grow their operation areas and increase their potential income.

Deal fever is also driven by misguided strategies to grow the company and overlook the intrinsic value of the deals. For example, in the case of Fidelity National Financial failed acquisition of a leasing company, the due diligence process, according to Brent Bickett, a veteran investment banker, broke down because “The desire to get into the industry overrode the attractiveness of the company” (Harding & Rovit, 2004:168).

Cultural Assumptions

In negotiation, details and assumptions matter and should be tested, especially in international and multi cultural negotiations, a hard lesson a Swedish company learned.

The joint venture agreement between a French company and a Swedish company stipulated that the French firm would own 50.01 percent equity, and the chairman of the newly formed joint venture would come from the French company. The Swedish company, on the other hand, would own 49.99 percent equity and the Chief Executive Officer (CEO) of the joint venture would come from the Swedish company. What the Swedish negotiators failed to realize was that in France a chairman of a company, known as President Directeur General (PDG) usually acts as both, as chairman and as CEO, getting deeply involved in strategic issues as well as in the daily operations of the business. The designated French PDG of the joint venture indeed got involved in the strategic and in the tactical issues of the joint venture. Eventually, conflicts over roles and responsibilities of the French PDG and the Swedish formal CEO, who was relegated to a non-CEO role, erupted. Later the Swedish firm management admitted that “it did not do its homework” and had they understood how powerful the role of the French PGD was, it would never have agreed that the chairman would come from the French firm (Inkpen & Li, 1999:40).

A study of 125 acquisitions found that there was a huge difference between deals that proactively identified cultural issues in the due diligence process and addressed them and in deals that did not (Harding & Rovit, 2004:189).

Narrow Focus

In many mergers and acquisitions, the due diligence effort focuses on the past and the present of the 4 Cs of competition: customers; competitors; cost; and capabilities. The competitive analysis, almost exclusively, is limited to financial, legal, and operational issues. The cultural, human resources, and strategically forward looking issues take back seat. For example, in 1998 Safeway, a leading grocery chain in the U.S. acquired Dominick’s, a regional grocer in Chicago for \$1.8 billion.

Although Safeway and Dominick's are in the same industry, the strategic fit and synergy between them was questionable. A due diligence from a strategic forward looking perspective would have revealed that the two companies are different. Safeway is a generic grocer focusing on store brands, private labels, 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 would later regret this deal when it could not re-sell Dominick's for a fifth of what it had paid for it (Cullinan, Le Roux, & Weddigen, 2004).

It is not just failing to look forward strategically in the due diligence process. It is also failing to recognize the criticality of "soft" cultural and human resources issues. A study of 125 mergers and acquisition between 1996 and 2000 and greater than \$1 billion by Bain & Company, found that "cultural-integration issues can make or break deals" (Harding & Rovit, 2004: 112). In the acquisition of First Chicago NBD by Bank One in 1998, the human resource issue became a problem: within three years of closing the deal, "none of the 16 top executives picked to run the merged company remain on the job" (Harding & Rouse, 2007: 124).

Cultural and human resources due diligence includes: performing a cultural audit of both companies – the acquired and the acquirer; evaluating the roles, responsibilities, motivation, and capabilities of the human capital; identifying capability gaps between the current the capabilities and the expected capabilities; and assessing the cultural gap between the acquiring and the acquired companies.

Successful Due Diligence

Serially successful deal makers like Bain & Company, a top-tier private equity firm; Cinven, a leading European private equity firm; and Nestle, a Swiss conglomerate and textbook acquirer, are aware of the traps to effective due diligence. They developed a disciplined due diligence process and superior negotiation capabilities.

- Collect available and valid information from primary and secondary sources of information.

- Develop a detective mindset and do not assume that information that is difficult to get is not available. Assume that all information is available and try to get it.
- Subject the collected information to a rigorous multi perspectives analysis, including a prosecutor – devil’s advocate – who will challenge the rational and the assumption of the deal.
- Restrain hubris and overestimate the other negotiators and the deal situation.
- Alien your interests with the interest of the agents. Monitor them, if you have the expertise, if not, hire expert-monitors to do that. Design contingent compensation contracts that are based on the closure of deals and their future success.
- Neutralize *deal fever* by separating between the deal analysts, the deal negotiators, and the deal decision makers (senior executives).
- Conduct due diligence from an assumption testing perspective, especially test cultural assumptions.
- Negotiate realistic and favorable deadlines.
- Broaden the scope of the due diligence process and include all material issues (e.g., financial, legal, technical, cultural, human relations, and managerial competencies).
- Develop a disciplined due diligence process that is guided by clear and specific success criteria.
- Keep your optimism in check, learn let go of sunk costs, and walk away from value destroying deals.

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