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NEWS LETTER

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Commercial Due Diligence: Reviewing and Reporting Company Positioning & Commercial Advantage

By David McClelland

COMMERCIAL DILIGENCE – BETTER THAN THE PUB

Equity investors, debt lenders and business management, including vendors, all face the challenge of assessing where value rests in a business. Opinions on approach may differ but one thing is sure: to evaluate true transaction value you'll need to link certain of the business's performance attributes to understood market sector yardsticks and industry norms.

Commercial Due Diligence (CDD) sets out to understand the strategic rational and logic of company management in taking a business down a certain path to market. It is an assessment of the wisdom, risk and benefit involved when positioning trading activities adjacent to certain customer groupings and in competition to alternative market providers.

Of course one person's risk is another's opportunity. The trick for the CDD reporting advisor is to view the transaction through the eyes of the client party, remaining aware of what about the deal will make the client comfortable or nervous. It is an ability to read the transaction, identify the issues, establish evidence and communicate final opinion that makes CDD effective.

Opinion is often subjective and like all advisory services, CDD can be done well or badly. Part of the 'art' is in knowing when to stop 'rowing the boat ashore'; substantiating and setting down 'opinion' in what is usually a restricted timeframe.

It comes down to the level of granularity in the analysis: high level, limited scope is enough to examine straight forward, singular issues within the business; or a more comprehensive scope, given greater complexity, such as determined by multiple revenue streams across differing business territory.

The variables examined may include the experience of the management team in setting and meeting objectives within the business and the bridge in forecast against historic earnings in the light of assumptions made about economic development in the addressable market; relationships held with existing/new customers and the impact of competitor activity on pricing.

The process mixes 'primary' market research, i.e. face-to-face or telephone interviews with 'secondary' (desk) research of information relevant to the business and its markets that is held in the public domain. And while either approach may be relevant to a specific transaction, CSA gives some preference to first-hand references obtained from personal contacts identified from within the industry supply chain: customers, suppliers, intermediaries and other peer group companies. Published market reports rapidly become out of date, particularly in niche markets and those prone to fast-change.

Is there a true alternative to CDD? Yes - one can always take company management out for a long beer or two... ... and then look them in the eyes!

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REVIEWING COMPANY COMPETITIVE POSITIONING

Business in the decade now emerging will want to see markets return to growth, pricing hold up and volatility reduce in patterns of trade. However, only those with more precisely defined competitive positioning will truly be able to exploit the hoped for economic upturn. Now is the time to take stock of relative business strengths in the company.

Meaningful competitive review must understand where and how value is created in the business. Performance can only be improved if attempts to add value reflect understood yardsticks set in a wider industry context.

Charting out the industry supply chain is a starting point. Noting the positioning of major industry participants, including: consumers, suppliers and intermediaries one can achieve an objective view of the role of demand vs. supply on comparative pricing power and margin build-up within the industry.

The key changes shaping development of the greater marketplace, the so-called political, economic, social, technological and environmental (PESTE) drivers may need to be assessed. The industry structure and spread of competitors matter because they reveal levels of direct and indirect competition. Market intelligence gained from knowledge about competitor strategy and comparative business direction is fundamental. This should include detail of the timing of new product launches, density of regional selling resource and an understanding of whether competition is 'head-on' or only partial, for example.

Use the customer/supplier/distributor to get at the necessary information. Contacts in procurement, sales and R&D will tell much about specific market circumstances, if adequately referenced.

Above all, base final decisions about a preferred competitive positioning on realistic, 'scenario-driven' assessments of core business strengths and competencies. For example, how dependent is the business on any concentration of customers, suppliers or product/service sales? What would the loss of a key company sales executive or technologist mean to customer relations, order intake or the project pipeline? Could unforeseen competitor advantage see sales substituted, and with what level of forewarning?

No business has to be a slave to fortune. Forewarning is forearming!

CSA's company competitive positioning assessment services are designed to sit alongside and complement the day-to-day activities of company senior management. They provide an independent and objective evaluation of the competitive strengths and weaknesses of a business relative to its trading environment, providing management with a road map for business performance improvement.

COMMERCIAL ADVANTAGE THROUGH OFFER DIFFERENTIATION: A NEED FOR CUSTOMER INSIGHT

It is essential for a business to be able to recognisably differentiate its offering and thus compete successfully against rivals. However, it is a truism that companies who do not understand their customers' specific needs cannot begin to do so.

Understanding a customer's needs is about 'people and processes'. It is about understanding and implementing customer growth strategies that are based on deepening relationships and long-term satisfaction. It is about finely-tuned marketing that best positions products against understood requirements.

So far so simple, but why do so many businesses get it wrong?

CSA believes that it is because companies frequently fail to sufficiently understand the business of their customers and the true nature of their relationship with that customer.

A customer referencing 'audit' is a good starting point and tool used to redress this situation. 'Referencing' offers a means of identifying how well a company's services hold up against a customer's supplier selection criteria. Carried out well, it supplies a balanced quantitative and qualitative performance rating against identified priority attributes – a metric that can be benchmarked against comparable industry peer groups.

Pre-prepared customer interview questions are usually centred on six key points:

1. Is the company seen as a leader, or follower, in its field?

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2. What particular strengths/weaknesses are noted?
3. Who in the marketplace are seen as near alternative suppliers?
4. What supplier threshold criteria determine selection?
5. How does the company rate compared to others for the criteria mentioned?
6. Is it easy to swap-out one supplier from another?

Indicators of success, such as these, help to demonstrate the level of customer value created by the company. Moreover, they confirm: loyalty (underpins forward company sales), how deeply an offering is embedded in customer operations (maintains pricing) and the difficulty of its substitution (barriers against third party market entry).

In summary, customer insight through formal referencing helps businesses understand what relative advantage they hold over alternative market participants.

CSA's customer referencing services help the company to understand relative customer value-add by linking understood business performance parameters to identified competitive yardsticks – from the customer's perspective.

CDD SHOULD NOT COUCH OPINION IN AMBIGUITY

Private Equity Investment Managers and Corporate and Structured Finance Banking Managers making a request for CDD in connection with a company transaction arrangement or banking facility can face a tricky situation. They don't want to be seen to lack faith in the business, nor do they want to appear to challenge a management team's somewhat natural view that 'the company knows its markets best'.

In addition to this, any late request for CDD at a point where the company is expecting an arrangement to complete can become quickly emotionally charged. It is a situation with which many investment and relationship managers may identify. They wish to support the company, but often some of the commercial fundamentals are unclear. They need to understand what can go wrong, as well as right, with the proposition.

CSA recognises this set of problems. It has designed a flexible approach to CDD reporting that aims to address key business and market risks without upsetting company management with over-costly 'chapter and verse' detail.

By first talking to our client, CSA seeks to define the required depth of project scope, working back from any drop dead date. CSA will also ask to review aspects of the initial credit application note, company business plan or information memorandum that may accompany company transaction formalities.

This is a vital step in the process, as it helps outline key issues and priorities – against those already identified by our client. The issue might be that while the EBITDA multiple, based on historic earnings, looks sufficient for the arrangement, there may be one or two 'loose bricks in the wall' that could be the undoing of the company's business in the future.

Typical situations that can be uncovered during the CDD process can include:

- Gaps in company functional resource
- Customer concentration/supplier dependency
- Weak forecasting visibility, delayed sales traction
- Unsatisfactory customer referencing
- Uncertain political, or industry, legislation
- Competitor strategy, impacting pricing

By recognising and flagging up potential 'deal breakers', key issues can be sensitised, working in conjunction with other due diligence providers - such as those in the Financial or HR arenas - to ascertain their impact upon transaction attractiveness.

Whatever depth of analysis is deployed, CDD should not couch its opinion in ambiguous terms. Clients and company management alike require early and clear opinion devoid of 'unexpected surprises' in any final reading.

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