

Karl-Heinz Sebastian, Ralph Niederdrenk, Andreas Tesch, Michael Olbrich *

Market Due Diligence (MDD) – Analysis of Companies from the Market Point of View

| | | |
|---|---|----|
| 1 | Introduction | 2 |
| 2 | Market Due Diligence..... | 3 |
| | 2.1 Initial Situation and Definition..... | 3 |
| | 2.2 Objectives..... | 4 |
| 3 | Areas of Analysis of the Market Due Diligence | 5 |
| | 3.1 Internal Company Analysis | 5 |
| | 3.2 External Company Analysis | 9 |
| | 3.3 Data Sources and Success Factors..... | 13 |
| 4 | Case Examples..... | 14 |
| | 4.1 Case Example: Machinery..... | 14 |
| | 4.2 Case Example: "Brand Value Analysis"..... | 17 |
| 5 | Conclusions and Outlook..... | 19 |

Dr. Karl-Heinz Sebastian, Senior Partner
Dipl. Kfm. Ralph Niederdrenk, Senior Consultant
Dipl. Kfm. Andreas Tesch, Senior Consultant
Dr. Michael Olbrich, Consultant
all at SIMON ♦ KUCHER & PARTNERS GmbH, Bonn und München, Competence Center M&A
(www.SIMON-KUCHER.com)

Februar 2000

1 Introduction

Since the beginning of the 1990s the mergers and acquisitions market has grown explosively in Germany. In 1999 company acquisitions were estimated to amount to almost \$198 billion in Germany alone and to € 1.2 trillion in all of Europe (Wall Street Journal Europe, 19.01.2000). The end is not in sight; experts believe that a volume growth in Europe for 2000 is not an overestimate.

Transactions in Great Britain accounted for a third of the volume in the M&A business in 1999 while Germany accounted for 16%. Mergers and acquisitions were especially prevalent in the financial services, chemicals, pharmaceuticals, trade and commerce, automobile parts suppliers and telecommunications. The reason for this development is the newly discovered growth orientation in capital investment businesses following the consolidation phase of companies through reorganization and concentration on central competencies at the end of the eighties and beginning of the nineties. Following the motto "Concentrate on your central competencies, reach your critical size and you will be successful" companies are buying, selling and merging.

Since the beginning of the nineties, another market has developed in Germany aside from the traditional mergers and acquisitions, namely the private equity market. Acquisitions through private equity companies reached record values in 1999. Owners realize that selling to private equity companies and to the management ensures a better future for their company than selling out to a competitor. In Germany a further factor is increasing the attractiveness of acquisitions through private equity companies: 300,000 mid-sized companies are faced with the question of a generation change. In view of the fact that many of these companies do not have a suitable candidate for successor within the family to lead the business, the potential for take-over through private equity companies becomes even clearer.

Parallel to the growth in mergers and acquisitions as well as equity participation is the growing demand for special advisory services in this market. So-called Due Diligence analyses are becoming ever more important within the framework of investigating a company before a buy-out or merger. Due Diligence analyses of the company performance and risks are the basis for the purchase and selling price negotiations. These analyses allow the investor to appraise and evaluate the company realistically before the purchase. Even though the company or take-over candidate is thoroughly investigated, a Due Diligence analysis is not an annual general audit.

In order to conduct this detailed analysis, financial indices based on past performance are central to the analysis. With the increase in Anglo-Saxon influence on the German M&A business, the degree of strategy and market orientation of a company has become more important. Due to this influence, the methods, indices and processes can be summarized with a Market Due Diligence.

2 Market Due Diligence

2.1 Initial Situation and Definition

Due Diligence analyses are carried out after the signing of the "Letter of Intent" which guarantees the absolute confidentiality of all information for the potential seller and buyer. It is generally at this stage that the first conflicts of interest arise. Therefore the company being investigated wants to divulge only the figures that are absolutely necessary to the buyer before the completion of the sale contract. On the other hand, the investigator wants to analyze the company "from head to toe", because he cannot quantify and minimize the risks of a take-over or equity participation unless his information database is large enough.

In the past, companies have been analyzed according to standardized Financial/Tax, Legal and Environmental Due Diligence. The **Financial Due Diligence** focuses on the analysis of the quality of the company's earning power. The company is investigated with respect to its assets, revenues, financial situation and budgeting, where success and asset-oriented indices as well as various accounting and evaluation methods are examined. These analyses are conducted with the help of an external expert, assisted by certified public accountants (CPAs) and tax advisers. However the Financial Due Diligence is in no way a company evaluation in the sense of a legally required annual general audit. Rather the plausibility of all the financial indices of the take-over candidate is checked and summarized in a report.

A lawyer usually carries out the **Legal Due Diligence** with the focus on commercial and company law. It is primarily the analysis of the company's legal situation. Existing company articles, contracts and deeds are examined and possible special circumstances in the legal formation and labor relations of the company identified. At the same time, the lawyers generally busy drafting the necessary new contracts. Lately so-called **Environmental Due Diligence** analyses have also been conducted, mainly to quantify and evaluate environmental risks. These studies are usually carried out by environmental institutes or consultants specialized in identifying threats from old encumbrances, the estimation of environmental risks in connection with the ongoing production and the calculation of costs for necessary decontamination of ground and/or buildings.

The Financial/Tax Due Diligence clearly shows the weaknesses in the balance sheet and financial indices. The certified public accountants (CPAs) and tax advisers base their results on the balance sheet and financial indices. These however are oriented purely towards past performance. A forecast for the future is not given, the competition has not been taken into consideration, and the strategic planning is often checked merely as an extrapolation of past data to avoid for logical planning errors.

This is where the **Market Due Diligence (MDD)** becomes important. In it the internally available information focusing on market-relevant data (volume, price and market share development, organization of marketing/buying, budgeting, quality of communication, price-

finding processes, product portfolios, and distributor portfolios) are investigated and compared with the demands of the market (customer needs, activities of competitors and statutory boundary conditions). The synergy potential with the purchaser is also examined and quantified in an internal company analysis.

In the external company analysis, customer evaluations are gathered and analyzed. Of course all relevant competitors as well as the company under investigation are included in the analysis so that the exact competitive position of the candidate can be determined. As well as determining the competitive position, the results of the external company analysis are also a good assessment of the future development of the demand for the company's products as well as possible substitute products.

The procedure, analytical methods used and possible data sources will be discussed later in this article.

2.2 Objectives

The MDD should be seen as a supplement to the traditional analyses during the take-over of a company. Thus the exact analyses of the financial indices or the legal boundary conditions are not made unnecessary by the MDD. The results of the financial analysis are often used directly in the internal company analysis (e.g. development of the gross profit on a per product basis, distribution costs and advertising expenditures). The major difference from the traditional investigations is the investigator's perspective. While the traditional analyses usually look only at the internal view of the company (inside -> out) and the Due Diligence analyst takes on the function of the strategic controller, the MDD combines the customer and the internal company perspectives. Here the MDD investigator looks at the company from the point of view of the end-customers, the distributors, and the competitors as well as the product managers, the production staff and the marketing controller.

Not just secondary information is used in the external analysis but rather all market participants are investigated with the aid of, in part, standardized procedures. Usually various data collection methods (telephone and face-to-face interviews) are used to obtain a valid opinion of the company and the situation and prospects in the total market.

Depending on its content, the MDD has three objectives:

1. determination of the competitive position,
2. analysis of the future potential of the market, and
3. determination of the potential for synergy

from the market's point of view.

The potential buyer learns from the MDD whether the assumptions on which the company's value, based on its planning, are plausible or whether they must be changed.

- Will the demand develop as it has been forecasted?
- Are the revenue growth rate and other financial forecasts realistic in the planned time period?
- How high are the market-related expected synergies of a merger?

These questions can only be answered on the basis of expert judgment. Within the framework of the MDD the validity of these estimates is increased by including the opinions of customers, distributors and experts from associations, industry journals, press releases, competitors and suppliers.

The results of the MDD give the potential buyer a well-founded basis for the decision of whether to buy the investigated company and arguments that can be used in the purchase price negotiations.

3 Areas of Analysis of the Market Due Diligence

3.1 Internal Company Analysis

Within the framework of the internal company analysis, on the one side, the marketing-relevant company areas, marketing planning and marketing strategy are examined and, on the other side, all available information in the company about market performance is gathered, analyzed, and systematically processed. These analyses broadly correspond to the familiar instruments of the marketing controlling and the marketing audit. Obviously, an internal company analysis can be conducted only through an open MDD, after the interested parties have signed a Letter of Intent.

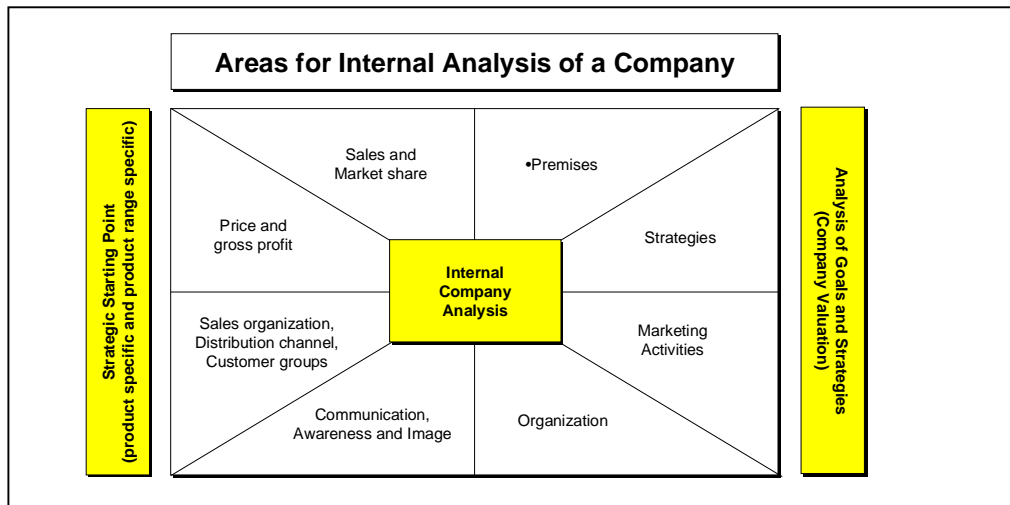


Figure 1: Internal Company Analysis within the Framework of the MDD

"No future without a past" is a tenet, which is only partially true for rapidly growing companies, especially in the areas of new technologies. However it is still true for the majority of industries. Therefore, in the analysis of the strategic initial situation, which is similar to the marketing controlling, the development over the last 5 to 10 years with respect to the market volume, market share (relative and absolute), sales, price, contribution and marketing expenditures by products, distribution channels and sales areas is documented and checked for plausibility. The open questions are handled in the form of checklists.

From previous experience there is already in this early phase a considerable need for explanation. For example, for auditing or tax reasons, revenue/results are assigned to certain billing periods to minimize the tax burden. This is often the explanation for discontinuities in the revenue trends. Within the framework of the MDD, the management of the company, which is being analyzed, always answers these open questions. Therefore the work must be carried out on the spot. Usually a data room is set up for the internal company analysis. However, it has become evident that much of the information needed for the MDD is often not documented in enough detail, so that this deficit must be made up through personal discussions. It is often the case that the Due Diligence team is seen as external business consultants because the entire staff has not been informed of the intent to sell.

In the result-oriented analysis of the strategic initial situation, the focus is on the following questions:

- "What product program does the company offer which customer segments (regional and qualitative differentiation)?"
- "How has the company developed in the individual segments over the last few years in terms of sales, market share, price, marketing costs, distribution costs and contribution?"
- "How do company prices compare with those of competitors?"
- "Which product contributions achieve a good return on the investment?"

- "What distribution strategies does the company follow?"
- "How many customers does the company have and what is the degree of their customer loyalty?" ... how long can one count on them remaining loyal?"
- "How high are the contributions in the various distribution channels/for various customers?"
- "What means of communication are used? What is the communications budget? How well-known is the brand?"
- "How are R&D activities translated into innovations?"

In the analysis of the information, it must be taken into consideration that the available data will be condensed on various aggregation levels (entire product range, product groups, individual products) into annual indices and compared with each other:

- Sales/customer
- Sales/population of the export countries or sales/GSP of the export countries
- Sales/trading partner
- Revenue/advertising expenditure
- Revenue/marketing employee
- Number of customers/marketing employee
- Contribution/product
- Contribution/customer
- R&D expenditure/revenue from newly developed products

The listed indices are only a representative selection. Obviously the indices must be adapted to the specific company and industry. In this way the relations between consumer goods and investment goods branches are fundamentally differentiated. Where the accounting department cannot provide detailed, categorized data the opinions of the management must be used.

The data should be graphically represented, especially when comparing data from several years, so that it is easier to identify irregularities. As well as the analysis of "hard facts", all available qualitative estimations by customers are gathered and classified in this phase. Especially for companies producing trademarked commodities, factors such as brand awareness, image and usage behavior play an important role. The information supplied by the company is often checked again for validity using external market research.

In the examination of the goals and strategies, the assumptions underlying the company planning are investigated, the formulation of strategies are analyzed, the expected effects of planned actions are estimated, and the organization is evaluated on the adequacy of its strategies.

The investigation of premises of a company involves all assumptions on which planning is based, such as price evolution and changes in the legal boundary conditions. In the next step, the plausibility of all assumptions is checked with respect to the strategic initial situation. Many of the open questions are dealt with in the external company analysis and form a part of the

questions that are posed to the experts. As well as the plausibility considerations, there are other questions to clarify:

- Are all decision-relevant premises (especially the competitors' behavior) identified and included in the planning?
- Is all available information included in the formulation of the premises?
- Is the existing information up-to-date, accurate and reliable? How large is the uncertainty with respect to the effects due to certain events?

The knowledge gained from the investigation of the premises is documented and can be used especially in the purchase price negotiations. Should large errors in estimates be found, it is valid there should be a second look taken at the company's planning.

In the checking of the strategy formulation, the goals and strategies fixed in writing are collected and analyzed. If changes in indices are significant (e.g. in planned contribution margin for specific products) or totally new sales areas (regions, customer groups, distribution channels) are opened, then the management must be asked for an explanation. Often the influence of competitors on the effectiveness of some strategies is neglected. This often also leads to further questions in the market investigation in the external market analysis. In addition, care should be taken that all goals are operationally formulated and their inter-consistency is checked.

The effectiveness of future marketing measures used to achieve the goals (product policy, pricing, distribution, communication expenditure) must be checked. Here, too, the use of historical data is helpful.

- Can the planned sales be achieved with the provided marketing budget?
- Are the marketing measures compatible with the formulated goals?
- Have the marketing mix components been checked against one another with respect to their contents and the total budget?

The comparison of past and planned indices (e.g. sales/distribution employee, revenue/advertising expenditure) often shows variations. A lack of plausible explanations for them can again be trump cards for the potential buyer when negotiating the sales price.

Finally the suitability of the existing and/or planned marketing organization for implementing the strategies must be checked. It is attempted here to estimate, as well as the numerical staffing of individual departments, the productivity of the remuneration system and the qualifications of key personnel. Discussions are conducted with selected staff members. For example, internationalization is often the object of company planning but the necessary additional expenditure for personnel and the willingness of existing staff to work abroad is incorrectly assessed. Furthermore, it is important to document the existing system and to test its efficiency. Company databases are often out-of-date and do not contain the information necessary for optimal customer processing.

To conduct an internal company analysis successfully, it is absolutely necessary to work quickly, accurately and in close cooperation with the management. Those responsible for the analysis should have experience in and know-how about the process. Aside from external consultants, the marketing controller of the potential buyer could do this job.

The result of the internal company analysis is the production of a "Company Fact Book", containing all data collected and all verbal information gathered from the management. At the end of the Fact Book, all still unanswered questions and areas requiring further clarification are listed. The face-validity achieved through the internal analysis and the corresponding modification of the planning is further increased by the external company analysis. A large part of the questions asked in this analysis, for example the expert evaluation of the planning assumptions, come from the internal company analysis.

3.2 External Company Analysis

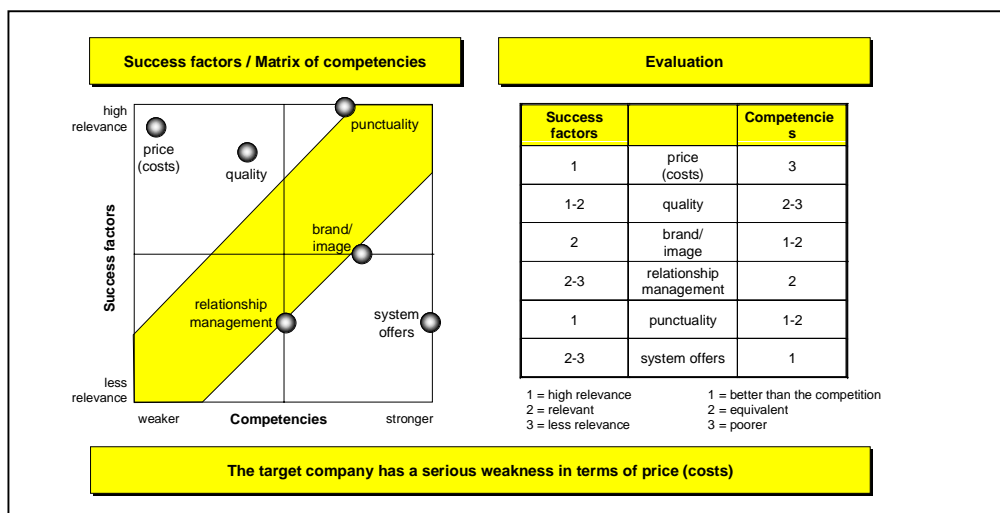
While the internal company analysis concentrates on the collection, evaluation, organization and interpretation of data available within the company, the external company analysis focuses on the company environment. It is based on data collected outside the company that must then be interpreted.

The external company analysis consists of two parts: the analysis of the critical success factors and the so-called feasibility study. These two analyses provide a comprehensive view of the competitive environment of the company.

The following questions are central to the analysis of the critical success factors:

- "Which success factors generally have an impact in that business?"
- "What is the ideal size for the company?"
- "What is the average revenue yield and margin in that branch?"
- "What general standards exist in that branch?"
- "Does the branch depend primarily on customer relations?"
- "What legalities exist between the various companies that are involved in the value-added chain?"
- "What future market trends must be taken into account in the long term?"

On the basis of these questions, the various success factors in the business can be determined, assigned priority relative to their importance, and then compared with the results



from the internal company analysis. The success factors and the company competences are often compared in a matrix, enabling the external observer to visualize quickly which success factors are competitively decisive in specific businesses and how well the company performs in these factors. The following figure illustrates the process.

Figure. 2: The Success Factor/Company Competence Matrix

In the example above, six decisive success factors can be identified from the discussions with the management within the company and through the integration of know-how from unbiased experts in the branch. The factors punctuality (keeping to agreed schedules), price and quality were classified as the top success factors. Brand/image, relationship management and systems offered were also rated as important but do not belong to the top criteria. The horizontal axis is the competencies of the company in these criteria. The first conclusions can be reached. In the very important factors price (costs) and quality, the company's competencies are not good enough to compete successfully. The company leads its competitors in the criteria systems offered, which is a less important success factor. Here one must ask whether resources that could be put to better use are being thrown away. These internal conclusions must be corroborated by an external evaluation.

As well as the analysis of the critical success factors, the external company analysis includes a second dimension, namely the feasibility study. The central question here is whether or not the company is competitive in the market in the long term. Additionally, the following questions are investigated:

- "How many companies are competing in the market and what are their respective market positions?"
- "Does the company have any strategic competitive advantages?"
- "Where is there potential for improvement in meeting customers' demands?"
- "What is the company's position in comparison with the best practice/benchmark company?"
- "How is the company/product portfolio positioned?"
- "What future market trends must be taken into account in the long-term planning?"

In principle, these questions in the feasibility study target the validity of potential competitive advantages of the company. The foundation for the competitive advantages is the existence of a long-term competitive strategy of the investigated company. Competitive advantages have to be created which are able to exist in the market over time. A company has a competitive advantage when its performance is superior in a factor that is important for customers. To be able to evaluate the competitiveness of a company, it is necessary to identify competitive advantages in comparison with the competition. To quantify these advantages, customers and potential customers (until now non-customers) are questioned about their purchase behavior relevant to the company. Thus the feasibility study is an extension of the analysis of critical success factors. This analysis inquires primarily into the critical success factors by means of discussions with managers and branch experts and through interpretation of other secondary statistical data such

as association statistics, government statistics or standardized market information systems based on original market research in the relevant market environment.

This view that is basically derived from the market research is new to the area of the Due Diligence analysis. The results from interviewing customers and non-customers, suppliers, and even competitors have long been under-valued and indeed their influence on the decision to buy or not buy the company has been under-estimated. A few discussions with customers often provide far more evidence than a well-founded analysis of book balances and financial indices. Nevertheless one should not dispense with these analyses. The feasibility approach should be seen as a necessary supplement to all other investigations.

Conducting the interviews is not without problems. Because of the time pressure, the interviews should be limited to the essential information. As for the customers and non-customers to be interviewed – according to branch, these end-customers or members of a buying center could be one company that has been contacted in advance through a personal letter to ensure their willingness to participate.

In the first part, information about the competitiveness of the company is to be gathered. By means of the relevant individually conceived interview concept for the company to be analyzed, it is possible to identify the Best-In-Class company in the branch. The business-specific performance factors could be determined for it, customer satisfaction measured, and their service competencies evaluated. In addition, through skilful questioning, the price standing of the leading company in the branch can be analyzed and, in comparison with the competitors, a statement of the degree of competitive differentiation of the purchase candidate can be made. Besides the repurchase rate, the duration of business relationships can be used as a measure of customer loyalty.

Based on this data on the competitiveness of the company being analyzed, a strengths-weaknesses analysis from the market's point of view can be made. The key factors are selected according to the importance of each individual relevant factor and the purchase candidate's performance in each factor is compared with the importance of that factor. The choice of relevant characteristics/factors should in all cases be made by a team consisting of the company management and the project team of the business consultants to ensure that the business and branch relevant factors are included.

The customer requirements and the perceived performance of the purchase candidate from the market's point of view are combined in the **Matrix of Competitive Advantages**. In an ideal profile, superior performance is achieved in the important requirements. To enable the concentration of resources on these strategic competitive advantages, below-average performance in less important factors is acceptable. The matrix of competitive advantages shown below makes it clear that the company being investigated possesses strategic competitive advantages. There are also factors in which, from the market's point of view, there is potential for improvement. This form of presenting the data gives the investor a first indication of where

competitiveness can be improved in the opinion of market-oriented customers and non-customers. This diagram can also be made for the important competitors in the market. Through this analysis, the information about the competitiveness of competitors can be gained.

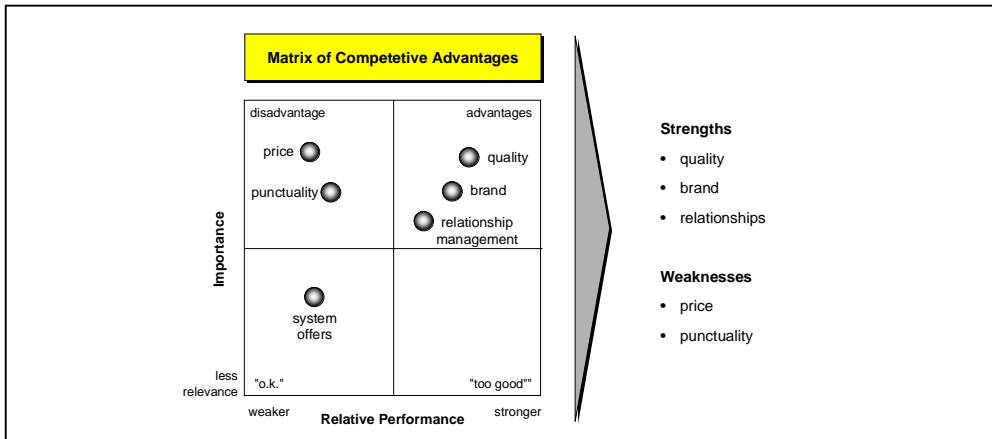
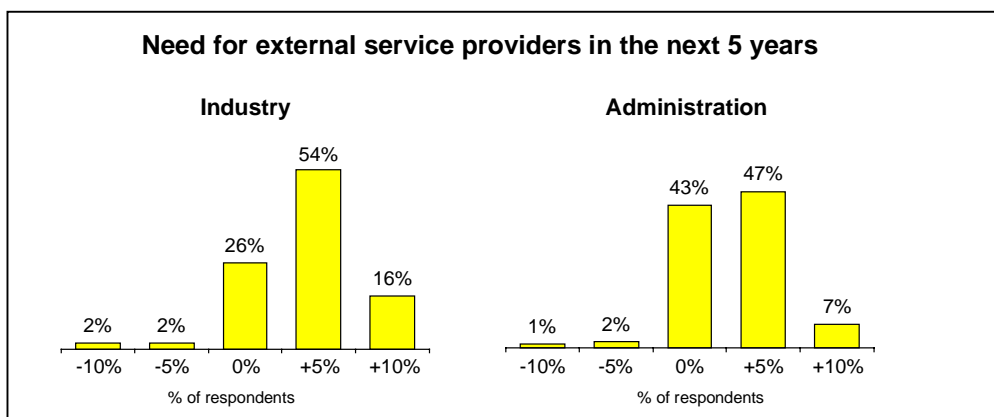


Figure 3: Matrix of Competitive Advantages

In this case, the matrix of competitive advantages must be seen as a supplement to the success factors/competencies matrix. The customers and non-customers are again asked explicitly about the success factors, thus checking earlier results against the market's point of view. In the opinion of customers and non-customers, the company has clear competitive advantages in the criteria quality, brand and relationship management. Company weaknesses exist in the factors price and punctuality. Comparing this with the success factors/competencies matrix, it is clear that the management correctly assessed the company's performance in price. Company performance in this criterion was also poorly rated in the success factors analysis. The company's performance for punctuality is completely overestimated: the management saw no need for improvement but the market's judgment was clearly the opposite.

A further important part of the external company analysis is the assessment of **the market** stability/prospects. If the competitiveness analysis is carried out for a specific point in time and data on how customers and the purchase candidate have worked together in the past is taken into account, then the focus of the market stability/prospects is related to a period of time and is future-oriented. Therefore statements about the market volume and evolution and other topics are also collected. Furthermore, questions should be asked about possible legal limitations that could perhaps place restrictions on the company policy. The analysis of price development in the market, possible substitute products, services or processes, and general trends in experience should be included in the questionnaire. Finally, information about the degree of



internationalization in the branch can be gathered. The analysis of market stability/prospects is supplemented by various secondary information such as branch reports, statistical information and by discussions with experts in the branch.

Figure 4: Estimates of Demand Development

For example, in connection with the MDD for a company offering external services, the demand over the next 5 years in the areas industry and administration was determined. A moderate annual growth of up to 5% could be identified in both branches

Finally this gathering of the external market data enables a statement to be made about the strategic market conditions under which the take-over candidate operates. It must be recognized that the time needed for the external company analysis is dependent on the size of the investigation. Thus this analysis could take up to four weeks. It must be clear during the data collection, that it is not a market research study. Rather the success factors analysis and the feasibility study represent a cross check using the collection of primary data supported by branch reports, association statistics, other secondary information, and discussions with market experts.

3.3 Data Sources and Success Factors

To be able to conduct a MDD successfully, different data sources must be made available. On the other hand, different frameworks must be taken into consideration so that the information can be combined into a final assessment.

Data is gathered from three different types of sources. The first is company internal data sources. Through discussions with the top two levels of management, an attempt is made to check the validity and plausibility of the systematically gathered internal data. Workshops are often conducted to gather further information. However, this is only possible when the company to be taken over knows about the possible new owner. Another source of information is the data on the market and competition. As already stated, customers and non-customers are interviewed and data on customer wishes and evaluation of the company is systematically collected. In addition, discussions with competitors and suppliers are often carried out to give the broadest possible picture of the take-over candidate. So as not to be totally dependent on the opinions of company-internal experts, customers, suppliers and competitors, a third source of data is used branch experts. They are consulted and/or invited to "round-table" discussions where they are asked for information about the market, competition and special characteristics of the branch. Benchmark studies about other areas, markets, companies and comparable MDD studies from the SKP-internal databank are also consulted. These sources of varying depth and type allow a systematic and comprehensive MDD.

Besides the data sources, the processing - calculation and interpretation - of all the data collected is especially important for a comprehensive final assessment. The "art" of a MDD is to

recognize "invisible" structures, correlations and assumptions within the shortest possible time. Therefore the collection of the market and competitive data requires a certain "stress resistance" on the part of the participating consultants during the interviews. The correct choice of discussion partners is decisive in the contribution of the individual results to the total report. The participation of customers and non-customers in these discussions must be worthwhile. It must be possible to play back partial results of the contents of the interview to the discussion partners. The internal analysis must take place on-site at the company. In this process a sufficient amount of trust must be built up to permit cooperation. The continual checking and re-checking of the information for plausibility is important. This requires several years' experience on the part of the consultants so that they are competent in the classification of correlations and in the interpretation of data. In principle, there should be a standardized procedure for carrying out of the various parts of an MDD. This enables the team of consultants to use experience from other similar projects, especially to identify problem areas more quickly. Communications within the team and with the client and the resulting continual feedback discussions guarantee the success of an MDD.

4 Case Examples

4.1 Case Example: Machinery

Within the framework of an MDD analysis, a company producing machinery was comprehensively investigated in all four areas of the internal and external company analysis. The following diagram illustrates the four different fields of analysis as well as the special methods used:

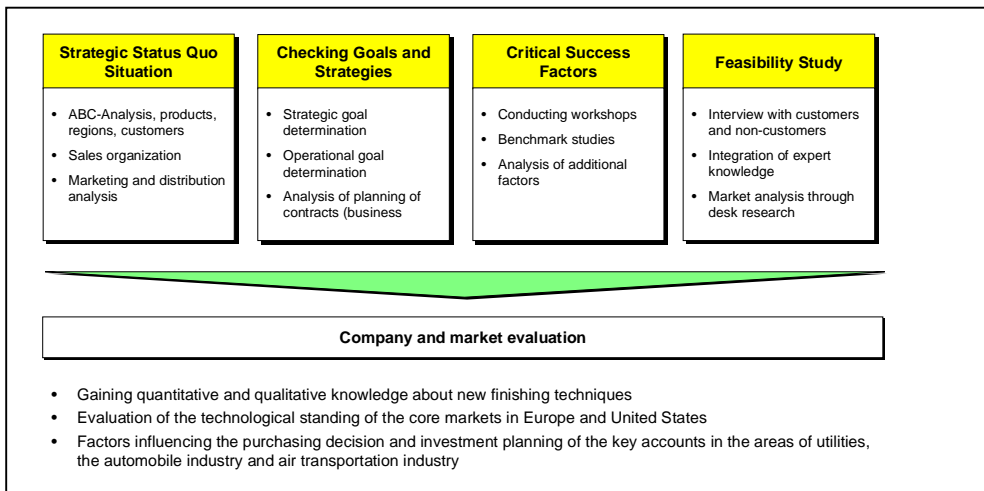
Figure 5: Areas of Analysis

After four weeks of comprehensive analysis, the following results were obtained. Before these are consolidated into a final assessment, the most important results from the four fields of analysis are listed.

Strategic Initial Situation

The company was rated as below average in the initial strategic analysis. 80% of the revenue was generated by 30% of the products. Whether this relationship is at present quite normal is made clear by a detailed analysis of the interdependence between products, market and branches. This showed that most (70%) of this 30% of the products was concentrated in the automobile industry. Over and above this, America was the leading market area with 65% of the company's sales. Thus a critical product dependence on branch and region was identified. However, this region-specific marketing alignment was not reflected in the organization. Thus, decisions were made primarily in Germany, there were various national teams which did not work together, an effective service network existed only in Europe, and the machinery was not sold in teams but rather by "one-man selling".

Checking Goals and Strategies



In the analysis of the goals and strategies, the operative planning was criticized especially. The chosen strategy was to maintain the leadership in quality, to improve the market position in the USA and to improve the balance in the branch portfolios and the national/regional portfolios through increased activity in Europe but no concrete measures had been planned to achieve this

goal. Neither operative marketing actions nor planning for the necessary adjustments in the organization could be identified. It was finally established that the "lip-service" to the strategy was not reflected in concrete plans for its execution.

Critical Success Factors

The company received a positive rating in the critical success factors analysis. The goal to maintain the leadership in quality was attainable given the internal competencies and success factor product quality. Furthermore the benchmark analysis showed an above average revenue yield in the comparison between sectors. In addition the company was sufficiently large, at least in the USA, to remain an active, long-term partner in the automobile industry.

Feasibility study

In the market discussions with customers and non-customers in Europe, the USA and Asia the demand for quality from machinery manufacturers was verified. The market analysis showed a growing importance of the target groups automobile industry and energy producers. Here too, the company was correctly positioned. The trend towards offering entire systems as well as the demand for global market presence was the central result from the round-table discussions with branch experts. The company was judged to be able to fulfill these new market demands in the long term.

Company Assessment

Finally the results were consolidated in the so-called Business Environment Matrix with the dimensions competitiveness and market stability/prospects and in a separate strengths/weaknesses table illustrated in the following diagram.

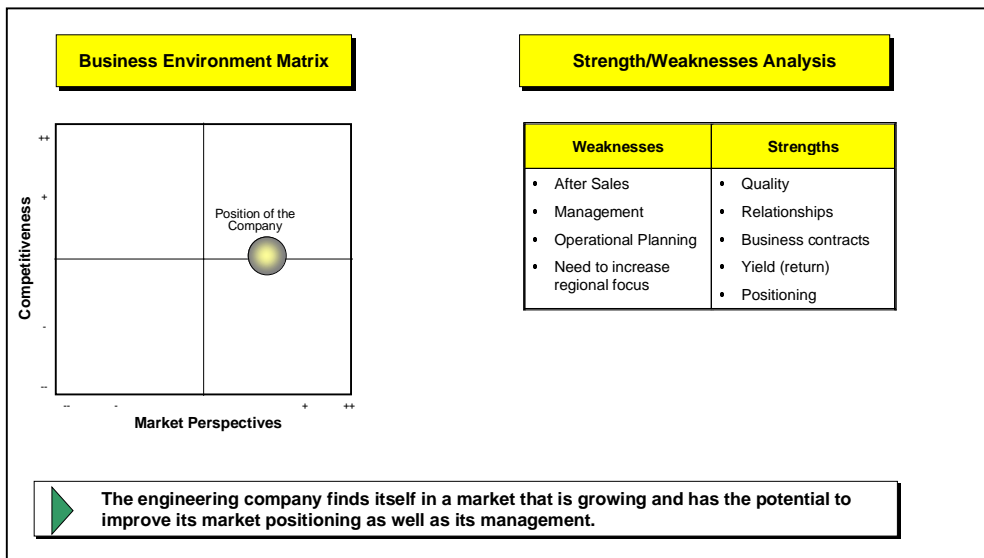


Figure 6: Company Assessment

The diagram clearly shows that the machinery company is competing in a growing market but improvements are needed in its management and marketing. Based on these results from a comprehensive MDD, the prospective purchaser was recommended to buy the company.

4.2 Case Example: "Brand Value Analysis"

The assessment of a company manufacturing branded consumer goods was a special challenge for the evaluation process. The various methods for determining the brand value produce vastly differing values and therefore their suitability for use in the M&A market has often been discussed in the literature on the subject but has not yet been accepted. In an actual evaluation of the brand "Pro 7" (german TV-channel) the various methods produced the values DM 2.2 billion, DM 1.6 billion and DM 0.2 billion. In three different publications the 1992 brand value of "Coca Cola" was given as US\$ 3 billion, US\$ 24 billion and US\$ 33 billion.

In an MDD the value of a toy company derived from the importance of a brand name was to be investigated.

Strategic Initial Situation

The company's strategic initial position was rated positively. Revenues had more than doubled in recent years. However, weaknesses were identified in exports that generated only 20% of the revenue. Furthermore the advertising budget was very low compared with competitors. A disadvantage was seen in the focusing on a few specialist dealers; the usual wide availability of such a brand article was lacking. According to statements from the management, other distribution channels were not exploited because of limited resources for marketing and because of a fear of diluting the brand. Marketing partners in other channels such as mail order, department stores, and gas stations would bring only isolated success. The brand was also well-known by non-customers and had a positive image. The results from the internally available market research were verified by market interviews and discussions with experts.

Checking of Goals and Strategies

The company value determined by the prospective buyer was based on discounting the expected future cash flow. With this forecast, a unique increase in revenue and results was predicted. Based on the strength of the brand, new distribution channels were to be used and further foreign markets entered. Until the present time, the expansion of the business had foundered due to a lack of resources. The focus over the last few years had been on intensifying efforts in the existing business. For the expansion, the planning took into account appropriate communication measures and strengthening in marketing personnel, since the existing staff was not well-qualified for the implementation of the internationalization strategy. In particular, the US market

could be much more strongly exploited than to date by choosing a suitable distribution partner. To verify these planning premises, intensive discussions with the management plus a series of telephone interviews were conducted and the Internet was used as a platform to gather information from and to communicate with product buyers. In the planning, the development of the product contribution margin was taken to be constant. The analysis of the competitive situation showed this assumption to be plausible, given the background of the stable competitive structure of this market segment and the relationship with reliable suppliers.

Critical Success Factors

The analysis of the critical success factors showed the brand name to be very important in the customer's buying decision. It was shown that, given the availability of the products (i.e. the product was easy for customers to find in shops), the brand name is a decisive purchase criterion. However, the brand was not so strong that customers would look specifically for that product. The distribution is crucial for future success in Germany as well as abroad. The outlets for the products must be increased. The analysis further showed that a wide distribution could only be achieved through developing relationships with retailers by personal visits by sales representatives and by support in marketing measures. Furthermore, it was shown that communication measures would strengthen the products' positioning. With respect to the product policy, the company received good ratings from both retailers and end-customers for their comprehensive product range. A comparison with competing products showed that, until now, no one had achieved a price premium. The investigation also showed that the brand strength influences product preference only at equal prices and a price premium would be very difficult to achieve.

Feasibility Study

Conversation with buyers in the trade, distributors abroad, and experts from clubs and specialist magazines, and interviews with a large number of customers and non-customers confirmed the brand's attractiveness to customers and the potential for further market expansion. It was also shown that the demand in the traditional marketing channel (specialty shops) would stagnate in the future, confirming the validity of the strategy to open new distribution channels. The interviews abroad indicated a large, unexploited potential for the brand in Japan and the United States. The staff increases needed in the export department had already been included in the planning.

Company Assessment

The planned growth based on the brand strength was shown to be plausible but the uncertainty attached to achieving the necessary organizational prerequisites was taken into account in the negotiations of the purchase price.

In addition, it was shown that a well-founded company evaluation based on discounted future yields or cash flows which take into account brand strengths is much better suited to evaluating a brand than the models often based on point estimation processes.

5 Conclusions and Outlook

There is a growing trend towards mergers, take-overs and equity sharing to ensure the competitiveness of a company or to solve succession problems in middle management.

Due Diligence analyses are in these cases the most important tools for the systematic evaluation of the take-over candidates. As a future-oriented analysis tool, the MDD analyzes the company both internally and externally.

The MDD supplements the Due Diligence analyses used until now through its innovative use of the combination of data sources within the company in the internal analyses plus market data sources in the collection of primary market data. The coordination of the four areas - statistical stock-taking, checking of goals and strategies, critical success factors analysis and the feasibility study – results in a final assessment which has taken into account both historical and future-oriented aspects.

With time, the MDD "tool" will become established next to the traditional Financial, Tax and other Due Diligence analyses, because the knowledge about customer requirements, competitive differentiation and market development is indispensable for a consistent strategy planning and implementation and must be included in the evaluation of take-over candidates.

References:

- Kotler, Philip/Gregor, William T./Rodgers, William H. (1989): The Marketing Audit comes of age, in: Sloan Management Review, Winter 1989, pp. 49-62.
- Niederdrenk, R. (2000): Fusionsmanagement, in: Frankfurter Allgemeine Zeitung, 10.01.2000, p. 27.
- Nussbaum, Cordula (1998): Der Wert der Marke in Mark und Pfennig, in: media & marketing, 6/1998, pp. 16 – 21.
- o. V. (2000): Germany's M&A Activity Slowed in 1999, in: Wall Street Journal, 19.01.2000, p. 13.
- o.V. (1989): Marken: How much in Dollar?, in: Absatzwirtschaft, 8/1989, pp. 50-54.
- Sebastian, Karl-Heinz/Niederdrenk, Ralph/Tesch, Andreas (1998): Market Due Diligence: Bewertung von Unternehmen aus der Sicht des Marktes, in: M&A Review, 5/1998, pp. 207 – 211.

Sebastian, Karl-Heinz/Olbrich, M. (1999): Goldgrube oder Fass ohne Boden: Die Market Due Diligence bei Internet-Unternehmen, in: Frankfurter Allgemeine Zeitung, 29.11.1999, p. 27.