Zachary Scott
TRUSTED ADVISORS

INSIGHT
PERSPECTIVES ON THE CAPITAL MARKETS
REPRINT
SPRING 2016

Improving Acquisition Success Through Better Assessment: Part 2—Assessing Internal Capabilities and Competencies

Businesses succeed for different reasons, and the reasons matter.

by Mark Working

The statistics on acquisition success, measured as realized return on investment relative to expected return on investment, are not good. Most of the research indicates that only about half of all deals are "successful." A recent Harvard Business Review Report claims that between 70% and 90% of all corporate acquisitions are deemed failures from a value standpoint. As advisors in mergers and acquisition transactions over more than a quarter century, we have observed that the most common villains stealing success from acquisitions fall into one of three buckets: misjudgments about the duration of the business model in its industry setting (sustainability), shortages of the necessary ingredients required to perpetuate the business under new ownership (capabilities), and an over-optimistic view of future profits, capital and the relationship between the two (price).

Each business offers a value proposition to its customers, suppliers, and employees. To deliver that value proposition, the business employs capital and labor in order to produce a "profit." Almost every business environment is dynamic, such that everything is under attack; whether from competitors, suppliers, customers, or substitutes that can challenge the validity of the value proposition that is the basis of the business. It is in this context that acquisitions are made. Not an easy job, but odds of success can be increased with thought and discipline.

PART II: CAPABILITIES AND COMPETENCIES: LOOKING FOR THE UNIQUE SET THAT EXTENDS THE DURATION OF SUCCESS

Businesses succeed for a variety of reasons. Why they succeed is of great importance in an acquisition, because the different reasons for today's success do not have equivalent future value. Each business is an organic entity operating in a dynamic ecosystem, and taking a snapshot of a company's success at any one time isn't necessarily insightful as to how successful the business will be following an acquisition.

In Part I of this series, we addressed how to look externally at the company's position in its industry, how it makes money, and the direction of the demand curve. However, even in a positive trend industry, businesses compete and there are winners and losers. In Part II, we expand on this foundation to address the particular capabilities and competencies of a business in the context of its future competitiveness.

The sum of a company's talents, processes, rights, relationships, and skills embedded within the organization determine how the business competes. Successful businesses demonstrate high levels of productivity that offer customers better value through better products or lower costs. Their ability to accomplish this can come from three general types of capabilities, illustrated by the following three companies:

As advisors in mergers and acquisition transactions over more than a quarter century, we have observed that the most common villains stealing success from acquisitions fall into one of three buckets: sustainability, capabilities, and price.

THE HUSTLE BUSINESS

- ABC Company is a very effective manufacturers' rep business for a high profile consumer product OEM. ABC has assembled an impressive team of experienced and professional account managers that deeply understand the products they represent, exhibit extraordinary sales skills, have developed meaningful personal relationships in the industry, and above all, have the motivation to pound the pavement. A very responsive and effective customer service function supports the account managers and the OEM they represent. Management has developed a culture of hard work, perseverance, and service, and has implemented a compensation system that rewards the desired attitudes and teamwork required to accomplish the company's goals. The business is and has been very profitable and requires only a small amount of capital (largely office equipment and receivables) to support the business. While others in the industry have the same access and opportunities, ABC's people execute the best. This is a "hustle" business.

THE BETTER MOUSETRAP BUSINESS

- DEF Company owns and operates refrigerated storage facilities physically attached to their customers' facilities which produce highly perishable food products where quality is directly associated with the time between harvest and a frozen state. These products are sold in small quantities over the entire year. Over the course of the relationships, DEF has undertaken significant efforts to organize joint operations to minimize the time from processing line to the freezer and has employed rigorous metrics and systems to report their achievements to their customers. Additionally, DEF has right-sized its operations to better fit the economics of their clients' facilities. Investment in facilities, equipment, and systems has given DEF a decided advantage over competitors that cannot meet the "speed to freeze" and incur transportation costs to move product. Despite the heavy capital investment, DEF earns a high rate of return on its capital, earning that return through efficiencies and service. Capital, knowledgeable work force, and systems management are the key ingredients. Simply put, DEF provides a service level that its competitors cannot match. This is a "better mousetrap" business.

THE PROTECTED BUSINESS

- GHI Company produces and distributes a high quality frozen center-of-the plate seafood

(continued p. 2)

product to high-end restaurants. Considered a delicacy, product of this quality is in short supply, originating in only a few fisheries in the world. GHI is an integrated operation from its government-granted and lawfully protected perpetual right to harvest, to an immediate processing, packaging, and freezing operation. GHI enjoys the benefits of "free" resource in constrained supply, as well as an efficient processing and delivery model. GHI produces a protein staple from a perpetual proprietary low cost source allowing it to earn extremely high margins and returns on capital. Other businesses would love the opportunity to take a share of GHI's value capture, but can't access the resource. This is a "protected" business.

Companies ABC, DEF, and GHI are very successful businesses, but they are not successful for the same reasons. ABC's hustle and service culture may be unique today, but is not guaranteed to continue. A competitor copying the model and hiring appropriate personnel could over time reduce ABC's advantage. DEF has built a defensible niche with economic advantages, both in transportation and operational integration savings, helping customers produce higher quality products that will achieve higher prices. Until and unless the economics of the customers' business models change and DEF no longer has the most optimal operating structure to service their needs, DEF will retain a favorable position. Finally, other than for the external risks of biology and consumer preferences, GHI has obtained an enviable proprietary low-cost channel with a short supply product.

MEASURING THE ADVANTAGE

Assessing the value of the individual businesses' capabilities and competencies comes from measuring the advantage the business enjoys from several viewpoints:

1. Are the capabilities valuable, in that they result in lower costs and/or better products?

2. Is the advantage rare, implying that it is unique and not available to others?

3. Can the advantage be imitated or replicated by copying, making investments, or adding new hirable skills?

4. Are substitutes available to replace the advantage?

Change will occur in the future. A major consideration in making an acquisition is how high and how durable are the barriers to beat back others trying to whittle away at the business' success.

Part III of this series addresses how to take the company's position, economic model, and capabilities into account in valuing the target acquisition. The mechanics are arguably the easiest task, once the guiding assumptions are determined. **ZS**

Zachary Scott

TRUSTED ADVISORS

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

Frank Buhler
206.224.7383
fbuhler@zacharyscott.com

William Hanneman
206.224.7381
bhanneman@zacharyscott.com

Ray Rezab
206.224.7386
rrezab@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Derrik Larsen
206.838.5527
dlarsen@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Mike Dannenberg
206.838.5531
mdannenberg@zacharyscott.com

David Petrisor
206.838.5529
dpetrisor@zacharyscott.com

Mark Working
206.224.7382
mworking@zacharyscott.com