Zachary Scott—an investment banking and financial advisory firm—has published this newsletter since 1997 to bring you a thoughtful analysis of issues affecting middle-market businesses.

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PERSPECTIVES ON THE CAPITAL MARKETS SUMMER 2018

IN$IGHT

Where Private Business Acquisitions Go Wrong

Part III: Effective Management of Cultural Mismatch

by Kapil Sharma

In previous issues of IN$IGHT, we discussed why successful private business acquisitions need clear strategic rationale and thoughtful post-merger integration (PMI). In this final article of the series, we explain why cultural mismatch is a major reason for M&A failure and share some practical suggestions for addressing this problem.

WHAT IS CULTURE AND WHY DOES IT MATTER?

There are numerous definitions for organizational culture. For our purposes, we will define culture simply as "the way we do things around here." Culture is the set of deeply-rooted values and beliefs that shape the behavior and attitudes of employees.

Ironically, we have found that it is often difficult for companies to define their own culture and how it influences their behavior. Trusted outsiders are often the best observers of culture.

It is important to realize that culture is learned. While formal training can help, new employees typically learn about culture informally through stories, language, rituals, and shared behavior.

Culture is lasting. It can and does change, but usually very slowly. Therefore, blindly imposing new cultural values on an acquired company rarely replaces underlying values and beliefs.

Why does culture matter? Historically, competitive advantage, for the most part, was a function of better assets and refined strategy. However, globalization and easy access to information has undermined these factors. Capital to build assets is now readily available and competitors can quickly replicate a successful strategy. What cannot be easily replicated is a superior performance culture.

IMPACT OF CULTURAL MISMATCH ON M&A SUCCESS

Culture can have a broad and far-reaching influence on M&A success. According to a large survey of American CEOs and CFOs, culture is one of the top factors affecting a firm's value; 48% would walk away from a target that is culturally misaligned.[1]

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Realization of M&A synergies can be complicated by some basic cultural differences between companies:

1. Attitudes Towards Hierarchy Effective integration requires rapid decision-making. However, differing decision-making styles can reduce decisiveness and slow implementation. This was one of the main reasons for the failure of the Daimler-Chrysler merger. Daimler was a hierarchical German company with a clear chain of command and respect for authority. Chrysler had an incompatible, team-oriented and egalitarian approach to decision-making.

There is not necessarily a "good" or "bad" culture. However, the company's culture must be compatible with its business strategy.

2. Beliefs Around Incentives Employees trained to achieve goals as a team cannot easily coexist with those who are used to being rewarded for personal successes. Interactions between competitive and collaborative employees can lead to friction and reduce overall productivity.

3. Resistance To Change Employees in an acquired company might have a strong bias towards the pre-merger state and goals. However, M&A brings about the inevitable necessity of change and new strategies. The failed AOL-Time Warner merger has often been blamed on staid Time Warner employees who had no appetite for change.

4. Shared Values About Systems and Processes In some organizations, people work together based on formal role definitions and adherence to established processes. In others, it is all about informal relationships. We saw this stark contrast in a recent transaction involving two large beverage distributors. Employees who were used to following established processes became frustrated by their colleagues' "unstructured and cowboy-like" approach.

WHEN CULTURE IS INCOMPATIBLE WITH STRATEGY

There is not necessarily a "good" or "bad" culture. However, the company's culture must be compatible with its business strategy. The following examples show how certain cultures fit with different strategies.

- A business that earns its customers as a result of product innovation thrives when its employees have freedom to investigate new ideas and approaches and where teamwork is supported to bring forth the best ideas to their final form.
- A "hustle" business, which depends on many unique sales of a product, benefits from a compensation culture that rewards individual performers.
- A business that requires consistency and minimal quality deviation usually benefits from a bureaucratic culture of rules, processes, and quality assurance safeguards.

DON'T UNDERESTIMATE HUMAN PSYCHOLOGY

People have different psychological profiles that might make them more or less of a "fit" for

[1] *Corporate Culture: Evidence from the Field, NY Federal Reserve, October 2015. Link: https://www.newyorkfed.org/medialibrary/media/research/conference/2015/econ_culture/Graham_Harvey_Popadak_Rajgopal.pdf*

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different organizational cultures. For example, a manager who craves personal achievement, recognition, and rewards is perhaps not suited to lead a team of technical equals, all of whom must contribute to obtain an optimal result.

Many companies think ascertaining cultural fit is so important that they require employees, typically above certain levels, to take "personality tests" to get them into the right roles.

MANAGING CULTURAL MISMATCH

If not handled properly, cultural mismatch can get in the way of realizing M&A synergies. The following three tried-and-tested suggestions effectively manage this potential problem.

1. Conduct Rigorous Analysis Culture should be examined with the same rigor as financial and operational issues during due diligence. The acquirer can have a checklist describing key elements of its own culture and compare it against observations from management meetings with the target. Furthermore, off-the-record conversations with the target's customers, suppliers, and distributors can reveal important differences between internal and external perceptions of behavior and attitude. Finally, websites such as glassdoor.com allow current and former employees to anonymously review their companies and management; these contain a treasure trove of data for assessing cultural fit.

When incompatibilities get exposed, calling off the transaction is not necessarily the only option. Some cultural issues can be tackled during PMI and these interventions can actually be transformative for the combined entity.

2. Clearly Define Expectations Leaders should be very clear about the culture they want to see emerge from the combination of companies. An acquirer has two fundamental choices. It can impose a single culture, either the buyer's or the target's, which usually implies a degree of fall out. Alternatively, it can create a blend of cultures, which is difficult because it means the greatest amount of change. No matter what the choice, to make it stick, cultural expectations need to be made specific and actionable for employees at all levels.

3. Start Change at the Top Culture is immediately reflected in the behaviors and attitudes exhibited by the organization's leaders. Leaders need to realize that managing culture cannot be a one-time effort; this needs their ongoing reinforcement, sponsorship and attention. Like any major change initiative, they will need to constantly "walk the talk."

In summary, to achieve success with M&A, culture cannot be an afterthought. Instead, organizational culture should be an integral part of any M&A strategy. The late management guru Peter Drucker was spot-on when he reportedly said, "Culture eats strategy for breakfast." **ZS**

Debt Markets Remain Favorable to Borrowers—For Now

Liquidity supply continues putting pressure on terms and pricing.

by Mark Working & Ben Adams

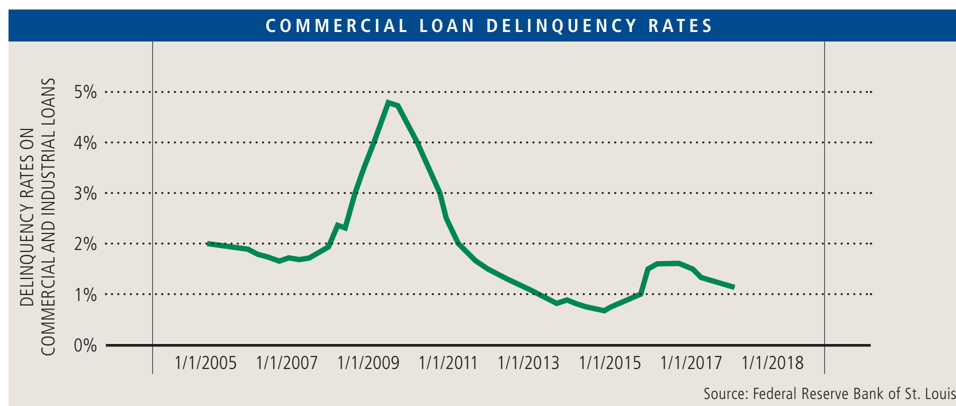
Debt markets serving the lower middle market remain favorable to borrowers and should continue despite the conflicting economic and political environment. The fact remains that there is so much liquidity relative to the demand for credit that pressure on terms and pricing continues.

We hear on a daily basis both good and bad economic news. The rate of growth of the US economy is increasing, with second quarter GDP growth expected to top 4% for the first time in 10 years. Unemployment continues to drop, reaching 3.8%, the lowest since the late 1960s. At the same time, the stock market is being jolted as fears of trade wars influence investors and the Fed is expected to raise interest rates at least two more times in 2018.

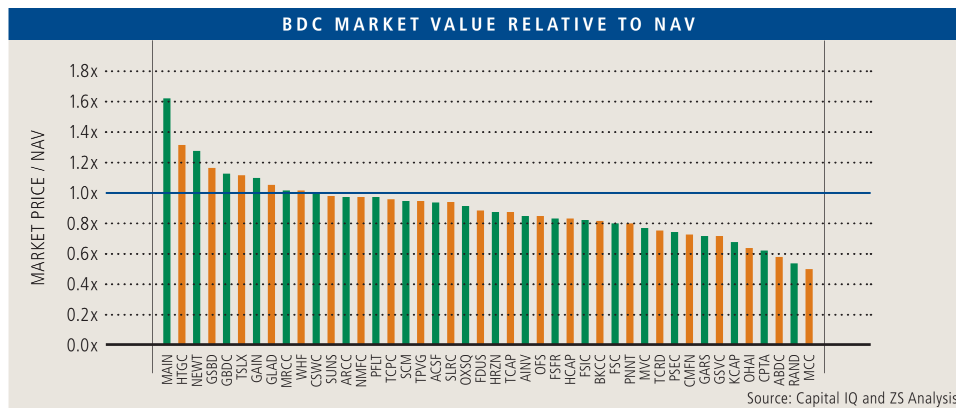
Against this backdrop, capital continues to flow into private equity funds; commercial and shadow banks are highly liquid and ready to deploy. Banks appear to be in good shape from a credit stance as delinquencies remain at low levels.

Meanwhile, the shadow banking system (non-commercial bank sources) continues to grow with more funds and new issues occurring daily. Business Development Companies (BDCs) have been the primary vehicle for private credit. Total BDC capital now exceeds $35BN and represents approximately 10% of the leveraged loan market for middle market companies. As we discussed in "Unitranche Debt – Higher Rates but Lower Costs?" (Insight Fall 2017), BDCs have become very popular with buyout private equity firms, which have rocketed their growth.

BDCs raise capital in the public market and generally avoid new issuances when their stocks are valued less than their net asset value (meaning investors think the loans are too cheap relative to the credit risk) to avoid diluting existing investors. BDC performance in that regard has been variable. As can be seen from the graph on the left, there are only a few BDCs that currently meet the test. All firms received a boost in March when the Consolidated Appropriations Act of 2018 became law and allowed BDCs to increase leverage from a 1:1 to 2:1 debt to equity ratio, the stated objective being to provide more capital to small growing businesses.



Source: Federal Reserve Bank of St. Louis



Source: Capital IQ and ZS Analysis

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If BDCs decide to borrow more in accordance with the new law, they increase the risk profile for shareholders but have access to more capital without diluting current shareholders.

DEMAND FOR CAPITAL

With all the liquidity available to borrowers, demand has not been nearly as robust. Capital is not getting deployed at the same rate as it accumulates. Relative to capacity, there is a very large overhang of credit and equity capital seeking homes in the lower middle market. As can be seen in the chart on the top right, commercial and industrial loan growth rates have been stodgy for years, dropping to zero in 2016. A small recovery has occurred over the last two quarters.

Private equity deal volume in the lower middle market has continued at relatively steady levels for the past five years but dollar volume has declined with Q1 of 2018 being the lowest dollar amount since 2011. It is too early to say that deal size has dropped as capital sources need to go smaller to find opportunities, but it is a trend worth watching.

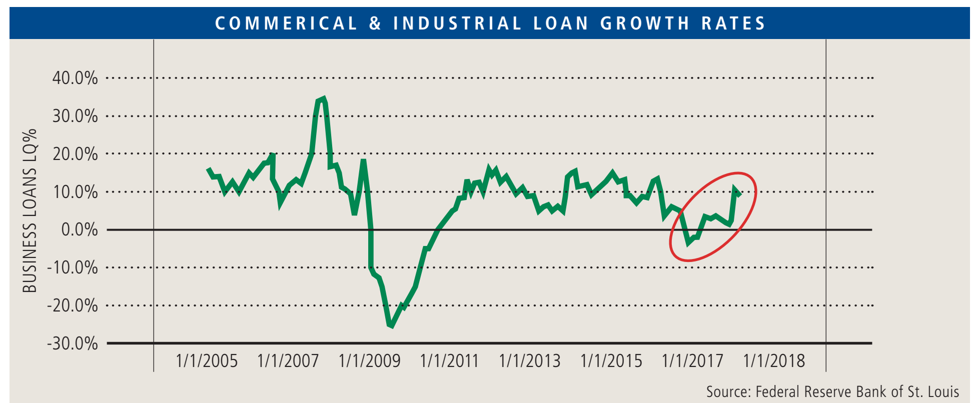
The consequence of too much capital chasing too few deals is that pricing on capital has declined. The graph on the bottom right shows the spread between commercial credit and treasuries of like term (the amount paid for credit risk). Commercial bank loan spreads have been compressed over the past two years to a level that is on par with the period right before the 2008 crash. It is difficult to show how equity is being priced in a private market other than to see what returns are actually earned at a later date. Anecdotally, private equity investors are worried about high purchase prices and the consequent effect on actual returns. We will have to wait for a few years to determine how cheap their money really was.

ANECDOTAL LOCAL COMMENTARY

Our friends at local banks indicate that these trends are also playing out in the Pacific Northwest. The additional flavor they add is that not only is pricing continuing to get squeezed but also that smaller credits are getting the best terms and pricing. For credits large enough to require multiple banks, pricing seems to have stabilized, but where a single bank has the opportunity to bring in-house an entire relationship, competition is the toughest. These same bankers also tell us that credit terms are still loosening. Amortizations, term, and covenants are all becoming more favorable to borrowers.

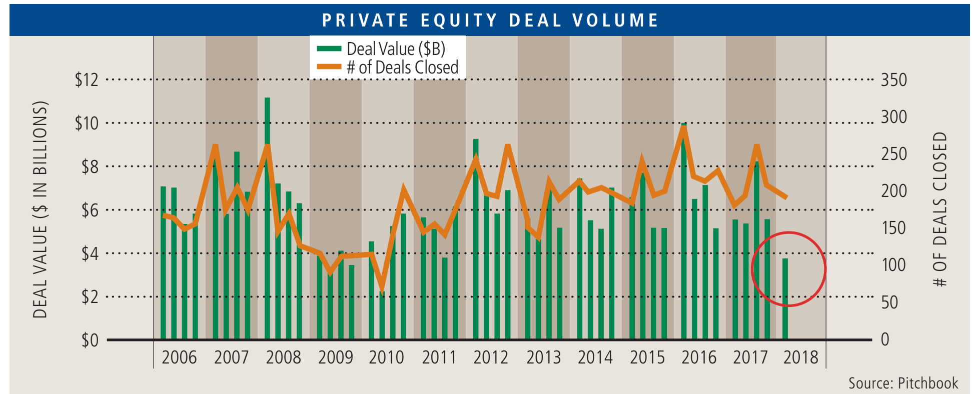
Capital is currently cheap and readily available under advantageous terms. Continuation of a strong economy and liquidity is required to have this condition continue. For the time being, the skies are clear. If not done already, borrowers should review their loan commitments to make sure they are receiving the most favorable treatment. **ZS**

COMMERICAL & INDUSTRIAL LOAN GROWTH RATES



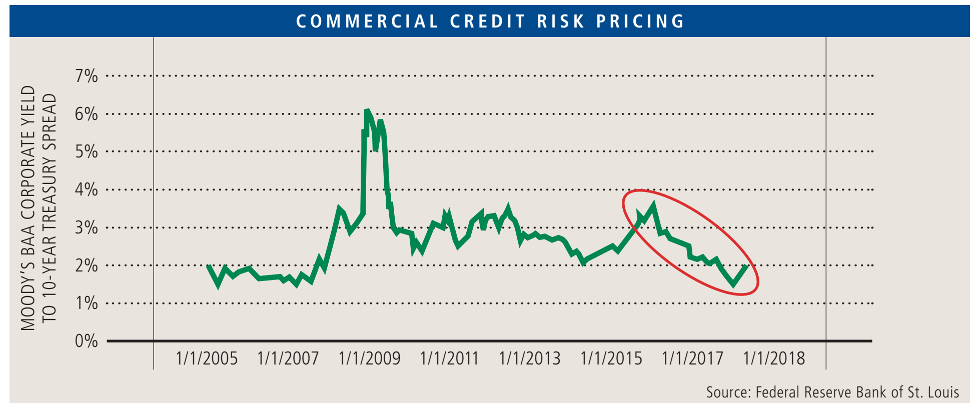
Source: Federal Reserve Bank of St. Louis

PRIVATE EQUITY DEAL VOLUME



Source: Pitchbook

COMMERCIAL CREDIT RISK PRICING



Source: Federal Reserve Bank of St. Louis

Due Diligence: Investigate What Matters

Investigating every little fact does not equate to thoroughness.

by Mark Working

We have written at length about due diligence from the seller's side ("Preparing for a Successful Transaction – Beyond the Diligence Checklist", January 2013, and "Due Diligence – a Survival Guide", October 2012). Over the years, we have taken pride in preparing our clients for the onslaught of questions and data requests from buyers. Our goal has been to make the job easy for the buyer, thereby not letting the process of collecting information or new findings derail or divert initial transaction parameters. Observing how buyers differentially approach the due diligence process has informed us that there is not a universally accepted approach. In some cases, extremely granular investigations to turn over every molecule of the business have not yielded a successful outcome while what appear to be limited scope reviews have produced great results. The point is not to suggest due diligence doesn't matter, but rather to suggest

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that checking every box on a due diligence list does not equate to thoroughness.

TRADITIONAL BUYSIDE DUE DILIGENCE

The traditional buyer process begins with the business team becoming interested in a specific acquisition or investment because it meets their defined criteria. Following some level of research, meetings with the target management team to ask questions, viewing the company's operations, and agreeing on value with the seller, a conclusion is often made that the business and the deal make sense subject to "verification" due diligence.

Verification begins with an extensive information request. Most law firms and investment banks have versions of the same basic request list, which has been developed over time to contain every conceivable question about a business. This list, often without modification to fit the company, is given to the buyer.

Donald Rumsfeld famously talked about known-knowns (things that we know we know), known-unknowns (things that we know we don't know), and unknown-unknowns (things that we don't know we don't know). Unfortunately, verification typically only focuses on known-knowns, running to ground whether the information that was provided by the seller is accurate and complete. As information is received by the buyer, it is often directed to topic experts in finance and accounting, tax, legal, insurance, equipment, environmental, and information systems, each of which reviews the requested data and evaluates them relative to what their experience tells them is standard or acceptable. When complete and no discrepancies have been detected, due diligence is complete. If you have ever experienced this process as a participant, it is hard to think that the buyer has been anything but thorough in its review.

INVESTIGATE WHAT MATTERS

Despite every attempt, it is not possible to know all about a business and what will impact a business's future performance. The famous criminal Willie Sutton was once asked why he robbed banks, and his response was simple, eloquent and humorous: "Because that's where the money is." That is the sort of prose that can only arise from clear thinking.

To apply the same clear thinking to due diligence it is necessary to first determine those attributes that will drive investment success. We think the way to start is with a concise investment thesis that defines specifically the assumptions about the company, the necessary ingredients required in a transaction, and the conditions that lead to a "no-go" decision or an adjustment to the proposed valuation. The due diligence process then becomes a process of inquiry designed to answer three critical and important questions:

1. Is the investment thesis valid?
2. Are we (the buyer) getting what we think we are buying?
3. Do we still want to make the investment and, if so, is the valuation reasonable given all relevant facts?

THE INVESTMENT THESIS

The investment thesis is the core set of reasons for making an investment. It states the critical presumptions and expectations that, if true, would make the business successful and, therefore, justify the investment.

The investment thesis is unique to each buyer and company. At its root is the presumption that the business will continue to succeed following the transaction in the marketplace in which the company competes. Often it can be broken into five parts.

- The market will continue to grow at a certain rate and the segment in which the company competes will retain its importance in the value chain, indicating that the company's reason for being will continue.
- There are no identified external threats that will change the company's market position.
- The company has attributes (assets and capabilities) that will allow it to compete effectively and earn attractive (or acceptable) margins and returns on capital.
- The company's management and organization have the skills, abilities, and systems to deliver continuous and sustainable performance.
- The transaction structure will not interfere with any of the desirable dynamics and attributes.

The investment thesis establishes the framework understanding for how the business competes in its industry and why it will continue to do so. It provides specific expectations for the assets and capital required to support the thesis, revenues, profits, and returns expected to be earned, and how collectively these assumptions affect valuation.

Interestingly, some of the most important areas demanding investigation may have more to do with what environment the company operates in than how the company operates (known-unknowns). Those are questions that rarely can be answered from information received as a result of a due diligence request list.

ALLOCATE PRIORITIES, RESOURCES, AND TIME TO THE BIGGEST QUESTIONS

The investigation should have a priority for each area of inquiry with an understanding of how important it is to the overall thesis and the boundaries for when a discovery is meaningful or not. Those issues that have the greatest probability of becoming showstoppers or could meaningfully change the outlook on the investment should be emphasized.

When questions are tough to answer, get help. It's easy to collect information about the internal operations of a business but that effort may exclude the most important drivers of success. Here are some areas we have seen that are critical to the success of the investment but are sometimes shortchanged because they are hard for an internal due diligence team to answer and would cost money to investigate otherwise.

- What trends are likely that could alter the existing value chain? An obvious recent example is the impact of the internet on how goods get from producers to consumers.Very profitable retailers have been left in the dust.
- What is the overall projected market demand and how does that compare to existing and projected capacity? Margins and value can erode as the balance between the two change.
- What attributes will determine winners and losers? Is it lowest cost? Highest performance? Convenience? How does the target company stack up to its competitors? A rising tide doesn't lift all boats equally.

If each area of inquiry could be weighted relative to the degree of importance it will have on the investment outcome, thoroughness would be measured as to whether the effort matched that weighting, rather than whether the effort was spread equally over all items on a list. This is a worthy aspirational, yet challenging, goal. **ZS**

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.**

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