Breaking with Tradition

With markets more dynamic than ever, traditional valuation models alone are failing to provide information about the value of intangible company assets. As a result, the trend for corporates and venture capitalists to outsource commercial and market due diligence work to specialist consultants is gathering pace. Clare Bates investigates.

Traditional shareholder value models have changed and non-financial performance is becoming more important for companies looking for investment opportunities. As non-financial factors increasingly influence company portfolios, more and more companies are turning to commercial due diligence (CDD) in a bid to assess all aspects of a business - outside of financial valuation - not taken into account by internal economic models.

The term commercial due diligence is a many splintered thing and it is this lack of definition that perhaps stunted its growth in the early years. However, the demand for independent CDD is picking up as corporates, venture capitalists and private equity houses are progressively acknowledging the need to analyse issues that fall outside the standard remit of an accountancy or law firm - not least with the emergence of dotcoms.

"In the past, all the corporates and private equity houses investigating M&A opportunities largely did all the due diligence. But over the last five years this has changed dramatically, as people have realised that M&A is very high risk and that misjudging management and misunderstanding the market and the company's performance is costly," says Chris Da Costa, director of due diligence consultancy CIL.

"Something very fundamental is that the ability for a business to grow profitably, is a function of its marketplace. Conducting financial due diligence, desk research and talking to management can take you so far but you need to undertake original research to really establish the target's prospects and potential. VCs and corporates now look to other companies to conduct due diligence on their behalf. When this was conducted in-house, often it was not comprehensive enough as companies did not have the resources or skills to carry out the required research," he continues.

Ernst & Young's research into shareholder valuations, Measures That Matter (MTM) goes almost as far as to say that with new economy companies, short-term cashflow projections and the valuation of tangible assets, although not insignificant, come second to research into non-financial performance.

In a statement, Andrew Tivey, head of strategic finance, Ernst & Young says: "In today's volatile markets, a company's non-financial performance, namely its ability to identify, demonstrate and communicate value in its intangibles, future growth platforms and strategic options, is a key differentiator for investors almost irrespective of short-term cashflows and tangible assets. And the greater the uncertainty, the greater the significance of non-financials to investors' decision-making as leading indicators of future financial performance."

The MTM research showed that almost 35% of investors are driven to portfolio allocation decisions by non-financial performance valuations. The relationship between risk and the value of non-financial performance is also linear. An increase in uncertainty leads directly to a rise in the importance of valuing intangibles.

This is not to say that traditional valuation models, which look at sales growth, profits, cashflow and return on investment, are no longer significant, but simply that higher valuations, intangibles and a rapidly changing marketplace has devalued their worth.

Historical financial records are no longer accepted as a blueprint for, or a guarantee of, future performance. "A lot of businesses were being valued on historical records not on potential future performance and that was where the problem was," says Clive Moffatt, managing partner of Moffatt Associates, which also offers due diligence services.

As Tivey explains, financial valuation models, which discount expected future cashflows at a single risk-adjusted rate, assume all future growth will attract the same degree of risk in the future, regardless of "management's ability to exploit future upside potential and manage downside risk".

Commercial due diligence and the valuation of intangibles is by no means a new concept; companies such as AMR and Celemi have been helping clients and conducting research into the area for the last 10 years. But the advent of dotcoms, which seldom have physical assets, the connected economy, and the growing trend for market values to be driven by future promise, has facilitated the need for alternative valuation methods.

"Dotcoms are challenging and difficult to value. The two most important issues are; is there a market and what is the management like. There is nothing for financial due diligence to go on, so the focus is on original research. We need to establish the level of demand for the service on offer from customers buying the goods in the conventional way. It is rather like new product development research," says Da Costa.

As the basis of competition has changed, a new company's ability to grasp the opportunities on offer, quickly and successfully, is as important as being able to demonstrate flexible business models and innovation.

Clive Moffatt believes that innovation is key to competing with traditional business models. "When you have scratched away at the exterior and drilled down, has the idea got legs? Does it have an edge? What information do they have about the market that gives them this edge? You need to be able to genuinely give people something better than the existing product."

He adds: "Success will be in the B2B area, developing ways to sell things to each other. Everything online should be transparent with what is available offline. Most people are happy o buy online, although there are security issues, but they still want physical confirmation."

Denzil Rankine, a director at consultants AMR disagrees. He believes that valuing a dotcom is not as complex as many make out. "You can apply the same methodology to valuing a dotcom as you would to traditional outlets. Many dotcoms are just opening up a new route to market, so you look at existing routes to form a view. Then you look at the dotcom business itself.

"The culture of a dotcom is very different from that of an established company. For instance, Amazon would have a very different culture to traditional book retailers. The culture of a successful dotcom differs in everything from remuneration to marketing," he continues.

One problem facing e-commerce and dotcom companies that are looking for investors or an acquirer is trying to convince them that they are not just looking for a "fast buck". Moffatt sees this as a very important aspect when valuing a dotcom.

"If people are looking for a quick out - we need to know. Most investors want to know that the management team is in it for the long haul to gain a growth of profits over time," he told *Acquisitions Monthly*.

Alternative valuation methods extend beyond new economy companies to include charitable organisations, which, like dotcoms do not have any physical assets, and to old economy businesses, to which non-financial due diligence has equal relevance.

Non-financial performance models are not just applicable to each specific company but also to its sector. In dotcoms, the quality and viability of the strategy is linked to the size of the target market, how innovative the strategy is and the sustainability of the business model, according the Ernst & Young's MTM report. But, these criteria are also applicable to old economy firms, which still need to address sustainability issues and research the competitive environment.

As well as analysing the company, its competitive environment and its long-term potential, CDD also looks at the management structure. With innovation and glowing strategies in abundance, investors look for an experienced management team, with a successful track record, that can execute its ideas.

"It is important that we assess what they [management] want from a deal," says Moffatt, who believes that CDD in the UK is finally following in the footsteps of the US when it comes to the "people factor".

"Previously, concentration has been on financial due diligence. Now it looks at the synergies at board level, but the process of assessing management teams takes more time than is available in the due diligence time-frame. The takeover process is unsettling for them when they don't know what will happen to them" so management assessment usually "comes after the other forms of due diligence, in the integration stages," says Fiona Sandiford, project director at Interim Team.

"The involvement of management specialists and commercial due diligence consultants gives the people at the centre of a takeover some assurance that there is an impartial view in what would otherwise be a highly charged, polar situation.

"It is very important for the new structure of the business to be clearly defined in the selection process to take the uncertainty out of the situation - at least as much as you can under the circumstances. Pride features highly at management level and there will be gaps in the team as well as duplication. If the new structure is not defined early on then you ma get rid of someone you later find you need," Sandiford continues.

Da Costa agrees: "If the team are not managed sensitively it can be counter-productive for the client. For more established companies it tends to come nearer the end of the due diligence process, whereas for start-ups it is usually early on. We find nearly all the people involved in this process quite enjoy it. It provides a conduit for management to convey aspiration."

VC houses have been quicker than most to recognise that an independent professional view of the management team is valuable, according to Da Costa. But corporates are also taking a closer look at management.

"It is important [for corporates] to look at how the board and/or senior management work as a team. How the different groups of people work together. Are gaps there? Perhaps the management style is too dominant in one area. This should always be rectified in M&A in order to integrate two cultures," says Sandiford.

Integration could become big within the due diligence industry itself if accountancy firms continue to branch out into the due diligence arena. Chris Da Costa believes that financial and commercial due diligence integration could be key to investors getting a "rounded view of both the past and the future".

"VCs and corporates recognise that if it were possible to integrate financial, commercial and market due diligence, it would have advantages. You would get the complete picture. But how do you do it? Research conducted by VCs suggests that many believe there will be benefits, but they are sceptical about accountants being able to do both commercial and financial on their own," says Da Costa.

"CIL has joined up with Ernst & Young [15 months ago] and that has been very successful. The two companies have developed an integrated due diligence unit that is real," he continues.

Even within the CDD industry there is a difference of opinion as to how the market is shaping-up. Da Costa admits that the industry has not yet fully matured, but says it is much more advanced than in any other country world-wide - including the US.

In contrast, Denzil Rankine says: "The market is still very fragmented. It hasn't matured yet. In time though, barriers to entry will go up, as investors become more aware of the quality of CDD."

In the UK, the commercial due diligence market is made up of a number of strands. Many strategy firms, such as Bain, NEK and Arthur D Little, have "come down" into CDD by forming separate departments, while CIL, Cober and AMR, have come from various backgrounds and are dedicated to due diligence. The third tier comprises smaller independents, which often specialise in due diligence within a particular industry.

Despite the continuing growth of the CDD market, there is still no evidence to support that carrying out research into non-financial assets will improve the success of an M&A.

"Surveys grab headlines by saying M&A is less successful. It used to be 50:50 but recent surveys suggest that it is now less than this, yet due diligence is becoming more sophisticated, So it is really hard to say whether CDD improves the shares of a successful integration," says Rankine.

Commercial due diligence is not a science. With different valuation models needed for each individual's need, the method for conducting research of this kind is not set in stone. But CDD is, it would appear, becoming an increasingly valuable resource for buyers and investors in the marketplace, who have realised they need more information about a potential target than financial due diligence can give them.