

Innovating the Due Diligence Playbook: Applying Lean Six Sigma to Mergers & Acquisitions

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The standard M&A due diligence playbook gives short shrift to assessing the target company's operational effectiveness, which may well spell the difference between a winner and a dog of a deal - particularly in today's challenging times. Lean Six Sigma (LSS) offers a number of techniques that can quickly yield operational insights at all stages of the M&A process, from due diligence through integration and beyond.

During the initial screen, companies can conduct Business Relationship Mapping (BRM) and Value Stream Mapping (VSM) activities to map out major components of their business from end to end, providing potential buyers or partners with a clear snapshot of the linkages across customers, operations, systems, and financials. The benefit comes from obtaining a holistic, integrated operational picture of the company that allows the potential acquirer to see otherwise hidden system synergies, disconnects with customers, and operational risks. Applying LSS concepts early in the M&A process facilitates the transition from paper synergies to real operational improvements, providing the building blocks needed to create a business transformational roadmap without negatively impacting the customer and employee experience.

Let's look at an example of how this approach was applied to bridge the financial disclosure gap common in acquisitions of privately held companies. The scenario was typical: aging owner wants to unload his company - a small trucking business in southern Texas, teetering around \$9 million in annual revenue - so he can play more golf. So he hires a financial advisor to dress his pig and take it to market.

As with many small business acquisitions, the data provided left much to be desired: last year's audited statements from the owner's country-club buddy's accounting firm plus an array of baffling, outdated sales forecasts and organizational charts. With limited financial data, discounting the cash flows and applying a multiple to arrive at an initial offer price was relatively simple. The balance sheet showed the fleet was aging. Receivables were being collected in a reasonable manner. Sales forecasts were based heavily on a small group of customers. The leadership team was a cantankerous collection of former drivers. After a legal review and interviews with senior management, most due diligence screenings would have ended and a "go/no go" decision made along with perhaps a price counter-offer to move the marriage along.

However, in this case an additional step was taken to take a look into the operational processes and system linkages within the target company. **BRM was used to identify key value streams and the associated resources, technologies, costs and key performance indicators.** Using a knowledgeable facilitator, this activity was completed through a series of interviews and a focused 2-hour session. The insight gained was that the trucking operation was being held together by a combination of brute force and undocumented "experience." Operational metrics were nonexistent. The "advanced" scheduling and tracking systems were in Excel, and oil-smeared paperwork was stuffed into rusty filing cabinets. Now, perhaps this was a "synergy goldmine." The BRM process suggested that if the customer base was stable, one could automate and streamline processes to enhance profitability. This operational understanding was combined with other components of the due diligence process -

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financials, management composition, legal risks, willingness to embrace change, and the asking price - to create a more complete picture of the value at stake.

How did the story end? The asking price was too high considering the operational heavy lifting required from an extremely change-resistant management and workforce. The pig was paraded to another booth.

The key to integrating LSS techniques into the acquisition process starts with remembering that “the perfect is the enemy of the good.” Owners bristle at being put under the due diligence microscope. Decision-making schedules are tight. The pressure for results is extreme, and patience for a deep statistical understanding, interrogations and data sampling is short. Given these realities, here are a few tips for success:

- **Apply the 80-20 rule.** It's probably good enough to understand where 80% of the revenue comes from, how the majority of customers are handled, and who the primary suppliers are. It is unlikely that the owner will provide the data and time early in the process to allow a deep statistical analysis. Even if you get “all” the data, the need for speed trumps the need to complete all your maps, value streams and data cells. Focus on the critical paths, products and customers.
- **Bring as much emotional intelligence (EI) as IQ to the due diligence process.** You are onsite to make an acquisition decision, not to fulfill your intellectual curiosity or prove your intelligence. Ask questions selectively and probe deeply, e.g., using the “5 whys,” only when necessary to ferret out essential information. Look at body language, understand key stakeholders, keep interviews short and crisp, and assume that the seller is trying to hiding the warts.
- **Remember that neatness counts.** M&A teams are used to working with professional service firms. Many LSS practitioners, coming from engineering backgrounds, tend to focus on facts and correct answers and minimize the impact of a crisp presentation and groomed appearance. To apply LSS beyond the factory floor you need to not look like you just came from one.