



VENDOR COMMERCIAL DUE DILIGENCE

IMPROVING PROCESS,
PREDICTABILITY AND PRICE

AT A GLANCE

- A recent CIL survey of investment banks found that the use of vendor commercial due diligence (VCDD) has increased significantly in the last 10 years as vendors and buyers alike recognize its value in transaction processes.
- European mid-market processes now use VCDD on more than 75% of occasions.
- The same survey shows adoption in the US lagging, with just 55% of respondents engaging VCDD in a process.
- However, CIL expects the post-COVID environment to further highlight the value of VCDD, accelerating its adoption in the US market and growing to around 75% as the US continues to trend towards European adoption levels over the medium term.



ENSURING AN UNDISRUPTED PROCESS

As the COVID-19 pandemic continues to send shockwaves across all industries, investors have intensified their focus on understanding the market dynamics and competitive positioning of a target. Vendor-led studies have become critical to ensuring deal certainty and securing the right price.

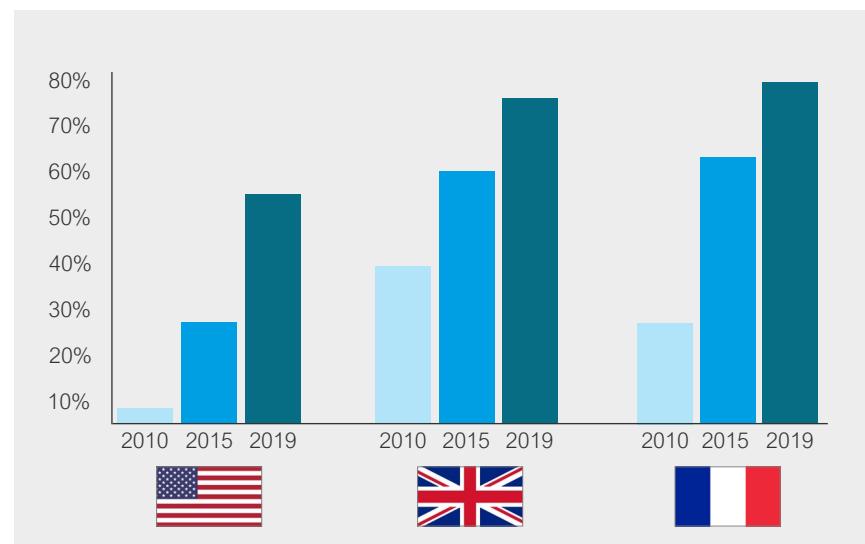
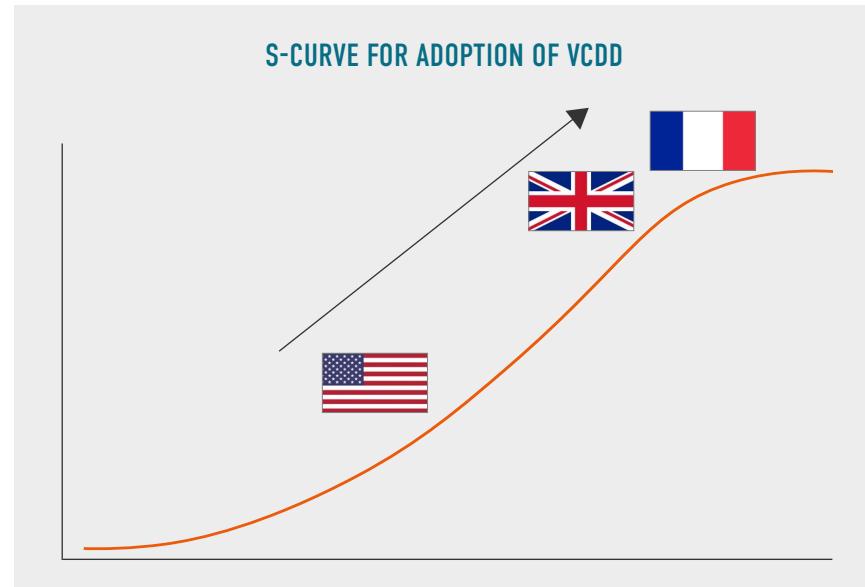
The pandemic has tested many businesses in novel and unique ways, disrupting markets, competitive structures and customer relationships. The resulting uncertainty for bidders means that conducting rigorous market work on the sell-side has become more important than ever. CIL expects the post-COVID environment to further highlight the value of this process, accelerating adoption and gaining popularity over the medium term.

A recent CIL survey of investment banks found that European mid-market processes now use vendor commercial due diligence (VCDD) on more than 75% of occasions. This adoption has increased over the last ten years with vendors and investment banks using these reports as an independent assessment of a business; providing targets with strong, fact-based commercial narratives, and bidders with increased transparency.

Yet, the same survey shows adoption in the US lagging, with just 55% of respondents engaging VCDD in a process.

A major inhibitor to the uptake of VCDD has been the US legal framework, which differs from that in Europe. The litigious culture of the US has led to VCDD providers not permitting US investors to place reliance on the reports. Sell-side studies, therefore, are rarely commissioned. When they are, they focus mainly on the external market, with limited company data or information.

In recent years, however, this barrier has started to erode. US-sellers have recognized VCDD's ability to ensure an efficient, undisrupted process for sellers and management teams alike. In this article we will examine how VCDD can benefit US sellers and add value through an M&A process.



DRIVING VALUE

VCDD can articulate market position, inform strategy and highlight upside opportunities, giving more bidders the confidence to increase the valuation.

European VCDD reports are wide in scope; reflecting the fundamentals of an opportunity, educating potential bidders on the business, its historic growth drivers and its position in the market, as well as an overview of the market dynamics. It will usually include a thorough review of the company's business plan and predictions, revenue modelling and competitor analysis.

Historically, reports generated in the US have tended to be lighter in scope, instead focusing on external drivers and containing limited company information.

We are beginning to see a shift towards a European mindset in the US market due, in part, to two key factors: a need for impartiality and a robust evidence-base.

Impartiality

During the deal process, US investors traditionally rely on their own research and the information provided to them by investment banks to appraise the value of a business. Yet with fees tied to deal-completion or business valuation investment banks can, perhaps understandably, be seen as biased parties during a process. An independent third-party is often better

placed to provide a fair and unbiased assessment of an asset.

An independent consultant is well placed for this as its client-base will usually span the full spectrum of stakeholders within a deal, meaning that potential investors are just as likely to involve the consultancy on engagements of their own. This creates an additional need to ensure the integrity of the VCDD process and final conclusions on the business. In Europe, bidders place such confidence in the impartiality of VCDD and they heavily rely on it during their investment decision-making process.

Robust evidence-base

Consultants bring niche expertise in research and analysis, providing bidders with a robust evidence base that they can interrogate. VCDD will leverage a range of sources and data points including primary research from surveys, interviews with market participants and focus groups. These not only provide rich commentary on the target business, but allow for modeling of the precise market size and growth dynamics.

VCDD helps drive value. This is because bidders are able to look at the VCDD and then put their best foot forward to make a more informed bid. For us, it really adds value to a beauty contest.

CEO, tech company

HOW WILL THESE BARRIERS BE OVERCOME?

BARRIERS TO US ADOPTION



Lack of reliance



Large pool of potential bidders



Deep sector expertise of many bidders



Lower perceived value of VCDD

REASONS THESE BARRIERS ARE DIMINISHING

- Well articulated value proposition can encourage more parties to bid and a higher price
- Niche businesses require outside expertise or the vendor wants to attract more bidders to drive competition
- Becoming more important in a post-COVID environment



Higher perceived value of VCDD

PROCESS, PREDICTABILITY, PRICE

We believe that there are three clear benefits that VCDD brings to each deal: *process, predictability and price*. As the economic fallout from the pandemic continues, each of these three levers will become increasingly important for vendors and bidders.

Process

M&A processes can place a significant burden on management teams, distracting them from core business operations. VCDD can help the vendor retain control of the schedule by increasing the efficiency of the bidding process.

An experienced VCDD provider will preempt questions and concerns from bidders, ensuring that they have all the information they need in the first instance.

They can also help to streamline the customer feedback exercise. When multiple bidders start calling customers in an uncontrolled manner it can cause significant disruption, suspicion and frustration. Instead, the VCDD provider can gather this feedback in one process, in a way that is guided and approved by management. The target is then in a better position to stipulate that customers must not be approached by bidders, without reducing interest.

With bidders better informed, earlier in the process, they need less time between bid rounds to conduct their own research and any questions which do crop up will be more relevant. Though management teams will, of course, have a strong view, VCDD will put the evidence base at their fingertips, making it easier to present the facts to bidders.

Predictability

While VCDD can highlight positive messages, it is by no means one-sided. A balanced appraisal of the market and business' position can help management understand the commercial issues that they face. This could be anything from slowing market growth to a new entrant disruption or a dissatisfied key customer.

By exploring issues at the beginning of the process, the business can choose either to address them or lead with them, reducing the chance of potential transaction derailment further down the line.

In the end, if due diligence is not conducted by the seller, there is the risk that commercial issues will be uncovered further down the line and used to influence negotiations. Approaching the sale with a buyer's mindset ensures that the vendor is in control and the process is conducted with the greatest levels of preparedness.

Price

The goal of VCDD is to produce better-informed bidders that stay in the process longer, creating greater competition and, ultimately, higher valuations.

If there is no VCDD, bidders rely on their own research which may focus on downside risk, meaning that they may not fully grasp the value proposition or underestimate the target's growth potential. Thorough – but most importantly – objective VCDD ensures that bidders are clearly informed of the target's value proposition and its future potential.

As a result, VCDD can increase the competition for an asset by piquing the interest of time-poor investment professionals, particularly in more complex markets, or in simple markets where the target has a complex or disruptive business model.

CREATING A POINT OF DIFFERENCE

CIL's research has shown that US mid-market processes currently leverage VCDD on 55% of occasions. We expect this to grow to around 75% over the medium term, as the US continues to trend towards European adoption levels.

In the short-term, however, the impact of the COVID-19 pandemic will continue to reverberate through the economy for many months. We expect to see an increased focus on the underlying commercials of any target business as well as deeper inspection into the business's financial and technological resiliency.

A well-researched, impartial VCDD report can help to distinguish robust and resilient targets from their competition and benefit sellers and buyers alike.

REASONS FOR USING VCDD IN MID-MARKET PROCESSES				
Improved credibility of sales memorandum		   		
More control of sale process		  		
Early identification of critical areas		  		
Ability to accelerate timelines		 		
Increased bidder competition		 		
Valuation certainty / enhancement				

GET IN TOUCH

CIL has extensive experience supporting clients throughout the divestment process, from strategy support, through business planning and vendor assist, to full vendor due diligence. Our experience working with and for acquirers enables us to anticipate their needs, to educate them and to pre-empt their questions.

To discuss any of the points raised in this article, please get in touch.



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