Wilson Perumal & Company's

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Tailoring your Diligence Approach to Bring M&A Success in Emerging Markets

In recent years, many companies have focused on emerging markets as a growth engine, particularly as the US and European economies have slowed due to the economic downturn. Unfortunately, corporations have learned the hard way that expanding into emerging markets is often fraught with peril. Take for example Home Depot's foray into China. Home Depot entered the Chinese market in 2006 with the acquisition of The Home Way. Unfortunately, they experienced such poor results that Home Depot exited the market just six years later. Other companies such as Best Buy have suffered similar fates. Even Google and Amazon have failed to gain traction with their China growth strategies.

M&A and partnership are often the preferred methods to enter emerging markets but as the above examples illustrate, they do not always lead to success. This is because the same methods for tackling due-diligence in developed countries simply do not apply to emerging markets. There are two main reasons for this: (1) key assumptions that are made in developing countries do not hold true for emerging markets and (2) risks in emerging markets need to be compared to the local environment, not judged according the same standards used in developed countries.

Clearly, due-diligence in emerging markets requires a more thoughtful approach. Applying the same process and criteria used in developed countries to emerging markets will uncover a vast number of red-flags and deal-breakers—yielding little-to-no viable targets to acquire or partner with. At the same time, you don't want to just ignore the risks and partner with anyone. Over time, we have developed the following framework to successfully approach due-diligence in emerging markets. This framework allows you to employ a thorough due-diligence process, while also adapting your approach to the uniqueness required for emerging markets.

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What due diligence in developed markets assumes at the outset…

Info	Record	Focus	Stability	Norm	Trust
• Information readily available • Clean financial accounts	• Target is established • Verifiable track record	• Partner is focused on mutual success	• Stable environment • Transaction friendly	• Familiar norms, culture, and geography	• "Presumed trust" starting point for transaction
• Info not readily available • Financial data unreliable • Language barrier	• New partner with no track record • Funding may be dependent on contract	• Strong entrepreneurs may have multiple ventures	• Dynamic market environment • Regulatory framework can be unclear	• Cultural understanding key to success • Government may play key role	• Reliability of management to be verified • Corruption may be present

…is largely inapplicable to emerging market diligence efforts

A MORE ROBUST APPROACH TO EMERGING MARKET DUE-DILIGENCE

Information availability:

Key Lesson:

If the target can't provide adequate information, you may need to work with them to gather the data you need.

In developed markets, due-diligence processes are designed with the assumption that all appropriate information is readily available. If all the information requested is not provided, it gives the impression that the target is poorly managed—or worse, is trying to hide something.

However, in emerging markets, there could be many reasonable explanations as to why information is not available. Even though the target is financially strong, perhaps they don't have good accounting systems. Or the target could have the information you need but due to the language barrier they don't understand what exactly you're looking for.

In emerging markets, you need to be ready to work with the target company to help gather the information you need. For example, we've seen potential acquisition targets unable to provide financial statements despite numerous requests and a detailed list of what information was needed. A deeper dive into the situation revealed that the target wasn't refusing the request; instead they needed help because their financial systems weren't capable of providing the necessary information (see the included Case Study for more details).

Track record:

Key Lesson:

When the target company doesn't have a verifiable track record, focus instead on experience, reputation, and the business plan.

Diligence processes in developed countries have a bias towards companies with track records. It gives senior managers great comfort to see a long and successful history of strong financial performance. For example, a large Fortune 500 company will almost certainly prefer to partner with a suppler that's been around for 20+ years to partnering with a recent start-up—even if the start-up is offering better pricing and has more modern production technology.

But in emerging markets, partners with long track records can be rare—and most likely will have already partnered with or been acquired by someone. Another common occurrence will be to find a potential target that doesn't even have existing operations—all they have is a business plan. In developed countries, this would be a significant strike against the target. In emerging markets however, this can cause you to miss out on a great potential deal.

To resolve this issue, we've found it helpful to focus on the background and reputation of the target's CEO and other key leadership. What businesses have they been involved with previously? Do they have the necessary experience? Do they have the appropriate connections to pull it off? Is their business plan sound and well-thought out? These are questions most companies are unable to answer with typical diligence processes but taking the time to dig into the target's background can help you uncover hidden gems that other companies pass on.

Focus:

Key Lesson:

If the target's CEO appears to be distracted by multiple ventures, focus instead on the person responsible for day-to-day operations.

It is rare to find a potential target in developed countries that is not 100% devoted to their company. We expect CEO's to be absolutely focused on the success of their company and any potential distractions with other companies or outside interests are viewed as a red-flag.

Strong entrepreneurs are not as common in emerging markets and those that exist often have their hands in multiple endeavors. In fact, this can be one indication that you're dealing with a very strong potential partner. The trick is to once again dig deeper into what is happening below the surface to discover if the potential target is capable of handling multiple businesses at once. For example, the target's CEO may be leveraging his or her unique connections in the local business environment to create multiple business endeavors, but in practice is leaving the day-to-day operations of each business up to trusted lieutenants. In cases like this, it's important to understand who is actually responsible for the target company's performance and ensure that this individual is properly focused and motivated.

Stability:

Key Lesson:

Broaden your diligence process to include the macroeconomic environment and employ alternate deal structures to mitigate any risks you identify.

It goes without saying that emerging markets tend to be less stable than developed countries—even when taking into consideration the recent economic and political crises in the US and EU. Market dynamics can swing considerably in emerging markets due to new political elections, an ever-changing regulatory environment, or the country's economic policies. Unfortunately, most diligence processes completely ignore the macroeconomic environment and instead focus on evaluating the target company and the market segments they compete in. However, in the case of emerging markets, macroeconomic factors can have a huge impact on the success or failure of the deal.

For emerging markets, you should consider broadening your diligence process to include the macroeconomic environment and its impact on the deal. If macroeconomic concerns are identified, you may need to incorporate alternate deal structures to help mitigate these risks such as joint ventures or earn-outs. Making a minority equity investment and then slowly increasing your ownership stake over time is another approach—one that the energy industry has had great success in using across the globe.

Norms:

Key Lesson:

Ensure that you properly account for the risks and opportunities presented by local norms and customs in your diligence process.

We often take for granted the norms associated with the M&A process in developed countries. When entering diligence, there is a base level of understanding between both parties about how the process will work. In-depth questions about the business will be asked with little offense taken. Detailed contracts will be signed and enforced by a trustworthy judicial system.

But in emerging markets, the same norms may not exist. If you take a contractual disagreement to the local courts, you may find your contract wasn't as enforceable as you originally thought. Another common theme in emerging markets is that relationships with local government officials are often critical to a business's success. In cases like this, you must have a plan to continue key relationships and ensure the target company continues to thrive—without crossing the line and violating laws like the Foreign Corrupt Practices Act (FCPA).

It's important to not only understand local customs, but to incorporate them into your diligence to ensure that you identify and can mitigate all potential risks.

Trust:

Key Lesson:

Trust in emerging markets should only be earned, not assumed from the outset.

Last but certainly not least, the level of trust assumed in emerging market diligence is completely different than that in developed countries. In developed countries, a more trusting approach is typically taken in diligence exercises. You generally take the information you receive at face value (except for any financial projections which everyone understands are overly optimistic). Only when something doesn't make sense or you are given contradictory information do you start to dig deeper.

Naturally, emerging market diligence should not start with the same basic level of trust. In many ways, the base assumption is that everything you are provided is wrong and you need to dig deeper in order to prove it to be trustworthy. Once again, this is a more detailed and involved level of diligence than what most companies are used to but it can be absolutely critical to success. For example, we've seen numerous examples of companies having two sets of financial records—one real and one given to the tax authorities. Trust in emerging markets should only be earned, not assumed from the outset.

Conclusion

Due-diligence projects in developed countries take a lot of time and effort to accomplish. However, proper diligence processes in emerging markets can take even longer and require significantly more effort. Western companies looking to do deals in emerging markets shouldn't have to lower their standards and acquire bad companies. Instead, they should use a more thoughtful and robust approach to pursue the attractive targets while continuing to weed out the bad seeds. Fortunately, if done correctly, the benefits will far outweigh the costs for those willing to put in the work.

The diligence process used in developed markets requires adaptation for emerging markets

Information availability	If the target can't provide adequate information, you may need to work with them to gather the data you need
Track record	When the target company doesn't have a verifiable track record, focus instead on experience, reputation, and the business plan
Focus	If the target's CEO appears to be distracted by multiple ventures, focus instead on the person responsible for day-to-day operations
Stability	Broaden your diligence process to include the macroeconomic environment and employ alternate deal structures to mitigate any risks you identify
Norms	Ensure that you properly account for the risks and opportunities presented by local norms and customs in your diligence process
Trust	Trust in emerging markets should only be earned, not assumed from the outset

Case Study: Are Poor Financial Statements a Deal-Breaker?

A large, Western manufacturing company was seeking to acquire a high-growth company based in China. However, the target was unable to provide useable financial statements. In fact, the target company was using basic spreadsheets as an accounting system and wasn't able to provide even simple income statement or balance sheet information.

Digging deeper to uncover value

Because the target offered significant growth potential in a highly attractive market, the decision was made to continue with the diligence process despite the lack of financial statements. The target provided open access to their "accounting system" and the buyer recreated financial statement based upon the transaction information provided. Once this exercise was complete, it was discovered that the target actually had an even stronger financial history than was originally thought.

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About Wilson Perumal & Company:

Wilson Perumal & Company is a premier management consulting firm and the leading advisor on how to manage and capitalize upon the complexity of today's world. To learn more, visit www.wilsonperumal.com.

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