A Framework for Validating an M&A Deal Thesis

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This paper organizes a variety of existing strategy theories, typologies and models into a framework that can be used to analyze and validate the investment thesis for a proposed acquisition by a strategic or corporate buyer. One dimension of the framework utilizes the classical models and theories of strategy. A second dimension applies models that were developed to understand M&A value creation. The third perspective examines if the acquirer is the best parent for the target firm. A fourth approach is to utilize tools that "stress test" the investment thesis based on common causes of M&A failure.

Over the last decade, there has been significant progress in the implementation of mergers and acquisitions as many of the best practices for merger integration have been adopted by practitioners. Likewise, extensive academic research and the expertise of investment bankers and other advisors has ensured that effective execution in valuation, deal financing and the entire deal phase of a merger. However the use of sound theory and best practices during the strategy phase, which provides the all-important direction and foundation for the deal phase and integration phase, does not appear to have migrated into the M&A process at most firms. Neither brilliant financial engineering nor excellent merger integration work can overcome a flawed deal – successful acquisitions must start with a solid rationale which ensures the deal is tied to the firm's overall strategy and will clearly advance the firm along its defined strategic path.

The early focus of M&A practice improvement was on the financial engineering issues determined during the deal phase. The next generation of research identified that poor execution during the integration phase accounted for a significant portion of deal underperformance. Recently literature has shown that a sound investment thesis is a key determinant in deal success (Bruner, 2004). While it might seem obvious that a sound deal premise is necessary, its importance has been underappreciated and it is often difficult to ensure that the investment thesis is valid (clearly tied to the firm's overall strategic plan), clear (defined, not vague, unambiguous) and sound (based on accurate information that has been verified). Indeed, Harding & Rovit (2004) found that 40% of deals had no written investment thesis.

When the M&A process starts with strategy, a firm generally achieves better results than firms that simply react to suggested deals (Harding & Rovit, 2004; Bruner, 2005). Ideally, the CEO provides the Corporate Development Officer or head of M&A with clear hunting instructions that flow from the corporate strategy. The best way to hit your target is to point the gun in the right direction rather than randomly looking at targets suggested by investment bankers and then bring them back to the CEO saying "This looks like a great fit." Clear hunting instructions flowing from clear strategy actually create the investment thesis in advance of looking at any deals. A simple decision tree, as depicted in Exhibit I, can help walk the corporate strategy forward to an M&A mandate. While there are many structures and vocabularies, a simplified example would be to first clarify the overall strategic direction: Are we trying

to expand our scope? Focus on our core? Redefine our core by moving into new businesses? Integrate backwards or forwards in the value chain? If, for example, the strategy were to expand scope, the next layer of decisions would include: New products? New customer segments? New geographies? A third layer would be the "buy versus build" decision and a fourth layer to determine if the best tactic would be full acquisition, joint venture, contractual, minority investment, etc. We are then ready to consider variables to screen/filter potential deals.

EXHIBIT 1
SAMPLE STRATEGIC PATH DECISION TREE
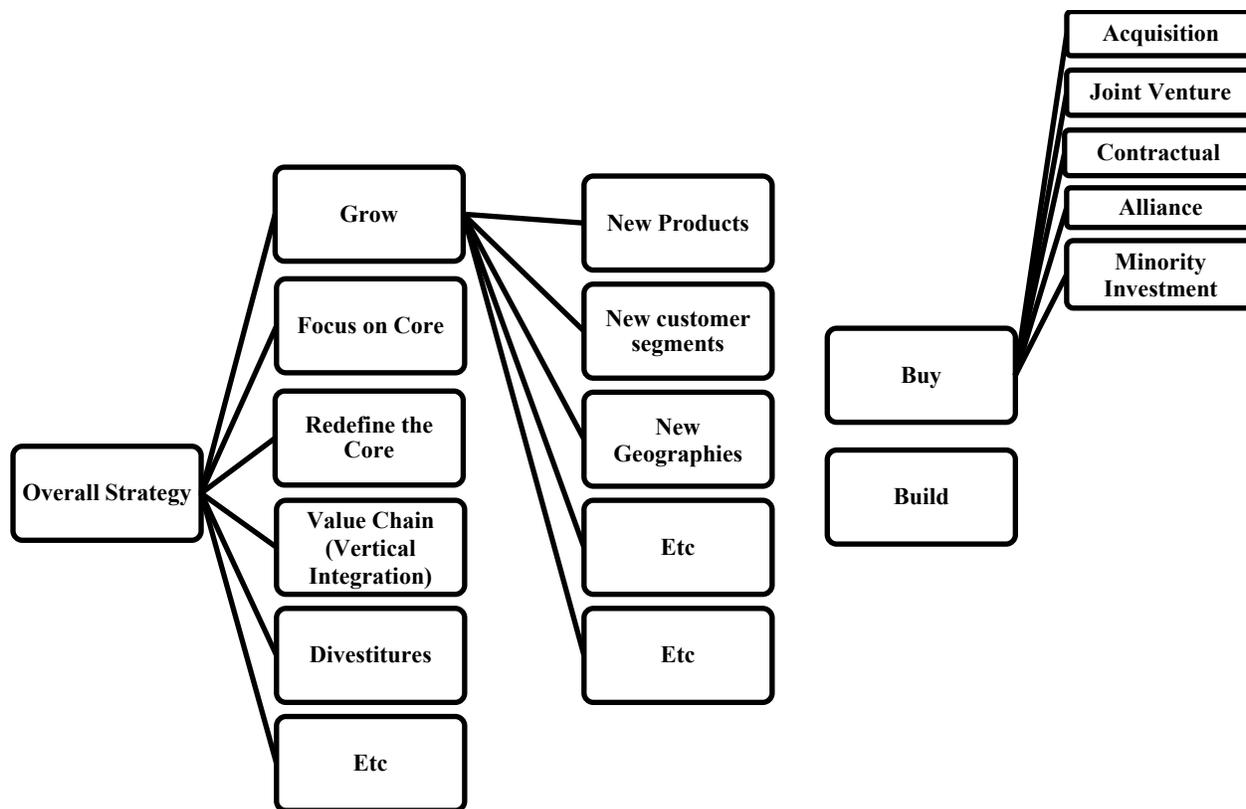
When a decision maker is presented with a proposed deal, the first stop is to ensure a concise and unambiguous understanding of the firm's overall strategy and growth strategy (as depicted first 3 layers of the decision tree described in Exhibit I) such as:

- Overall Strategy: "Pizza Planet is in the fast food pizza business. We win customers because we offer the most convenience (most locations in best spots) and a good value (good tasting product at good price)."
- Growth Strategy: "We have two growth engines: more stores/purchase points (both through de novo store openings and acquisitions) including international locations and expanding the number of products we sell through our stores."

Developing concise, unambiguous strategy statements is more difficult than one might expect; see Collis & Rukstad (2008) for advice on developing succinct and meaty strategy statements.

Next, a clear statement of the deal thesis is needed such as "Acquiring Speedy Italian brings us the skills and recipes needed to expand our menu to include many Italian dishes and will allow us to increase our penetration of the dinner-time customer segment", "The acquisition of Pizza D'Brazil expands our

store footprint in the important South American growth market", "Our purchase of Flying Pizzas expands our store presence in airports throughout the world", or "FrozenPie brings us the expertise and distribution relationships to extend our convenience to our customer's freezer through grocery store frozen distribution of our product."

With a clear description of the firm's strategy and a concise rationale for the deal, the decision maker can now validate the deal using the tools described below. The first section of the framework utilizes the classical models and theories of strategy. Section II applies models that were developed to understand M&A value creation. Section III examines if the acquirer is the best parent for the target firm. Section IV utilizes tools that "stress test" the investment thesis based on common causes of M&A failure. The framework presented in this article is analogous to the portfolio of diagnostic tools used by a medical doctor. Just as a physician uses a variety of tests and diagnostics to fully understand the patient's condition, the diagnostics presented here can be used to provide a multi-dimensional understanding of a proposed deal's investment thesis.

GENERAL STRATEGY MODELS

The first perspective is to understand the deal in terms of the company's overall strategy. Many of the classical strategy tools are useful diagnostics when applied to deal analysis and help place the proposed deal in the context of the existing business strategy:

- Industry View/Porter Five Forces: Does the deal improve our ability to deal with industry forces? If so, which force(s) does this deal impact? Does it make it more difficult for new entrants? Is it a vertical integration play locking up a key supplier? (Porter, 1980)
- Product Life Cycle: Does the proposed deal improve our position from a product life cycle perspective? Does the deal help our new product pipeline? Does it add breadth of offerings needed to compete as a product matures? (Kotler & Keller, 2012)
- Porter Fundamental Strategy: Does this deal change our position on the broad versus narrow, low-cost versus differentiated field? (Porter, 1980)
- Ansoff: Is the deal a play to get market penetration (same product/same market), product expansion (new product/same market), market expansion (same product/new markets), or diversification (new markets, new products). Is it consistent with the Ansoff quadrant(s) describing our business strategy? (Ansoff, 2007)
- BCG Growth-Share Matrix: Which products of the target company are stars? Cash cows? Question Marks? Dogs? Does the target change our position? How does the target company's product(s) change our portfolio? (Stern & Stalk, 1998)
- GE/McKinsey: Is target in high attractive markets? High competitive position? Change our position? (McKinsey, 2008)
- Knez: How change/improve our value proposition? Target markets? Capabilities? Revenue model? Cost model? (Knez & Gertner, 2012)
- Competitive Position: Does the target add products or capabilities that move our position on our key competitive variables?

Often when validating the deal rationale, it becomes obvious that the acquirer does not have a clear understanding of their overall strategy. The methods and tools to refine/define a firm's strategy are outside the scope of this discussion; however, the classical tools discussed above are useful resources to define a firm's strategy as is the robust literature on strategy development. At this stage, if the decision-maker identifies that the corporate strategy is blurry, he has two choices: 1. He can stop the M&A process if consideration of the deal is deemed impossible and proceed to address the fundamental strategy problem or 2. He may decide that it is reasonable to proceed because the risks of proceeding with the deal are manageable despite a blurry overall strategy. Interestingly, many CEOs comment that facing a major M&A decision forced them to confront their strategy and clarify it to a much greater degree.

After using general strategy tools to help determine if a clear path from the firm's strategy to the proposed deal exists, the analysis can proceed to apply several models more specific to mergers and acquisitions.

M&A THEORY AND MODELS

While the classical tools cited above provide some insight into a proposed deal's rationale in context of the firm's overall strategy, several excellent tools have been developed over the last decade which provide a more penetrating analysis of an investment thesis.

Is It Scope, Scale or Capabilities?

A fundamental question is to determine if the deal is primarily about scope, scale or capabilities. Scope deals typically add a new product, new line of business, new distribution channel, new customer segment or new geography. Scope deals are typically described by comments such as "We have great cross-selling opportunities: Our customer base is clamoring for their products" or "They bring us great access to markets across Europe". Scale typically describes deals that are an expansion in the same business whereby the rationale is combining operations for maximum efficiency or to obtain minimum efficient scale. Scale deals sound bites sound like "We can lower their costs by utilizing our dealer network" or "Our combined resources give us the strength to succeed." The capabilities rationale relates to acquiring new talent such as R&D capabilities. While it is helpful to distinguish these three primary rationales, most deals have a benefits related to all three rationales. However, the "scope, scale, capabilities" trichotomy is very useful screen. The primary rationale amongst these three views should be clear. If the deal team cannot agree on this fundamental view of the deal, it points to a blurry and fractured investment thesis.

A word of caution on scope deals: The M&A trail is littered with ill-advised expansions of scope that stretched the boundaries of the firm to incredulous degrees. Did it make sense for Pepsi to own North American Van Lines? Quaker Oats owning Fischer Price Toys? Reebok (shoes) owning Boston Whaler (boats)? There is a rich base of classical literature on diversification and the boundaries of the firm such as Porter (1987) and Coase (1937) as well as more recent theories on "relatedness" and "adjacency" that find that errors in business boundaries is the most frequent and dangerous form of strategic error (Zook 2003, 2004, 2010).

Buy Versus Build

As depicted in Exhibit I, the path from strategy to acquisition should address the "buy versus build" question – why are we proposing to buy this company rather than use organic development? Key dimensions of this question are speed, cost, risk and unique assets. "Speed to market" is a common rationale for using an M&A rather than organic development. Regarding costs, it is often difficult to compare the cost of organic development versus M&A. Many view organic development as less expensive than M&A; however, the full costs of organic growth are difficult to measure and most likely understated. While the financial systems at most companies might capture the most obvious direct costs such as R&D and advertising, other secondary costs such as costs for employees working partially on the project (or product or market) and partial use of other resources are likely not captured. On the M&A side, it is helpful to apply some "cost per" metrics. For instance, if the average cost to develop and launch a new product organically is $x, then one can take the premium for the M&A transaction and also express it in a cost per product acquired measure. A more obvious example is the cost of acquiring new customers (Selden & Colvin, 2003). If the rationale for the deal is to acquire the target's customer book, the deal can be considered by comparing the cost-per-customer-acquired (deal price/# of customers) versus the cost to acquire a new customer organically.

Most view organic growth as less risky than acquired growth because organic growth is a series of smaller investments and decisions whereas an acquisition is a larger, singular bet. While most managers

are sensitive to the risks of M&A such as over-paying and integration execution, similar risks of organic growth are often understated. In many industries, the failure rate for organic growth is quite high – perhaps higher than M&A deal failure rates – even reverse-engineering a target's product is more difficult than often understood. Also, it is often difficult to forecast the cost and time to develop a new product or enter a new geography. Few new products make it out of R&D and those that do sometimes fail – think "New Coke."

One additional consideration is a target's ownership of unique assets that cannot easily be "built" organically such as intellectual property/patents, licenses or other barriers to entry, physical assets such a prime locations and raw materials access/reserves.

Ally or Acquire

If the proposed acquisition is superior to the organic development option, the next test is to determine if the objective can be better accomplished by contract or some type of alliance rather than full acquisition. Thinking on the contracting question is rooted in the foundational work by Ron Coase (1937) that found the primary issue of using contracts was the existence of transaction costs. Between contracts on one extreme and full acquisition on the other extreme, there is a continuum of control options such as non-equity alliances, equity alliances, and joint ventures. Bruner (2004) suggests that the alliance versus acquisitions issue rests on two variables: the need for control and the need to manage risks. Contracts work well if need for control is low and level of risk is low. Conversely, if there are high needs for control and managing risk, his decision tree would suggest full ownership acquisition. Various types of alliances fall between these two extremes depending on the degree of desired control and risk management.

Dyer (2004) developed a model that allows managers to consider if an acquisition or alliance is the better structure to accomplish their strategic objectives. His model has three dimensions: type of synergies, nature of resources, and market conditions. If synergies are "reciprocal" (firms work together closely sharing tasks and knowledge such as hospital beds and inpatient surgery) then an acquisition is more effective; whereas, if the synergies are only somewhat interdependent (such as airlines and hotels), then an alliance may be more effective. Regarding resources, Dyer suggests that firms that need to combine hard resources such as manufacturing operations are likely to use acquisitions whereas firms that combine soft resources such as R&D staff might use alliances more often. Data collected by BCG (2005) indicates that alliances to secure soft resources such as expertise receive favorable reactions from investors. If market conditions are very uncertain (changing customer behaviors, regulatory uncertainty, rapid technological change, etc.), Dyer suggest alliances; however, if there is intense competition for the target (or its assets), a full acquisition is warranted. Dyer (2004) provides a decision rubric to evaluate whether the firm's situation is better suited for acquisitions or alliances.

Core & Adjacency

One of the most robust resources for understanding corporate growth strategy and M&A deal rationale is the work by Bain's Chris Zook on "core" and "adjacency" (Zook & Allen, 2003; Zook, 2004; Zook & Allen, 2010). His work implores a company to understand its core business and exploit it fully before too quickly jumping to M&A as a growth strategy. His "adjacency map" is a tool to help companies visualize how a company uses deals to push out and expand on various frontiers which he defines as product, channel, customer, forward/backward integration, geography, and white space. He also provides a framework to discern if the proposed deal is a near adjacency (higher probability of success) or distant adjacency (high risk). Zook's work offers several questions to validate an investment thesis:

- Have you focused enough on your core business? Invested enough? Demanded enough?
- Does the deal put your core business at risk?
- Does the deal create value or is it just succumbing to the pressure to grow? (Zook offers some interesting research demonstrating that an unhealthy pressure to grow is a frequent cause of bad deals)

- Is the deal an attempt to modify or transform our core? (transformation deals are difficult and risky)
- For the proposed deal, is the type of adjacency clear? (product, channel, customer, etc.)
- Is the deal a "far" or "near" adjacency? "Far" deals are more risky. Near adjacency is characterized by high degree of shared/common customers, shared distribution channels/sales process, shared/common capabilities such as production or marketing, shared/common competition.
- Will we be in the top three in the space after the deal?
- Are we pursuing only one opportunity at a time? (Executing multiple deals is more risky.)
- Are we changing only one variable? (Changing multiple variables is more risky.)

Bower

Bower's research provides one of several categorization models that help clarify the rationale for a deal (Bower, 2001). He offers five types (described below) based on different strategic objectives. Decision makers can place their deal into one of his categories and consider the major concerns raised by Bower.

- Consolidate excess capacity: Can we quickly rationalize costs? How long will it take the industry to right-size and restore margins/profitability?
- Geographic roll-up: Can we retain customers and sales/service talent? How quickly can we capture back-office synergies? What are the key integration risks as we standardize processes?
- Get new product or new market: How different is this product and/or market – do we understand it or is it a distant stretch? Is this a easy "plug and play" or "bolt-on" deal or does the deal change our size and/or scope so greatly that it puts our core business at risk?
- Get R&D: How will our due diligence validate that we are getting the intellectual property and/or talent we think we are getting? Will the talent stay?
- Industry Turbulence: If your core industry is changing, are we ready to make this bet based on our view of the industry's future? Do we have a vision of our path to the future industry structure and how does this deal help us move along that path? Given the turbulence, does this deal increase our flexibility or reduce it? Is our integration strategy flexible so as to adapt as the industry changes? What can we do to preserve our options and hedge our bets?

McKinsey Archetypes

Research by McKinsey finds that most M&A deals fall into several archetypes, some more successful than others (Goehart *et al.*, 2010). The successful deal types include: improve the target company's performance, remove/consolidate excess capacity, accelerate target's access to market, get skills/technologies/capabilities at a lower cost and/or faster than internal development, and pick winners early to develop their business. More difficult approaches to M&A include roll-ups, consolidate to improve competitor behavior, do a deal to transform/fix the buyer's business, and buy cheap.

The purpose for considering the proposed deal in terms of McKinsey's archetypes or Bowers categories is not that labeling provides much value – the benefit is considering how your deal fits within these frameworks. This consideration will help the deal team clarify the deal's rationale and communicate it more effectively.

After using the tools presented in Section II, a decision maker will have a more fulsome understanding of the deal thesis having considered it from multiple perspectives and will likely have determined if this specific acquisition is likely to be an effective tactic to accomplish the overall strategy.

PARENTING ADVANTAGE

When evaluating an acquisition, the most primary question to ask is "Does the acquisition fit us?" An important second perspective is to ask what value we bring to the target - to ask "Are we the best parent?" The "best parent" question can be decomposed into two sub-questions:
- What is our normal parenting style? (rarely can an acquirer change style)
- What parenting style is best for the target?

Some view this as an integration question; however, it is not simply a question of how we will approach the 6-24 month integration phase, but, rather, it goes to the core question of how the two entities will relate on an ongoing basis to maximize value. Below are four views on these parenting questions that are helpful when evaluating a proposed deal.

Porter

Porter (1987) provides a robust discussion of M&A's role in strategy including the parenting issue. He describes four paradigms for the relationship between an acquirer and a target:
- Portfolio Management ("banker and reviewer"): mostly hands off except executive selection/coaching, must buy right to win, sometimes add value by sourcing capital; typical outcome is they underperform and someone buys them/splits it up.
- Restructuring ("intervener"): restructuring industry, not just the company; once restructuring is done, need to sell company since not add on-going value.
- Transferring Skills (synergies between businesses): transfer skills; cannot be just similar activities, activities must be a key source of competitive advantage.
- Sharing Activities (share activities in the value chain): examples would be Proctor & Gamble sharing distributing system across multiple businesses and General Electric service/repair force that serves multiple product families.
- Porter posits that #3 and #4 are the better strategies for corporate buyers.

Best Owner?

Another perspective on parenting is provided by Campbell, Goold, Alexander (1995). When considering a proposed deal, Campbell emphasizes that the parenting question is not simply a matter of fit but that the deal must meet a superior test: Are you the <u>best</u> parent? Or, said another way: What businesses should this company own rather than some other owner? It is not sufficient to have a "good" fit; the target should be able to create more value as part of your organization than it could as part of any other organization or as an independent company.

They also provide another interesting insight: "It is difficult for parent organizations to behave in fundamentally different ways toward different businesses in their portfolios….[it is] easier to change the portfolio to fit the parent organization than to change the parent organization to fit the business." (Campbell *et al.*, 1995).

Also, to ensure clarity on parenting issues, they recommend a "decentralization contract" which defines the relationship between the parent and the business. Looking forward to integration, they suggest an acquirer consider which organization structure, management processes and philosophy will foster superior performance.

McKinsey (Brandimarte *et al.*, 2001) offers a valuable insight that the best parent might vary over the lifecycle of a corporation. Their view is that best ownership varies over the corporate lifecycle similar to the notion that a different type of CEO is often needed during the start-up and growth phases of a company versus the maturity phases. A target company transitioning from the start-up phase to the commercialization phase may need a parent with capabilities in marketing, logistics, channel management, and finance. A target company in the later phases may need a parent with excellent skills in

process improvement and cost reduction. As such, a parent with mostly cost reduction skills might not be the best owner for a firm in the earlier stages where growth capabilities are needed.

McKinsey (Dobbs *et al.*, 2009) provides an interesting perspective on parenting by asking the question from the divestiture perspective: Are you <u>still</u> the best owner? They suggest that you consider the following questions:

- What unique links exist between your businesses that add value? (R&D? Distribution?)
- What distinctive and replicable skills do you offer?
- Do you offer better governance?
- Better insight or foresight?
- Better access to talent, capital or relationships?

They also explain that best ownership is not permanent - the implication being that companies should both acquire and divest companies as appropriate if they are no longer the best parent. As such, the question can be enhanced: Are we the best parent *at this time*? Like Campbell, they also remind acquirers to be mindful that targets have different values for different owners.

Integration/Organizational Strategy

While a full integration plan is developed later in the acquisitions process, a valid investment thesis must have a view as to how the business will be run after the acquisition. A deal rationale based on cost synergies should have a different integration strategy than a deal meant to acquire new capabilities/talent. Knez (2012) offers three degrees of integration: autonomous, partially integrated, absorb-assimilate. Mercer Consulting describes five degrees of integration: fully integrated, operationally integrated, coupled, loosely coupled, and separate holding (Mercer, 1998). At this stage the deal sponsor should be able to answer these questions: How do you plan to run the acquired business? What level and type of integration is best to accomplish the objective of our acquisition? What are the greatest integration risks? What is the cultural compatibility between our organizations? During due diligence, what data should we collect on the significant cultural issues? (See Harding & Rouse, 2007)

Section III has reversed the perspective from "Is this acquisition a good fit with us?" to "Are we the best parent for this target?" and provided tools to allow the decision maker to consider if they are the best owner of this target. As a final method to test the investment thesis, Section IV provides a few additional checks based on insights from M&A failures.

STRESS TESTING

This final section is a set of tools that might best be categorized as "stress tests" for an investment thesis.

Why Now?

Anand offers a valuable question when considering a deal: Why now? Decision makers would benefit from considering several dimensions of the "why now" question including: Is this the right time for the seller to sell? Why does the seller want to sell now? Is this the right time for us to buy? What else do we have on our plate that could detract from the success of this deal? In a perfect scenario, when would be the best time for us to acquire this target? Is our judgment impacted by the pressure to put excess cash to work? Do we feel pressured to act now because of competing acquirers? Are we fully aware of the other acquisition opportunities if we decide to take a pass on this deal?

Many acquirers have developed a longer-term view of the M&A process and pipeline which enables them to have more flexibility as deal opportunities arise. If M&A is viewed as a process with a pipeline, an acquirer is less likely to succumb to "once in a generation opportunity" pressure.

Porter

Michael Porter (1987) offers three simple but powerful questions:
- Are you buying into attractive industry?
- Is the cost of entry (premium paid) too high?
- Will the target be better off with us as their parent?

Zook

Zook (2004) provides a statistical analysis documenting what he phrases as the "pressure to grow" to describe the gap between Wall Street growth expectations and actual growth prospects for most companies. He explores the question: How do you keep Wall Street happy when your industry is growing at 2% and stock market expects 12%? His research finds that the best performing companies focus on their core business first and, if they do M&A, they do so mostly in businesses close to their core business. The stress tests questions would seem to be:
- Should you first focus on improving performance in your core business rather than investing time and money in the proposed transaction?
- Is the proposed deal a strong/close adjacency that builds/enhances the core or distracts/detracts from the core?

Decision Bias

It is important to guard against various forms of cognitive bias when considering the rationale for an acquisition. Several studies have documented that behavioral issues such as CEO overconfidence, "deal fever", and various forms of cognitive bias may lead to suboptimal decisions about potential acquisitions (Roll, 1986; Lovallo & Sibony, 2010; Kahneman, 2010; Hayward & Hambrick, 1997; Bliss & Rosen, 2000; Hietala *et al.*, 2003; Lovallo *et al.*, 2007, Finkelstein *et al.*, 2008). Their findings suggest several questions to be considered when validating an investment thesis:
- What assumptions/biases do I have that I may need to manage? What about bias in the deal team?
- Do we have issues with CEO decision bias ("overconfidence", "hubris", "empire building", "pressure to grow", etc.)?
- Given the risk we may be over-confident in our ability to capture synergies, does this deal still make sense if we reduced our synergy estimates?
- What process do we use to avoid "deal fever" such as having a second person/team make an independent/"cold" review of the deal?
- Could our process be impacted because the deal team believes the CEO wants to do the deal?
- How does our process encourage/support disconfirming data or perspectives?
- Have you defined your "walk away" point in terms of price and risk?

If the preliminary investment thesis supports moving to additional stages such as due diligence and negotiation, it is important that the due diligence plan be crafted to mitigate behavioral risks.

Avoiding "Deals from Hell"

The title of Bruner's work, "Deals from Hell" (Bruner, 2005) is a vivid description of this final section of deal validation. Work by Nolop (2007), Schrager (2010) and Bruner (2005) have identified some common pitfalls and errors to consider when making M&A decisions:
- Is the deal too complicated?
- Is it too tight/no room for error?
- How much does it increase risk? What kinds of risks increase?
- Are we being pushed by a "hot" market/market momentum? Don't shop when you are hungry. Buy when others are not buying.
- Are our synergy estimates credible/conservative or inflated/optimistic?
- Don't bet the company on one big deal. Big buying small works best.

- Does the deal have a clear business/line sponsor?
- Don't do a merger of equals; one lives, one dies.
- Do we know how to do a merger of this type?

None of the "stress tests" described above is a singular gate that can stop a bad deal. Rather they are another set of tools to be used by a decision maker to better understand the rationale and decide if the deal should go forward.

CONCLUSION

The goal of this paper is to help decision makers know exactly why they are buying a company – and then test the accuracy and strength of the answer. The framework described in this article began with the classical models and theories of strategy to consider if the proposed deal is well connected to the firm's core strategy. Section II applied models that were developed to understand M&A value creation such as Zook's core and adjacency concepts. Section III examined if the acquirer is the best parent for the target firm. Section IV provided tools that "stress test" the investment thesis based on common causes of M&A failure.

While the tools presented here can be used early in the deal process to determine if a deal should be pursued and can also be helpful in the due diligence phase, it is important to emphasize that this framework is not meant to describe the full diligence process needed to test a deal. This framework helps understand and validate the investment thesis; however, only thorough due diligence can fully test the validity of a deal under consideration. In addition to all the typical risk management objectives (financial, legal, etc.) found in the due diligence phase, it is important that due diligence include "strategic due diligence" to collect data and test important strategic dimensions such as a full understanding of customer (segments, value proposition, defection risk, etc.), competitive (competitive position, possible competitor response, etc.) and organizational (differences in culture, leadership styles, compensation programs, people development, etc.).

The tools described here can help a decision maker consider the rationale for a proposed acquisition in a complete and penetrating manner. Simply requiring a written investment thesis for a deal is more disciplined than half of the firms doing acquisitions (Zook, 2004). Like a physician that must decide which tests and diagnostics are best suited to a particular case, a decision maker can use the tools presented here to obtain a multi-dimensional understanding of a proposed deal's investment thesis. Similar to the medical model, it is often advisable to get a "second opinion" from another physician; in the case of M&A, an independent review by someone uninvolved in the deal process (hence, no chance of "deal fever") can provide a valuable objective and dispassionate perspective. Applying the tools presented here may help a firm improve their decision making and reduce the probability that they pursue an acquisition that ultimately proves to be a mistake. However, good decision making is not simply "running the tests"; the tools must be administered properly. Any bad deal can be "validated" if the tools are used in a superficial manner; the tools must be applied with discipline and skepticism about the deal to truly test an investment thesis and avoid rationalizing an alluring but flawed deal. Using these tools solves the Type 1 problem of not asking the right questions. The more common and worrisome risk are Type 2 errors – errors that occur because the decision maker accepts shallow or faulty answers. The framework provided here should help reduce Type 1 errors by providing decision makers with the right questions. To address Type 2 errors, it is the responsibility of executives to provide the discipline to demand deep and accurate thinking on these questions to increase the probability of M&A success.

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