CHAPTER 7

Acquisition Search and Deal Origination: Some Guiding Principles

INTRODUCTION

Compared to other phases of M&A transaction development, *acquisition search* is nonlinear and even unruly: One hits many dead ends and must refine a lot of ore to get the valuable metal. AlliedSignal Corporation surfaced 550 attractive potential businesses to acquire in 1996–1997. Of these, 190 targets were selected. Further screening reduced the sample to 52 firms, for which the firm initiated negotiations on 28. Detailed due diligence research was conducted on 17; AlliedSignal consummated 10 of these deals.[1] Perhaps the all-time record for acquisition search was Ciba-Geigy's acquisition of Airwick Industries in 1974, which was preceded by a review of more than 18,000 companies, a more detailed review of 100 firms, and ultimately the acquisition of one.[2] Against these small ratios of "done deals" to firms reviewed, even modest improvements in the efficiency of search could yield major improvements in results.

M&A transactions may spring from a search process by a buyer or from an origination process by an intermediary (hereafter called "the banker") who stands to gain from the consummation of a deal. Search and origination draw on the same principles. Thus, this chapter uses the terms "search" and "origination" interchangeably.

Search skills entail a large amount of tacit knowledge best learned at the side of a seasoned professional. The aim of this chapter is not to displace that kind of learning, but rather to offer a few insights that will help the reader get started down the right path. This path begins with the insight that acquisition searches are essentially intelligence-gathering operations, and therefore the search effort needs to be structured in a way to enhance the acquisition of *information*, and the right kind. The path begins at the intersection of four crucial perspectives:

1. *Economics of information.* Searches should be focused on gathering high-quality information about prospective targets. Research on the economics of information lends a succinct profile of what "quality" means in the M&A search world. Deal-rich information is private and clear—it is also likely to be costly. Develop *private information* and private insights.
2. *Networks.*[3] Connectivity with others helps the deal searcher get high quality information. Research on networks suggests that through the short cuts that participating in a network affords, you may be closer than you think to your targets.

3. ***Options.*** Investment to build a search network is like investing in options. While the payoff on those options remains uncertain to the researcher, the very uncertainty of the search makes that network valuable.
4. ***Contagion.*** The *diffusion* of information about deal opportunities through a market resembles the spread of rumors in a financial crisis, or of disease in an epidemic. Research on diffusion suggests that your awareness of other buyers and sellers depends on the setting, on the clarity of your message, and on the existence of key people who can help carry the message.

The virtue of thinking about acquisition search in these terms is that they afford a framework for strategy, management, and evaluation of an acquisition search. Knowing how a search is going and how effectively the searchers are performing is of serious concern to investors, observers, and the searchers themselves.

SOME PRINCIPLES OF ACQUISITION SEARCH

To most practitioners, the search process feels pretty haphazard. It is neither possible nor desirable to eliminate the role of chance. However, a healthy observance of a few principles can enhance one's odds of success.

The Currency of Acquisition Search Is *Information*

Acquisition search is an information-gathering process. While this may seem obvious, many searchers assume that it is merely a deal-gathering process or a contact-building process. A good search process begins with building a network of information-generating contacts and results in a stream of deal opportunities. But the path from contacts to deals is paved with *information.* As Exhibit 7.1 suggests, contacts generate information; information generates insights; and insights generate deals. Information and insights also feed backward through the chain: a flexible

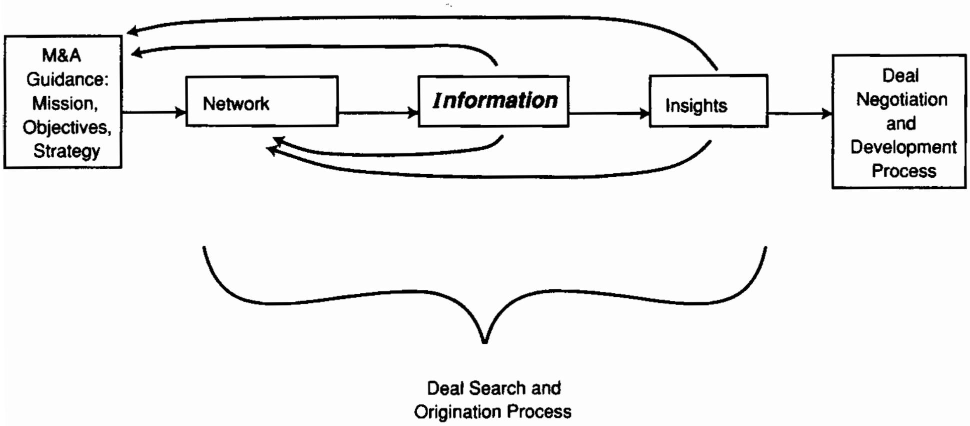

EXHIBIT 7.1 The Linkage between Deals and Contacts

system adapts to news. One needs to build a search effort that generates a flow of high quality, credible, usable information.

Some M&A professionals think of the transaction itself as the basic unit of the search. While the virtue of focusing on outcomes should not be ignored, to focus solely on transactions will not yield insights about how or from where a transaction originated, and where the search might go to his or her best advantage. When one is in search mode, it is better to focus on interesting facts because they tend to lead to interesting transactions. Focusing on information, rather than transactions, implies a very different perspective on acquisition search: a focus on *process* rather than outcomes. This is an insight known to many golfers; focusing on how you swing the club results in a better game than focusing on driving the ball a long way.

Clarity, Privacy, and Cost: What the Market Knows Clearly Is Fully Priced

Not all information is created equal. Two key dimensions explain a great deal of the impact that information can have on asset prices: *ambiguity* and privacy. High quality information is clear and costly. Think of your options receiving television broadcasts; you can use a rabbit-ears antenna and get a grainy picture; but such a picture is much less expensive than the picture you get by cable or satellite. Markets discount ambiguous signals and mark up clear signals, a core idea of the budding field of information economics.[4] For instance, Michael Spence (1973) and Stephen Ross (1977) considered markets of employers and investors in a world of *adverse selection* (i.e., where the seller has an incentive to misrepresent the item to be sold). They found that *costly attributes* (such as academic degrees or promises to pay dividends or interest) would tell buyers things that mere words would not. Sirri and Tufano (1998) report that investors choose mutual funds that are less costly to find.

Clarity is not the only driver of quality. Another is how widely it is known. Capital markets are reasonably efficient. Academic research on security prices confirms that *public information* gets impounded into security prices rapidly and without bias. This is the so-called "*efficient markets hypothesis,*" first advanced by Eugene Fama in 1965. Efficiency in pricing is produced by competition among investors, who, through their buying and selling in the market, reflect in their settlement prices the information they know. This implies that if you want to beat the market you must know something that the market doesn't. *Information asymmetry* is the telltale for profitable arbitrage. Efficiency and competition eliminate profitable arbitrage.[5]

To extend one's understanding of the deal development implications of the privacy of information, consider a range of publicity across three situations in time: (1) At the start, an acquisition opportunity is privately known; there has been no public announcement. (2) A public announcement has just been made that the target firm is available for sale, but diffusion of the news through the market is slow and incomplete—at best, the information is "semipublic." (3) A public announcement was made, followed by active marketing of the target and even possibly an auction; as a result, diffusion of the news is complete. Exhibit 7.2 gives some implications of each scenario: It suggests that public information is fully priced; private information is not. The buyer's "sweet spot" is the world of private information. There, the buyer is likely to find lower competition, more advantageous pricing,

EXHIBIT 7.2 Three Information Scenarios and Their Impact on Competition, Pricing, and Tailoring

	Information about the Acquisition Opportunity Is:		
	Private	Semipublic	Fully Public
Degree of competition among potential buyers	Low	Medium	High
Likelihood that the opportunity is fully priced	Low	Medium	High
Likelihood that a buyer can intervene in ways to tailor the pricing and terms to greater advantage	High	Medium	Low

and better opportunities for deal tailoring. There, too, the banker is likely to provide greater service, build a stronger reputation, and earn higher fees. Quite simply, private knowledge of high return investment opportunities is a crucial ingredient for creating value through M&A. Exhibit 7.3 depicts this "sweet spot."

The significance of private information implies that the deal search should be structured to generate private information and transactions before they become widely known. The potential asymmetry of information in the market implies the existence of a *first-mover advantage*. Specialists (i.e., bankers) who focus their expertise will thrive in the context of information asymmetries because they can get paid to help buyers exploit a first-mover advantage.

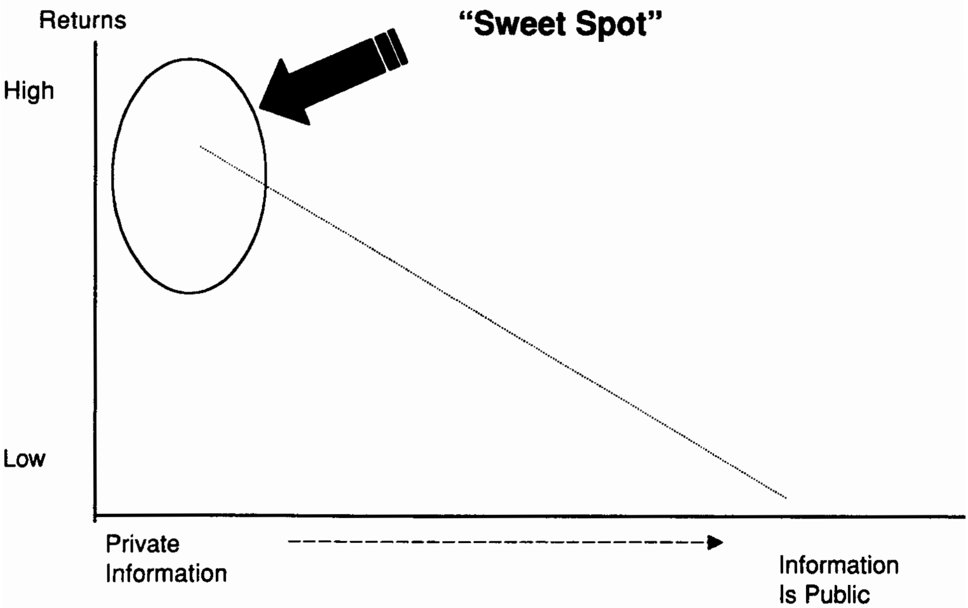

EXHIBIT 7.3 Locating the Sweet Spot

Information Arrives Sequentially and Must Be Filtered

This third principle underscores the crucial importance of *screening criteria*. News over a *network* arrives randomly; as information accumulates, deal opportunities begin to take shape. But they rarely gel in a way that permits pairwise comparison of comparable opportunities. Thus, the searcher is faced with the need to make "yes/no" decisions sequentially, rather than the vastly preferable "either/or" kind of decision. One of the large lessons of the field of economics is that "either/or" decisions are better because they permit an assessment of the *opportunity cost* associated with taking one path over the other. In the absence of a peer comparison, how is one to assess the cost of the lost opportunity?

Discounted cash flow (DCF) valuation analysis explicitly tests the cost of the lost opportunity through the choice of a discount rate that presumes the existence of other assets with comparable risk. But valuing *every* possible deal that the searcher encounters is impractical: Valuation is so time-consuming that the searcher can value only a few firms in a brief period. One needs to prequalify the deal opportunities worth valuing. Screening criteria enable the searcher to reject unattractive opportunities.

Popular screening criteria would include the following:

- ***Industry and position in it.*** Strategic searches will give great attention to industry and even segments within an industry. This criterion is the predominant screen for one's thinking about strategic "themes" or "big bets." Frameworks such as Michael Porter's (1980) industry and competitor analysis can help illuminate the attractiveness of a firm's position in the industry—but it is also time-consuming to do well. One should do this analysis later in the screening process. Chapter 6 describes various frameworks for industry and competitor analysis.
- ***Resources and strategic capabilities.*** Some searchers look for unusual resources or capabilities, rather than market positions. Hamel and Pralahad (1994) argue that it is capabilities, rather than current market positions, that better predict future performance of firms. Examples of strategic capabilities are animated film production at Walt Disney, know-how in the production of computer chips at Intel, logistics management at Wal-Mart, and naval architecture skills at Johnson Boats. Strategic capabilities favorably position a firm to be the leader even as its industry continues to evolve. A strategic capability creates high rates of return, enhances agility, and promotes the survival of the firm.
- ***Size of the business: sales or assets.*** Searchers usually have a target range of firm size. This typically reflects both a strategic view (e.g., how large a firm must be to survive and prosper in the field), and the searcher's own resources or investment budget.
- ***Profitability.*** This is a test of financial health: while the target may have passed the size test, it might not be generating enough earnings to justify acquisition. At the very least, searchers must have a view on the desirability of buying assets or a firm in bankruptcy or financial distress. While there is a well-known search strategy of focusing on distressed targets, "vulture acquiring" requires a special expertise and thus remains a very small portion of all transactions. More often than not, searchers dictate a desire to buy a stream of profits expressed in absolute terms (e.g., earnings before interest and taxes of at least $5 million) or in percentage terms (e.g., a net profit margin of at least 5 percent).

- ***Risk exposure.*** Searchers often have strong aversions to some risks, and a willingness to accept others. Potent risks for many firms are environmental liabilities, inflation exposure, and uncertainties about health care expenses for employees and retirees. Classic concerns for operating managers are technological change, supply chain disruptions, and union activism in the form of strikes. Marketers justifiably worry about undue concentration of sales with one major customer—the risks of the customer thereby become the risks of the supplier. "Key person" risks arise when one employee is crucial to the survival and prosperity of the firm—illness, accident, or disgruntlement could destabilize that firm. Chapter 8 ("Due Diligence") describes in more detail how one would search for risks.
- ***Asset type.*** Some searchers will screen away firms for whom a large part of its market value resides in intangible assets that are difficult to audit and value. Such intangibles may include patents, brand names, and human capital. For instance, at many service businesses, it is said that the most important asset walks out the door each night. For many retailers, a crucial asset is *location.* Technology firms depend not only on existing patent positions, but also on R&D-in-process that will determine the competitiveness of the firm in the future.
- ***Management quality.*** Searchers should have a view on the quality of management currently in place and likely to transfer to Newco after a transaction. Large corporate buyers with depth of management may be indifferent to the quality of target management because they can fill the target's ranks from their own. But smaller buyers may depend crucially on the quality of management in place.
- ***Prospective control.*** Not all transactions are for sale of 100 percent control. The searcher must have a view on the desirability of total versus partial or minority control in the target.
- ***Organizational fit.*** This is the most difficult screening criterion to test in a short period of time, but probably accounts for the failure of a large number of acquisition discussions. Searchers who are intimately familiar with the players in an industry will know by direct experience or hearsay about the culture and values of the target firm. The less familiar searcher will learn in due course about these.

Specialized searches will generate additional screening criteria. A relatively short list of criteria, however, can serve effectively to eliminate the bulk of the uninteresting deals and information, preserving the searcher's time for the more promising subset.

The reality is that your search experience feeds back upon the criteria and tends to shape them as you learn more. Haspeslagh and Jemison (1991) wrote, "Most acquisitions involve an iteration between a strategy that is clarified over time and the opportunistic consideration of acquisition possibilities." (Page 45) Acquisition search involves *dynamic learning by doing.* One must allow for a certain degree of opportunism, since opportunities help clarify strategy.

Invest in Social Networks: They Make Search More Efficient and Effective

The nature of a search is that one seeks to acquire information held by others. Successful searches are almost never conducted simply by reading one-way communications, such as want-ad listings of businesses for sale. High quality information is obtained through a social contact and exchange, such as payment to attend an industry trade show, payment for a research report, or subscription to a directory of players in an industry. The relationships between a searcher and other players in the environment form a network that can reduce the cost of search. The alternative to a network would be a sequence of one-off exchanges of information—but this alternative is a costly way to acquire information. Networks afford economies of scale and scope in search.

Two ideas from research on social networks are especially relevant to the problem of searching for firms to buy. The first is your *degree of separation* from those people who know about attractive acquisition opportunities. The second is the *rate of diffusion* by which knowledge spreads through a network.

In 1967, Stanley Milgram undertook a study of the "small world" phenomenon: You meet a stranger and discover that you have a friend in common. In unison, you and your new acquaintance say, "It's a small world." He tested the linkage of acquaintances in the United States by asking a sample of people in Omaha, Nebraska, to send a letter to a stockbroker in Massachusetts only by passing the letter through a chain of people they knew by first name. Travers and Milgram (1969) reported that the average length of the chain was 5.2 people; this is the origin of the phrase "six degrees of separation."[6] Subsequent studies have replicated the finding across racial lines giving the six degrees of separation more universal status. This is a surprising finding. Most of us would guess that the chain would run into the hundreds or thousands. The variance was large, ranging from as few as one link to as many as 11. About a quarter of the letters never made it. Travers and Milgram speculated that the people at the dead ends were either not sufficiently motivated or did not know someone to forward the letter on to. Equally surprising was a second finding: About half the letters that did get to the target passed through three key people. Travers and Milgram called these "stars." Stars are very rich *nodes* in a network.

The way networks function was the focus of a stream of research[7] on *diffusion* of innovations, influence, fashions, diseases, and new drug adoptions. Research on word-of-mouth advertising reveals that news travels unevenly: At first it disseminates slowly; then it spreads explosively. Malcolm Gladwell (2000) has written, "The best way to understand the emergence of fashion trends . . . [and] the transformation of unknown books into bestsellers . . . is to think of them as epidemics. Ideas and products and messages and behaviors spread just like viruses do." (Page 7) The *tipping point* is the dramatic moment of explosive growth.

But diffusion occurs at different speeds through networks. Davis and Greve (1997) studied the diffusion of the golden parachute and poison pill antitakeover defenses[8] through a sample of large U.S. corporations. The presence of interlocking directors[9] proved to be a major predictor of whether a corporation would adopt these defenses: having an authoritative voice from an estimable corporation lent legitimacy to the spread of these defenses. But the two defenses diffused at different rates. It took the pill just three years to be adopted by 50 percent of the corporations, while it took seven years for the golden parachute to reach that mark. The existence of a network of interlocking directors proved to be decisive in the spread of the poison pill. In the case of the parachute, what mattered more was geographic proximity. The authors argued that the rate of diffusion is affected by three factors: "Complex innovations spread slower than simple ones. . . . Practices that are observable spread faster than those that are not. . . . Innovations that are compatible with the norms of a social system spread faster than those that are not." (Page 30) They argued that the pill was more observable and more compatible with social norms.

The "small world" and diffusion research streams offer insights that are highly relevant for acquisition search:

WHAT YOU SEEK MAY BE CLOSER THAN YOU THINK Close proximity is surprising. The party game, "Six Degrees of Kevin Bacon," challenges the players to find an actor separated by a chain of six links (movies) or less to the actor Kevin Bacon. You can play this game on the Internet through a program devised by the computer science department at the University of Virginia.[10] It is challenging to find an actor separated by more than *four* degrees from Kevin Bacon.

YOUR SOCIAL NETWORK GIVES YOU PROXIMITY TO YOUR GOAL Watts (1999) argues that the essence of the network's value lies in its shortcuts to the goal. You don't have to be everywhere and know everything. You just have to be connected. The small world research adds a new phrase to the M&A lexicon: social capital. One's connectivity to others is an asset that M&A professionals should cultivate as carefully as other categories of assets such as talent, financial capital, and physical property. It helps to be visible in the network. Achieving search economies through a network may require an initial investment for letter or brochure that describes the searcher and the search, mailings and telephone calls that introduce the searcher, attending industry conferences and conventions, fees to gatekeepers, retainers to river guides.

THERE IS STRENGTH IN WEAK TIES: DIVERSITY AND BREADTH OF THE NETWORK MATTER Mark Granovetter (1973, 1974) studied how people find jobs. He discovered that personal connections were decisive. But the surprise was that three-quarters of the successful connections to a job offer were through "weak ties," people whom the job seeker saw "occasionally" or "rarely." Commenting on this, Malcolm Gladwell (1999) wrote, "*Weak ties* tend to be more important than strong ties. Your friends, after all, occupy the same world that you do. They work with you, or live near you, and go the same churches, schools, or parties. How much, then, do they know that you don't know? Mere acquaintances, on the other hand, are much more likely to know something that you don't. . . . The most important people in your life are, in certain critical realms, the people who aren't closest to you, and the more people you know who aren't close to you the stronger your position becomes. . . . Granovetter, by contrast, argues that what matters in getting ahead is not the quality of your relationships but the quantity—not how close you are to those you know but, paradoxically, how many people you know whom you aren't particularly close to." (Pages 12–13) The "weak tie" phenomenon emphasizes the virtues of diversity and breadth in a network. It turns out that networks are more valuable the more "nodes" there are. A node is one point of connection (such as a person) in a network. The relationship between nodes and networks is well illustrated by the fax machine. In a world of only one fax machine, the machine is useless and without value. But the value turns positive and increases as the number of other fax machines to communicate with rises. This is Metcalfe's Law: The value of a network is proportional to the number of working nodes in it.[11]

SIMPLE SEARCHES BASED ON OBSERVABLE CRITERIA GO FASTER The diffusion research suggests that the kind of information the network is asked to channel will affect the speed with which the network delivers. This would argue for using simple and clear search criteria. But it also points to network capacity (the richness of the network's nodes, and the bandwidth of its links) as determinants of *speed.* Evans and Wurster (2000) argue that "richness" of a node determines its effectiveness. Richness consists of credibility, contacts, information, interpretive insights, and resources for generating more insights. As a search adviser, becoming a rich node is the most powerful way to compete in a world where former economic relationships are getting "blown to bits" by the Internet. Very substantive, useful, helpful nodes gain the attention of users, and possibly even acquire their loyalty. "*Bandwidth*" is a term used by information technologists to indicate the information carrying capacity of a channel, such as a fiber-optic cable. High bandwidth channels are more valuable because they are more flexible to surges in demand. Moore's Law suggests that hardware capacity increases at an accelerating rate.[12]

The Best Information Is Firsthand

As argued earlier, the extent to which information is public affects the potential returns on an investment—the existence of *tipping points* lends urgency to the question of *where* the searcher should position himself/herself in the stream of news. Tippy news (an event or new information that triggers a tipping point in the diffusion of an idea) suggests that the searcher should seek an early or "*upstream*" *position* in the flow of news about investment opportunities. Market positioning is always an important consideration for business people, but it becomes crucial in tippy markets because they tend to give winner-take-all outcomes.

In studying new product introductions, Geoffrey Moore (1991) illuminated the variety of positions in the stream of dissemination: innovators, early adopters, early majority, and so on. Moore argues that there are large differences among the groups, and that they tend not to communicate well from group to group. The implication of this research for acquisition search is that there may be no substitute for *being upstream* in the flow of news about deal opportunities. Simply looking (as opposed to being) upstream is probably insufficient for identifying emerging *sweet spots*—the way to get upstream is with the help of *navigators.*

Primary research is the best and safest source of insights about investment sweet spots. Such research includes field interviews with managers and industry observers, attendance at trade shows and product demonstrations, and direct surveys of public information on firms and industries. *Secondary* research, though less rich, is also less costly; one must examine the trade-off on cost and richness. A great deal of information about companies is in the public domain. Exhibit 7.4 offers a synopsis of sources of public information that have proved useful to M&A searchers.

Navigators Affect Dissemination and Search: Gatekeepers and River Guides

The speed of dissemination is affected by the setting or context, by the impact of the message, and by the involvement of people with special gifts. Gladwell (1999) describes three types. First, *connectors* know lots of people, and the right kinds of

EXHIBIT 7.4 Annotated List of Recommended Sources of Public Information about Companies

The Directory of Corporate Affiliations

The Directory of Corporate Affiliations (DCA) provides insight into more than 174,000 parent companies, affiliates, subsidiaries, and divisions—all the way down to the seventh level of reporting relationships. The DCA is available in print, CD-ROM, and on the Web. Information includes type of business, net worth, sales data, and contact information of key personnel and outside firms. *The Directory of Corporate Affiliations* is published by Lexis-Nexis Group.

Dun & Bradstreet's Million Dollar Database

D&B's North American Million Dollar Database provides information on approximately 1,600,000 U.S. and Canadian leading public and private businesses. Company information includes industry information with up to 24 individual 8-digit SICs, size criteria (employees and annual sales), type of ownership, principal executives, and biographies.

D&B's International Million Dollar Database (IMDD) provides information on over 1,600,000 international companies. Find SIC, total employees, legal status, annual U.S. sales dollar equivalent, and more, plus identify up to four executives on the world's largest entities.

Factiva

A journal and news database created by Dow Jones and Reuters, Factiva includes a "Company Quick Search" module, which allows researchers to gather contact information, list of competitors, business description, corporate performance information, and the latest news on public and private companies. A "Company Screening" feature is also available.

Hoover's Online

A company and industry database that provides company profiles for public and private companies. Company profiles include contact information, history, news and analysis, financial data, locations and subsidiaries, products and operations information. An "Advanced Search" feature allows users to screen for companies by location, industry, size, exchange, number of employees, assets, annual sales, and sales growth. The "StockScreener" feature allows users to screen by other financial and performance data.

Lexis-Nexis

Lexis-Nexis is primarily a journal and news database that also includes various domestic and international public and private company directories. The directories include Disclosure, Hoover's Online, Nelson's Public Company Profiles, Standard & Poor's Register of Corporations, U.S. Business Directory, and many other international company directories.

InfoUSA

InfoUSA.com is a provider of sales and marketing support for products for all types of businesses, from small businesses to large corporations. The company compiles a database of 14 million U.S. businesses and 300 million U.S. consumers, and 1.2 million Canadian businesses and 12 million Canadian consumers.

(Continued)

EXHIBIT 7.4 *(Continued)*

Standard & Poor's Stock Reports
Standard & Poor's Stock Reports cover approximately 5,000 publicly traded companies listed on the New York, American, Nasdaq, and regional stock exchanges. Each report provides a concise picture of a company's health, along with Standard & Poor's estimates of the stock's worth, whether it's overvalued or undervalued, and analyst opinions on investment potential and earnings estimates. Features includes analysis, commentary, and quantitative data on about 5,000 publicly held U.S. corporations, STARS rankings that provide the buy/hold/sell recommendations of Standard & Poor's analysts, more than 200 data elements used to screen stocks, and Wall Street consensus data from I/B/E/S, current and historical financial performance, comparative peer company statistics, and earnings and dividends news. The stock reports are available in print, on the Web, or via fax.

Value Line Investment Survey
The *Value Line Investment Survey* is a source of information and advice on approximately 1,700 stocks, more than 90 industries, the stock market, and the economy. It has three parts. The *Ratings & Reports* section contains one-page reports on approximately 1,700 companies and more than 90 industries. Each company report contains, among other things, Value Line's Timeliness, Safety, and Technical ranks, financial and stock price forecasts for the coming three to five years, an analyst's written commentary, and much more. The *Summary & Index* contains an index of all stocks in the publication as well as many up-to-date statistics to keep investors informed about the latest company results. It also contains a variety of stock "screens" designed to help investors identify companies with various characteristics. The *Selection & Opinion* section contains Value Line's latest economic and stock market forecasts, one-page write-ups of interesting and attractive stocks, model portfolios, and financial and stock market statistics. This publication is backed by an independent research staff of more than 70 independent professional security analysts.

Ward's Business Directory of U.S. Public and Private Companies
Ward's lists approximately 100,000 companies, 90 percent of which are private. The first three volumes are arranged alphabetically and offer data on small and mid-sized companies as well as complete profiles of large corporations. The fourth volume lists companies geographically by ZIP code within state and offers evaluations of industry activity through rankings and analyses. The fifth volume ranks companies nationally within SIC codes. The sixth and seventh volumes rank companies in each state by sales within SIC codes. The eighth volume sorts companies by NAICS codes.

Source: This annotated list was prepared by Frank Wilmot, research librarian.

people. Second, *mavens* accumulate knowledge, and use it in potentially helpful ways. Gladwell writes, "Mavens have the knowledge and social skills to start word-of-mouth epidemics."[13] Third, *salespersons* convince people downstream of the importance of what they are hearing. One can imagine other categories as well; but the three categories convey a useful mosaic of the attributes of people who are upstream in the flow of information about acquisition opportunities. For shorthand, we can call these critical intermediaries *navigators*. They are especially important in turbulent industries and business climates. For instance, Evans and Wurster (2000) argued that in industries being affected by disruptions of the Internet, these two kinds of navigators become important:

> *Deconstruction implies choice. Choice, beyond a certain point, implies bewilderment. Hence, . . . the rise of navigators as independent businesses is destined to be one of the most dramatic aspects of deconstruction. It is also destined . . . to drive fundamental power shifts among the other players.*[14]

In the acquisition search, field navigators appear in various guises such as consultants, lawyers, accountants, venture capitalists, business brokers, and investment bankers. Many of these are highly professional and effective players, but the searcher should remain cautious until a skill is proved. Moreover, other useful upstream players may defy any discrete professional label. It is perhaps more useful to group the upstream specialists into two categories:[15]

1. ***Gatekeepers*** give access to information and deals. The starkest example of a *gatekeeper* is a broker or investment banker who has an exclusive engagement to sell a firm. Other gatekeepers may control proprietary data that could greatly influence a search.
2. ***River guides*** explain existing conditions in an industry or region, and highlight emerging trends that might affect the availability of investment opportunities.

Gatekeepers and river guides are important, because as conduits for information, they make decisions about who hears news, what they hear, and how soon they hear it. Cultivating strong relationships with players such as these effectively moves the searcher farther upstream.

Plainly, not all navigators are equally attractive. How should one choose? Shapiro and Varian[16] offer some insights into the attributes of the best navigators:

- ***Control over an existing base of customers or suppliers.*** Firms with proprietary information and/or exclusive rights to represent a seller will carry an advantage in the market.
- ***Intellectual property rights.*** In the search field, these may appear in the form of patents over specialized search software, or unpatented but proprietary knowhow.
- ***Ability to innovate*** better than other navigators.
- ***First-mover advantages.*** Good navigators discover trends and sweet spots before others. Through research or direct inquiry, one can ask whether the navigator has a record of successful discovery.
- ***Low-cost provider of search services.*** The best navigators enjoy a cost advantage over competitors, owing perhaps to economies deriving from large scale, or specialization. Strictly speaking, costs should never be weighed alone, but always be weighed relative to benefits. Thus, one should determine how costly is the navigator relative to deal concepts or proposals that have been delivered in the past.
- ***Reputation and brand name.*** Good navigators benefit from a positive reputation in the field, and seek to conduct business in a way that maintains or enhances that reputation.[17]

Organize Consistently with the Search Environment

One of the leading principles in cybernetics, Ashby's Law of Requisite Variety, states, "Any system must encourage and incorporate variety internally if it is to cope with variety externally" (Ashby 1956). This implies that the searcher that is most flexible and has prepared the best will have the highest probability of succeeding. The practical implication is that the search or origination team needs to be organized in ways consistent with the complexity of the external environment. Adopt a flexible organizational structure where the environment is changing rapidly.

Persistence and Repeated Effort Pay

Investing in an acquisition search or deal development effort is like investing in an option. Option pricing theory suggests that a search will be more valuable the greater the probability of a positive payoff. The searcher can influence this probability through:

- Choosing *promising arenas*. Option theory says that options are more valuable the greater the uncertainty. As described earlier, an important driver of uncertainty is information asymmetry. Thus, a promising arena for transaction development is one where there is uncertainty about who knows what information.
- Increasing the *total number* of deal opportunities reviewed. To the extent that search is a learning process, the search will improve as one gains experience. An improved search should help skew the probability of doing a good deal in the favorable direction.
- Increasing the *frequency* of reviews. Frequency will rise as one shortens the cycle time to absorb information and do a deal. This presumes, of course, that the quality of the analysis and decision making does not deteriorate as cycle time declines.
- Optimizing the network infrastructure so that it sends to the searcher valuable information and high-quality deal opportunities.

Searches require pro-activity. Passivity is costly. Activity pays. As Thomas Jefferson said, "I am a great believer in luck, and I find that the harder I work, the more I have of it."

CASE STUDY: KESTREL VENTURES LLC

Kestrel Ventures[18] was a partnership organized in the fall of 1998 by three young entrepreneurs (Bart Crawford, Dave Edinger, and Jim Kingdon, henceforth the "Managers"), who raised $750,000 from private investors for the purpose of searching for a company to acquire. This type of enterprise was called a "search fund," and was an investment vehicle by which an entrepreneur could finance the expense of a one- to three-year search for a business to acquire. Typically, the entrepreneur would organize a company in which equity shares would be sold to 10 to 20 investors. The shares would carry the right of first refusal (without an obligation) to invest in the ultimate acquisition. Targeted acquisition size and search criteria would be stated in the offering memorandum, suggesting the likely attributes of the ultimate acquisition. Once the acquisition was completed, the entrepreneur would assume general management of the firm. Typically an interest in the search fund would carry over into a share in the equity of the firm acquired. Some observers believed that the search fund was developed in 1984, but the concept had existed for some time.

Typically, the search fund offered wealthy individual investors access to investment in a class of firms that were too small for leveraged buyout funds, too mature for venture capital groups, and too large for outright acquisition by an individual. One study[19] of 16 search funds established between 1984 and 1996 concluded that they provided investment returns (IRRs) in the range of 32 to 40 percent. Another study[20] of nine search funds found a 32 percent median IRR to investors.

In their promotional materials and conversations with investors, the Managers expressed the intention to focus their acquisition search on three fields:

1. Animal health and companion animal products and services.
2. Postsecondary education products and services (including business-to-business training).
3. Geriatric ancillary services (health care and otherwise).

These had been chosen after a complex process of analysis and reflection by the three. Large players did not dominate the fields; competition was fragmented and seemed to offer entry opportunities for energetic Managers. None of the three fields was technology-intensive or subject to rapid technological change of the sort that might surprise new entrants or extend beyond the technical familiarity of the three. Demand for goods and services in these fields seemed stable; yet expected changes seemed to offer opportunities for growth in the future. Within these industries, the managers focused on finding companies for sale with:

- Revenues in excess of $5 million.
- Operating cash flow in excess of $1 million.
- A low- to medium-tech business process or product.

They sought to place at least one Manager in an active day-to-day position in the company acquired. Also, they required a majority-stake ownership position, and the opportunity to offer substantial returns to Kestrel's investors.

In describing their search approach, the Managers wrote:

> *The viable transaction opportunities we see at KV come from several sources. First, we utilize a traditional "outside-in" approach relying on our ever-growing network of contacts . . . in the investment banking, private equity, professional services, and business brokerage sectors. Regular contact . . . ensures that we see a higher percentage of deals fitting KV's profile. The maintenance of this growing contact base is equally important as our grassroots industry efforts.*
>
> *We detailed the "inside-out" approach in our brochure as a strategy unique to the search fund concept. By initiating direct contact with companies,*

> *industry consultants and other professionals not directly related to the transaction process, we hope to uncover transactions before they are formally represented by an intermediary. Through this approach, we endeavor to avoid auctions and to negotiate a favorable transaction price and structure. Our primary selling points when approaching companies are the quality of the KV team—Managers, Advisory Board and investors, our day-to-day management focus versus installing separate management, and our growth strategy.*
>
> *We borrowed the term "River Guide" to indicate an industry expert interested in leading us to viable acquisition candidates. These guides may be industry consultants, retirees or another form of expert. River Guides bring years of focused industry experience and contacts to KV. We intend to build relationships with River Guides in each of our target industries.*[21]

The Managers planned to focus on inside-out industry coverage through the use of River Guides. They believed that this route would provide the best opportunities to find transactions that would leverage the Managers' skills in day-to-day positions with the acquired company.

In the first three months of their search, the Managers focused on developing a network of useful contacts, both the outside-in business brokers and the inside-out River Guides. They estimated that there were more than 2,000 intermediaries in the United States, but that most of these were inappropriate for various reasons. It was necessary, therefore, to screen the intermediaries, and thereby reduce the number to 450, whom they would contact regularly. Each of the three Managers assumed responsibility for developing a geographic segment of a network of contacts.

In addition to developing their network of deal intermediaries, the Managers evaluated opportunities that began flowing in almost immediately. Some of these opportunities arrived in the form of professionally developed business investment proposals. Others were rather crude "spec sheets" of the sort that might be mass distributed by business brokers. Still others were oral descriptions of an opportunity without written documentation—in these cases the Managers would need to develop their own research on the opportunity. The research and deal development process would entail several phases:

- ***Preliminary evaluation.*** One of the three Managers would screen an opportunity to determine its fit with the search objectives of Kestrel. Of the approximately 360 deals Kestrel had identified as of the advisory board meeting, only 170 survived the preliminary evaluation phase. Rejection of an opportunity at this stage was due typically to a mismatch on size, industry, or control criteria, absence of information, and/or low expected returns. About 55 percent of all investment opportunities were rejected at this stage. In other words, the Managers proceeded with more thorough company and industry research on approximately 45 percent of transaction opportunities.
- ***Company and industry research.*** If an opportunity met the basic criteria, one of the Managers would assume responsibility for building the base of information on the target firm and its industry, interviewing customers, suppliers and competitors, and ultimately visiting the company itself. Most private firms were reluctant to release a great deal of information without a signed letter of

intent and/or confidentiality agreement, so much of the research derived from public or semipublic information. The Manager responsible for a specific opportunity would begin to build a written case describing the opportunity, its fit with Kestrel's criteria, and its potential investment returns. Many opportunities were rejected at this stage on the basis of the discovery of company- or industry-specific risks, or unusual requirements of the sellers. Kestrel had analyzed 75 opportunities at this level by late August, implying survival rates of 45 percent of the preliminary evaluation stage and 20 percent of total deals seen.

- ***Company visit(s) and meetings with management.*** If the research warranted it, Managers visited companies exhibiting potential. This phase represented both an additional deal evaluation step, to evaluate company management and post-transaction Manager integration, and a chance to describe the unique features of Kestrel's structure and philosophy. The Managers had visited 31 companies by the end of Kestrel's third quarter. Work at this stage was the foundation for a decision to sign a letter of intent, with a preliminary offering price. As the letter of intent approached, the investment opportunity would demand an intense commitment of time.
- ***Letter of intent and in-depth due diligence research.*** Kestrel would submit a letter indicating a serious interest in acquiring the target firm at a likely price or price range. The contents of the letter and the price might be the source of ongoing negotiations, with a revised draft submitted to the seller. As of August 1999, six preliminary term sheets or letters of intent had been submitted, but none were accepted. Rejection typically followed from differences in valuation or seller withdrawal from the process. The Managers expected that with the acceptance of a letter of intent, they would embark on an intensive, time-sensitive due diligence research process to be followed by the negotiation of definitive agreements, including a purchase-and-sale agreement, and ultimately, closing of the sale.

Over the first three quarters of 1999, of the universe of 2,000 intermediaries, the Managers had screened 1,429, and established continuing relationships with 437. Furthermore, the rates of change in various categories suggested that in recent months the Managers were shifting their time and attention away from network building and toward research on companies.

Acquisition Guidelines

Industries were reviewed and prioritized based on macroeconomic dynamics and trends. Companies within selected industries will be evaluated on the basis of transaction completion and return potential. All search and return objectives were based on a mid- to long-term view as opposed to short-term strategies. The Managers did not consider turnaround or workout investing. Kestrel Ventures believed that disciplined adherence to the following industry screening criteria would support the identification of acquisition candidates with above-average return potential. A summary of the acquisition guidelines used by the Managers is given in Exhibit 7.5.

EXHIBIT 7.5 Acquisition Guidelines, Kestrel Ventures LLC

Industry Criteria	Description
FRAGMENTED INDUSTRY STRUCTURE	A highly fragmented or newly consolidating industry offers advantages to Kestrel Ventures across the entire search and acquisition timeline. • Numerous companies within the $10 to 50 million revenue range will support an efficient search. Intensive up-front industry research may be spread over a broader field of potential acquisition candidates. • Industry fragmentation supports incremental growth postacquisition through niche identification and avoidance of dominant industry players. • Fragmentation encourages postacquisition growth through follow-on acquisitions. • Industry consolidation trends enhance exit opportunities.
FAVORABLE GROWTH POTENTIAL	Because top-line growth generally improves investment return, Kestrel Ventures will participate in industries that exhibit favorable future growth trends. While historical growth trends are a well-correlated indicator of future potential, multiyear historical growth trends will not serve as a prerequisite to industry selection. Kestrel Ventures will target newly developing industry segments exhibiting multiple sources of growth in an effort to improve the fundamentals for company growth.
REASONABLE VALUATIONS	While numerous industries show fragmentation, consolidation, and favorable growth potential, not all such industries will be appropriate for Kestrel Ventures' consideration. Kestrel Ventures anticipates competitive pressure in the industries it reviews and expects that its screening criteria will be sought by other investors, thereby driving up company valuations within commonly identified industries. Kestrel Ventures will generally avoid "popular" industries and focus on dormant, emerging, or otherwise unidentified opportunities.
BASIC OPERATIONS	Kestrel Ventures will target industries with basic operations. A simple product or process will facilitate acquisition financing, management integration, and incremental operating improvement. Long product life cycles and low product obsolescence may provide stability and should allow the Managers and existing management to focus on revenue growth. Kestrel Ventures intends to develop competitive advantages by employing sophisticated financing, management, and operational improvement tools and techniques.

(Continued)

EXHIBIT 7.5 *(Continued)*

Industry Criteria	Description
RECURRING REVENUE STREAMS	Kestrel Ventures is interested in industries where a major portion of ongoing revenue comes from regular, periodic payments by customers (e.g., cable TV, alarm systems monitoring), or from business-to-business outsourcing relationships (e.g., janitorial services, document management). Recurring revenues, which "lock in" customers and revenues for a defined period, are highly desirable because they: • Contribute to the stability of cash flows and support cash flow based financing. • Enable concentrated selling efforts on new accounts and provide sales leverage. • Provide the opportunity to strengthen relationships with "captive" customers, building loyalty and increasing switching costs. • Permit time and resources to be focused on service efficiency and operating margins.
LIMITED REGULATION	Kestrel Ventures will target industries with minimal government or other regulation. Regulatory constraints may cap investor return potential and can often become a corporate resource drain. Kestrel Ventures believes that a low-regulation criterion substantially improves industry financing opportunities, management focus, and strategic planning by mitigating the chance of uncontrollable externalities limiting growth prospects.

Source: Used with permission of the company.

Company Screening Criteria

Kestrel Ventures sought opportunities where the seller would like the company placed in approved hands. The seller's careful consideration given to succession may stem from:

- Lack of a logical successor within the company.
- Emotional ties to the company and reluctance to relinquish them.
- Strong relationships with company employees.

Because of the long-term, nondisruptive strategy taken by the Kestrel Ventures management team, sellers may view the transaction differently from alternatives with other strategic or financial buyers. A summary of the screening criteria used by the Managers is given in Exhibit 7.6.

Kestrel Ventures' search was ultimately successful, resulting in an acquisition of a firm 17 months after the partnership had been organized. The case study of Kestrel Ventures illustrates:

- The use of industry and company screening criteria.
- The use of navigators.
- Organization for flexibility.
- Investment in a network and in becoming a valuable node.
- The value of information and the development of primary research.

EXHIBIT 7.8 Screening Criteria, Kestrel Ventures LLC

Company Criteria	Description
ESTABLISHED MARKET POSITION	Kestrel Ventures will target companies with geographic and/or product/service niche potential. The Investment Opportunity's established market position could serve as a low-risk platform for niche development through incremental growth and/or acquisitions.
GROWTH POTENTIAL	Although related to industry growth potential, corporate growth potential will also serve as a screening prerequisite. Company growth may be achieved through optimization programs including but not limited to human resource reallocation, enhanced capital spending programs, and internal incentive programs. Expansion of a company's core capabilities, geographically or through products and services, may serve as an effective means of gaining incremental growth. Expansion potential may be limited without significant capital spending; therefore Kestrel Ventures will conduct thorough due diligence of asset leverage capabilities for all candidates.
STRONG CASH FLOW POTENTIAL	Stable, positive cash flows will service acquisition debt; therefore, Kestrel Ventures will target companies exhibiting suitable cash flow performance. Companies with varied historical performance may be considered but identified improvements must be feasible.
	Cash flow stability will mitigate risk by creating cash cushions against early-stage and unforeseen problems. Therefore, seasonal companies and turnaround opportunities with unstable cash flows will be avoided.
FINANCING POTENTIAL	Targeted companies will exhibit cash flows or assets suitable to support acquisition leverage. Additionally, Kestrel Ventures will seek companies with seller financing potential.
MANAGEMENT PLATFORM	The Managers and Investors will determine the best fit for existing management at the time of acquisition, and will seek to rely on existing management for information and expertise where applicable. Kestrel Ventures will retain existing Managers who will maintain stability and successfully implement key programs.

Source: Used with permission of the company.

In these various ways, the experience of this firm shows the usefulness of the principles offered in this chapter.

SUMMARY

This chapter introduces the reader to some guiding ideas about acquisition search and illustrates them with a case study of a successful search. Exhibit 7.7 summarizes the principles described here. Central to all of these is the use of an

EXHIBIT 7.7 Summary of Search Principles

Principle	Implication
1. The currency of acquisition search is *information*.	Build a search effort that generates a flow of high-quality, credible, usable information.
2. Clarity, privacy, and cost: What the market knows is fully priced.	The deal search should be structured to generate credible private information and transactions before they become widely known.
3. Information arrives sequentially and must be filtered.	Acquisition searches require a screen, a set of criteria that afford the basis for a go/no-go decision on any particular opportunity without seeing the entire potential set of opportunities.
4. Invest in social networks. They make search more efficient and effective.	The opportunity may be closer than you think. The network provides shortcuts to the opportunity. Social capital is valuable. Weak links are the source of strength. Build a search network. Search networks are more valuable the more the "nodes"; the higher the bandwidth; and the higher the speed. Search nodes in a network are more valuable the higher the content.
5. The best information is firsthand.	Firsthand information is valuable because it helps the searcher find the sweet spot in a particular situation. Try to beat the news to the market. Intercept it before it disseminates explosively. The way to do this is to move upstream in the news flow.
6. Navigators affect dissemination and search: gatekeepers and river guides.	Navigators help one move upstream. Look for navigators who control access, and who provide counsel.
7. Organize consistently with the search environment.	Design the search team in ways to match the complexity of the environment. Adopt an adaptable organization.
8. Persistence and repeated effort pay.	Focus on increasing the total number of deal opportunities reviewed, increasing the frequency of reviews, and optimizing the network infrastructure.

information-gathering network as the foundation for critical ideas. As a foundation for due diligence research (see Chapter 8), the gathering of information-rich ideas is key.

NOTES

1. "The Acquisition Search Process," public presentation by AlliedSignal Corporation, April 14, 1998.
2. Reported in Salter and Weinhold (1981), page 162.
3. As used in this chapter, "network" describes one's social connections to others. The *Oxford English Dictionary* defines "network" as "an interconnected chain or system of immaterial things."
4. As another mark of importance of the economics of signaling, the Nobel Prize in Economics in 2002 went to three scholars who explored the problem of signaling quality: George Akerlof, Michael Spence, and Joseph Stiglitz.
5. Assuming that the pricing of a firm's shares is efficient is probably a reasonable default. However, it is healthy to retain a sense of irony about the efficiency assumption. First, research indicates that the market is not "strong form" efficient; that is, the market does not know *all* information, both public and private. Second, there remain numerous anomalies not consistent with efficiency such as panics and crashes, January effects, and firm size effects.
6. This was later the premise for a play and movie *Six Degrees of Separation* (Guare 1990).
7. Rogers (1995) notes that there are over 4,000 studies on diffusion.
8. Antitakeover defenses are discussed in Chapter 35.
9. Persons who sit on more than one corporate board of directors are said to *interlock* the boards by creating a social connection between them; as generally used, *interlocking* is a social, rather than legal or economic phenomenon.
10. See www.cs.virginia.edu/oracle/.
11. Robert Metcalfe, who founded 3Com Corporation and invented the Ethernet protocol for networks of computers, asserted that the usefulness of a network rises with the square of the number of users in the network.
12. Specifically, Moore's Law pertains to the number of transistors capable of being embedded in a semiconductor: the number will double every 18 months. Gordon Moore is one of the inventors of the semiconductor.
13. Gladwell (2000), page 67.
14. Evans and Wurster (2000), page 64.
15. These categories were named by Bart Crawford, Dave Edinger, and Jim Kingdon.
16. See Shapiro and Varian (1999), pages 270–272.
17. Reprinted by permission of Harvard Business School Press. From *Information Rules: A Strategic Guide to the Network Economy*, by Carl Shapiro and Hal R. Varian. Boston, MA, 1998, pages 270–272. Copyright © 1998 by Carl Shapiro and Hal R. Varian; all rights reserved.
18. This description is based on Bruner (2000).
19. Reported in James C. Collins, "Keystone Management Corporation (A)" undated case.
20. The study was conducted by Douglas A. Wells, MBA student at Stanford Uni-

versity, June 28, 1996, and reported in an unpublished manuscript. The IRR was based on a blended return across classes of securities within each fund, and assumed the same start date across all observations. Wells noted that "For the purpose of this study, search funds are defined as those individuals who had recently graduated from business school prior to beginning their search. Three of the nine respondents had already sold their companies and the returns on these funds were straightforward to calculate. In the cases of companies still under search fund management, several assumptions had to be made to determine investor returns. To calculate the value [of] the company, presidents were asked to assume they sold their company at their purchase multiple. In at least one case, the original purchase multiple was considered to be above the current fair market multiple. To remain conservative, the study used the fair market multiple for this company. In all cases, the study then assumed that all debt was repaid and that funds were disbursed to investors in proportion to the equity owned by them. All returns are calculated on a pre-tax basis to investors. Finally, to eliminate skew based on deal size, it was assumed that individuals invested equal amounts in each search fund and subsequent acquisition. In addition, all search funds were assumed to start on the same date. However, the actual search period was used for each fund. If one fund finalized their acquisition in 12 months and another in 24 months, that is the time period that was used. Utilizing the same start date had the effect of lowering the blended IRR. Results are based on fiscal year 1995 performance for the companies, or their last 12 months of operating history for those that had recently completed their acquisition."

21. "First Quarter Highlights" newsletter from Kestrel Ventures LLC, to investors, March 31, 1999.