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The role of intelligence for M&A in relation to disruptive start-ups

Understanding who you are dealing with

Many established businesses are seeing the limits of growth in their traditional business models, and are increasingly appreciating the value that can be brought by acquiring smaller market players which seek to challenge how business is done in their sector. Where such targets are start-ups offering innovative high technology solutions or smaller companies using online technologies to bypass traditional and asset-heavy routes to market, investors face a range of new uncertainties compared to the acquisition of well-established operators in the field. In particular, such smaller companies may not have a long track record, and may be led by entrepreneurs who do not have past experience as executives or who lack experience of corporate governance.

The benefits of gathering intelligence – that is, conducting 'Integrity Due Diligence' – on a potential target to assist in understanding its possible association with illegal activities is now well understood to add huge value in certain circumstances (such as where the target is located in higher risk jurisdictions). However, such enquiries can also provide valuable insight into the culture, operations and potential governance risks associated with start-up companies wherever they are located. In addition to supporting the wider due diligence effort, such work can feed directly into both negotiation and integration strategies.

A basic level of Integrity Due Diligence can be undertaken through public record research, but taking the additional step of gathering intelligence through human sources operating in the relevant sector and jurisdiction typically provides more valuable insight into the asset being acquired.

Investing in a start-up is often an investment in an entrepreneur – understanding how that individual thinks, their working habits and negotiating style may be crucial to a successful deal

Intelligence gathering can be tailored to fit many needs, and the following are some examples of the types of risk that we have identified in the past:

- **Poor standards of governance which endured as the company grew**
  A rapidly growing disruptive tech company had clear policies around the protection of customer data; however, intelligence gathered from former employees identified that these policies were not implemented within the company: developers routinely downloaded, analysed and made use of customer's personal data, presenting a significant regulatory risk to anyone who acquired the company without remedying the situation.
- **Key technical staff did not intend to remain at the company following the acquisition**
  Intelligence gathering on an innovative technology company established that – as is common in disruptive start-ups – it relied heavily on the knowledge of a small number of technical employees. A number of sources in the sector reported that these key employees were looking to exit the company following the deal. Our client was able to structure their deal to motivate key individuals to stay.
- **Misrepresentation of unsuccessful operations**
  Our client had been informed that a regional team of the target served as a think tank, specialising in developing new innovations in a highly technical field. However, intelligence gathered from those in the industry established that this team served more as a holding tank for problematic senior employees who the CEO – an inexperienced entrepreneur – felt too loyal to dismiss out-right, with the think tank having little impact on the target's operations overall.
- **Unique workplace culture which might be difficult to integrate**
  Intelligence gathered from industry sources found that the target – a fast growing start-up – had developed an unusual workplace culture, originating from its eccentric founder, which would sit very uneasily with many modern corporate environments. However, sources close to the company also reported that the founder's main contribution had been to bring a talented team together, and that he was no longer considered necessary for the operation of the company. These findings enabled the client to consider their approach to the acquisition, talent retention and integration.

> Gathering intelligence can help companies identify – and then remediate – issues which could prove costly if left unchecked

- **Difficult negotiators**
  We have seen several situations where the entrepreneurs behind disruptive tech companies – who are used to exerting full control over their companies – may have unrealistic expectations of the sale process. In situations where clients anticipate difficulties negotiating with sellers, intelligence can be gathered from those familiar with previous negotiations to help understand what the seller is looking for, their trigger points and their attitude to formal discussions. Being forearmed with such knowledge can make a difference to the success of negotiations.

Gathering intelligence is a relatively low-cost exercise which can help companies to identify – and therefore remediate – issues which might, if left unchecked, prove expensive to resolve further down the line (in terms of reputational damage, business failure, and regulatory fines or litigation). It can be conducted at any stage of the transaction process, but adds greater value to the M&A process if it is done sooner rather than later.

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