# Targeted due diligence

BY CLAIRE SPENCER

As the business climate worsens, dealmakers are finding it increasingly challenging to meet expectations. Acquirers are still active in the mid-market, but they are proceeding with caution. In addition to focusing on innovative deal structures, it is now more important to bring that originality and creativity to their due diligence. Current trends involve casting the net widely in the initial stages, but focusing on specific risks later on. Ensuring that this process is as efficient as possible is fundamental to a buyer's analysis and consequently, the long term profitability of the deal.

In a tight environment with reduced liquidity, low consumer demand and the threat of insolvency, investors will need to prove that their value creation opportunities are tangible and grounded in reality. "Due diligence under the prospects of a recession and tighter credit markets will focus efforts to better understand and reflect the risks involved in a transaction," says Juan Carlos Webster, a principal at Booz Allen Hamilton. "There will be an increased awareness of the credit exposure of targets, including their long term contracts with clients and suppliers, together with a more intense analysis of their solvency and liquidity." Essentially, potential risks need to be identified at an early stage so that steps to mitigate such risks can be taken.

But widespread uncertainty is not expected to stifle transactions completely. In some cases, it can open new doors. "The increased risk awareness creates a slowdown in transaction pace but provides plenty of opportunities for bullish and insightful investors", says Petter Kilefors, the Global Practice Leader of Strategy & Organisation, Corporate Finance and Private Equity at Arthur D. Little.

Given that the macroeconomic climate is generally depressed, notably in the US, it is likely that the widespread liquidity squeeze will focus attention on financial due diligence. "Financial due diligence in support of bank lending proposals is likely to continue while there is demand for acquisition funding from this source, and there is liquidity to enable them to lend," says Cameron Cook, a principal at MacIntyre Hudson Corporate Finance Limited. "Closer attention will be placed on the financial viability of proposals and the width of sensitivity analysis as an assessment of risk for the lender. Indeed, cashflow lending may decline with greater emphasis on asset lending by banks. This will require the focusing of financial due diligence in those specific areas." He adds that there is even the potential for more unusual requirements, such as psychometric testing to ensure that investors seeking to borrow are the right type of people.

### Identifying key risk areas

With additional pressures on financing the deal and general instability in the business climate, it doesn't come as a surprise that due diligence practices have fallen under greater scrutiny. Although deals of a high standard are still being done, particularly in the mid-market, industry players are aware that there are more opportunities for them to fail than there were a year ago. As such, attitudes are changing, and dealmakers are being more calculating and thorough. "In a corporate acquisition, there is a greater emphasis on the management team 'getting to know the target' throughout the process," observes Mr Cook. "The purchasing management team are always involved in the due diligence process, but the knowledge they gain has been given greater emphasis to assist the post acquisition integration of the acquired people and business. The trend is to make a better initial assessment, identifying risk areas and focusing the scope of due diligence in those areas." This method encourages practitioners to perform due diligence with fresh research and analysis, instead of using existing sources or management assumptions. It allows a more accurate and efficient evaluation of the value and risk involved in a transaction. Focusing due diligence on key areas is essential for the acquirer to conduct a thorough analysis while optimising its financial and human resources.

Covering all the necessary areas of due diligence allows an acquirer to mitigate most liabilities, some of which can be hard to discern unless investigated. "Adequately executed due diligence can help identify specific risks that might merit indemnification clauses, or that the assumption of which should drive a purchase price adjustment. Big risks are obvious, such as when Nabisco Holdings spun off RJR in 1999 with a significant amount of cash to cover for liabilities. However, obscure, hidden ones are more difficult to detect and can later bring a company down," warns Mr Webster. He adds that asbestos liabilities have been particularly problematic due to its former role in industry. But evaluating at such a level is easier said than done – not all companies have a perfect set of records to be referred to at a moment's notice, particularly in jurisdictions whose business practice is still developing. It is crucial to understand that while due diligence is considered part of the process in more developed economies, in others it is considered a cost that should be mitigated, or worse, eliminated.

Assembling specialist global due diligence teams from within the relevant jurisdictions can help to preserve value while emphasising the importance of the due diligence process to the target. "Companies must assemble multinational teams of professionals representing expertise in each of the areas of interest. It is essential to have team members who understand not only the regulatory – for example, accounting, tax, legal – environment in each jurisdiction, but as importantly, the cultural and business traditions as well," asserts Dan Reid, a national managing principal of transaction advisory services at Grant Thornton LLP. One method to allow the efficient exchange of data and information across borders is the 'virtual data room', an internet site that can only be accessed via secure log-on details, supplied by the vendor.

### Creative due diligence

What is deemed to be a thorough due diligence exercise has evolved in line with market trends and developments. "While traditional due diligence remains essential, other aspects are becoming increasingly important," says Mr Webster. These include the analysis of market fundamentals, environmental issues, insurance and risk management together with cultural and organisational due diligence. For example, an internal and external communications effort combined with an adequate organisational due diligence could help avoid the possible bleeding of talent or any negative impact on morale."

In the last year, more and more buyers, particularly private equity funds, have started to conduct 'industry screenings' via third party consulting firms. Having identified a promising sector, it is thoroughly examined, taking into consideration the market fundamentals affecting growth, and any other issues relevant to a potential investment. Then the investigation analyses individual companies in terms of the company's investment ▸▸

criteria. This differs wildly from auctions that were previously prevalent in the market, as it allows investors to conduct the traditional forms of due diligence such as financial and legal more thoroughly to assess whether a deal will be value accretive, but also allows time for strategic due diligence to understand more about the target's industry and the realistic prospects of the deal.

In a rapidly globalising world, acquirers are also paying more attention to the international standing of the target including its reach and competition. "Firms are increasingly studying the competitive landscape in the target's industry at a global level. With competition surfacing from across the globe, a thorough understanding of these competitive factors is essential. Site visits to manufacturing locations to identify value creation opportunities are also prevalent in looking at a target on a global level," says Mr Kilefors. Any company undergoing or about to undergo global expansion will inevitably face legal, cultural, managerial, organisational and governance differences, all of which could have a big impact on value realisation. Understanding the global position of the target together with how it conducts its operations across multiple jurisdictions forms an essential part of the due diligence exercise for cross-border M&A.

As competition mounts, it is essential that acquirers get to the root of the target's operations in order to identify any practice that could enhance the rate of growth. This has led to a rigorous operational due diligence exercise in collaboration with commercial due diligence being more widely practiced, explains Mr Kilefors. "With increased competition in the buyout industry, firms need to be able to know how to influence change in a target in advance. This means more than identifying top line strategic growth opportunities and top line improvement areas. Thoroughly examining cost rationalisation and bottom line savings potential pre-close is essential to maximising value. An increasing demand for procurement and capital efficiency improvement programmes exemplified this."

The success of a business, and any acquisitions of that business revolve around its key staff. The need to retain those employees — the renewed focus on employment law, incentive schemes (for example, bonus or share options), and personality assessments — has become more important in recent years. Recognising and dealing with the impact on staff before, during and after an acquisition is essential, asserts Mr Cook. "That first meeting when the acquisition is announced to target staff is key and needs to be delivered in the right way. Hard-nosed negotiators and 'figure-people' do not always have the right people skills, so having this resource is essential. Knowing the people in the target, through drawing together knowledge and impressions gleaned at due diligence is often a good guide to making the acquisition gel," he says.

Furthermore, it can be difficult to extract information about the target from current staff and contractors if they are apprehensive about the company's future under new management. Acquirers need to look beyond the traditional management interviews when conducting their research. Interviews with customers, competitors, industry experts, and academic experts can all be invaluable in establishing an exact, contextually accurate picture of the target. Undertaking customer due diligence via customer satisfaction surveys is one way of revealing the relationship between target and customer, helping to assess if this is a risk area.

**Future value**

The due diligence results can be used to great effect in laying the foundations for a new company. Mr Reid maintains that there is a lot more to due diligence in 2008 than simply sifting through a vendor's financial records. "The findings should also serve to modify or support the reps and warranties the buyer requires from the seller, and to establish the framework for the post-closing adjustments and damages sections of the purchase agreements. Additionally, due diligence should be used to establish the groundwork for the 100 day plan – those critical items that must be addressed early on during the transition or integration process if the transaction is going to achieve the buyer's identified objectives for entering into the transaction," he says.

Pre-planning allows a buyer to enter a deal knowing the key issues that need to be addressed at deal close, and enables processes and procedures to be implemented at a quicker rate with fewer errors. Operational improvements can start immediately following deal completion. For example, a US private equity firm recently commissioned an operational due diligence study to examine the cost benefit analysis of consolidating multiple manufacturing facilities at a potential target. The study found that several of the facilities could be effectively consolidated, so the firm purchased the target and quickly started reorganising the manufacturing footprint. Releasing value in this manner is the eventual goal of the due diligence, and anything that prevents that should be highlighted as soon as possible.

Another trend, which can improve value for the vendor, is sell-side due diligence, which has become a part of more and more deals in the last few years. This is simply the act of the seller performing due diligence on itself, explains Mr Reid. "This is not done to provide the results to potential buyers, rather, it allows sellers to either identify issues upfront or, ideally, resolve the issues prior to the sales process. Sellers are beginning to understand that buyers and their advisers will find issues during due diligence and since a problem cannot be hidden, it is better to disclose it or resolve it at the start of the transaction process." In an increasingly difficult market, it is prudent for a company to know their position before being placed on the market – reducing uncertainties and increasing transparency will maximise both the chance of being acquired and the purchase price.

While there is liquidity in the mid-market, high quality deals will continue to be done, but investors will not act hastily. This does not necessarily mean that they will be doing more due diligence than this time last year, but the evaluations they undertake will be tailored to the deal's needs. Due diligence is no longer a cursory glance over a balance sheet, but encompasses all pertinent aspects of a company's activities. Due diligence should be used as the catalyst to drive improvements post deal close. Investors should know exactly where they are heading well in advance of setting off. This can be difficult, but in distressed times, targeted due diligence may be the only way to maximise profitability in the long term. ■