M&A Planning: Buy-Side Due Diligence

Arthur F. Rothberg, Managing Director, CFO Edge, LLC

The acquisition of a company or division can help a firm broaden its product lines, increase geographical diversity, acquire key personnel, obtain access to patents and other intellectual property, and create cost synergies in production, sales, legal and purchasing activities, among many potential benefits. Where the acquirer is a private equity firm or other financial investor, the transaction offers the opportunity for a substantial return on investment through restructuring, as well as making management and other changes within the organization.

Of course, as we all know, acquisitions can have their potential downsides as well as benefits, and many acquisitions that seemed to make perfect sense before the transaction was closed, have turned out to be losers. The reasons for a less-than-optimal outcome will vary – e.g., over-estimation of the potential synergies, weaker demand than projected, acquired managers that turned out to be less than competent, unexpected turns in the economy, and unanticipated legal liabilities or compliance issues.

Some problems that surface after a transaction has closed cannot necessarily be predicted or helped – e.g., the introduction of a new technology that makes the acquired product or service obsolete; or a natural disaster that devastates an acquired facility.

But to the extent that problem issues with the target firm, the market environment or other potential negatives *can* be anticipated, it is critically important for the acquirer or investor to conduct an extensive due diligence process prior to the acquisition so that they can be satisfied that they have covered all bases to the extent possible.

What Is Due Diligence?

In very basic terms, M&A due diligence from an acquirer's perspective is a thorough analysis of the potential risks involved in a proposed M&A transaction, in order to ensure that the potential benefits of the deal outweigh those risks. "Many a deal that looks good on the back of an envelope looks bad in a spreadsheet," write Alexandra Reed Lajoux and Charles M. Elson, in their recently published book, "The Art of M&A Due Diligence: Navigating Critical Steps and Uncovering Crucial Data," and, "Acquirers must face all the facts – even worst-case scenarios."

Buy-side due diligence typically encompasses a thorough review of the company's financial statements, as well as projections of future financials; evaluation of the target company's management and operations; a look at the company's product lines (current and pipeline) and customer base; visits to company offices and facilities; and a legal compliance review, among its many aspects.

The establishment and maintenance of a virtual as well as a physical "data room" that would contain original documents, contracts, financial records and other information pertinent to the valuation and risks of the target company would also be part of the due diligence process.

How It Works

To conduct the due diligence process, the potential acquirer will typically form a due diligence team that would include both internal and external experts in such areas as finance, accounting and auditing, legal, taxes, marketing, compliance, strategy, industry specialists, engineers and environmental experts, as needed, to participate in the process.

To maximize the effectiveness of the due diligence process and to ensure that all bases are covered, this team will compile a due diligence checklist to cover all of the documentation and other information required to complete the process. This checklist would include a wide range of financial, legal, product, marketplace, production, sales, customer, regulatory, environmental, management and personnel information.

A due diligence process should be conducted for all acquisitions, whether the target firm is publicly held or privately owned. The difference, of course, is that publicly owned companies that trade in the open financial markets are subject to many more legal, compliance and disclosure requirements than are private companies. Furthermore, recently-enacted laws, such as the Sarbanes-Oxley Act of 2002 and others, have significantly increased the disclosure requirements for public companies. The larger amount of information available for public companies makes conducting due diligence on these companies somewhat easier than for private companies.

Because of the shortfall of information on private companies, due diligence on such companies requires a much more intensive effort to investigate all aspects of the company. Further, the acquiring company will typically ask a target private company for additional assurances in the final acquisition agreement in the form of representations and warranties statements (R&Ws). But, Alexandra Reed Lajoux and Charles Elson warn in "The Art of M&A Due Diligence," companies that resist providing R&Ws are "high-risk transactions and are rarely the bargains they appear to be."

The period of time required to complete the due diligence process will vary depending on the size of the target company, how complex its product line is, its geographical reach, whether it is a public or private company, how eager the target company is to make a deal, whether or not it has been audited by a major firm, how long it has been in business, and many other factors. The length of this process can run anywhere from a few weeks to a year or more, although most due diligence processes will take place within a matter of months.

Evaluating "Culture Clash" or Integration Risk

When conducting due diligence, it might be smart to consider the risk of starkly differing cultures between the acquirer and the target company, says Connie Barnaba, a human resources consultant in Houston. Barnaba says that due diligence processes often overlook vital information that could help acquirers avoid bad deals.

In a recent article in the Houston Business Journal, she cites "culture clashes" between acquiring and target organizations as a major contributor to poor post-acquisition performance. She garnered this insight after surveying 100 M&A practitioners on the reasons for post-acquisition deal failures.

"Each company is wedded to its way of operating, which sets up a natural conflict when integration is attempted," she says. Furthermore, in many cases, this type of risk is not identified during due diligence because "the deal-makers aren't looking for it."

"Traditional assessments of M&A risk overlook the considerable risk exposure created by human resistance to change," she notes. These deals typically put employees of the acquired company under stress due to layoffs, changes in compensation and health benefits, and in general, going from the certainty of known and accepted working conditions to conditions that are highly uncertain. Prolonged uncertainty and stress can also result in the departure of key sales people and other critical individuals, putting relationships with top clients at risk.

Barnaba concludes proper due diligence should include a "pre-deal assessment of post-deal integration risk and the development of a people strategy to support business integration."

Additional Sources for Due Diligence Information

Andrew Farrell, a private equity professional in New York, suggests that additional information about a target company can often be found where due diligence processes often don't look. Searching "off the beaten track" can often yield new insights, he says. He cites five non-traditional sources for due diligence information: (1) local journalists, who often have good insights or knowledge from reporting on the target company; (2) locating people with an "axe to grind" (by using expert networks and social networks), e.g., those who were forced out of the company; (3) contacting former customers, who may have a different viewpoint on the company's products or service; (4) hiring a "devil's advocate," i.e., a second advisor to make the case against the acquisition, could provide useful insights; and (5) consulting with front-line employees can yield useful information about the target company.

The Bottom Line

In any type of proposed acquisition – a large or small company, a public or private company – it is vitally important to conduct an extensive due diligence process to minimize the potential post-acquisition risks. The process typically requires the deployment of a team consisting of both internal and external professionals and requires the input of significant time and energy.

In addition to helping to validate or reject the proposed acquisition, the due diligence process also delivers two distinct benefits to an acquirer, according to Alexandra Reed Lajoux and Charles Elson:

- If the deal is approved, the individuals who participated in the due diligence process will have excellent insights into the financial, operational and legal areas of the acquired company, and will be able to provide guidance in the post-acquisition "re-start-up" of the company under the new ownership.

- If there is a claim by the acquirer or the acquired company against the other, the resolution is likely to be achieved by reference to a due diligence issue. If the acquirer has conducted a thorough due diligence process and kept good records, it will be in good shape to deal with the issue.

To conduct a thorough due diligence review of a proposed acquisition requires the input of a team of both internal personnel and external advisors. For example, an outsource CFO services provider with knowledge and experience in implementing due diligence can be invaluable in this regard.

References and Further Reading

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