Value Highlights™
Electronic Newsletter for Company Principals and Trusted Business Advisors

Courtesy of Highland Global, LLC
www.HighlandGlobal.com

Getting to Know the Basics of Due Diligence

Once the privately-held business owner has signed the letter of intent (LOI) from the potential acquirer of the company, the transaction process progresses to the due diligence phase during which the buyer accesses more detailed information regarding the target than was available during negotiations. The due diligence process is intended to confirm the information previously provided by the target company in more depth and to allow the acquirer to determine if the information warrants their continued interest in proceeding with the acquisition. The due diligence process may be perceived as very intensive and exhausting, especially if the target is unfamiliar with what to expect. Though the transaction advisor or business broker typically will manage the due diligence process, the target should be aware that this is the "make or break" stage of the deal—the final step prior to the signing of a definitive agreement and closing. The target, therefore, has every incentive to be knowledgeable about the various aspects of due diligence and to remain fully focused and cooperative during this phase of the process in order to ensure a smooth and successful closing of the transaction.

At the outset of due diligence, the acquirer will typically establish a due diligence timeline providing guidance for the process leading up to the signing of a definitive agreement, and ultimately, closing. (Generally a well-constructed LOI will include a timeline for due diligence and closing. A target's advisor/investment banker will usually suggest this be included in the LOI.) Further, the acquirer will generally provide a detailed list of documents that are needed for examination, which typically may be segregated into four broad categories, including:

1. **Strategic—**This area focuses on the strategic fit between the two companies and whether that fit has the potential to benefit the acquirer to the extent that was initially determined during the negotiations. Recall, the acquirer up until the due diligence process may have limited information regarding the target company. Sometimes the acquirer finds that the "grass is not as green" as it first appeared.

   Some of the most common issues that arise in the strategic due diligence category include business strategy, competitive environment, corporate cultures & management, diversification, industry conditions, integration

issues, synergies & value creation, and tax & financial benefits or consequences.

2. **Financial—**During the negotiations, the target provided the buyer with various financial statements, which are many times merely compiled or reviewed by the target's accountants. During the due diligence phase, the target company's books are usually audited by an independent accounting firm in order to present the financial statements according to United States GAAP (Generally Accepted Accounting Principles). This should provide a full, complete, and accurate accounting of the company's financial condition for the acquirer.

   Some of the most common issues that arise in the financial due diligence category include accounting systems, budgets & forecasts, capital structure, detailed breakdown of revenues & expenses, employee benefit plans, foreign exchange issues, non-operating assets, non-recurring items, and receivable ageing.

3. **Operational, Marketing, & Sales—**Due diligence in these areas may focus on issues such as customers—a list of which the buyer typically would not have been privy to prior to this stage—as well as marketing strategies and how they may integrate into a combined entity's operations. The acquirer may also request interviews with the company's key customers and suppliers. This is generally approached with great caution so as not to raise any unwarranted concerns among customers and suppliers who could wrongly perceive a potential sale of the company as a negative indicator of the company's stability.

   Operational due diligence is intended to provide details of issues such as proprietary technology, manufacturing techniques, inventory management, etc. This information is generally very sensitive, as exposure of trade secrets, for example, could have an adverse impact on the target company's future, should the deal fall through. At this point, the acquirer has shown a strong commitment to consummating a deal—as evidenced by the issuance of an LOI—thus making access to this confidential information more palatable.

   Some of the most common issues that arise in the operational due diligence category include business segments, customer data, distribution channels, employment issues, environmental impact, equipment & capacity data, inventory management, organizational data, research & development, and supplier information.

4. **Legal—**Legal due diligence is conducted to ensure that there are no legal issues that may derail the deal or create future problems for the acquirer. One of the purposes of legal due diligence is to uncover any liens or

judgments against the target company that may have adverse ramifications for the acquirer. This portion of due diligence is also intended to uncover any contingent liabilities such as potential asbestos claims, for example (relating to a business the target company may have closed many years ago), that may become the responsibility of the acquiring company should a deal be closed[1]; undoubtedly, an acquirer would want to take an issue such as this into consideration when determining the feasibility of the deal.

Legal due diligence may also involve checking for any criminal or civil charges or convictions against the company or any of its management team. Background checks are often conducted on the executive management team (including the board and any independent directors) and key operational managers. It would certainly be beneficial to an acquirer, for example, to know if the Chief Financial Officer (CFO) had been involved in securities fraud in the past. Issues like this could have a major impact upon the acquirer's decision to proceed with or adjust the terms of the deal.

Some of the most common issues that arise in the legal due diligence category include leases, litigation, permits & licenses, product warranties, regulations, shareholder or corporate agreements, tax disputes, trademarks, patents, copyrights & intellectual property.

By being adequately prepared and informed, the target can greatly facilitate the due diligence process for all parties, thus eliminating some of the associated stress and anxiety. There are several issues that the target and its transaction advisors/business brokers/investment bankers may address in advance in anticipation of the due diligence process.

First, the target company should make sure that all corporate documents are in order. This includes having complete and current bylaws and minutes of meetings as well as copies of the certificate of incorporation, etc.

Second, the acquirer may ultimately conduct a lien and judgment search on their own; however, it may be helpful for the target to conduct its own search and provide the acquirer with these findings. Though the acquirer will no doubt confirm the findings, this proactive step by the seller may still accelerate the due diligence process, and may uncover small errors or problems that can be addressed in advance.

Third, the target should have interim financial statements prepared, since the transaction may be closed well after the company's year-end. This provides the acquirer with valuable information regarding the progress of the target company since

[1] This presumes a stock sale. If the transaction were an asset sale, the contingent liabilities likely would not convey with the sale of the assets.

the last full-year financial statement should enable the acquirer to make more informed decisions regarding the potential deal.

Fourth, in conjunction with preparation of the financial statements, the target should make the necessary adjustments that will remove any items that could distort the balance sheet or create confusion during due diligence. The objective of this is to present a clear and accurate accounting of the company's financial position.

These adjustments include removing any non-operating assets from the balance sheets. For example, suppose the target company owns a condominium in Florida that is used primarily by the owners. Though the company may pay for this real estate and its associated expenses, the condo is not involved in any fashion in conducting the company's business. Furthermore, it is unlikely that the owners would include this as part of the sale of the company; rather, it would be treated as a separate transaction should the owners desire to sell the property. Therefore, it is best if such non-operating assets are completely removed from the balance sheet.

In addition, adjustments should be made to the working capital account to remove any bad accounts receivables that may have accumulated without being charged off as bad debt. Without such "housekeeping," the working capital of the company will be distorted, which may create confusion during due diligence.

Finally, one of the most difficult issues to approach is informing key employees. The potential sale or merger of the company is certainly a very sensitive issue, especially given that employees may draw negative conclusions regarding the ramifications of a transaction. Key (and other) employees may become fearful of corporate redundancies or a clash of corporate cultures, thus prompting them to seek other employment. However, the pending transaction cannot be kept secret from key employees, many of whom can greatly assist during the due diligence process and some of whom may be randomly interviewed by the acquirer during this time.

Key customers and suppliers must also be informed, as the acquirer may request interviews with them as well. Again, this is a sensitive issue, given that customers or suppliers may misconstrue the implications of the potential transaction. The target company and the acquirer must reassure the customers and suppliers that, even if there is a transaction, it will still be business as usual and that there may even be substantial benefits to them after the transaction. This should help allay any concerns that suppliers or customers may have and should also assist in developing strong relations between the parties.

Though following the previous suggestions will enable the target company to be well-prepared for due diligence, the process itself can still be difficult and complicated. However, the target company can assist in making the due diligence process flow smoothly by following some basic guidelines such as:

1. **Ensure There are No Skeletons in the Closet—**The most common reason for an acquirer to back away from a deal is the discovery of previously undisclosed information that has material and oftentimes adverse implications. These skeletons may make the deal unattractive or may damage the credibility of the target's leadership, severely damaging the trust that may have developed between the parties. Therefore, the target company's interests are better served by getting the skeletons out of the closet before the 11th hour.

2. **Ensure the Free Flow of Information—**Open channels of communication are vital to the success of the due diligence process. The target company will be responsible for ensuring that the documents requested by the acquirer are assembled and provided in a timely fashion. Any bottlenecks with the relay of information will only delay the due diligence process and ultimately the signing of a definitive agreement and closing and will potentially put the whole deal at risk.

3. **Ensure Accessibility of Advisors—**Often, the acquirer will have legal or accounting questions that may best be answered by the target company's professional advisors. The acquirer should have ready access to the target company's accountants or lawyers so that there is not an unnecessary delay in providing the required information and answers. The target's transaction advisor who is managing the process is generally, of course, deeply involved in communication with the acquirer, and thus, is in a position to facilitate communications, as needed.

4. **Ensure Cooperation—**Cooperation on behalf of the target is key to the due diligence process. Without the target's full and willing cooperation, the process and the deal are greatly complicated, since only the target and its advisors can provide the essential information regarding the company. Being a team player builds a strong relationship between the parties and facilitates the due diligence process for everyone.

Hopefully, the due diligence process will result in the signing of a definitive agreement between the target and the acquirer. At the conclusion of due diligence, there is the possibility that the parties will change the terms of the LOI, depending upon the nature of the information provided during the process. Of course, there is the possibility that either party may decide not to consummate the deal, which could result in the payment of break-up fees. Deals most frequently fail when due diligence uncovers skeletons or other information that makes the transaction less attractive than originally thought. Though every effort is made to cover all the bases during due diligence, there will undoubtedly still be some questions or lack of information. The acquirer protects against any errors and omissions by the target during due diligence by including specific representations and warranties in the definitive agreement. Should the acquirer discover something that has a material adverse impact upon the company

after the acquisition, the target could face serious consequences in the form of monetary penalties, etc.

Ultimately, the due diligence process paves the way for the signing of the definitive agreement and for closing. Though the process may be very intense and stressful for sellers unfamiliar with what to expect, the transaction advisors managing the deal may facilitate the process by educating their clients regarding this stage of the deal process. Furthermore, careful and adequate preparation by the seller as well as full cooperation during the process will contribute greatly to a smooth and successful due diligence experience.