

## Effective Acquisition Due diligence – Do Not Miss These Two Key Steps

Companies positioning for a sale generally target one or both flavors of prospective buyers: Investors (private equity, venture, etc.) and strategic buyers (going concern businesses). These buyers are similarly motivated by the expectation of a financial return on their investment but they each have unique and specific acquisition criteria. An investor will look for an eventual exit strategy and a multiple return on its investment within a reasonable period of time. A strategic buyer is looking for enhancements to their business by the addition of new or complimentary products, geographic market expansion, enhanced profits from operational synergies, technology applications or other business attributes.

Regardless of the type of buyer or characteristics of the selling company, the transaction process usually includes: a) hiring of an investment banker, b) executive management introductions, c) business presentations, d) negotiations, e) due diligence, and f) the drafting of a transaction agreement.

### The Due Diligence Process

The due diligence process is extensive and exhausting. Teams of professionals are hired to manage and perform diligence in their respective areas of expertise. The process includes numerous document requests, seller presentations, interviews, question and answer sessions and multiple series of follow up questions. This process starts early on, continues through the negotiation of an agreement, and often does not conclude until the day of final agreement.

Hundred of thousands of dollars can be spent in this phase for a typical middle market transaction or millions in a large company transaction. With all of the money spent on diligence, how valuable is the resulting information in evaluating the selling company and what information is uncovered that can impact negotiations? Is diligence considered necessary to confirm representations made by the company, to uncover dirt about the company or is it done so that there is a paper trail in case an issue crops up later that should have been uncovered in diligence? All of those reasons keep the professionals very busy.

Transaction specialists in Big Four or other accounting firms usually perform financial diligence. The bulk of their diligence is comprised of reviewing the workpapers of the audit firm that audits the target company. Subsequent to their review, they follow up with a list of clarifying questions for the target company management. In addition, the acquiring company usually has a team of financial personnel who will accumulate and analyze historical data and financial projections, usually delving deeply into specific areas of focus such as revenue streams and cost category trends.

The other main area of diligence comes from the buyer's law firm which submits a request list that is usually so long it makes the target company's legal and finance departments heads spin. The list usually directs the seller to produce a summary list and copy of every vendor contract, lease, trademark, employment agreement, sales contract, etc. If something is documented on a piece of paper, is maintained in an electronic file, or has been submitted to a government or other regulatory body, they will probably ask for it. Sometimes there is a materiality factor in diligence requests but risk concerns often weigh towards providing more than less information.

In addition to finance and legal diligence, there are many other diligence tracks that have their own consultants, company personnel, request lists and presentations. These areas include operations,

regulatory, human resources, insurance, marketing, procurement, information technology, sales and others depending on the nuances of the business and industry.

With all of that time, effort, and money spent, how can anything important be missed? It is not that something is missed, but more that it is not part of the process. What is often ignored is gaining important insights into intangible aspects about the target company. These aspects often excluded from the diligence process because of the methodology that is customary in M&A transactions.

When a company decides to sell or raise capital, its goal is to get the highest bid or the best value. They hire an investment bank to help them through the market process. The banker's goal is to create a seller's market. They structure an auction sale process that has specific deliverable dates for offers and follow up offers, structured due diligence processes with secure electronic data rooms, and limitations on the actual communication and contact with the target company. All contact is usually structured in multiple person meetings with pre-arranged agendas and question lists. By the very nature of this process, it is rare that the prospective buyer has direct and unfiltered access to the C-suite and other managers in the company. Buyers see the seller's executives when they have their best business suits on, their shoes shined and are on their A games. They do not see the back room politics and interpersonal interactions of the team.

While the diligence process encompasses a huge amount of information and data review, it is sometimes lacking in two key areas:

1. Perceptive analysis of the personalities, management traits, and business acumen of the management team
2. Probing interviews with line management

#### 1. Perceptive analysis of the personalities, management traits, and business acumen of the management team

How often is identifying attributes about the company culture part of diligence? How well does the buyer really know the executive team? How much effort is spent in diligence probing into the quality of the support management team?

Most buyers rank the quality and experience of the management team as significant criteria in their desire to acquire a company. But other than what is learned from the presentation slide that boasts the experience and expertise of the management team in the introductory meeting, how well does the prospective buyer get to know the true personalities and qualifications of the team? The dynamics of every management team are unique, especially in entrepreneurial environments. Getting more familiar with how the management team executes on day-to-day activities when the microscope of diligence is not hovering over them is important in gaining a sense of how the company is run. Additionally, the success of a company is often influenced by, and highly dependent on the quality of support management. It is rare in due diligence to get true personal contact and insight into this level of management.

If given the opportunity to get to know management at a more personal and direct level you are able to gain additional insights that confirm or contradict your initial impressions. Is the team effective or is it just lucky? What does the decision-making matrix look like? How do executives communicate within the team and internally to other managers? Is the CEO a collaborator or an autocrat? Are the executives just talkers or are they effective doers? What does middle management think of the C-suite? Do they respect them, fear them or mistrust them? Who are the strong and weak links on the team? Insights into these intangible areas can sway a buyer's enthusiasm in either direction.

#### 2. Probing interviews with line management

Typical diligence does not always effectively pull back the veil and display what is going on behind the scenes. Management's goal in selling the company is to put their best foot forward. They may not

intentionally hide business concerns, but they are not incentivized to purposefully layout these issues for a buyer. Some of the company challenges may not be obvious or evident to outsiders. That is why it is important to pierce the veil and dig beneath the surface. A great way to probe into this layer of the business is through access to secondary or line managers in the company. These discussions can expose day-to-day challenges and what is going on behind the scenes. Struggles at this level eventually percolate up to business obstacles for the whole company.

For instance, a review of the sales pipeline with the sales management team may provide a better barometer into future revenue streams, client trends, and other market obstacles and opportunities. Direct access to human resource management can yield insights into future labor trends that may be different than historical data. Do they see a change in turnover trends? Are there any management personnel that have not been happy and could be at risk to lose? Speaking to operations management can uncover client service issues that could foretell future challenges.

Getting the opportunity for one on one discussion with this level of management can be hugely informative. The answers to these types of probing questions at the line manager level often provide significant insights into the company that may not be drawn out during typical structured due diligence question and answer periods. Another reason for these discussions is to corroborate information obtained in other steps of the diligence process. And sometimes the best way to gain information in the diligence process is to give the opportunity for one department manager to talk about another department. That often exposes personality conflicts and operational issues.

Do not expect much change in the way diligence is performed in M&A transactions. It is a burdensome process with the true intent of uncovering important business issues. It is conducted in a way that promotes papering the transaction to protect buyers and sellers. But that does not mean that a little extra effort requesting one on one access with executives and other management to probe into some of the softer areas of diligence cannot be accomplished with the hope of producing valuable insights into the target company.

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