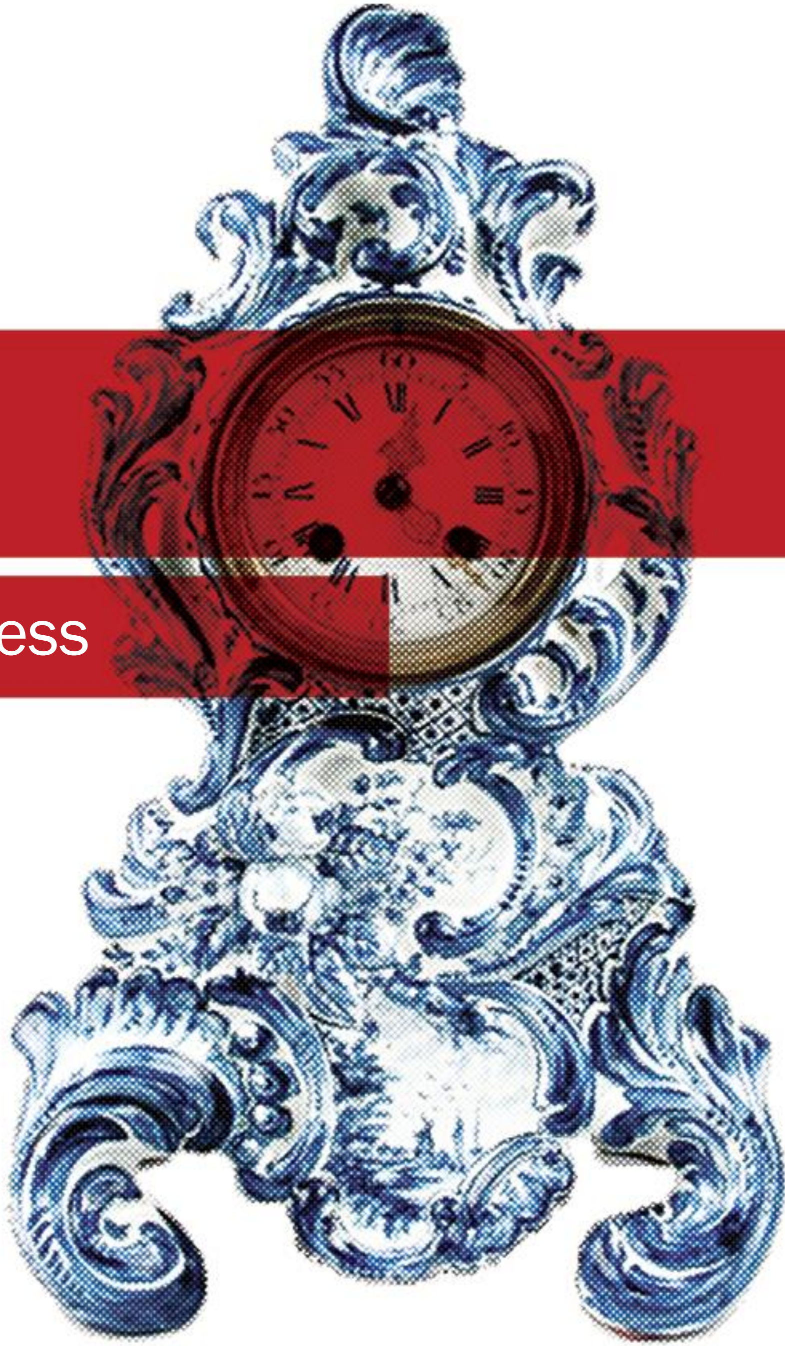
LISBON SCHOOL OF ECONOMICS & MANAGEMENT
UNIVERSIDADE DE LISBOA

Master in Finance

M&A – The Due Dilligence Process



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The Due Diligence Process

1) *Due Diligence*: A Fundamental Step for the Acquisition Process

Definition of Due Diligence

Consists on the pursuit of relevant information about all company's resources, businesses opportunities and risks, associated to the company's past, present and future that have the capacity of affecting, in some way, the company's cash flows.

Fundamental Areas of Analysis

- **Strategic Diagnostic** (analysis of the opportunities and threats of the competitive environment in which the company is involved);
- ***Marketing* and Distribution Auditing** (analysis of the strong and weak points at level of *marketing*, distribution lines, products, etc.);
- **Technology and Operations Auditing** (analysis of the adopted technology, the productive *lay-out*, efficiency of the production, etc.);
- **Staff and the Organizational Culture Auditing** (analysis of the human resources quality, formation level, age, etc.);

Fundamental Areas of Analysis

- **Fixed Assets Auditing** (analysis of the tangible assets);
- **Financial Auditing** (analysis of the company's financial situation, its assets, liabilities and equity);
- **Tax Auditing** (analysis of the company's tax situation);
- **Legal Auditing** (legal structure of the human resources, verification of the assets' ownership, etc.);
- **Environmental Auditing** (analysis of the legislation in which the company is, trends of its evolution, etc.).

Why Due Diligence?

- Due Diligence will take part in the valuation process and in the elaboration of the company's integration planning after the acquisition.
- However, this is an aspect that is not taken into account at most of valuation processes.
- So, *"the big mistakes of valuations happens not because it was used a wrong updated rate, but because the managers were not worried to know if the pensions planning was financed correctly, if there was environmental risks, etc.."*

Richard Brealey

Why Due Diligence?

• The analysis of the financial data is a very important factor for the company's survival although, according to most investors, the analysis of these data is not enough.

• Financial data reflect the present situation of a company and it may just help on making a short term forecast.

• However, some kind of future information concerning the company, the sector and the environment in which it is involved, could predict an eventual success or failure of the company.

Why Due Diligence?

• It is necessary to obtain information about the most critical factors that can affect a business:

- Competence and stability of management;
- Market trends;
- Capacity and quality of the production;
- Staff rotation;
- Agreements with suppliers;
- etc.

Why Due Diligence?

- The investors would make better decisions if they had more information about the really important factors.
- So, a suitable Due Diligence is appropriated and applicable to investors and buyers in any kind of business, either if it is focusing on production or services and also if it is a big or small business.

How to get advantages with the Due Diligence?

- **Investors**: could make a deeper valuation on both financial and not financial aspects of a future investment;

- **Intermediaries:** could understand faster and efficiently the business that represent;

- **Credit Institutions**: could make a better valuations of the requested loan;

- **Consultants**: could protect themselves better and improve their valuations in all kind of aspects;

How to get advantages with the Due Diligence?

- **Accountants**: could prepare their reports in a more accurate way;

- **Directors and Board Members**: could perform better their functions focusing at the duties they want to approach;

- **Students**: could get a higher knowledge coming from the field they study.

The Due diligence Importance

- It helps, in the process of a company's valuation, getting assistance, suggestions and a deeper knowledge of the important factors for the investor, such as:

  - to recognize unusual or negative responses that may lead you to rethink your position.

The Due diligence Importance

- We cannot forget that, as every business is unique, it will also be the rates, standards and objectives used on making the valuation.

- In this way, an acceptable condition in a small business could be unacceptable in a big business and vice versa.

- So, the Due Diligence will have to be improved in quality and quantity focusing at the specifications of the business in question.

The Due Diligence Process

2) Methodology and Components of the Due Diligence Process

The Due diligence Planning

- The Due Diligence is one of the procedures that we use to study, research and make a valuation of a business opportunity and usually it will happen after the part involved, agree that the business is financial viable and a pre-contract has been signed.

- If we want the Due Diligence to be successful, it must be planned carefully beforehand.

The Due Diligence Planning

- So, the first steps of the Due Diligence Planning consist on:
  - ➢ checking that the business is what it seems to be (through interviews, studying documents, etc.);
  - ➢ checking that the investment is matched to the criteria of the investor;
  - ➢ quantifying the main key of the Balance Sheet (and not just identify the value of the assets, liabilities and equity);
  - ➢ preserving all documents, reports, information and data available to resolve possible problems that can appear after the deal.

Criteria to estimate a profitable business

- Performance obtained;
- Financial Ratios;
- Potential forecast performance;
- Comparison between the book value and the market value;
- The management quality;
- Type of business.

Estimation of the Risk and defining the analysis extension

- The investor should estimate, at the beginning of the process, the level of risk that he is willing to take;

- So, if the investor is just willing to take low risk, the Due Diligence should be studied in more detailed procedure and vice-versa;

- The investor should take into account that if a Due Diligence is not approached in a detailed way, relevant aspects of the business may be misinterpreted or just ignored;

Estimation of the Risk and defining the analysis extension

- Yet, a Due Diligence well developed does not guarantee a successful investment, we must always consider that the risk exists;

- The only way to avoid the risk completely is not making business at all;

Estimation of the Risk and defining the analysis extension

- Factors which indicates a reduced risk:
  - Stable and experienced management;
  - Audited accounts;
  - Continuity of the operational activity;
  - Strong position on the market;
  - Absence of litigations;
  - Independence of the clients;
  - Reduced extraordinary incomes and expenses;
  - etc.

Estimation of the Risk and defining the analysis extension

• However, a really deep study of Due Diligence could discourage the investment even in an attractive business because, the more information we have the higher the number of defects found in the business.

• The result is that we will focus on the why we have these defects and not why we have these qualities.

Estimation of the Time and Costs spent

- As a whole, the pre-agreements define a period of time in which the final deal will be signed, so the investor has the opportunity to manage the Due Diligence.

- Its important not to spend too much time on the Due Diligence because meanwhile another investor could make another proposal and we lose all the time and costs that had been spent on carrying out this Due Diligence.

Estimation of the Time and Costs spent

- The Due Diligence should be started as soon as possible.
- A lot of investors continue to not take the option of making the Due Diligence due to the costs that are associated with the study.
- However, there are investors that make sure that the cost spent on the study of the Due Diligence is compensated with the "guarantee" of doing a good investment, minimizing therefore the future risks and losses.

Characteristics of who carry out the Due Diligence

- Must have a wide knowledge of the industry;
- Must have a wide knowledge about the investor and know how to defend his interests;
- Must have accounting and financial knowledge;
- Must not be intimidator;
- Must not compromise the investor;
- Must have the knowledge about business politics and culture;
- Must have a strong and mature presence;
- Must be open-minded.

Characteristics of who carry out the Due Diligence

- As always as possible the Due Diligence should be made by a qualified person and not by the own investor.

- Then, it should be made by a company or person in the auditing, consulting or accounting area.

Characteristics of who carry out the Due Diligence

- All the information obtained orally, must be rapidly reported and written down;

- The target company must be informed of who is going to make the Due Diligence, its duration, the people who will be involved and all the general information that will be required;

- It is essential to visit the company.

Characteristics of who carry out the Due Diligence

- Acquiring information:

  - ➢ Proceed to a *check list* well organized, containing all the necessary information and documents in order of avoiding the repetition of questions and the need of coming back to the company, which is quite annoying for the people who supply us the information;
  - ➢ Obtaining the highest quantity of information in the shortest time, without interruptions;
  - ➢ From the beginning, accept the information with the minimal comments, taking it like real, and after checking if it is right;
  - ➢ The consultants must obtain all information requested, and also all that could be interested to know;

Characteristics of who carry out the Due Diligence

- Acquiring information: (cont.)
    - When there are negative points, and the informant pretend to explain the origin of these points, the consultant must listen to it, and limit his comments;
    - The consultant must keep in mind that some question are inappropriate, so it could annoy and being understood as a disrespect, such as:
        - Ask something which was answered previously;
        - Ask for documents which were previously delivered.

Elaboration of the *Check List*

- When an investor decides to consider seriously a business opportunity, he must require a list of the necessary information and documents;
- A *check list* is a guide for gathering information in a valuation process;
- The acquisition of superfluous information will only confuse, delay and distract the consultant;
- As a rule, when it is impossible to recognize a topic or a document as an important point, it is better to include it than remove it;
- During the process of Due Diligence it is also recommended to include questions, if it was suitable or there are problems coming up;

Elaboration of the *Check List*

- Some questions to help preparing the *check list*:

  - There is enough information to understand the business?
  - The information that was already asked will be necessary later?
  - Did the information asked, avoid mistakes and misunderstandings?

Check List for the process of Due diligence

Financial Information:

- Annual and quarterly financial results from the last 3 years until now;
- Accounting principles of valuation;
- Fiscal documents or fiscal *dossiers* of the years which we are studying;
- Adjust the financial results;
- Financial projections;
- Equity structure;
- Composition of the equity. What part belong to whom, and their rights;
- Detailed analysis of the amounts of debts;
- Annuals budgets;
- Strategic planning.

Check List for the process of Due diligence

Fixed Assets:

- Description of all assets that belong to the company;
- Description of all assets in leasing;
- Contracts linked to fixed assets;
- Worksheet with amortizations and depreciations from the last 3 years until now;
- Estimation of the right assets' value (at least, the most relevant);
- Amortization policy;
- Analysis of the investments which were made every year;
- Insurance contracts.

Check List for the process of Due diligence

Products:

- Description of every product in each segment of the market, considered turnover and gross margin;
- Unit cost of each product and perspectives about the future evolution or trend of this costs;
- Comparison with the competition;
- List of the major raw materials and packaging materials in the last fiscal year;
- Information about the critical point of the sales: mix of products, fixed and variable costs;
- List of the main suppliers;
- Copies of the main services and the guarantees related with these services.

Check List for the process of Due diligence

Information about clients:

- List of the most important clients in relation to the turnover;
- List of the strategic relationships;
- Gross margin *per* client;
- Description of the most relevant commercial relationships.

Check List for the process of Due diligence

Competence:

- Analysis of the competitive environment in every segment of the market;
- Annual reports of the direct competitors.

Check List for the process of Due diligence

Marketing, sales and distribution:

- Strategy and implementation;
- List of the main clients, total sales and percentages by client and/or group of clients;
- Perspectives of development new businesses;
- Analysis of productivity of the sales force;
- Information on the *marketing* campaigns undertaken by the company;
- Results of market research already carried out;

Check List for the process of Due diligence

***Marketing*, sales and distribution: (cont.)**

- Account receivable average;
- Discount Policy;
- Sales statistics of the last 5 years;
- List of the main competitors by each business segment.

Check List for the process of Due diligence

Research and Development (R&D):

- New products introduced by the company;

- List of patents, recorded brands, names, *copyrights* and corresponding contracts;

- Description of the R&D organization.

Check List for the process of Due diligence

Management and policy of Human Resources:

- Organization chart;
- Information of the full staff with the corresponding labor specifications, namely, the role, seniority, age, wages and salary and education;
- Curriculum Vitae of the team management;
- Employment contracts;
- List of the conditions applied in the employment contracts in general;
- Work insurance contracts;

Check List for the process of Due diligence

Management and policy of the Human Resources: (cont.)

- Incentives, *stock options* and *golden parachutes;*
- Labor problems;
- Costs of the staff;
- Healthy and work accidents insurance;
- Pension funds (retirement payments).

Check List for the process of Due diligence

Liability:

- Analysis of the provisions policy, namely, pensions, taxes, ongoing litigations and others;
- Analysis of the loan contracts;
- Analysis of the leasing contracts;
- Analysis of the State debts;
- Statement of Treasury and Security Social debts;
- Analysis of current legal process.

Check List for the process of Due diligence

Environment:

- Analysis of the current legislation for the sector;
- Analysis of the environmental situation of the company;
- Analysis of the future trends of regulatory and the implicit impact on the company.

Difficulties with the elaboration of the Due Diligence

- **A hostile environment:**

  - Delivery of only old financial results, or in a brief way, showing that information is being hidden;

  - Information restricted under the tax management, fearing a governmental action;

  - Who opposes, or is directly affected by the transaction, in a hostile attitude, can refuse cooperation, or cooperate in a misleading way;

Difficulties with the elaboration of the Due Diligence

- **A hostile environment: (cont.)**

  - The lack of uniformity on the financial indicators, is a constant source of confusion that may lead to wrong conclusions;
  - The existence of a fake document indicates that much more can exist;
  - The delivery of fake documents is a heavy and powerful reason to finish with the Due Diligence;
  - Another big problem may appear when the information or the documents that are required, are lost or do not exist. When unacceptable for the consultant, he must demand this information or finish with the Due Diligence.

Conclusion

- Making business is quite complex, and depends on several interrelated functions and activities;

- Potential buyers or investors, need to be able to identify, understand and make valuations of *pros* and *cons* of every aspect of the investment, and being as efficient as possible;

- Due diligence supply knowledge and a strong position of business;

Conclusion

- The Due diligence is the pursuit of surprises, and the business may be seen in a different way after doing the Due Diligence;

- In the Due diligence conclusions, the secrets of the target company must be minimized;

- It is very probable that surprises or unknown characteristics of the company may appear, being necessary to ask for additional information to understand in a whole sense its nature and for make a valuation of its impact on the company;

Conclusion

- As our society is becoming more and more competitive, the Due Diligence is becoming more essential in cases of a business transaction;

- The failure of an appropriate Due Diligence, can represent:
  - **A Civil Responsibility**, receiving damages losses of millions of Euros for the investor;
  - **A Criminal Responsibility**, the **consultant** could be exposed to criminal prosecution, for not having done a rigorous Due Diligence.

Conclusion

- The Due Diligence should avoid these two statements:

"If we had the knowledge of this, we would never have invested!"

"If we had known this, we would have invested with no doubt!"

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Exercise:

- Admit that you were hired by the Hilton Group to study the acquisition of a 5 stars hotel located in Algarve.

- Prepare a list of information for a first analysis of the target company which owns the target hotel.

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