

Master in Finance

M&A – The Due Diligence Process

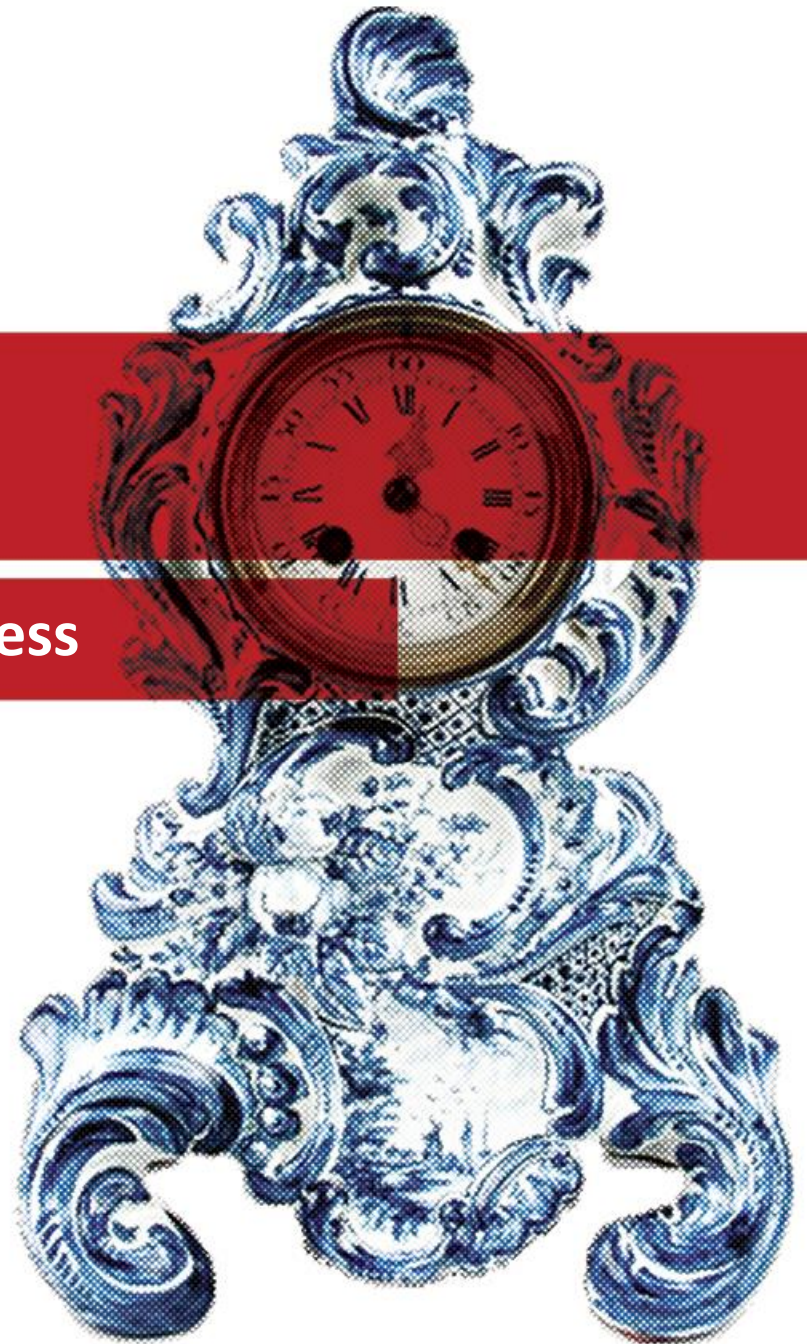
2020

Telmo Francisco Vieira



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT

UNIVERSIDADE DE LISBOA



The Due Diligence Process



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

- i) Definition of Due Diligence
- ii) Fundamental Areas of Analysis
- iii) Why Due diligence?
- iv) How to get advantages with the Due Diligence?
- v) The Due Diligence importance

The Due Diligence Process



2) Methodology and Components of the Due Diligence Process

- i) The Due Diligence Planning
- ii) Criteria to estimate a profitable business
- iii) Estimation of the Risk and defining the analysis extension
- iv) Estimation of the Time and Costs spent.
- v) Characteristics of who carry out the Due Diligence
- vi) Making the Due Diligence
- vii) Making the Check List
- viii) Check List for the process of Due Diligence
- ix) Difficulties with the elaboration of the Due Diligence
- x) Conclusion

The Due Diligence Process



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



Due Diligence:

A Fundamental Step for the Acquisition Process



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

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 in some of valuation processes.
- So, *“the big mistakes of valuations happens not because it was used a wrong discount rate, but because the managers were not worried to know if the pensions planning was financed correctly, if there was environmental risks, etc..”*

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.

Due Diligence:

A Fundamental Step for the Acquisition Process



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

Why Due Diligence?

- The investors would make better decisions if they had more information about the really important factors.
- 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 large 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;

Due Diligence:

A Fundamental Step for the Acquisition Process



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

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.

Due Diligence:

A Fundamental Step for the Acquisition Process



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

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.



The Due diligence Importance

- 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.
- 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 parts involved, agree that the business is financially 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

- The first steps of the Due Diligence Planning consist on:
 - checking that the business is what it seems to be (through interviews, analyzing documents, etc.);
 - checking that the investment is matched to the criteria of the investor;
 - quantifying the main key aspects 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/she is willing to take;
- If the investor is just willing to take low risk, the Due Diligence should be carried out with more detailed procedures and vice-versa;
- The investor should consider that if a Due Diligence is not approached in a detailed way, relevant aspects of the business may be misinterpreted or just ignored.

Due Diligence:

A Fundamental Step for the Acquisition Process



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

Estimation of the Risk and defining the analysis extension

- Nevertheless, 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 from the clients;
 - Reduced extraordinary incomes and expenses;
 - etc.

Due Diligence:

A Fundamental Step for the Acquisition Process



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

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.



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.
- Some investors continue not taking 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.

Due Diligence: Exercise



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

Exercise 1

The failure to do an exhaustive Due Diligence can be very serious.

- a) Based on public information identify situations of Mergers & Acquisitions where the Due Diligence failed.
- b) Search and characterize also the cases of:
 1. Hewlett-Packard (2012) acquisition of UK software maker Autonomy - \$11.1 billion
 2. Facebook acquisition of Oculus (2014) - \$3 billion



Due Diligence: Exercise



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

Exercise 2

a) Provide a definition of Vendor Due Diligence and what are the potential benefits associated to it

Vendor
Due Diligence



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.

Due Diligence:

A Fundamental Step for the Acquisition Process



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

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.

Due Diligence:

A Fundamental Step for the Acquisition Process



Acquiring information:

- 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.

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;

→ 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.

Due Diligence:

A Fundamental Step for the Acquisition Process



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

Virtual Data Room

More deals utilize the Virtual Data Room (VDR).

It is an online site used for storage and distribution of documents during the Due Diligence process.

Data Security is the number one challenge in using VDRs.

Example of one platform for Virtual Data Room:

<https://www.idealsvdr.com/>

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.

Due Diligence:

A Fundamental Step for the Acquisition Process



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

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?

Due Diligence:

A Fundamental Step for the Acquisition Process



Check List for the process of Due diligence

Financial Information:

- Annual and quarterly financial results from the last 3 to 5 years until now;
- Fiscal documents or fiscal *dossiers* of the years which we are studying;
- 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.

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 related to fixed assets;
- Amortizations and depreciations from the last 3 years until now;
- 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.

Due Diligence:

A Fundamental Step for the Acquisition Process



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

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.

Due Diligence:

A Fundamental Step for the Acquisition Process



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

Check List for the process of Due diligence

Competitors:

- 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 of 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;

Due Diligence:

A Fundamental Step for the Acquisition Process



Check List for the process of Due diligence

Marketing, sales and distribution: (cont.)

- Accounts receivables average;
- Discounts Policy;
- Sales statistics of the last 3 to 5 years;
- List of the main competitors by each market segment.

Due Diligence:

A Fundamental Step for the Acquisition Process



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

***Check List* for the process of Due diligence**

Research and Development (R&D):

- New products introduced by the company;
- List of patents, 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 concerning the full staff with the corresponding labor specifications, namely, the role, seniority, age, wages and salary and education;
- Curriculum Vitae of the management team;
- Employment contracts;
- List of the conditions applied in the employment contracts in general;
- Work insurance contracts;

Due Diligence:

A Fundamental Step for the Acquisition Process



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

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).

Due Diligence:

A Fundamental Step for the Acquisition Process



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 debts to the State;
- Security Social debts;
- Analysis of current legal process.

Due Diligence:

A Fundamental Step for the Acquisition Process



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

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 concerning taxes, 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 strong reason to finish with the Due Diligence;
- Another relevant problem may appear when the information or the documents that are required, are lost or do not exist. When unacceptable for the consultant, he/she must demand this information or finish with the Due Diligence.

Due Diligence:

A Fundamental Step for the Acquisition Process



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

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 much efficient as possible;
- Due diligence supply knowledge and a strong position on the business;

Conclusion

- The Due diligence is the pursuit of surprises, and the business may be seen in a different way after performing 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 making 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**, as a consequence of losses that can be of millions of euros for the investor;
 - **A Criminal Responsibility**, as the **consultant** can be exposed to criminal prosecution, for not having done a rigorous Due Diligence.

Due Diligence:

A Fundamental Step for the Acquisition Process



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!”*

References

- M. DePamphilis, Donald (2018) *Mergers, Acquisitions and Other Restructuring Activities*, pp.179-182
- NEVES, João Carvalho (2002). *Avaliação de Empresas e Negócios*, McGraw-Hill
- BING, Gordon (1996). *Due Diligence – Techniques and Analysis*, Quorum Books

Due Diligence:

Exercise

Exercise 3

- Consider that you were just hired by the Hilton Group to study the acquisition of a 5 stars hotel located in Algarve, Portugal.
- Prepare a list of information for the Due Diligence concerning the target company which is the owner of the hotel in Algarve.





Telmo Francisco Vieira

tfv@iseg.ulisboa.pt

+ 351 917 820 650

