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Financial Services Newsletter

Due Diligence: Four Questions to Make Smarter Acquisitions

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Private equity firms, lenders, lawyers and other interested parties conduct due diligence to kick the tires on a potential transaction or target acquisition. Due diligence means the comprehensive review of a target company's financial, operational, customers and markets, legal, tax, HR and IT functions prior to the completion of a transaction.

In short, due diligence is the process of getting the answers to these four primary questions:

1. What are we buying?
2. What is the target's stand-alone value?
3. What are the synergies and the skeletons?
4. What is the walk-away price?

In turn, these primary questions result in related questions. Our guidance follows.

What are we buying?

This question may seem simpler than it appears. In some transactions, the seller will sell the parent company which includes all the subsidiaries. Or, they may carve out certain assets, subsidiaries, product lines or geographies. When it comes to acquiring lower middle market companies, IT due diligence can be one of the most overlooked processes in the pre-close stages. Although many deal professionals are thorough with their financial and legal diligence, often IT matters barely enter the conversation.

Suppose an operating company relies on valuable intellectual property (IP) that it licenses from a separate corporate entity. Often, we see that the IP creators establish a special purpose LLC to own and license the IP. The target company pays license fees that may include a fixed license fee and/or a variable license fee based on a milestone. Before the acquisition, the entity that owns the IP is an affiliate, i.e. a related party. Post-acquisition, the licensor would become a completely independent entity.

Assuming the target company cannot operate effectively without the IP:

- What is the strength and tenor of the license agreement?
- Does the target company acquisition price take into account the license as opposed to the ownership of the IP?
- What rights does/will the licensor have to use the IP in its business or license the IP to a competitor?

As the buyer:

- Have you accurately estimated your license fees post-acquisition and in light of your financial projections?
- Does the company really own its product or service?

- Is the technology integrated/constructed in the right way?
- Can their technology scale?

Needless to say, it is crucial to determine that the seller's asking price is consistent with your understanding of exactly what you are buying. The seller's financial statements should roll up (consolidate) properly and accurately reflect the results of operations and the financial position of the collective business you intend to acquire.

What is the target's stand-alone value?

Some of our private equity fund and portfolio company clients implement a roll-up or build businesses that are complementary. Many organizations maintain a "shared services organization" that provides procurement, HR, employee benefits, etc., on a group basis. This creates cost savings. If that is the case:

- Have you properly assessed the business on a go forward basis when it exits the fund's or parent company's umbrella?
- Which key contacts and partners do you need to contract with to operate effectively and realize your financial projections?
- Do you need to secure additional or alternative distribution or supplier channels?

The target's books should be rigorously analyzed not only to verify reported numbers and assumptions but also to determine the true value of the business as a stand-alone concern. Often when a company is a unit of a larger company or group, the financial and operating results may differ markedly as a stand-alone entity.

Where are the synergies and the skeletons?

Acquirers have high hopes for achieving synergies when they acquire a new target company. The key to realizing your target rate of return is a function of achieving an attractive or reasonable acquisition price and actually implementing processes and systems that enable achieving the identified synergies. Due diligence can help you not only identify potential synergies but also assess the likelihood you can achieve the synergies.

What are the hidden pitfalls the target company carries? Since the seller's goal is to maximize their sales proceeds, they may try to downplay or overshadow problems the business is facing.

Due diligence can be used to carefully distinguish between different kinds of synergies and to estimate both their potential value and the probability that the identified synergies can be realized. That assessment should also include the speed at which the synergies can be achieved and the investments it will take to realize them. Due diligence can help you surface these and adjust the acquisition price or change the terms.

What is the walk-away price?

All too often, due diligence becomes an exercise in verifying the target's financial statements rather than conducting an independent and unbiased analysis of the deal's strategic logic and the acquirer's ability to realize value from it.

Seldom does the process lead managers to kill potential acquisitions, even when the deals are deeply flawed. Given the direct (inverse) relationship between the acquisition price and your rate of return, it is important to set limits on your acquisition price, lest you erode your returns.

In addition to financial limits, it is very important to gain a firm handle on the potential liabilities your target company and you, as the owner, may face. Examples include:

- Product liability
- Patent and trademark infringement
- Environmental damage
- Representations and warranties
- Title issues

Takeaway

Due diligence can help you identify risks inherent in the transaction and the target company and help you frame seller representations and warranties, post-closing adjustments, holdbacks and indemnities.

Thorough and insightful due diligence can help you increase your investment returns and reduce the risk of disputes and litigation.

Contact Us

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