



# Due diligence - Hits & Misses

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# Need of Due diligence

*Mostly sought for the following transactions:*

- Acquisition of shareholding interest by a strategic investor
- Acquisition of an undertaking / business
- Investment by private equity funds/ VC's
- Inbound and overseas investments

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*The changing business equation and the complexity in transactions makes focused/ informed decisions imperative.*

# What is due diligence?



*A measure of prudence or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstance.*

*...Blacks law dictionary*

- Defined as “an investigation into the affairs of an entity prior to its acquisition, flotation, restructuring or other similar transaction.”
- The process by which information is gathered about:
  - a target company
  - its business; and
  - the environment in which a target company operates.
- The objective is to ensure that prospective investors make an informed investment decision.

# What is due diligence?



*It is not just:*

- *Checking the facts*
- *Reciting them*

*Its about:*

- *Evaluation*
- *Interpretation*
- *Communication*

- A business oriented analysis and not an accounting analysis.
- A fact gathering exercise with a focused analysis of information.
- Understanding the industry of the target.
- Reasonable level of enquiry into the affairs having a material impact on the prospects of the business.
- Evaluation of the business model and key business practices.
- Examination of relevant aspects of the past, present and near future of the business.
- Assessment of the benefits and liabilities of the proposed transaction.

# Types of due diligence



- Financial & tax due diligence



- Commercial due diligence



- Legal & regulatory due diligence

- Technical due diligence



- HR due diligence

- Information technology assessment

# Types of financial due diligence



- Due diligence commissioned by the acquirer
- Focused on areas of interest for potential acquirers (financial or strategic)
- Reporting – generally issue based
- Auction < > exclusive
- “Vendor Due Diligence”
- Commissioned by the vendor
- Key tool for maximizing success of the transaction in a reduced timetable through maintaining competitive tension



# Vendor Due Diligence

## It is

- Independent due diligence commissioned by the vendor
- Focused on areas of interest for potential acquirers
- Identifies potential “show stoppers” early allowing an effective strategy to be devised

## It is not

- Sales-focussed in the same way as an Information Memorandum
- A form of audit
- Duplication of other reports commissioned by the vendor

- Sharing of reports - use of hold harmless letters.
- Reliance on report by investors.



# Types of financial due diligence



*Limited*

- Focus on certain key areas based on the level of comfort desired by Client.
- Carve out - strictly limited to the part of business proposed to be sold.



*Full scale*

- Focus on all major aspects of financial statements
- Extent of focus and coverage is more comprehensive.

***It is important to know what's driving value for your clients***

# Evolution: Investor expectations

## Markets in the past

- **Full access** and **exclusivity** in processes
- Significant **information** available
- Significant **access** to management
- Completion accounts and purchase price adjustments
- **Adequate** time to discuss, deliberate and negotiate due diligence findings

## Markets today

- Competitive multi stage **auctions**
- **VDD** prevalent
- Limited additional information
- Limited access to management and managed Q & A processes pre exclusivity
- Move towards locked box mechanisms

## What clients want

- Top up due diligence
- Focused reporting on what is important
- Short lead times for completion of work
- Contribution to all aspects of the process including the valuation model
- Opinions
- Ability to be able to share our reports with various stakeholders including financing providers

# The process



*“The steps involve an interface with management and other advisors to ensure that all aspects of the project are duly considered and reviewed. This is a pre-requisite for a well informed decision.”*

# The process

- Pre due diligence information
- Timing of exercise
- Resources
  - Experienced deal professionals
  - Access to industry and functional specialists with transaction experience
  - Technical thought leadership
- Integrated teams
- Focus on issues important to clients

# The process

- Logistics
  - Data room considerations
  - Paper < > electronic
  - Deadlines
- Interactions with statutory auditors
- Site visits
- Consult, collaborate, and communicate
- Confidentiality

# Quality of information

- Lack of critical information - product wise/ customer wise margins, monthly /quarterly working capital etc.
- Public listed companies – Insider Trading Regulations.
- Information largely received through oral discussions.
- Reconciliation of MIS and audited financial statements.
- Unaudited/provisional financial statements
- Disclosure of related parties and transactions with such entities.

# Conduct of due diligence

- Interactions with Target management
  - Voicing of opinions
  - Discussion of issues
- Personal interviews – who & at what stage
- Too much information – how to filter
- No fishing enquiries

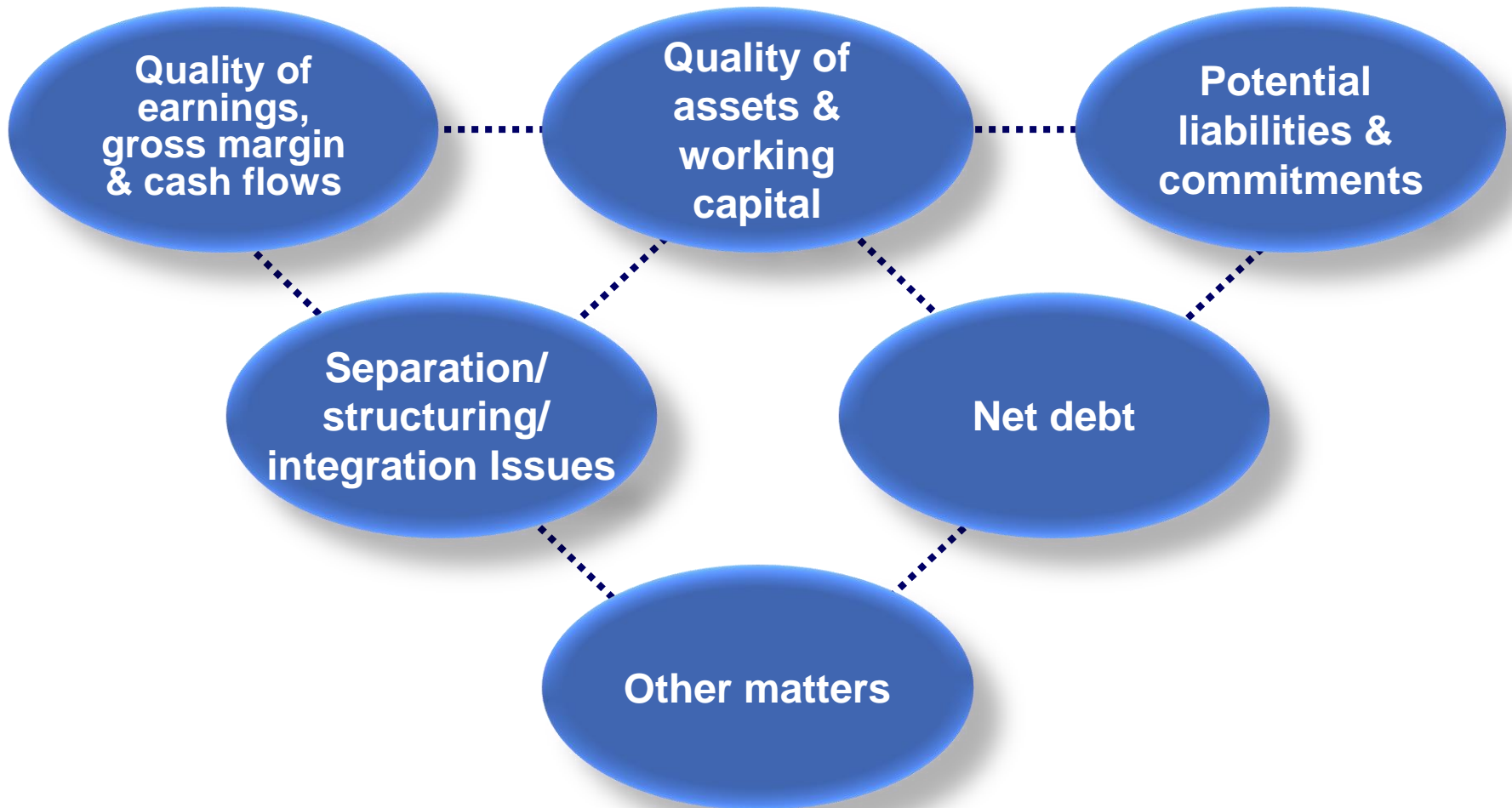
# Focus areas

## Deal fundamentals

- Business environment - markets, competition, regulations
- Public listed company
- Third party interests - ROFR
- Sale of business < > sale of shares of the target
  - Carve out of financial statements
  - Carve out of assets and liabilities
  - Tax considerations



# Focus areas



*Co-ordination with other work streams is very important. It is an iterative process requiring prompt communication of and acting on findings.*

# Focus areas

## Strategic investor

- Historical earnings
- Quality of assets and liabilities
- Contingent liabilities
- GAAP effects on consolidation and effect on EPS
- Fit with current tax structure
- Synergy and integration risks



## Financial investor

- Cash flows – sustainability/reliability
- Strong and clear track record of Normalised EBITDA
- Normalised working capital, net debt
- Assumptions behind projections
- Capex – present and future
- Quality of management
- Quality and capacity of IT systems

*However, needs are converging very quickly...*

# Due diligence findings

- Anticipate problems and opportunities
  - Early identification of and discussion of preliminary issues with client
- Measure exposures and seek solutions
  - Quantify estimated amounts and likelihood of exposures resulting in future cash outflows (range/sensitivity analysis)
- Interpret findings in ways clients can use
  - Focus on material issues
  - Use plain English – many of the decision makers at clients will not understand or appreciate a detailed technical GAAP or tax answer to a question
- Timely communication of findings

# Key benefits

- Inputs for making Go / No go decision, valuation, risk mitigation in transaction documents and matters to be addressed post acquisition

Those issues which would impede the consummation of the proposed transaction

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**Deal Breakers**

Those issues which would be necessary to consider in the valuation of business / negotiation of bid price

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**Valuation and Negotiation points**

Those issues which would need indemnities and identify conditions precedent for consummation of the transaction

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**Issues for agreements**

Those risks and issues which are knowingly taken over as a calculated commercial decision.

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**Commercial override**

# Limitations

- Not equivalent to an audit conducted in accordance with generally accepted auditing standards,
- Not an examination of internal controls,
- Not attestation or review services or services to perform agreed upon procedures in accordance with standards established by the ICAI.

# Limitations

- Dependency on Target
  - Information and explanations provided (verbal or written) are materially correct.
  - Financial information, details and other documents provided for analysis are materially correct and complete.
  - Various documents furnished are genuine.

# Hits & Misses (1/2)

- Seasonality in revenues – impact on w capital;
- Dependency on customers – expiry of long term contact;
- Expiry of lease – no long term arrangement;
- Standalone costs – key employees not forming part of the business;
- Related party transactions;
- Non compliances with key regulations;

# Hits & Misses (2/2)

- Open tax litigations – potential liabilities – no scope for adjustments (recurring/ non recurring issues);
- Off balance sheet exposures could be unearthed;
- Valuation adjustments post term sheet;
- Identification of non recurring revenue/ margins;
- Identification of non disclosed liabilities/ facts.



# To conclude...

- *Due Diligence plays an important role in identifying, quantifying and reducing the risks related to an acquisition.*
- *Although due diligence focuses on negative information, the aim is not to raise obstacles to transactions, but rather to facilitate transactions by identifying problems and risks and by devising solutions to problems or mechanisms to reduce or manage the risks involved in acquisitions.*

**This document discusses various facets of the due diligence process. The style contained herein is intended to articulate the due diligence process in relation to general issues and concerns. The approach might be different depending on the facts and circumstances of each potential transaction.**

**Further, the information contained in this document is intended only to provide a perspective on due diligence and the process followed. It should be in no way construed to be an opinion or advise and is in no way represented as such. The information provided herein should not be used and reproduced and should be considered privileged and only for the intended recipients.**

# Questions/Comments