

GE Capital

Due diligence: Main steps and success factors



imagination at work

Due diligence: Main steps and success factors

Your company has decided to pursue an M&A strategy for growth, and you've identified a target. Now what? After the planning and identification comes due diligence, a thorough fact-finding mission that allows you to learn your target inside and out and determine whether the acquisition makes sense for your company.

For acquiring companies, due diligence is a critical process that cannot be overlooked. Due diligence not only nets the hard data you need to assess potential financial, legal, and regulatory exposures, but also gives insights into the target company's structure, operations, culture, human resources, supplier and customer relationships, competitive positioning, and future outlook. Done right, due diligence is a way to spot potential deal-killers/shapers and provide assurances that the acquisition is the right decision at the right price. Done fully, due diligence can also give management a deep, holistic view of the target company that can later inform integration of the target's people and business.

A: Preparation

Good preparation is the first step toward effective execution and closure of due diligence. In this phase, you will gain a basic working knowledge of the target company's products, sales, and profitability; begin to outline synergies and analyze risks and opportunities; lay the groundwork for communication with the target company; and put the resources in place that will enable a successful due diligence process.

Once you've begun a serious dialogue with the target regarding an M&A deal, you will need to:

- **Form and begin prepping your due diligence team.** Your team should consist of skilled financial, business, and legal representatives (preferably

with M&A experience), as well as subject matter experts in all key functions. Clearly define each team member's responsibilities, and begin creating a due diligence timeline.

- **Bring in outside expertise as necessary.** If your company lacks any of the required expertise, you may have to seek outside help from a law firm, accounting firm, consulting firm or investment banking firm. Since the due diligence process has a strong element of project management to it, it may be valuable to have the outside bank or consultant fill that project manager role.
- **Get the integration manager involved early.** Participation at this stage allows the manager to become familiar with the target company and hit the ground running should the deal go through.
- **Create due diligence checklists.** Such lists should be exhaustive and tailored to the particular risks associated with the target company.
- **Prepare your data requests.** Materials commonly sought include information relating to the target's corporate structure and history, financials and accounting, management, operations, real estate and facilities (including leases and tangible personal property), intellectual property, material contracts and agreements, personnel, suppliers and distributors, customers, current litigation, tax issues, insurance issues, and regulatory and environmental issues.



- **Negotiate and sign a confidentiality agreement.** This facilitates the exchange of sensitive information and restricts the signers from sharing the information with third parties.
- **Establish and index a physical or online data room for confidential documents.** An online data room is cheaper and more efficient, accessible via secure log-in.
- **Prepare a communication plan.** A detailed internal and external communication plan lays out what should be said, and by whom, throughout the due diligence and deal phase and into the integration phase.



The scope of your due diligence will be influenced by a variety of factors. It may be less extensive if all of the following are true:

- The target company is financially strong.
- The target is willing to give extensive representations and warranties and indemnities.
- Those representations and warranties and indemnities survive closing.
- The selling entity is creditworthy and survives closing.
- The transaction is an asset purchase with only understood liabilities being assumed (and no successor liability concerns).

Conversely, any of the following considerations would require you to ramp up the scope of your due diligence:

- The target is not strong financially.
- The target is not willing to give extensive representations and warranties and indemnities.
- Representations and warranties and indemnities don't survive closing.
- There is no creditworthy surviving entity or shareholder after closing.
- There is a very small margin for error.
- The transaction is a stock purchase or merger or an asset purchase with broad liabilities being assumed (or there are successor liability concerns).

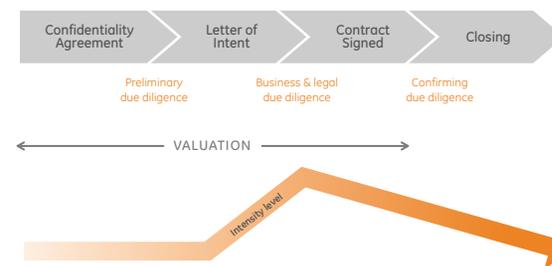
B: Execution

Due diligence is not a courtship, a negotiation, or an inquisition; it's a fact-finding mission, and after your company submits its letter of intent those facts start coming in fast and heavy. Your business review of the target becomes a true audit, aimed at gaining a thorough understanding of the target's operations, assets, liabilities,

and outlook. Your due diligence team will be looking to confirm the target's representations, validate its valuation, probe any legal, regulatory and compliance concerns, and affirm expected synergies and integration plans. They also need to consider the "soft" aspects of the target, such as its corporate culture, to assess its fit with your business. The big questions are: (1) are there any problems with the target that would force your company to abandon the deal, at any price? and (2) are there any issues that should occasion a change in the structure, terms, or price of the deal? To unearth the answers, your team will need to be asking questions such as:

- Do the target's financial statements accurately reflect the company's financial condition?
- Would the integration of your operations with those of the target have any adverse effect on profitability?
- What is the target company's outlook in terms of its customer base and concentration, its competitive positioning, and its ability to preserve or increase its margins?
- Is the target company exposed to any significant and unexpected regulatory, governance, or liability risks?
- Are there any issues associated with long-term sustainability (e.g., availability of raw materials, environmental factors) that could affect the target's future operations?
- Have future costs (for example, underfunded pension liabilities) been figured into the acquisition value?
- What is the quality of the company's management team?
- Who are the target's key, value-creating employees, and what's the outlook for retaining them?
- Are there any clashes of corporate culture that could adversely affect integration of the target with your business?

Intensity of due diligence varies by legal stage



- If the M&A is cross-border, are there cultural, legal, tax, accounting, employment, merger-control, corruption, or environmental challenges that will present real roadblocks to the deal? (For a more detailed examination of these questions, see our overview titled "Cross-border M&A: Additional considerations.")

As you pursue the answers to these questions, you may find that answering them requires making additional data requests of the target.

To this point, much of your examination and analysis can be conducted virtually, using a secure online data room, but don't rely on virtual methods completely. "Walking the floor" of the target company's operations and establishing personal contact with the key players is vital to accurately assessing the target and its potential fit with your operation.

Examiners may be so intent on reviewing their individual functions that they miss the big picture, so it's imperative for due diligence captains to regroup as a team every day to share their findings (which should be recorded in a document) and reset the team's priorities for the next day.



Are there any problems with the target that would force your company to abandon the deal, at any price? Are there any issues that should occasion a change in the structure, terms, or price of the deal?

Common due diligence mistakes

- Examiners may misidentify the risks associated with the acquisition.
- Examiners may get so focused on their individual functions that they miss the big picture.
- They may overlook the “soft” but important element of the target’s corporate culture.
- Team members may disclose expected synergies with the target company (leading them to, for example, increase their asking price to capture that value).
- The team may rely solely on virtual due diligence, and never put boots on the ground.
- The team may be so focused on spotting risks that they overlook opportunities.
- Executives may be so in love with the deal that they ignore risks identified in due diligence and move ahead anyway.

C: Closure

The right team can execute a good business due diligence of a midmarket company in three weeks or less, after which it submits its report to management. That report may give the target a clean bill of health, identify misrepresentations made by the target’s management team, or unearth other issues that could complicate the deal or scuttle it outright. If your team has exposed irregularities or unexpected risks, this information can serve as the basis for a lowering of your company’s bid, modifications of the representations and warranties required of the target, and changes in the section of the purchase agreement that deals with post-closing adjustments and damages.

If, on the other hand, the target has passed muster and the deal has been green-flagged by management, the members of the due diligence team pivot into integration planning mode.

Just looking under the hood isn’t enough; you also need to know what you’re looking for, and have the experience to know what you’re seeing.

Key takeaways

An M&A due diligence is successful if it confirms (or contradicts) your valuation of the target company and provides a complete, accurate, and multifaceted picture of the company’s risks and potentials, and provides information you can use post-closing to facilitate the effective integration of the target company into your business.

Remember...

- **Know exactly what you’re buying.** Valuations need to be informed by effective due diligence from the outset.
- **Due diligence is a detective game, so you need real detectives on your team.** Just looking under the hood isn’t enough; you also need to know what you’re looking for, and have the experience to know what you’re seeing. Appoint people to your team who can see what others may miss—both in issues and opportunities. If you lack the in-house talent, bring in experts from outside.
- **Look for deal-breakers and deal-amenders.** Look for problems with the target that are true deal-breakers, forcing you to abandon your pursuit of the company. Also look for issues that can force changes in the structure, terms, or price of the deal.
- **Consider both “hard” and “soft” aspects of the target business.** Financials won’t amount to a hill of beans if you can’t retain the people who made those financials happen.
- **Think of due diligence as the first phase of integration.** The insights gleaned through the process are integral to integration planning and capitalizing on the first 100 days post-closing.
- **Don’t “fall in love with the deal.”** If your due diligence team uncovers irregularities that turn the prince into a frog, be prepared to walk away.



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