EVALUESERVE

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Securing Success in Deal Execution: Risk Mitigation Through Due Diligence

Introduction

Once a target has been identified and evaluated for the deal, due diligence acts as a reality check. The due diligence process is a critical stage in deal execution, which protects the stakeholders from any unseen pitfalls and risks. The process involves in-depth scrutiny of the target company's financial, legal, operational, and other aspects to assess the validity of the claims made in the initial stages of the deal. Essentially, the due diligence process enables the buyer to authenticate the risks and opportunities of the deal.

A thorough due diligence includes evaluation of and checking the corporate licensure & regulatory documents, contracts and material agreements, intellectual property documents, operational information, financial documents, environmental policies, real estate and property, risk management and insurance, people operations and closing items.

Purpose of Due Diligence

Confirm and verify the information brought-up during the deal

Manage transaction risk through comprehensive due diligence

Helps identify the potential shortcomings that could lead to no deal

To make sure the buyer and seller are on the same page and the deal fulfils both their criteria

To reduce chances of unpleasant surprises post deal-closure

Common Challenges

- **Confirmation Bias:** This means that we seek information that confirms our preconceptions and dismiss the information that contradicts them. This may lead to poor decisions. To avoid this, the due diligence process should be conducted objectively. Additionally, we should seek feedback and inputs from different perspectives and sources.
- **Inadequate information:** Sometimes hurdles might pop up in the process due to incomplete information provided by the seller. However, it is important to determine if this opaqueness is deliberate or simply a case of bad record keeping which can be improved by the buyer in the future. In the absence of deliberate obstruction, decisions can be made on the basis of available information.
- **Subjective Nature:** Certain aspects of due diligence involve making decisions and judgements based on imperfect information, therefore it is recommended to build a clear understanding of the business relationship and clarify where the authority to take such decisions lie.

Key Types of Due Diligence

Financial Due Diligence

Commonly known as FDD, Financial Due Diligence leads to an in-depth analysis and investigation of target company's financial health before entering into an agreement. As a result, this helps appraise the value and calculate potential risks. The items involved in the process are statement of profit and loss, balance sheet, valuation multiples and ratios in comparison to competitors and industry benchmarks, forecasts and projections and inventory schedules.

There are three primary key pillars on which the financial due diligence stands:

- **Earnings Sustainability**

An assessment is conducted to understand the nature, trends, and sustainability of the earnings in order to get a clear picture of the company's financial strength. This usually comprises of a thorough review of revenues, gross profit and EBITDA which eventually culminates into the calculation of a normalized earning metric. The agenda to calculate a normalized metric is to be able to understand what the company can yield after ruling out all one-time, non-recurring and non-operational items.

- **Working Capital**

The next metric to assess while conducting the financial due diligence is to review the working capital of the business to understand its cash generation or consumption. This analysis can enable the buyer to understand the "normal" level of working capital requirement going forward and can also provide them with a heads up to arrange the funding facilities required, if any.

- **Net Debt Analysis**

Generally, enterprise value is used to assess the business valuations. However, while calculating the consideration to be paid, the enterprise value is usually adjusted with net debt. In a typical deal, the acquirer pays for any cash or cash like items and gets a deduction for any debt or debt like items. Therefore, the net debt analysis enables the parties to assess the likely impact of cash and debt on the final consideration to be paid.

Legal Due Diligence

This type of due diligence investigates all the legal aspects of the organisation and the contractual ties with the relevant stakeholders. Items analysed include contracts, corporate documents, compliance doctrines and board meeting minutes. The idea behind conducting this sort of investigation is to identify legal red flags and uncover hidden liabilities. It essentially helps the acquirer to gather an understanding of any potential legal problems that might occur in the future due to the acquisition.

Reasons for conducting a thorough legal investigation are:

- **Building Initial Understanding:** Develop an understanding of the target and its operations before purchase
- **Consideration Determination:** Enables in determining the right amount of consideration for the transaction. This sort of analysis enables the acquirer to closely analyse the financial, structural, and operational aspects of the organization and develop an understanding on other important things like employee and labour arrangements, indemnification processes and intellectual property details
- **Preparation of Documents:** Aids in drafting appropriate M&A documents and other ancillary documents as required
- **Impediment Identification:** Helps in identifying potential hurdles and ways to timely address them to ensure a smooth deal completion

Commercial Due Diligence

Commercial or Operational due diligence reviews the target company from a commercial perspective. It therefore provides the investor with a detailed and objective review of the target's strategic risks and opportunities, as well as a quantitative assessment of the growth projections. Understanding company's operations at a granular level is crucial to ensure smooth and seamless integration post-deal and realize expected synergies.

The major areas of interest under the commercial due diligence process are:

- **Industry / Market:** It is essential to analyse the target's addressable market to ascertain the incremental value generated by the customers from the company's offerings.
- **Customers:** It is important to comprehensively understand how the customer base perceives the brand, products and services, and the technology used by the target. This enables the analyst to comprehend the purchasing criteria of the potential customers and strategize accordingly.
- **Competitors:** Understanding the competitive challenges and its impact on the growth of the company aids in the decision-making process of the acquirer.
- **Growth Projections:** Analysing primary growth avenues of revenue like pricing optimization, customer retention and incentives enables the acquirer to get a clearer picture of the prospects of the deal.

How Evalueserve Helps

Evalueserve has a pool of trained analysts having years of experience in managing the deal origination and execution process. The analysts support deal team of leading boutique and advisory firms and private equity firms in managing the deal flow and conducting a meticulous due diligence process for live deals. Following are a few benefits that clients gained from partnering with Evalueserve on this process:

- Creation and maintenance of data banks
- Comparison of the Quality of Earnings
- Identification of any "red flags"
- Maintenance of due diligence trackers to record the questions and related documents
- Informed decision making
- Increased trust between the parties and smooth flow of the transaction

Evalueserve extends support for both the Pre-LOI Phase and the Post-LOI Phase. Before the LOI is signed, the team conducts a preliminary analysis of financial statements, basic financial modelling, initial customer analysis, and more. Post the LOI is signed, a more thorough analysis is conducted like analysing the ageing of accounts receivables and payables, calculating adjusted profitability metrics, conducting sensitivity analysis, sales and purchase analysis, and tracking of operational metrics.

Conclusively, for the buyer, Evalueserve enables in protecting the shareholders by determining if the transaction makes sense in terms of valuation and integration. It helps in repricing, changing the terms or scope or determining if the deal should be cancelled or moved forward as originally planned.

For the seller, the analyst team goes through a rigorous examination to ensure that the fair market value of the company is in line with the initial discussions.

Conclusion

To conclude, the process of due diligence is of utmost importance for both the buyer and the seller. The process helps evaluate the risks and the opportunities and plan for the final offer. Therefore, immense amount of focus and attention is required while checking and analyzing the various documents. The process is then followed by final offer creation and deal closure if everything goes well. To understand and read about various steps involved in a successful deal execution process, click here: https://www.evalueserve.com/blog/7-key-steps-in-the-deal-execution-process/

Evalueserve has extensive experience of working with large, mid-market investment and boutique advisory firms providing deal execution support for live deal mandates across various sectors. Most mid-market and boutique advisory firms have leaner deal teams and require support for deal preparation and deal marketing phases. Our trained pool of analysts supports deal teams across the deal execution process, thus helping our clients to execute more deals. For more information, please visit: https://www.evalueserve.com/solutions/deal-execution-support/

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Acknowledging Ria Kansal's contribution to this blog.

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