

## Due diligence: 'Kicking the tyres' or 'priming the pump'?

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When we think of the 'exciting' world of mergers and acquisitions how many of us automatically place it alongside a much duller picture of people in suits running through ledgers and ticking boxes as they complete the due diligence exercise that inevitably accompanies any significant deal? The

truth of the matter is that 'due diligence' although an integral part of such transactions rarely makes headlines except when the merger or acquisition in question ends in disaster or serious shortcomings in the transaction are exposed. Remember the famous 1998 sale of Rolls Royce car production to Volkswagen which dramatically outbid the existing engine supplier BMW? The deal ceased to be regarded as a coup when it emerged that Volkswagen ('VW') had omitted to buy the rights to use the Rolls Royce name; rights which had, in fact, been scooped up by BMW. BMW paid £40m to license the Rolls-Royce name and "RR" logo, a deal that many commentators thought was a bargain for possibly the most valuable property in the deal ! Quite clearly, the due diligence exercise performed by VW was somewhat lacking, although whether the fault lay with the team or the terms of instruction is less obvious.

### What is due diligence?

Many view due diligence ('DD') as being akin to a financial audit and fundamentally a 'box ticking' or superficial 'tyre kicking' exercise. This is not the case, and failure to properly understand the reasons for conducting the DD process can result in damaging oversights and omissions. Audits are largely set in the past and focus on historic transactions. DD is substantially directed at assessing the current business and its future prospects. Properly used DD exercises assist the potential buyer by:

- Confirming that they will get what they think they are buying (e.g., the brand name and the production rights),
- Identifying areas of risk for the business and quantifying their potential impact on future performance (e.g., is the company about to face a class action for polluting water supplies, is a key customer teetering on the verge of insolvency, is an overseas subsidiary at risk of being nationalized etc.)
- Identifying areas for negotiation when finalizing the deal price and structure (e.g., a price reduction if the lifespan of core business assets is likely to be less than originally assumed or if the quality of the debtor book is dubious or if there is a hefty pension liability to be taken on).
- Identifying potential upsides and areas where cost savings and synergies may be possible (as opposed to desirable!).
- Helping to plan integration should the deal go ahead (e.g., examining if and how IT or admin departments can be combined, whether the corporate culture or cultures fit with the buyer's vision for the future entity etc.)

In short, DD does in fact 'prime the pump' to get the deal finalised and the ongoing business moving forward.

## **DD has three faces!**

From the above it should be apparent that DD is a whole lot more than an accounting exercise. Properly performed, DD has three core elements: Financial; Legal, and Commercial. Ergo, successful DD teams are not solely comprised of accountants but may involve several professional disciplines and whilst occasionally these may be found under 'one roof' it is more normal for the 'team' to be made up of several specialized units reporting to, and directed by, a central coordinator. Sometimes a businesses' own people may form part of the team (e.g., they may be viewed as having superior commercial and market knowledge). However, it is worth remembering that outsiders are free of any form of 'internal politics' bias and therefore should provide information and opinion on the proposed deal which is truly objective. What is important in all cases, is to ensure that advisors are properly briefed on the businesses and the proposed transaction. This should enable them to focus on the areas that are most critical to the deal and the ongoing success of the business. Failure to properly hone the investigations can result in the production of masses of data (as advisors try to protect themselves by covering all bases) but a lack of properly presented and relevant information.

Broadly speaking the areas covered by the main DD strands are as follows:

### *Financial DD*

This aims to provide a view on the underlying profitability of the target and of the maintainable profit going forward. It provides an opportunity to check that the assumptions made in arriving at the valuation of the target are reasonable and should also expose financial risks to future performance. It should identify what warranties or protections may be required and the priority that should be attached to obtaining them. Additionally, it should provide an estimate of the probability that those risks will actually occur and attempt to quantify the damage to the business should the worst happen. The only way to do this is to fully understand the business which means inter alia, examining the business history, commercial activities, operational activities, organisation structures, assets and liabilities, trading results over an extended period, cashflows, taxation position, cross border activities and differing accounting policies, and so forth. Crucially, it also means forming a view on the compatibility of cultures and systems. Anticipated cost savings from shared overheads etc. will only materialized if integration is truly possible. For example, Sabadell's acquisition of TSB bank in April 2018 landed it with hefty costs of GBP 178million due to a struggle to migrate customers from one IT system to another. Conversely, the \$95 billion Royal Dutch Petroleum merger with Shell in 2004 made sense and was well received as it reduced several layers of management and increased the company's asset base.

### *Legal DD*

This is directed at identifying the legal risks and opportunities to the potential buyer of doing the deal. Something which can become more complicated when there are cross border issues involved. For example, some jurisdictions such as the UK and Cyprus have systems largely based on 'Common Law' whereas elsewhere in the world 'Civil law' may dominate. Nonetheless, properly conducted legal DD should expose potential liabilities and the likelihood of them actually materializing and give advice on the appropriate warranty or indemnity protection that may be needed. It should also expose any legal or contractual barriers to getting the deal done. This will necessarily involve the team in a variety of tasks including examination of the corporate and share records, key shareholders, a review of indebtedness including off balance sheet agreements, any pending litigation or winding up writs, titles to property and

intellectual property, reviews of relevant agreements including employment contracts, supplier and customer contracts, licences, insurances and pension plans to name just a few. The work done by the legal team will generally form the basis of any final agreement. Being central to the deal means that it is vital that they are fully informed of all aspects of the deal and of any 'news' good or bad which emerges as the DD exercise progresses. Properly performed Legal DD ensures that the buyer is actually buying what they think they are buying. Improperly performed it can result in a situation which faced Bank of America in 2008 when it bought the 'mortgage' book of Countrywide for \$2 billion, only to find what it had actually acquired was \$50 billion of bad debt.

#### *Commercial DD*

Although often something of an afterthought it is commercial DD which, when properly conducted, can actually best help to identify and quantify the future growth prospects of the ongoing business. When performed well it can provide a form of strategic review. Commercial DD investigates a business and its markets. Thus, it looks at issues such as existing products, product lifecycle, product pipeline, product strengths and weaknesses, buyer strength, marketing strategy, competitors, existing and potential market share, pricing policy, competitors, potential for opening new territories, regulatory and new entrant threats, distribution issues and so forth. All of which are extremely important for underpinning the validity (or otherwise) of the post deal forecasts. Indeed, this was a lesson learned the hard way when Time Warner was purchased by America Online in 2001. The managers pushing the deal were anxious to get into 'new media' but totally failed to understand the market that they were entering into. As a result, they overpaid massively and a year after the deal were forced to report a massive \$99 billion write down.

It should be apparent that these three faces of DD are inextricably linked to one another. For the 'financials' to stack up the commercial and legal information must support them. Hence for the overall exercise to produce the desired results there must be true cooperation between all parties involved. Furthermore, whilst these three disciplines represent the core strands it will often be necessary to call in additional experts from other fields such as Environmental Science, Information Technology, Human Resources, Pensions and Taxation, depending upon the business at issue, to properly assess the true status of a business and its prospects for future success. Strong areas of concern for many would be buyers currently include management teams, taxation and environmental issues with cybersecurity and IT systems 'waiting in the wings'. In short, DD is not an exercise to be undertaken lightly. It can be costly, and the formal process should only be embarked upon if both parties genuinely believe that there is a viable deal to be done. If that is agreed, then properly directed and conducted, the costs incurred should more than be offset by the benefits accruing from the exercise. DD not only verifies what is being 'bought' or 'merged' it lays the foundation for driving cost reduction, integration and growth of the emergent business!

Elias Neocleous & Co LLC has the most experienced and best resourced legal due diligence team in Cyprus. It has extensive expertise in dealing with cross border acquisitions and mergers and is part of an extensive global network. To find out more or to discuss your due diligence needs speak with our [Corporate & Commercial team](#) or reach out to your usual contact at Elias Neocleous & Co LLC.