The Other Side of Due Diligence – Operational Challenges During a Transaction

By Paul Cogswell

According to Merriam Webster, due diligence is the care that a reasonable person exercises to avoid harm to other persons or their property, or in the commercial setting, the research and analysis of a company or organization done in preparation for a business transaction.

It has also been described by Alexandra Lajoux and Charles Elson's publication of The Art of M&A Due Diligence as, "the safety net to validate whether a deal (or transaction) will create value." Even more importantly, the primary objective of due diligence is to validate the theory of the transaction in a "forgiving environment."

At its basic component, due diligence provides a confirmation that the strategy will work for both target and acquirer, the assets and liabilities are as represented, the combined operation's business plans are grounded, feasible and to a certain degree reliable, and that the opportunities presented through the transactions have a realistic foothold as projected.

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Transactional due diligence is meant to mitigate risk. In every transaction there are challenges that can be both foreseeable and unforeseeable. Due diligence is meant to provide verification tempered with trust. As an old Russian proverb stated, "doveryai no proveryai," which translates to "trust, but verify," and is the motto and driving principle behind due diligence.

However, in the real world, the clock is ticking and most individuals " hate it when a gang of ugly facts beats up their theory." So the purpose of this primer is not to discuss the necessary requirements of a sound due diligence process, but to point out that while every transaction deserves due diligence, there are common challenges to applying the principles so that there may be a return on energy and investment in the process commensurate with the value expected.

Applying a broad based due diligence process without regard to the subtleties of the transaction can be likened to having a large toolbox containing only hammers. When diligence is approached in that fashion, everything tends to look like nails.

The reality is that there are an infinite number of potential risks that face a typical buyer emanating from financial, legal, strategic and operational areas. For example, is there a clear title to both tangible and intangible assets and can they be conveyed without contingent liabilities following them? Does the target have unresolved existing or potential litigation issues brewing in the embryonic phase that can range from employment issues to environmental issues to issues facing foreign operations? Has the target adequately addressed the risk and properly disclosed the mitigation and insurance strategies? Have the finances been "dressed for the occasion" or are they accurately depicting the operational realities of the company?

Due diligence can be performed easily with time, unlimited resources and an abundance of available information. However, the frequency of this environment occurring can be compared to the appearance of Halley's Comet – a "periodic" comet that returns to Earth's vicinity about every 75 years, making it possible for a human to see it twice in his or her lifetime.

The fact is that every due diligence project involves a fundamental analysis of

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the risks and how those risks apply to the transaction. It is essential to identify these risks as well as the opportunities so that the proper allocation of resources can be assigned appropriately.

Assigning and weighing risks is a primary challenge facing the experienced and novice firm alike in the practice of due diligence. Every transaction can face both strategic and practical errors affecting the quality of the product.

Let's look at some of the common challenges that face almost any due diligence team:

Confusing hope with strategy – Objectivity on the part of the buyer is critical and presenting critical items, such as quality of earnings reviews, legal challenges and operational deficiencies bluntly allows for the correct weighing of certain risks therein.

Misallocating resources between the information and the analyst – It may be that the complexity of the target exceeds the competency of the analyst to grasp unknown risk contained in critical documents or items presented for review.

Lack of planning in preparing for the assignment – A 200 question questionnaire where 100 questions have little or no applicability to the target's operations, financials or status discloses a lack of understanding on the diligence team that may even be exploited. Additionally, a target may not only find it distracting, but annoying. It is not important to ask a multitude of questions, just the right questions.

The story behind the story – Financial statements provide some excellent clues, but they don't present the total value proposition in a target, or worse, they could provide unrealistically optimistic presentations of the future. Good due diligence goes beyond the numbers.

Time – The Rolling Stones' song that starts out stating, "Time is on my side, yes it is," should not be used as a mantra for a due diligence project. Most due diligence providers must be able to balance priorities with the urgencies and exigencies of the assignment and understand when to use a shovel and when to use a spoon.

People - Every aspect of careful diligence involves a deep understanding of the collective intellects and personalities that make up a transaction. Experienced due diligence teams need to operate beyond the numbers, acting in the capacity of detective, psychologist, ambassador and architect not only to understand the motivations of the business, but to understand the importance of specific roles and how they will relate to the new entity or acquisition.

> **"Due diligence is a constantlyevolving process of art and science."**

Emerging issues – Missing critical, but specific industry issues that may face a target can ignore dormant risks. For example, purchasing a foreign subsidiary or plant in an asset deal where the ultimate parent may have engaged in violations of the Foreign Corrupt Practices Act, or ignoring potential hidden environmental issues not necessarily affecting the immediate target.

Understanding relevant benchmarks – Every organization adapts metrics to drive success. What are the dynamics of these metrics? Are they realistic both as they exist currently and as they may exist in the new organization?

Operational Assessment – Often overlooked and seen as a weak link in the diligence process. Overlooking internal business inefficiencies because of the belief they can be overcome through the integration process is sophomoric. A poor grasp of the target's organization and integration of process, people, technology and the related interdependencies can leave an important chapter out of the report. Additionally, not exploring issues not easily seen at first, such as liquidity impairment, damage or disruption to information assets, or the target's reputation can quickly turn treasure into trash. Experienced teams are cognizant of the more obtuse risks and can allocate the proper resources to balance the amount of effort needed.

Conclusion

No one article can provide the many different theories that drive the due diligence process. Due diligence is a constantly evolving process of art and science. The application of diligence to a transaction is extremely dependent on how much time and resources a company wants to extend balanced naturally by the company's internal and external risk tolerances.

No academic grasp of the diligence process can replace real world experience. Due diligence must also be cooperative, patient, equitable and understandable. A basic understanding and recitation of key ratios and quality of earnings can provide critical intelligence, but that is often only the start. The diligence team should not only be able to deliver clear pictures of the critical financial metrics at the very least (current ratio, debt to equity, net working capital, etc.), but they must also be able to extrapolate and report on other not so obvious and calculable factors as well. The team should mirror as closely as possible every facet of the target or transaction, so when finished, they can truly and deeply understand the objectives of the transaction and more importantly, deliver the critical information necessary to verify the value of it.

Weaving a coherent picture of actionable financial, legal and operational intelligence and pushing through the challenges will come when an experienced, competent and corroborative team is put in place. Proper assessment combines specialized knowledge of the target, financial and legal acumen, and deep diligence experience to bring true value to the process.