Due Diligence Tips

by

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"Tips for Better Due Diligence"

(1) What Is Due Diligence – one definition?

A "Due Diligence" investigation is a careful and methodical investigation of a company. It's done prior to doing business with the company.

The most common reason for due diligence investigations are corporate acquisitions and mergers - investigating the company being acquired or merged. These also tend to be the most thorough types of due diligence investigations. The buyer or merger partner
wants to make sure it knows what it's buying.

Partnerings are another time when parties will investigate of each other in conjunction with the negotiations. Here is a list of the different types of partners and partnerings where due diligence investigations are appropriate:

- Strategic Alliances, Joint Ventures, Strategic Partnerships
- Business Partners and Alliances, Partnering Agreements, Business Coalitions
- Just In Time Suppliers and Relationships, Sole Source Suppliers, Outsourcing Arrangements, OEM Suppliers and Customers
- Technology and Product Licensing, Joint Development Agreements, Technology Sharing and Cross Licensing Agreements
- Business Partners, Affiliates, Franchisees and Franchisers
- Value Added Remarketers and Resellers, Value Added Dealers,
- Distribution Relationships

A Little History on the term "Due Diligence"

The term "Due Diligence" first came into common use as a result of the US Securities Act of 1933.

The Act included a defense that could be used by Broker-Dealers when accused inadequate disclosure to investors of material information with respect to the purchase of securities. As long as they conducted a "Due Diligence" investigation into the issuing company's equity they were selling, and disclosed their findings to the investor... they would not be held liable for nondisclosure of information that failed to be uncovered in the process of that investigation.

The entire Broker-Dealer community quickly institutionalized as a standard practice, the conducting of due diligence investigations of any stock offerings in which they involved themselves. While the term "Due Diligence" was originally limited to public offerings of equity investments. Over time it has come to be associated with any investigation of a company or business partner.

Post-Acquisition Due Diligence...
Once you've consummated a transaction, you face a whole new set of challenges. The due diligence you will have done, however careful, however thorough, looked only at observable factors.

Your decisions, from this point on, have to be made with an in-depth understanding of the Operating Dynamics of the company. These are the organizational and interpersonal issues you can't examine from the outside.

This activity is known as post-acquisition due diligence. Post-acquisition due diligence is as important as the pre-acquisition due diligence. If you don't get it right, you can get the deal done, but fail to achieve the true objective... generating new post-acquisition corporate value.

This applies not only to acquisitions, but to mergers and large scale joint ventures as well.

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(2) Due Diligence Tip 2 - Using Common Sense

Too much due diligence can kill the transaction, particularly on small deals.

It's not practical to investigate every possible avenue of consideration. For most transactions to do so would be too costly and too time consuming.

Pruning the possible lines of investigation and inquiry should be done in a conscious and informed manner - not at random. That is the art of Due Diligence investigation.

We provide checklists to help do that. Our Due Diligence Checklists are comprehensive menus of items from which you can choose what you want to investigate and what you will overlook.

In most instances, you'll investigate only a portion of the possible items the checklists highlight - some briefly and others in depth.

In general, if you are getting a great deal, good pricing, and favorable terms... you will want to move quickly and lightly. On the other hand, if you are doing a highly leveraged deal and are paying top dollar, you'll have little or no room for error. You require a very complete due diligence, or don't do the deal at all. There is no room for error.... so you tolerate no room for error.

For instance, in the process of an investigation, you may find a large number of relevant agreements that you will want to read. In the imperfect world we live in, that may be impractical - you may have to pick and choose which ones you read, which you skim, and which you pass over. How much you invest in this activity depends on how much room for error you have. It may not make sense to invest $75,000 of Due Diligence effort into a $150,000 deal, but for a $15,000,000 deal the calculus is far different.

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(3) Due Diligence Tip 3 - Develop a Due Diligence Strategy

Before starting your Due Diligence investigation, develop a due diligence strategy. Consider the following factors:

- What's important to you? What isn't?
- Which problems will be costly? Which ones will be minor?
- What drives profits - products, technology, sales staff, contracts?
- Where are you most likely to find problems? Where are you unlikely to find problems?
- What is the type of transaction you are expecting? How large or small is the transaction? How complex? What will the investigation cost in time and in money?
- What is the risk to you if the unexpected causes the transaction to go bad?
- How much time do you have? What do you have to lose by delay? What do they have to lose? How badly do you need the deal? How badly do they?
- After the transaction is closed will you have something the other party needs or wants? Can you use this to secure warranties on the due diligence items? Can you put money into an escrow to secure warranties?

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(4) Due Diligence Tip 4 - Lawyers, Accountants and Due Diligence

Lawyers and accountants have their uses. You can rely on them to read agreements and count numbers - and do it well.

You're ill advised to rely on them alone to conduct due diligence. You need someone who understands the particular business and industry - an industry expert. If you don't have that experience, find a businessperson who does. That person will know what to look for, where to probe, and what questions to ask.

We believe our checklists are the most thorough ones available (with the exception of a three-volume set that sells for approximately $1,500). It's the one used by M&A professionals

Still, no matter how thorough your checklists are, they can't be sufficiently complete to deal with the unique issues of companies in unique industries. For example if you are doing something in an industry with special peculiarities such as telecommunications or oil, general-purpose checklists will need to be supplemented. This is where your industry expert, his industry savvy and personal contacts will be invaluable.

You will never be able to conduct a complete due diligence investigation. In most transactions you will have to exercise business judgment to assess risk versus reward - with imperfect information. By disposition and training, many lawyers and accountants aren't well suited for doing this.

This is where a practical understanding of the industry will be of great help. Knowing how to cut to the chase... knowing beforehand where the skeletons are likely to be buried, and which questions will surface areas of weakness. There is just no substitute for industry specific experience.

(5) Due Diligence Tip 5 - Other Reasons for Due Diligence Investigations

Earlier I mentioned acquisitions, mergers and partnerings as major reasons for due diligence. These aren't the only uses for Due Diligence investigations. Here are more:

- Selling your company.
    - You want to know the financial status of the buyer. Also what is the buyer's history of acquisitions? The buyer's past behavior is the best indicator of how the buyer will conduct itself with you and your company.

    - Will you be accepting debt from the buyer? Will you be taking stock in the seller? If so you're really an investor. You're investing the buyer. You need to know what you're investing in.

    - You may conduct a due diligence check-up on yourself. It'll prompt you to areas of inquiry. Prepare well and you'll increase your control of the buyer's due diligence investigation.

    - Before putting your homestead up for sale you should spruce it up and give it a new coat of paint. An introspective review will help identify the areas of your company you need to primp.

- Taking charge of a turnaround company.
    - One of the first things to do when taking charge of a company to turn it around, is collect information. The checklist is perfect for that.

- Investing in a private company.
    - Before investing in a private company you need to ask a lot of good probing questions. The checklist will help prompt you for those questions.

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(6) Due Diligence Tip 6 - Interviews with Insiders

One on One Sessions With Insiders.

The insiders are the ones who really know what is what. They often now more about the company than does the CEO, especially about those little details that can come back and bite you in the fanny.
Pay special attention to those insiders with the longest history with the company. Don't overlook the assistants of these insiders either.

Here is where to look for these people:

- Members of Senior Corporate Management and Department Heads.
    - The Chief Financial Officer, the Controller, the Treasurer.
    - The Top Human Resources Officer

    - R&D and Engineering Management.
    - Sales & Marketing Management
- Members of Corporate Planning and Development Department
- Operational Departments
- Internal Legal Department
- Product Group Presidents
- Outside auditors
- Outside legal counsel
- Current consultants (business, technical, other)

Typically you will not be permitted access to most of these people until after the transaction is announced, or even until after it is closed. The smaller the company, the more likely this is to be a problem.

But you will usually get early access to the CFO. Here is a trick you can use.

When meeting with the CEO get permission to take the CFO out for a one on one lunch. Then as you are leaving, with the three of you together, ask the CEO to direct the CFO to give full and complete answers to your questions. That gives the CFO cover to be open and forthright with you.

Then your job is to convince the CFO, that

(a) the deal will close and he will soon be reporting to you,

(b) you will hold in confidence anything he tells you (assure him you will find a way to discover it yourself without blame going to him), and

(c) that he doesn't want you to discover unpleasant surprises after the transaction closes.

Ask him how to conduct your due diligence. You can learn a lot from him. It's the CFO's chance to ingratiate himself or herself to the new owner.

Depending on the circumstances, you may be able to use this trick with other key insiders. You most likely will only be able to use it once though.

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(7) Due Diligence Tip 7 - Going to Outsiders

Interviews with Outsiders

Outsiders, particularly those who were once insiders can serve as excellent reality checks. They are less likely to put a positive spin on things. Even when they do it is easier to read between the lines.

While they may have their own ax to grind they are excellent at sniffing out areas deserving further investigation. If at all possible, get their names, addresses and phone numbers as well permission to gracefully contact them.

Here is a list to work from:

- Key customers.
- Ex-customers.

- Past and current suppliers.
- Past and current competitors, dealers, jobbers, manufacturer's representatives.
- Past and current bankers, creditors, insurance agents.
- Past consultants (business, technical, other).
- Ex-auditors.
- Ex-employees with personal knowledge of specific issues of interest. You can often find these people by running a want ad.
- Ex-shareholders (for privately held companies).
- Personal references of key shareholders and/or principals of the company. Get their resumes as well.
- Officials and other representatives of government agencies that regulate the company.

Ex-employees can be a particularly fertile area. In fact the more skeletons there are hidden, the more willing you will find ex-employees to disclose them. Doing so seems to perform a cathartic function and you'll get a lot of good information from them, if they are willing to talk.

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(8) Due Diligence Tip 8 - Shareholder Agreements

Whenever you share control of a corporation with someone else, you need to think about a shareholder agreement. If you are purchasing a company with partners, or with a financial backer, it is never too early to start thinking about your shareholder agreement. The Shareholder Agreement will control your exit strategy and your ability to capture and harvest all the value built incorporated in company.

There are five basic types of Shareholder Buy/Sell Provisions.

1. The "Texas Showdown" Buy/Sell
2. The "Russian Roulette" Buy/Sell
3. The "Armenian Handshake" Buy/Sell (the best one for protecting financially weaker shareholders)
4. The "Right of First Refusal" (and Right of First Offer) Buy/Sell
5. "Appraisal Rights"

A related provision is the "Talking Money" provision. This provision requires that the person who initiates a Buy/Sell transaction pay a fee for doing so.

Shareholder Agreements frequently have provisions relating to the control and management of the company. These provisions are typically more important than the number of seats you control on the board. They can include provisions (a) relating to access for corporate information, (b) causing certain actions and decisions to be made only with a super majority vote, (c) giving some directors specific veto power over other decisions, (d) and shift many decisions from the control of the CEO to control of the board, or even a single member of the board.

There are eight basic ways to handle board level deadlocks.

1. A tie breaking independent director
2. Mediation

3. Arbitration
4. A dispute escalation process
5. A Mutually Assured Destruction provision
6. A rotating tie breaking chair
7. Court ordered dissolution
8. A Trustee

The operative provisions of Shareholder Agreements often turn on the valuation of the Company. What that valuation is, often has a huge impact on who benefits most from the appreciation of the Company's value, and who is hurt by a depreciation of its value. There are four basic types of business valuations.

1. Net Asset Valuations - based on the actual net assets that the Company can sell
2. Market Comparables - based on the actual sale prices of other comparable companies
3. Discounted Cash Flow - takes projected cash flow and calculates its present value
4. Strategic Valuations - uses one of the above methodologies to calculate a value for the company then adds to it a second valuation that includes an estimated increase in valuation from the joining of the two companies.

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(9) Due Diligence Tip 9 - Post-Acquisition Due Diligence

Once you've consummated a transaction, you face a whole new set of challenges. The due diligence you have done, however careful, however thorough, looked only at observable factors.

Your decisions, from this point on, have to be made with an in-depth understanding of the Operating Dynamics of the company. These are the interpersonal and organizational issues, which you can't examine from the outside.

This post-acquisition activity is known as Post-Acquisition Due Diligence. Post-Acquisition Due Diligence is as important as the Pre-Acquisition Due Diligence. If you don't get it right, you can get the deal done, but fail to achieve the true objective... generating new corporate value. This applies not only to acquisitions, but to mergers and large scale joint ventures as well.

One of your first orders of action, once you take charge of a company, or a business organization composed of pre-existing teams of people, is to develop an understanding of these Operating Dynamics.

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(10) Due Diligence Tip 10 - Taking Control of a New Acquisition

Before you made your acquisition, while you conducted your due diligence, you undoubtedly interviewed senior management. You may have talked to others below that level too, although many people were defensive and some even afraid.

Now it's show time. You'll have to:

(a) take charge
(b) stabilize what you have taken charge of
(c) formulate and implement changes to start generating new and additional value

To do this you need information. If the Due Diligence Checklists are being used, the pre-acquisition due diligence has already captured a great deal of useful information.

Still, it's unlikely you captured all the soft information you now need. This is the type of information you seldom find in writing. It is the interpersonal and organizational issues... you can't examine from the outside and drive the greatest part of the performance of most organizations. If you don't get this right, your acquisition will fail.

What is this information? Here are some questions you will need to get answered... and quickly:

- How did the old management team work together... and how did they fail to work together?
- What will be the effect of the initial changes to the management team to the existing web of interpersonal relationships?
- What kinds of directions have employees been receiving... and how clear are these directions?
- Which of the current employees and managers are predisposed to the new priorities and philosophies that are being brought in by the new owners?
- How are corporate decisions made, and why? How centralized or decentralized is the process? How does it vary by person and department?
- What are the internal reputations of significant employees and managers? To what extent are those reputations earned... and to what extent generated by the environment and priorities fostered by prior management? Which managers are ambitious for the company ... and which for themselves?
- Which key managers and employees know what they are doing, and which ones don't. How is mediocrity handled?
- Who is carrying their weight and who is not? Who has been getting a free ride by prior management?
- What the heck are the internal politics? How intense is it?
- How are meetings conducted? Who is invited to which meetings and why? Who isn't invited and why?
- Which departments have been inappropriately undermined of decision-making influence? Which are been inappropriately given too much decision-making influence?
- How is morale? Are people having fun? How does it vary throughout the company?
- Who are the team players? Who are not?
- What less important priorities in the past have distracted employees and managers from more critical priorities? What are those more critical priorities?
- How are priorities set? Who sets them... using what criteria?
- Where is the resistance to change going to come from?
- Which people and which departments are best organized and efficient? Which are most adaptable? Which are neither efficient nor adaptable?

We have a technique that can quickly extract this information in a matter of days. It includes a structured series of one-on-one interviews and group interviews that feed into one or more computer mediated assessment and planning meetings.

It's a Post-Acquisition Due Diligence process coordinated by a consultant named Curt Sahakian, Esq.. Call and ask about it.

(11) Due Diligence Tip 11 - (Part 1 of 2) Your Post Acquisition Strategy

As a practical matter the M&A market has always been a sellers market.

As a result almost all acquirers are compelled to pay more for the acquisition target than is justified by their current risk-adjusted value as a pure investment. This situation has been studied to death and has even been given a name "The Winner's Curse." When a company is put on the market, and multiple companies bid on it, it is almost always sold for a premium over what it is worth as a pure investment.

This has serious consequences for post-acquisition planning. Staying the course won't cut it. In order for most acquisitions to be reasonably profitable for the acquirer, the acquirer must make changes and generate new value.

If the acquirer can't or won't do that.... the money is better invested in government bonds that provide a better risk adjusted return... with the certainty you will get your investment back....with interest at the end of the investment.

The Bottom Line - What the Sellers Market Means to Acquirers

This is why you need to have a Post Acquisition Strategy and successful implementation of that strategy. If you don't have that strategy and a credible prospect of implementing, it's unlikely you will find a source of financing foolish enough to finance the acquisition.

You can only get yourself into trouble when --

(a) You win a bidding war to buy a company,
(b) You pay a competitive price for it, and
(c) You don't have an effective plan to improve its performance in order to improve its value in your hands. Don't buy it unless you have a plan to improve its financial performance.

So here is what you need to do:

- First... have or devise the plan.
- Second... communicate the plan to your employees
- Third... get them to implement it

The nature and types of plans you can devise to improve the financial performance of a newly acquired company are limitless.

There is a simple yet powerful tool to help articulate your plan and communicate it to your employees. It's also amazingly useful for refining your plan as well. We call this tool the One-Page Strategy Sheet.

The "One-Page Strategy Sheet" is a single piece of paper that communicates to all the people in an organization the information each person needs to coordinate everyday decisions. A one-page business plan is one that every one of your employees can understand and follow. It's designed to incorporate a detailed objective standard against which all business decisions throughout your organization can be judged.

Due Diligence Tip 11 - (Part 2 of 2) Your Post Acquisition Strategy

Here is how The One-Page Strategy Sheet works to help implement your post acquisition strategy

In any organization, people at all levels within the organization make countless decisions everyday. The cumulative impact of these many everyday decisions dwarfs the impact of most CEOs. What that means is that the CEO of a newly acquired company has a lot less immediate impact than you would intuitively imagine.

When these multitudes of decisions are randomly made by people with conflicting priorities and goals, you will get problems. Each person and each department will have a predisposition to apply their resources and energy in different and often conflicting ways. Salespeople will head in one direction. Manufacturing will take a different tack. Customer service will take still another direction.

This is before management even attempts to impose its new order of priorities and decision making into the mix.

There will always be goals set by someone. If you don't set them, your employees will. They may want to protect their department's interests, avoid change, or maintain a low workload. Guess what? It's almost certain that people will set conflicting goals. And this is even before you start implementing your new goals and priorities.

The One-Page Strategy Sheet was designed to solve this problem at its source. It functions in your company much like DNA functions in your body.

DNA provides the blueprint that organizes the functions and relationships between of all your various cells. It is what prevents one part of your body from fighting other parts. Every cell has a copy of it and follows the blueprint. The One-Page Strategy Sheet does the same for a company. Without it, employees will follow their own priorities. It communicates critical and fundamental decision making criteria that everyone can know and understand.

The One-Page Strategy Sheet has two parts

- The First Part... encapsulates the immediate short-term tactics the company uses to conduct its business.
- The Second Part... contains the company's long term strategy for growth.

We've designed these two parts to train people to use the same decision making process used for centuries by successful chess masters.

A chess master will make each move to achieve two simultaneous goals:
(1) trapping and taking his opponent's pieces, and
(2) moving toward a future position to place them in the right place at the right time to trap and take more pieces.

A Chess Master will judge every move by how well it simultaneously accomplishes both goals. This decision-making process works in business as well as it does in chess. The best results always come from decisions that simultaneously

(1) achieve short-term immediate goals, and
(2) attain long-term positional advantage.

How to Construct Your Own One-Page Strategy Sheet

We publish a short, to the point, instruction manual that shows how to construct your own One-Page Strategy Sheet.

It shows how to use the following techniques create a concise one-page business plan:

(1) Michael Porter's Five Forces Analysis
(2) The Discretionary Dollar
(3) The Virtual Dollar
(4) Value Chain Ratcheting

The resulting one-page business plan is one that every one of your employees can understand and follow. One that incorporates a detailed objective standard against which all business decisions throughout your organization can be judged... uniting your employees into a coherent force with a singular purpose... permitting you to telegraph mid-course changes in strategic direction to your entire organization overnight.

We recommend that on your first day after the acquisition, you issue your first One-Page Strategy Sheet to represent the then current strategy of the Company. Then conduct your Post-Acquisition Due Diligence. Refine your plans to incorporate what you learn in your Post-Acquisition Due Diligence. Then in a week or two issue an updated One-Page Strategy Sheet with your new plans, priorities and goals. The first one gives your employees a point of reference to understand the changes you are making and how they differ from the past.

Our Instruction Manual "The One-Page Strategy Sheet" even includes a sample deal sheet you can use as a template for your own Strategy Sheet.

Demanding change from employees who don't understand what is expected of them is like trying to teach a pig to dance... all it does is waste your time and annoy the pig. The One-Page Strategy Sheet is an alternative to wasting your first critical months trying to teach pigs to dance.

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(12) Due Diligence Tip 12 –
Changing the Ship's Direction - Rules for Driving Post-Acquisition Change

There is nothing more dangerous or difficult than bringing about change. There are always people who benefit from maintaining status quo. They will see what they have to lose, and will fight to keep it. While there are always people who will benefit from change, it is hard for them to know, or see, how they will benefit. Even then, people will fight harder to keep something they have, than they will to obtain something they don't have. (This rule is as old as man and has been noted by people as varied as Machiavelli, Jean-Jacques Rousseau, and Balthizar Gracien)

Here are our rules for driving post-acquisition change... it's all about people and overcoming their natural resistance to change.

- Agents of change have few friends or allies. Most people do not like change and will resist it - even if they may benefit from it.
- Make sure you understand why things are the way they are, before you change them. When things have been done a certain way over time, there is probably a reason for it.
- When accomplishing anything of significance, you will offend people and make enemies. These people can do nothing but cause you grief later. Keep their number to a minimum.
- Concentrations of power and authority will vigorously resist attempts at change. Organizations with evenly distributed power and authority are the most open to change. Before starting a program of change, distribute additional authority and responsibility to those most likely to support change.

There is one exception to this general rule - organizations at the other end of the spectrum. Organizations in which there is a single concentration of power and authority in one person or office also present few barriers to change.

- When you take on a new project or position, talk to your predecessor or someone who has been in your place before. The mistakes you make should be new ones. It makes no sense to repeat the mistakes of others.
- When taking over from a predecessor:
    - Get actively involved in operations immediately. Get in front of your subordinates. Standing back and being passive - merely results in the concentration of authority and power in the hands of those people most likely to lose from any change.
    - While being active, avoid early changes. The organization will need time to learn how to accept direction from you. You will need time to learn how it responds to your direction.
    - There is great benefit to bringing in several of your own people to hold key positions. You will offend only a few people by doing this and your new people will be more cooperative and responsive to your direction and goals.

- If you make changes (including staff cutbacks or any other type of change), do it all at once. The wounds caused by the change will be forgotten more quickly than if you do it over a period of time. Extending such change over too long a period of time permits people to brood about it.

To implement these rules it's best to develop a map of all the people issues.

Post-Acquisition Due Diligence

To implement these rules it's best to develop a map of all the people issues.

There is a service that permits one to quickly populate their information, extract it in a matter of days, then map it out for you to guide your change management program. It includes a structured series of one-on-one interviews and group interviews that all feed into one or more computer mediated assessment and planning meetings.

If you are planning an acquisition, call us. Give us notice and we'll be ready to drop in and hit the ground running on the first day.

Our "Due Diligence Checklists" are the ones used by M&A professionals and have "Questions You Should Ask Before You Acquire or Merge With a Company!" Uncover hidden "Gotchas." Operations, Distribution, Customers, Products, Suppliers.

For more Due Diligence Checklist info visit:
http://clicks.aweber.com/z/ct/?btj5POCl2UwLNil4rn9QiA or look at it's detailed table of contents:
http://clicks.aweber.com/z/ct/?9NC0djCvWkAZlGES43xtVA

If you'd like to purchase our Due Diligence Checklists you can order them by phone at 1-800-948-1700 (ask for Heidi) or you can order them on-line:
http://clicks.aweber.com/z/ct/?oOXYpYrMPsN56SiJYaIYdQ

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