Presentation on due diligence

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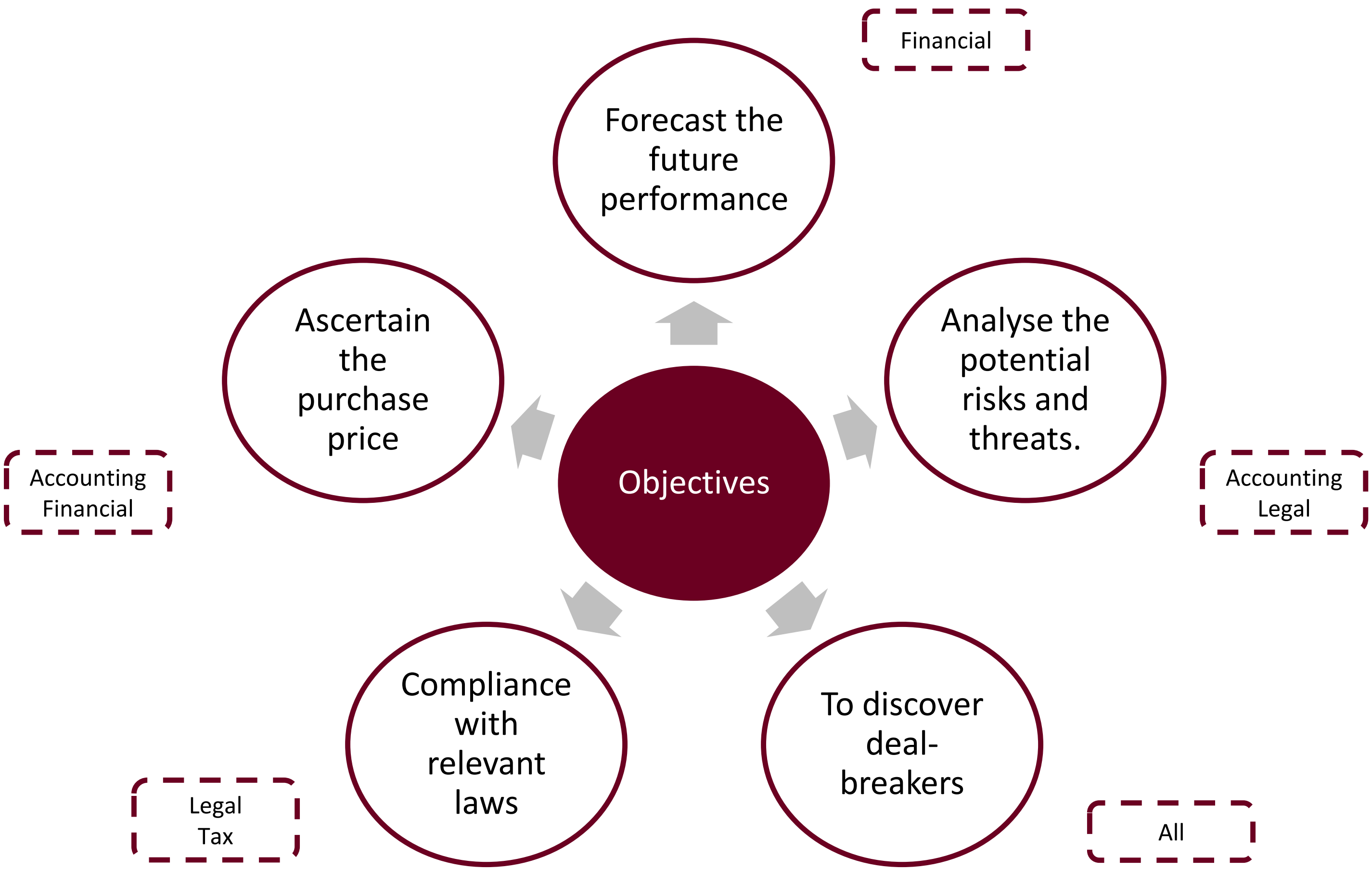
January 27, 2017

Due diligence and its objectives

Due diligence is a process by which all the **relevant information to making a decision** on a particular transaction comes to light!

We as accountants take up the **accounting, tax and financial due diligence process** and closely work with the **law firms and information system audit firms, environmental audit firms, HR specialists** to take up the other aspects.



Due diligence and its objectives

Objective of due diligence	To **investigate** into the **affairs of business** as a prudent business person
	To confirm all material facts related to the business
	To assess the **risks and opportunities** of a proposed transaction.
	To reduce the **risk of post-transaction** unpleasant surprises
	To confirm that the business is **what it appears.**
	To **create a trust** between two unrelated parties
	To **identify potential deal killers** defects in the target and avoid a bad business transaction.
	To verify that the transaction complies with **investment or acquisition criteria.**

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Due diligence process

1. Define scope of the engagement and relevant information requirement
2. Analysis of preliminary information
3. Understanding key transaction drivers
4. Analysis of historic financial information
5. Industry research
6. Benchmark forecasts and proposed deal multiples with market and industry data
7. Discussion with key management personnel to validate findings
8. Discuss the implications of key findings
9. Issue of final report

Types of due diligence

Accounting due diligence

- Review of financial statements and management accounts
- Review of significant accounting policies and compliance with relevant Generally Accepted Accounting Principles (GAAP)
- Historical revenue and cost trends
- Consistency between historical results, versus budget and forecast
- Historical and anticipated capital expenditure and working capital levels
- Review of debt covenants and terms of other debt-like instruments

Financial due diligence

- Basis for future business plan
- Valuation
- Deal financing
- Market dynamics and customer attractiveness
- Industry structure and dynamics
- Distribution channel dynamics
- Business plan review
- Quality of assets

Tax due diligence

- Assessment of tax impact arising from "change in control"
- Assessment of historical tax exposures
- Identifying tax saving opportunities
- Assessment of current tax position
- Assessment of various modes of tax neutral deal structing

Legal due diligence

- Liabilities and potential risks
- Competition authority implications
- Transaction mechanics, execution and closing

Post acquisition accounting

Indian GAAP

Particulars	Amount
Purchase consideration	1,000,000
Minus: Net assets acquired	(400,000)
Goodwill	**600,000**

Ind AS/ USGAAP

Particulars	Amount
Purchase consideration	1,000,000
Plus: Fair value of liabilities assumed	200,000
	1,200,000
Minus: Fair value of tangible assets	(600,000)
Minus: Fair value of identifiable intangible assets	
Customer relationship	(100,000)
Tradename	(60,000)
Non-compete agreements	(40,000)
Goodwill	**400,000**

Buy side v/s sell side due diligence

Are you buying what you think you are buying??

Buy side due diligence → **Assist the buyer maximize his return on the deal**

Do you know the issues a potential buyer may negotiate on?

Sell side due diligence → **Assist the Vendor / Seller get the best value on the deal**

Due diligence enables negotiating team in a transaction to take on critical decisions pertaining to the transaction. The process allows negotiating team to strategize the course of action and terms of negotiations going forward

Due diligence findings

Deal breakers - Issues which would impede the consummation of the proposed transaction

Negotiation points - Issues which would be necessary to consider in the valuation of business / negotiation of bid price

Commercial override - Risks and issues which are knowingly taken over as a calculated commercial decision.

Issues for agreements - Issues which would warrant indemnities and identify conditions precedent for happening of the transaction

Key discussion points

FINANCIAL MATTERS

The buyer will be concerned with all of the target company's historical financial statements and related financial metrics, as well as the reasonableness of the target's projections of its future performance. Topics of inquiry or concern will include the following:

LOOK AT HISTORY……

- What do the **historical financial statements** for the **last three years** reveal about its financial performance and condition?
- Are **all liabilities**, both current and contingent **set forth** in the financial statements?
- Are the **margins** for the business **growing or deteriorating**?
- Are there any **unusual revenue recognition issues** for the company or the industry in which it operates?
- What is the **aging of accounts receivable**, and are there any other accounts receivable issues?
- Has **EBITDA** and any **adjustments to EBITDA** been appropriately calculated?

TO PREDICT THE FUTURE….

- Are the company's **projections** for the future and underlying assumptions **reasonable and believable**?
- How do the **company's projections for the current year** compare to the **board-approved budget for the same period**?
- What **normalized working capital** will be necessary to continue running the business?
- What **capital expenditures and other investments** will need to be made to continue growing the business?

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Key discussion points

<u>TECHNOLOGY/ INTELLECTUAL PROPERTY</u>

The buyer will be very interested in the extent and quality of the target company's technology and intellectual property. This due diligence will often focus on the following areas of inquiry:

- What **domestic and foreign patents** (and patents pending) does the company have? **<u>HAVE THEY MISSED OUT ANYTHING?????   SPEAK WITH THE LAWYERS!</u>**
- Has the company taken appropriate steps to protect its intellectual property? **Are there any material exceptions from such assignments (rights preserved by employees and consultants)? <u>CASE OF PROMOTERS OWNING THE IP</u>**
- **Is the company infringing on (or has the company infringed on) the intellectual property rights of any third party, and are any third parties infringing on (or have third parties infringed on) the company's intellectual property rights? <u>CASE OF IP REGISTERED BY TWO PARTIES AND ONE MADE IT BIG</u>**
- What technology in-licenses or **In Process R&D** does the company have and how critical are they to the company's business? **Implications under US GAAP and New GAAP? <u>IMPACT ON THE POST ACQUISITION P&L</u>**
- Has the company granted any exclusive technology licenses to third parties?

Key discussion points

<u>CUSTOMERS/ SALES</u>

The buyer will want to fully understand the target company's customer base including the level of concentration of the largest customers as well as the sales pipeline. Topics of inquiry or concern will include the following:

- Who are the **top 20 customers** and **what revenues are generated** from each of them? **<u>CUSTOMER CONCENTRATION RISK????</u>**
- What are the **customer retention rates**?
- Will there be any **issues in keeping customers after the acquisition**? **<u>LOOK AT THE CoC clause and assignability clause</u>**
- How satisfied are the customers with their relationship with the company? **<u>DON'T HESITATE TO SPEAK WITH THE CUSTOMERS</u>**
- Are there any **warranty issues with current or former customers**?
- What are the sales terms/policies, and have there been any unusual **levels of returns/exchanges/refunds**?
- **How are sales people compensated/motivated**, and what effect will the transaction have on the financial incentives offered to employees?

Key discussion points

STRATEGIC FIT WITH BUYER

The buyer is concerned not only with the likely future performance of the target company as a stand-alone business; it will also want to understand the extent to which the company will fit strategically within the larger buyer organization. Related questions and areas of inquiry will include the following:

- Is the strategic fit based on a historical business relationship or merely on unproven future expectations?
- **Does the company provide products, services, or technology the buyer doesn't have?**
- **Will the company provide key people and if so what is the likelihood of their retention following the closing**?
- What **integration** will be necessary, how long will the process take, and how much will it cost? **(SPLITTING OF SAP ALMOST COST THE DEAL)**
- What **cost savings** and other synergies will be obtainable after the acquisition? **CONSOLIDATION OF WAREHOUSE AND MANUFACTURING FACILITY**
- What **revenue enhancements** will occur after the acquisition? **INTRODUCTION TO THE INDIA MARKET POST ACQUISTION**

Key discussion points

MATERIAL CONTRACTS…WORK WITH THE ATTORNEY

One of the most time-consuming (but critical) components of a due diligence inquiry is the review of all material contracts and commitments of the target company. The categories of contracts that are important to review and understand include the following:

- Guaranties, loans, and credit agreements
- Customer and supplier contracts
- Agreements of partnership or joint venture; limited liability company or operating agreements
- Contracts involving payments over a material dollar threshold
- Settlement agreements
- Past acquisition agreements
- Equipment leases
- Indemnification agreements
- Employment agreements
- Exclusivity agreements
- Agreements imposing any restriction on the right or ability of the company (or a buyer) to compete in any line of business or in any geographic region with any other person
- Real estate leases/purchase agreements
- License agreements
- Powers of attorney
- Franchise agreements
- Equity finance agreements
- Distribution, dealer, sales agency, or advertising agreements
- Non-competition agreements
- Union contracts and collective bargaining agreements
- Contracts the termination of which would result in a material adverse effect on the company
- Any approvals required of other parties to material contracts due to a change in control or assignment

Key discussion points

<u>EMPLOYEE/ MANAGEMENT ISSUES</u>

The buyer will want to review a number of matters in order to understand the quality of the target company's management and employee base, including:

- Summary of any labor disputes
- Employment and consulting agreements **LOOK OUT FOR CoC Clause, Severence pay clause and Vested and unvested stock option clause**
- Schedule of compensation paid to employees for the three most recent fiscal years **showing separately salary, bonuses, and non-cash compensation <u>KNOW YOUR FUTURE EBIT</u>**
- Employment manuals and policies **<u>SATURDAY WORKING Vs SATURDAY OFF</u>**
- What agreements/incentive arrangements are in place with key employees to be retained by the buyer? Will these be sufficient to retain key employees? **<u>CANCELLING STOCK OPTION AND EMPLOYEE LEAVING</u>**

Key discussion points

LITIGATION

An overview of any litigation (pending, threatened, or settled), arbitration, or regulatory proceedings involving the target company is typically undertaken. This review will include the following:

- Filed or pending litigation, together with all complaints and other pleadings
- Litigation settled and the terms of settlement
- Claims threatened against the company
- Attorneys' letters to auditors
- Matters in arbitration

Speak with the company's outside counsel!!!

Key discussion points

RELATED PARTY TRANSACTIONS

The buyer will be interested in understanding the extent of any “related party” transactions, such as agreements or arrangements between the target company and any current or former officer, director, stockholder, or employee, including the following:

- Any **direct or indirect interest** of any officer, director, stockholder, or employee of the company **in any business that competes with or does business with the company.** **PROMOTERS S CORP DOING BUSINESS WITH THE COMPANY**

- Any **agreements** where any officer, director, stockholder, or employee has **an interest in any asset (real estate, intellectual property, personal property, etc.) of the company**

Key discussion points

ONLINE DATA ROOM

It is critically important to the success of a due diligence investigation that the **target company establish, maintain, and update as appropriate a well-organized online data room** to enable the buyer to conduct due diligence in an orderly fashion. The following are the common attributes and characteristics of an effective data room:

- The target company **makes it available to the buyer as early in the process as possible**
- The data room has a **logical table of contents or directory and full text search capabilities**
- Subject to confidentiality concerns, the buyer is **permitted to print documents for offline review**
- The data room is **indexed to any due diligence checklist** provided by the buyer to facilitate cross-referencing and review
- **Updates** to the data room are clearly marked or **trigger email notifications** to the buyer's counsel, to help ensure that nothing is missed as supplemental materials are added during the process

Valuations in DDR

Valuation approaches

Income approach → Reviewing future earnings and establishing risk factors which may have an impact on required yield

Market approach → Relative assessment with comparable industry firms serves as a benchmark in selection of valuation multiples

Asset approach → Identification of risks relating to assets which may have an impact on the value of the assets

Valuations in DDR

Revenues
Cost of revenue
Gross margins
Minus: SG&A
EBITDA
Minus: Depreciation and amortization
EBIT
Minus: Taxes
EBIT (net of tax)
Plus: Depreciation and amortization
Minus: Capex
Plus/ Minus: Release/ (investment) in working capital
Free cash flows to the firm

$$g = r \times b$$

- Less is more
- Use industry benchmarks
- Growth and reinvestments need to move in the same direction

Cost of equity
Risk-free rate (Rf)
Equity risk premium (RPm)
Beta / Industry risk premium (Rpi)
Size risk premium (RPs)
Company specific risk premium (RPc)
Ke ("Cost of equity")

Cost of debt
Cost of debt
Tax rate
Kd ("Cost of debt") after tax

Due diligence report

The due diligence report would typically consist of the following three sections:

Executive summary:

- This draws to the attention of the Acquirer, any items of concern or otherwise requiring attention and could usually start with the most critical points or deal breakers

Main body:

- This would ideally follow the order and headings of the terms of reference or the checklist

Appendices:

- This section includes data sheets and/or documentation which are relevant to a critical issue

M&A gone wrong!

USD 2.6 billion
Ebay and Skype
Tech integration failure

USD 3.2 billion
Google and Nest
Different company cultures

USD 8.8 billion
HP and Autonomy
Accounting irregularities
DD failure

Key take aways

- **Deal driven by revenue synergies are better compared to cost synergies**
  - Cross selling
  - Strong market position
  - Better utilization of technology

- Make an implementation plan and make it early and make sure you get delivery on it
  - People having **fingerprint on the acquisition plan** need to be part of the post implementation process

- Margin for error – Warren Buffet
  - If deal does not turn out as suggested, but still looks good….**THATS A GOOD DEAL!**
  - Just **SCRAPING** the deal, **DON'T DO IT!**
  - Management has doubts on its ability to implement the deal, **DON'T DO IT!**
  - Target/ Seller not being completely straight forward, **DON'T DO IT!**

- Once deal is structured, **move to close it quickly**

- For Sellers, perform a sell side DDR with a SWOT analyses before approaching potential buyers. **<u>DO A SELF DDR</u>**
  - Analyze why a buyer should pay what they think they must pay
  - View the preparation for sale as an opportunity to be able to close the transaction when opportunity comes knocking
  - Do not make forecast too aggressive. DDR's and deals take time to close. **<u>DON'T GET CAUGHT OUT</u>**

- **Sellers should consider placing before the buyer negative traces** of its business, since it would be terrible if the buyer find out in the course of the DDR.
  - **Set the stage to explain** why the above may not be viewed too negatively.

Thank you!

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