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What is Due Diligence?

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Robbinex surveyed more than 50 private equity groups (PEGs), to understand their expectations when purchasing a business. We discovered many interesting things from that survey, including that:

- The average PEG looks at over 200 opportunities at a time;
- They review detailed information on approximately 50 of those 200;
- They will visit between 15 and 20;
- They issue letters of intent (LOI) to 10 to 12;
- They expect to reach an agreement with four or five; and
- From the original 200 they would complete only one transaction.

As you can see from those numbers very few transactions are completed. What concerned us the most was, that only one in four or five transactions were being completed after having an agreement in place. Further studies revealed that these companies in which letters of intent that had been agreed to, in fact failed due diligence, from the buyer's perspective.

So what is due diligence? It is similar to having a forensic analysis done on all the company's various activities. For example, a company's analysis would include but not be limited to the following: financial reports; the business's market and its position in the market; marketing and advertising programs; sales and distribution methods; manufacturing or processes; the company's technological position in the industry; and the company's customers and their well-being.

In actual fact, large acquirers take this process extremely serious and will abort any transaction that does not meet its requirements. We recently sold a small manufacturing business ($5 million transaction value), and the purchaser's due diligence checklist was 42 pages long – single-spaced.

Why do so many companies fail due diligence? Failing may not be the appropriate term; meeting expectations of the purchaser may be more appropriate. Understanding the M&A process is the first step to understanding the problem. Many companies set strategic goals, which include making an acquisition. Knowing that they will review hundreds of opportunities before finding an "ideal fit", they will send out the word far and wide.

As a result, they will uncover many potential candidates who have not been thinking of selling, and have not prepared their own business for sale. The result will be limited information to determine values, prepare a letter of intent, and complete their due diligence. The original acquisition criteria may have been vague. Once the LOI is agreed to, the acquirer then starts thinking about the strategic goals for the business, and will try to fit the target company into that vision.

We end up with a buyer trying to do a transaction without clearly defined goals and objectives; and an owner, with a letter of intent in hand, who has not prepared his company for sale (but does not want to miss the opportunity of a lifetime). The business owner will incur professional costs, spends days or weeks preparing information, and potentially lose business opportunities due to focusing on selling the business not running it.

Due diligence should be done before a business goes to market. A professional will prepare a data book or profile containing information that any qualified purchaser would require to assess the business, and the buyers need to be qualified as to their 3 M's (Money, Management, Motivation), before any information is provided.

A potential client, (attended one of our workshops) received an unsolicited offer for 1.1 million dollars. He was seriously considering it when he asked us to give him a second opinion. The book value of the company was 1.1 million dollars, contained the usual assets and liabilities plus $600,000 in cash. The shareholder's discretionary cash flow was $600,000 per year. The offer was $500,000 in cash down, a note for $600,000 paid over three years, and the client had to sign a three-year employment agreement to operate the business for the buyer. The true value of the business was about $1.8 million after the cash was removed.

Had this owner taken the time at the beginning of this process to learn the true value of his business, he would not have wasted his time with this proposal. Fortunately, he decided to ask for a second opinion before he sold the business.

Anyone thinking of selling their business should take the time to do it right and have a professional take the Company through a due diligence process, to determine what the value the Company might be to a prospective purchaser, to avoid any obstacles or impediments to the sale of the company that can be removed prior to going to market, and to determine any value enhancement opportunities which may make a significant impact on the value of the company. The professional should then structure the sale of the company in a manner to yield the highest after-tax dollars to the seller.

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