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Buyer Beware:

How to Avoid Common M&A Problems with Uncommon Due Diligence

With sellers understandably keen to position their businesses in the best possible light, all may not be as it seems.

In this month's newsletter, we reveal some techniques sellers use to maximise their earnings and why going beyond a typical due diligence enables you to detect and defuse these potentially devastating financial time bombs.

To be effective, due diligence must be more than a "check the box" exercise. Often, advisors who perform due diligence follow strict regimented lists, similar to the requirements for statutory reporting. However, this may not always be the best approach for your deal.

While it is vital to examine financial statements and scrutinise legal documentation, the most revealing information often comes from walking the plant floor, interviewing employees and probing into what drives your target's volume and profits.

Have Earnings Suddenly Gone Up?

Earnings is one of the key measures a seller tries to increase. There are plenty of simple methods to make earnings look higher. Cutting spending on research and development, advertising, maintenance and other essential business activities.

This strategy may improve short-term earnings, usually at the expense of the company's long-term financial health. The effects are often not felt until years after the deal is completed, when anticipated synergies have not been achieved.

Case Study:

Think Long Term

A technology-driven company with the leading market share was offered for sale. The buyer conducted typical financial, tax and legal due diligence. Although financial due diligence revealed a downward trend in R&D spending, the buyer performed limited technology due diligence, relying heavily on the seller's market position as evidence of its superior technology.

Within months of acquiring the business, two competitors unveiled better technology. It took the target months to respond. The target lost its reputation as the market leader and never recovered.

In industries where a company's continued growth depends on developing new products and technologies, depressed R&D spending is a big red flag, especially if expenditure falls short of industry benchmarks.

If you are considering buying a company whose primary products are at the top of the bell curve, think carefully. Does the company have a program to continue development and replacement products in its pipeline?

Has the Workforce Been Deferred a Pay Rise?

Another simple way sellers can increase earnings in the short-term is by deferring remuneration and bonus payments to a friendly workforce. It is not unknown for a seller to negotiate with its workforce to forego promised salary increases until after the deal is complete, or to agree to pay lump sum payments out of the sale's proceeds. However, this means the workforce will expect the buyer to adjust their salaries to market levels.

Typically, these arrangements are informal and undocumented. Whether the buyer is legally bound by such promises is debatable, however, failing to honour them can be devastating to employee morale.

Thorough due diligence can help you avoid such unpleasant surprises. The first step is to look for deviations from historical salary patterns. If you discover anything unusual, ask employees about any deferred salary or bonus arrangements relating to the transaction.

Can Earnings be Maintained, or are they a One-Off?

Often a seller will identify expenses that are "one-off" or non-recurring whilst ignoring sales which may not reoccur. It is important for buyers to understand whether the revenue and earnings figure is maintainable, especially after the deal is completed.

Case Study: Maintainable or one-off?

A manufacturer of specialised earthmoving machinery ("the Target") sold the majority of its products through distributors. We were engaged to perform the financial due diligence.

The Management accounts showed that sales to a particular distributor ("the Distributor"), amounting to 15% of total revenues, had increased over the last 3 years. Our procedures identified that whilst the Distributor had ordered large amounts during the previous 3 years, the Distributor was unable to on-sell the product and had built up large levels of stock. The impact to the Target was the risk to the collectability of the Distributor's debtor balance and the potential reduction in future maintainable earnings.

As a result of our report, an earn-out mechanism was implemented with other warranties and indemnities included in the Share Purchase Agreement that specifically focussed on this risk. This limited our client's financial exposure.

In situations like this, it is important during due diligence to understand the financial position of distributors and their stock levels. If it becomes apparent there is a stock build, look at whether this is due to the distributor's inability to on-sell the product which will make the revenue non-recurring in future periods.

Giving Diligence it's Due

There are many reasons why M&A transactions fail to meet buyers' expectations: valuation errors, unanticipated costs, culture clash, lack of true strategic fit and poor integration plans. Thorough due diligence digs beneath the surface of financial statements and legal documents. It enables you to anticipate these problems and adjust your valuation or walk away from the deal. In the end, this can mean the difference between success and failure.

For Further Information

For further information, please contact your local Transaction Services Team.

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