Due diligence, it's priceless!

In this article, our corporate advisory expert Michael McCreadie shares his experiences of why conducting due diligence is priceless in any business acquisition.

I often hear from parties looking to make an acquisition that they can't afford to hire external due diligence support (in terms of cost and or time), or they know the business and can do it themselves.

My response is often, can you really afford not to do the appropriate level of due diligence. Three examples demonstrate what I mean.

Client X approached FTI Consulting to discuss problems he was having with one of his businesses. Turns out it was acquired within the last two years. The client admitted that he had not engaged any support to conduct due diligence other than his legal advisors to assist with the sale and purchase agreement. He took on approximately $10m of debt over the past two years to acquire and then keep the business afloat, with much of the $10m including personal guarantees. Unfortunately, given the state of the business and the potential for insolvency it was agreed the business needed to be placed into formal administration, which ended up in liquidation. The client is still dealing with personal guarantee issues arising from the liquidation and in what has turned out to be a very expensive investment.

With hindsight the client readily admitted to underestimating the running costs of the business and the capital investment required, while overestimating the profitability of the business as a sustainable operation, all of which cost them dearly. All the challenges identified by client X would have been picked up through a due diligence process.

Statistics tell us that over 90% of all acquisitions never deliver the intended benefits[1]. Client X's experience clearly falls into this category. Correctly designed due diligence programs not only look to address existing accounting issues, but identify future operational and financial issues as well.

Acquisition failures often can come down to the integration of the acquired business. However, if a comprehensive due diligence process is conducted up front then a large part of the integration planning can be done during the due diligence process ensuring that post integration actions kick off quickly after the deal is closed. Expert due diligence advisors are there to help their clients identify integration issues, not just be the accountants in the room.

In my next example, client Y engaged us to conduct due diligence on a target. A stop start sale process over a two year period resulted in two due diligence reports. During our second review it became apparent the current financials of the target were not a true representation of the business nor at least the future of the

[1] As highlighted by the Harvard Business Review article "The big idea: The new M&A playbook"

business. The forecast just didn't stack up. Through our analysis we discovered issues around changing channels to market that were impacting product profitability and unexplained increases in inventory that future orders were not going to negate. However, after discussing the issues with our client we agreed the underlying business was still valuable and that with certain investment and attention the business could be turned around.

The deal ended up moving forward but only after a 30% reduction in the purchase price was agreed to. An appropriate result for a target in this situation.

Our client was clearly thankful we were re-engaged to look at the past 18 months of operations and that they did not just rely on the previous due diligence report. It demonstrates that it doesn't necessarily take long for sales and cost of sales to turn and a seemingly small change in direction can have a significant impact on profitability in a very short space of time.

Client Z similarly engaged us for due diligence services on a target acquisition. An indicative letter of offer had been agreed between the parties and through our due diligence process we identified an unusual accounting practice resulting in an overstatement of inventory. In addition to this and following an extensive review of inventory levels, we discovered a number of slow-moving items with no obsolescence provision against them.

We shared our thoughts and had an open discussion with the client around the underlying causes of the adjustments and whether this reflected any major business issues. In the end they decided to go forward, albeit with a reduced price at near on 25% below the original offer price.

As demonstrated by the work we completed for clients Y and Z, due diligence is not just about the underlying financial analysis. Our clients are also looking for our thoughts and insights into the business, how it operates, the competitive environment they operate in and the people in the business. They value our input in all these areas, not just the accounting side of things.

So, to come back to the original question, the above examples show that due diligence can not only save you money – through a reduced acquisition price, or indeed result in the acquisition not proceeding on the basis there are too many red flags – it can also highlight areas of future investment in capex, or working capital, to ensure acquirers understand the full costs of the acquisition. Only one question remains. Can you really afford not to do upfront due diligence and engage appropriately qualified external advisors to support you through the acquisition process?

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