

Are You Ready for the Due Diligence Challenge?

Due diligence is a necessary stage in the M&A process, but most sellers would just as soon skip this stressful step if they could. Unfortunately, due diligence is only getting more onerous. In the wake of the recent economic downturn, business buyers are focused on risk like never before. And they're using due diligence to head off negative surprises, such as excessive debt or pending litigation.

Sellers in 2010, therefore, should be prepared to provide a serious prospective buyer with everything from extensive financial records to long-term strategic plans to detailed lists of hard assets. You also should expect the due diligence period to last longer than it might have only a few years ago — potentially delaying the deal's close.

Inevitable development

Although the collapse of the financial markets in 2008 has fueled a more cautious attitude among buyers, ramped-up due diligence is a long time coming. Implementation of the Sarbanes-Oxley Act of 2002 (SOX) was a turning point, as SOX rules required public companies to assume greater responsibility for accurate financial reporting and fraud prevention — including those of the companies they acquired.

Some experts estimate that the average length of the due diligence process now is eight or nine months, compared with an average of four months in the mid-2000s. Several factors, of course, determine the length of this stage, including the size of participating companies,

their industry, whether the seller is financially distressed and whether the buyer is public or private.



In this environment, public company buyers likely will solicit input during the due diligence stage from, among others, risk management, forensic accounting, human resources and information technology experts. Further, it's not

uncommon for a buyer to request a second or even third go-round on a target's financial statements.

Ready for inspection

Although you can't eliminate this extensive review process, thorough preparation can reduce the time it takes. Assemble a due diligence team with representatives from every relevant department to be overseen by your CFO. The team should divide potentially large data production tasks among themselves and regularly report on their progress to the rest of the group. If you don't have the staff to spare or in-house expertise to prepare for due diligence, hire a third-party consultant to spearhead this important effort.

Your CFO also should prepare for the types of queries that risk-averse buyers are likely to make about your financials. For example:

- How much senior debt do you have, when does it mature and what are its terms?
- Are you guaranteeing any other debt of which you're not the principal holder?
- What's the extent of your junior (for example, mezzanine) financing?
- How many leases or mortgages do you hold?
- What's your break-even sales mark, with or without debt servicing?
- What are your primary revenue streams?
- How have your earnings fared during the market downturn?

As with all facets of the due diligence process, it's essential that your company provide candid answers and full disclosures. Any potentially damaging piece of information will come out eventually. If it isn't revealed until after the deal closes, you could face legal and financial repercussions.

Culture critique

Although debt, assets and legal liabilities are at the heart of any due diligence review, business sellers also need to prepare for organizational due diligence. This process typically focuses on a target company's culture to ensure that it won't clash with that of its buyer during the critical postdeal integration stage.

The concept may seem a little vague, but you should approach organizational due diligence as an opportunity to frame your company in a positive light by highlighting similarities and minimizing differences. Your buyer is likely to consider:

- Long-term strategies,
- Business philosophies,
- Organizational structures and hierarchies, and
- Corporate culture, including everything from work environments to employee dress to salaries and benefits.