

DUE DILIGENCE

You're about to buy a business and assume you have all the necessities in place to ensure a smooth transaction. But what about due diligence? One of the most intrinsic factors to consider when buying a new business is to investigate the company thoroughly. It's about minimising risk and the level of due diligence undertaken is influenced by a number of factors. Profit spoke to several experts, all of whom attest the importance of ensuring that risk mitigation is squarely laid out on the negotiating table.

Why should a buyer conduct financial and legal due diligence?

to settlement and also equip the purchaser with important information that may be used to negotiate a lesser purchase price or more favorable terms.

significant losses or facing major risks or liabilities that haven't been properly dealt with or priced into the transaction. Some famous due diligence failures include AMP's takeover of GIO and NAB's purchase of Homeside lending - both resulted in massive losses. Contractual warranties give some protection to buyers but will almost inevitably involve litigation - effective due diligence can enable a buyer to get the purchase price reduced up front or allow a prospective buyer to avoid getting in to an unwise deal in the first place.



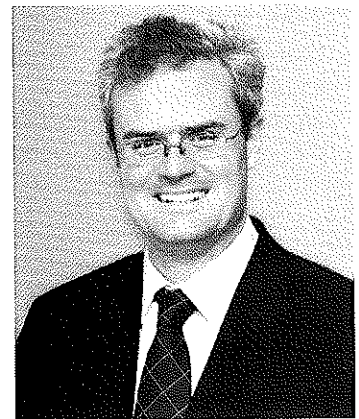
David Rivers, partner WMS Chartered Accountants

Carrying out a due diligence process is primarily a tool to gain a thorough understanding of the business or asset to be purchased. This understanding will mitigate the risk of unforeseen liabilities subsequent

Paul Venus

Partner Holding Redlich

A buyer in any M&A transaction should always conduct some form of financial and legal due diligence. Financial due diligence is critical in order to understand the value of the business you are buying and to uncover accounting or tax issues which the seller may not have resolved which affect the value of the target business and its accounts. Legal due diligence is all about identifying the key legal risks and exposures facing a business, which often lie hidden until a buyer's legal team really drills into issues the seller may not have really considered. Sometimes businesses haven't even obtained licences needed to operate or certain approvals required by law. Due diligence can reveal that some businesses which are supposed to be making profits may in fact be making



Paul Venus

Can you give a guide on costs for different categories? Under \$500,000 up to \$1million and \$1million plus?

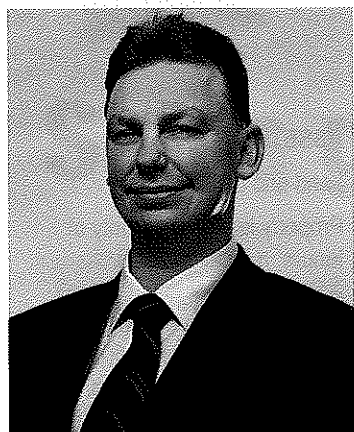
David Rivers

For purchases up to \$500k a financial due diligence engagement would cost in the range of \$5k to \$12k. Above \$1m, the costs will depend greater on the scope of works that is required on that particular engagement, although these engagements may start at around \$15k the more complicated engagement may cost in excess of \$100k.

Paul Venus

Costs can vary significantly depending on the scope of the investigations being carried out. Some professional service firms are prepared to fix their fees and link them to transaction value where the scope of work is well defined and the volume of due diligence material to be reviewed is well understood. However, some buyers are prepared to invest more in due diligence than others and they tend to get fewer nasty surprises after a deal goes through. Often a financier will require a buyer to undertake additional due diligence to give it more comfort (this will be at the buyer's cost).

What are the pitfalls and benefits of due diligence?



Jonathan Tennent
Associate Ashley Munro

The only pitfalls of a due diligence process are that it can take a little time to complete all the investigations, and there is a financial cost involved. In this respect it is important to obtain a quote from the provider once a scope has been agreed.

The benefits of a due diligence can be enormous, as a single issue being identified as part of the due diligence process can save the purchaser significant amount of time, effort and money. There have been a number of transactions which have fallen through as a result of unacceptable risks being identified as part of the due diligence process, and many clients view these due diligence investigations as a small investment that saved them a lot of money.

Does due diligence include a business valuation?



Grant Field
MGI

Usually they are separate engagements. However, valuations invariably consider two main issues – risk and return.

That is, how risky is the business and how certain are the future profits that the business will generate. Many of the things that would be considered in a valuation in relation to risk, would also be considered as part of the due diligence.

Similarly, considering the longevity of future cash flows is also something that is considered in both services. In most cases, an offer would be made (usually via a Heads of Agreement) which would include the purchase price and would be signed subject to completion of due diligence to the satisfaction of the purchaser.

In order to arrive at an offer price, the purchaser will have made some assumptions about risk and return. Once the due diligence is completed those assumptions can either be confirmed or not.

If additional risk factors arise as part of the due diligence then the purchaser has the option of renegotiating the deal or pulling out altogether.

How do you deal with due diligence in 'cash' businesses?

Grant Field

This is very difficult and is generally where the 'chickens come home to roost'. In this case, vendors will invariably have an inflated view of what the business is worth. On the other hand, a purchaser is less likely to pay for profits that he can't see on paper (i.e. in the Profit and Loss Statement). Consequently, there is an expectation gap. If the purchaser is unwilling to pay for invisible 'blue sky', then the vendor may need to revise his expectations of sale price



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Do you look at 'benchmarks' for COGS, margins, expenses, and profit?

David Rivers

Benchmarks are an important tool in the due diligence process. From comparing a target business to others in a similar industry we can identify areas of difference and in turn investigate these in greater detail.

Jonathan Tennent

Benchmarking can be a good way to identify areas in which the business is under performing and therefore opportunities for the new owner to increase its performance. Alternatively a benchmarking exercise can identify areas of exceptional performance, which may be too good to be true.

Whilst industry benchmarking does occur, it can sometimes be expensive to obtain, and may be of little relevance to that specific business. The more common form of benchmarking undertaken as part of a due diligence is internal benchmarking, looking for historical trends and spikes in performance.

How do you treat Work In Progress and Stock under due diligence?

Paul Venus

WIP and stock tend to be dealt with in purchase price adjustments rather than as a due diligence issue.

However, they can be a source of disputes and it is important that sale contracts contain both an appropriate valuation methodology for WIP and stock and agreed dispute resolution processes (eg expert determination).

Do you have a checklist?

Jonathan Tennent

We have several checklists that we use as a starting point depending on the size and type of acquisition being undertaken. Once we have chosen the suitable checklist we remove the items that the client does not require to be investigated and add any specific requests of the client.

Paul Venus

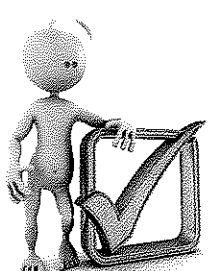

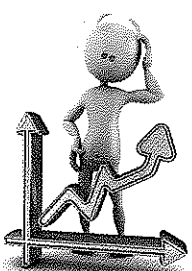
Yes we do and a good due diligence checklist is a great place to start when carrying out due diligence investigations.

It also allows you to target your inquiries and scope the role of external advisers properly. However, at the end of the day due diligence is not 'one size fits all'. No checklist will cover everything and you need to give consideration to the type of business involved and what special risks or issues it may have that need to be investigated.

Grant Field

Yes, but again you can't just blindly follow a checklist. You need to assess risk and weight your efforts to higher risk areas. This will vary from business to business.

Checklist at a glance

<p>STRUCTURE</p> <ul style="list-style-type: none"> Corporate Structure. Chart structure, ownership confirmed, subsidiaries, ABN, TFN Current owners – history, bankruptcy, reputation Details of companies associated Registered Business Names Domain Name Registrations Constituent Documents Trademarks Authorised & issued capital Future trade restrictions / covenants Training for new owners 	<p>ACCOUNTING</p> <ul style="list-style-type: none"> Internal systems – cash or accrual? Assets Creditors, accruals and provisions External accounting – Name of accountant BAS & ATO compliance Stock levels and management reconciled Gross and Net Profit Margins – Benchmarked Returns – Funds invested, Total funds, cap rate Discretionary Expenses Unrelated Income Rental adjustment Wages adjustment FBT adjustment Payroll Tax Private items Compliance Stocks, debtors, WIP 	<p>FINANCING</p> <ul style="list-style-type: none"> Capacity to borrow funds Bank lending criteria Preferred industry bankers Current bankers/financiers Financing structure Projected future financing costs Acquisition costs Stamp Duty  <p>LEGAL</p> <ul style="list-style-type: none"> Actual, threatened or pending claims Past action or claims PI and insurance coverage Contingencies Potential legislative changes Name of lawyer 	 <p>ASSETS</p> <ul style="list-style-type: none"> Land and buildings Property leases – security of tenure, relocation costs. Plant & Equipment Motor Vehicles Work In Progress/Orders In Hand Software Licenses, databases, IP Permits & Licenses Balance Sheet – Debtors Cash Goodwill – Locational, Personal or Commercial
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