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**INVESTORS & CAPITAL**

## Financial due diligence in acquisition: back to basics

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**Very sluggish since 2008, the acquisition market could flash a hint of a recovery in fall 2009. Difficulty in levying debt, uncertainties about the cash flow forecasts, apprehension of stakeholders...the situation has not been conducive to the acquisitions/sales since late summer 2008.**

However, we feel that a number of signs are hinting at a recovery of activity in the field of corporate acquisitions and sales.

**As for major groups:**
• The situation seems conducive to business combinations, sometimes defensive, which can be accomplished without recourse to debt and/or in the form of a paper exchange.
• Disposals of subsidiaries or business activity are studied or even prepared for then being launched.
• Some financially troubled companies under LBO or companies in insolvency proceedings (for example, court-supervised reorganisations) could provide acquisition target opportunities in order to expand industry segments.

***"Targeted, analytical work with conclusions that are clear and pragmatic"***

On the small- and mid-cap market, private equity funds remain rather active, and disposals related to business transfers, delayed since 2008, could start to get moving again for the end of 2009.
As for turnaround funds, rather discreet for now, they could go on the offensive when they consider that business activity is lower and that recovery is imminent.

**In this context, the analyses conducted by "Transaction Support" experts, the authors of due diligence reports, must adapt to new buyer priorities.**
As part of these operations, the analysis of targets is crucial. Potential buyers have therefore called upon specialised firms, particularly in their financial due diligence measures. We feel that the contents of these due diligence measures in the current setting differ substantially from what was required during the period preceding the crisis.

The crisis and its effects on businesses have led to a growing need for assessment and evaluation of risk, through three factors that seem most crucial to us:
• Awareness of the volatility of profitability in many sectors. The level of reference aggregates, mainly EBIT and EBITDA, is not a given that can be projected infinitely by sometimes applying strong growth coefficients; the crisis has provided a brutal reminder of that.
• The updating of certain practices of sellers who maximised the value of their disposal through some "window dressing" actions or sometimes worse (over-valued inventories, off-balance sheet items not disclosed, working capital requirements polluted by non-operating items, etc.). The competition between buyers in 2004–2008 had resulted in the signing of agreements with no protection clauses, which were considered disabling, secondary in this context; the crisis has brought back the need to better protect the buyer.

• The tension of cash flow, which affects most companies, including those that will be the targets for future buyers; this tension is at its peak in companies under insolvency proceedings. The cash position and its growth are undoubtedly the most sensitive indicators in this new context.

These factors are all key issues determining the fundamentals of the substance of the financial due diligence work, which will accompany the corporate merger and acquisition operations of fall 2009.
However, during the boom years for acquisitions, particularly for capital investors for LBO schemes (in 2006, we saw up to twenty investors competing to buy the same company), targets were frequently analysed through a standard product: “Vendor Due Diligence”.
This corresponded to the standards imposed by the London market, filling hundreds (or thousands) of pages, in which compliance with these standards sometimes outweighed the relevance of the analyses and the volume of which could, in some cases, prevent efficient use by buyers, given the very short time frames.
Above all, this document made it possible to expedite an operation’s conclusion. Prepared at the initiative of the vendor, the Vendor Due Diligence was sometimes the only reference analytical document for the transaction. The prospective buyer and its advisors were limited to careful reading and, if possible, had to assess the quality of the data presented. At best, this review of Vendor Due Diligence was supplemented with data presented in an electronic “data room”; any issues raised were addressed during Q&A sessions, limited to a few hours by the clock.

In the new context, potential buyers can no longer be satisfied with this work carried out on a sometimes very incomplete basis. It is now crucial to back up an investment decision with “buy-side” financial diligence work, which should be an in-depth analysis of the figures before any critique. As for the summarisation of this work, the report should be clear and explicit, as the trend of the boom years had sometimes been to dilute the conclusions in a voluminous, stodgy collection.

Thus, the expert must analyse and criticise the financial aggregates and the items likely to vary the value of the target, constitute special safeguards in the agreement, or even compromise the investment decision. For example, the steps in the “buy-side” financial due diligence work include:
- An analysis of the reality, substance, and sustainability of the revenue.
- A study of the recurrence of profitability indicators: EBIT, EBITDA, etc., summarised on tables of restatement of these indicators, which show the “adjustments” made to the indicators initially presented by the target.
- A review of the availability of cash, i.e. the actual possibility of having access to it within a reasonable time.
- An analysis of the actual net debt, including off-balance sheet items that may give rise to foreseeable disbursements, as well as “recurring non-operating” items presented by the target in the WCR; here again, the proposed adjustments are presented in a clear, explicit table.
- A review of the target’s ability to achieve the business (“top line”) and cash-flow objectives indicated in the budgets and the business plan, taking past achievements into account.
- The plausibility of these forecasts, given the market data.
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In addition, in order to be effective, “buy-side” due diligence must be conducted largely on site, in contact with the general management and the financial department of the target in order to obtain answers, additional information, and explanations in real time. If possible, access to other executives of the target (Sales, Production, Technical, etc.), permits cross-checking of information. This is essential in some sectors, such as activities with long-term contracts, in order to analyse the final forecast earnings and the conditions of a contract's execution.

However, the electronic "data room" is still appropriate in very preliminary stages, but it is no longer sufficient for an in-depth analysis of a target.
Thus, among the "lessons of the crisis", there will be a return to "the basics" in the performance of pre-acquisition financial due diligence: targeted, analytical work with clear, pragmatic conclusions. They are intended to provide information about the risks incurred by the buyer of a target and enable preparation for its negotiation and/or protection.
In addition to this due diligence work, it is also important for experts to be able, without the constraints related to performing of regulated professions involving figures, to assist their clients and their advisors during negotiations on prices, price adjustment terms, definitions of reference aggregates, and the wording of the agreement.

**KEY POINTS**

The acquisitions market could flash at hint of a recovery in fall 2009.
Analyses performed by "Transaction Support" experts must be adapted to new buyer priorities.

After several years of accelerated transactional processes, the difficult access to the debt market is once again providing the time to conduct thorough due diligence.

**ABOUT THE AUTHOR**
Frédéric Duponchel is a graduate of ESCP and holds a Chartered Accountant degree. He spent more than fifteen years at Arthur Andersen, where he became a partner in 1999.
Since 2004, he has been Chairman and CEO of Accuracy, a company specialising in corporate finance consulting, which he founded with his associates.
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