Guide to Due Diligence
# Contents

<table>
<thead>
<tr>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overview</td>
<td>3</td>
</tr>
<tr>
<td>The Three Pillars of Due Diligence</td>
<td>4</td>
</tr>
<tr>
<td>The Deal Life Cycle</td>
<td>5</td>
</tr>
<tr>
<td>Scoping a Due Diligence Engagement</td>
<td>5</td>
</tr>
<tr>
<td>Asset Versus Share Transaction</td>
<td>10</td>
</tr>
<tr>
<td>Pricing the Engagement</td>
<td>11</td>
</tr>
<tr>
<td>Preparation</td>
<td>12</td>
</tr>
<tr>
<td>The Due Diligence Process</td>
<td>13</td>
</tr>
<tr>
<td>Due Diligence Etiquette - Key Considerations</td>
<td>14</td>
</tr>
<tr>
<td>Working with Virtual Data Rooms (VDRS)</td>
<td>15</td>
</tr>
<tr>
<td>How to Report Findings and Negotiate the Transaction</td>
<td>18</td>
</tr>
<tr>
<td>Common Due Diligence Mistakes</td>
<td>19</td>
</tr>
<tr>
<td>Key Terms</td>
<td>19</td>
</tr>
</tbody>
</table>
If you have decided to pursue an M&A strategy, and have identified a Target, consideration must be given to Due Diligence – an in-depth fact-finding exercise helping you to understand a Target in detail and establish whether the acquisition makes Strategic, Commercial and Financial sense for your organisation.

Due diligence is a crucial stage in the deal life-cycle, where the Target makes available all financial, legal and other information that is material for the acquirer’s evaluation of the Target and its value. The process cannot be overlooked and can be viewed as an investigation into a Target prior to acquisition, investment, refinancing, restructuring, public listing (IPO) or similar transaction. The process may require many months of dedicated time if the Target is large with a global presence.

The purpose of due diligence is to increase the acquirer’s understanding of key information supporting a transaction – for instance, what exactly is being purchased – therefore, facilitating informed decisions while serving to identify and mitigate key risks pre-deal.

Due diligence helps an acquirer to understand how the business of the Target is conducted and how it may be able to be integrated into an existing group of companies. In addition to it revealing the information required to assess possible financial, legal, and regulatory issues, the process provides valuable insight into a Target’s structure, culture, operations, human resources, supplier/customer relationships, competitive positioning and future outlook.

During the due diligence process the Target is usually expected to disclose everything requested by the acquirer – unless the acquirer is a close competitor and the Target has a very strong position in negotiations.

Companies conducting a high level of M&A activity often develop their own in-house M&A due diligence expertise, while those pursuing occasional transactions usually engage external advisors to assist them.

A successful due diligence process should enable a potential acquirer be able to answer to any question from three conceptually distinctive areas – namely:

- Strategic Rationale for the transaction;
- Risks Reduction (which may result in “deal breakers”);
- Post Diligence technicalities in order to close the transaction successfully (see Figure 1).

The due diligence process should provide assurances that proceeding with the acquisition is the right decision and that the right price is being paid for the Target, identify reasons for price negotiation, or provide suitable rationale for walking away from the transaction.
The Three Pillars of Due Diligence

**Figure 1.**

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<tr>
<th>Strategic Rationale</th>
<th>Risk Reduction</th>
<th>Post Diligence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transaction Rationale</td>
<td>Financials</td>
<td>Revise Valuation</td>
</tr>
<tr>
<td>Market Attractiveness</td>
<td>Tax</td>
<td>Assess Risk</td>
</tr>
<tr>
<td>Competitive Position</td>
<td>Legal Issues</td>
<td>&quot;Go/No Go&quot;</td>
</tr>
<tr>
<td>Value Creation Potential</td>
<td>Human Resources</td>
<td>Transaction Documentation - e.g.</td>
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<td>Integration Enablers</td>
<td>Environment, Real Estate, and Insurances</td>
<td>Disclosure Letta, SPA (Protections &gt;</td>
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<td>IT Operations</td>
<td>Warranties &amp; Indemnities)</td>
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**Standard outputs of the due diligence process may include:**

- Information which may have a significant bearing on the decision to proceed with the transaction;
- Information upon which transaction terms may be based;
- Information which could be used in price negotiations;
- Factors affecting tax and financing structure;
- Risks for which protection in the form of warranties* and/or indemnities** may be necessary.

Due diligence usually takes place upon the signing of the Letter of Intent/LOI (or Heads of Agreement in the UK) with an offer typically predicated on the basis of "subject to due diligence" – see Figure 2.
Scoping a Due Diligence Engagement

The first stage of a due diligence engagement should be to consider the scope of the work required. In doing so, consideration must be given to the significance of the proposed transaction in the eyes of the acquirer, the size of the Target relative to the acquirer and the degree of access to information expected to be granted by the Target.

The company requiring due diligence of a Target should be mindful of (i) what benefits are expected to arise from the due diligence process (ii) the areas of work to be covered by external advisors (if appointed) and (iii) what areas the acquirer may cover themselves via access to in-house resources.

The company commissioning the due diligence should work with the Target to formulate a timetable (also with their external advisors if appointed) to ensure a smooth due diligence process and timely
delivery of findings/the report (which will act as a meaningful decision-making tool).

There is no prescribed format for what a due diligence engagement may encompass – rather, each engagement will be bespoke and tailored to the specific transaction and needs of the user. However, there are some fundamental practical issues to consider when scoping a due diligence engagement:

- **Communication/misunderstanding** due to language barriers and cultural issues if the transaction is cross-border;

- **Timezone differences and public holidays** if the transaction is cross-border – particularly important if either side is working to tight timeframes;

- **Inexperience in the M&A process** (Target, acquirer or external advisors) creating confusion and delays;

- **A smaller Target should be encouraged to use professional advisors** (M&A advisors and lawyers) from the outset rather than trying to deal with the complexities of the M&A process alone;

- **Limited access to the Target** (particularly if competitors) may limit the scope of due diligence possible;

- **For reasons of confidentiality** a limited number of key individuals may be involved with the Target, therefore causing delays;

- **Scheduling/meeting deadlines** may be difficult if several parties are to be involved in the due diligence process (for instance – key management of the Target and any appointed external advisors – lawyers, M&A advisors, consultants).

The scope of a due diligence engagement depends on the user’s assessment of their needs, the nature and size of the Target and transaction and the perceived risks associated with the Target. The extent of due diligence required may vary due to a number of factors.

**The scope of due diligence may be less extensive if:**

- The Target is in a strong financial position (for instance - creditworthy, strong cash reserves, low level of debt, customer contracts in place providing certainty over future revenue);

- The Target is prepared to provide assurances to the acquirer in the form of representations, warranties and indemnities (see p.20);

- The transaction represents an asset purchase (rather than share purchase) with liabilities not being taken on by the acquirer (see p.10).
Conversely, the scope of due diligence may need to be increased for reasons such as:

- The Target is not strong financially (for instance – low credit rating, minimal cash reserves, significant debt, limited contracts in place giving uncertainty over future revenue);
- The Target is unwilling to provide extensive representations, warranties and indemnities;
- The transaction is a share purchase, merger or an asset purchase with a number of liabilities being taken on by the acquirer.
- Due diligence typically falls into the categories as outlined below. To ensure comprehensive coverage a detailed due diligence checklist can be used to assist with the scoping process.

Financial Due Diligence

Covering a review of historic financial results including the balance sheet, profit & loss and cash flows of the Target (including any subsidiary companies to be acquired) with the possibility of particular attention being given to significant projects/contracts, the quality of earnings (contracted and recurring or one-off in nature), how realistic future financial projections are, the strength of the balance sheet (including the composition of assets and liabilities) and the quality of management reporting;

Any tax issues arising – such as historic compliance with mandatory (corporate and social taxes) and any other specific taxes.

It is notable that the scope of financial due diligence is dependent on the availability and quality of financial information and how it organised within the Target (for instance, smaller companies may not produce monthly/quarterly management accounts).

Furthermore, in today’s economic climate particular focus should be given to any pension schemes and the associated liability position, which in some instances, could exceed the total transaction value.

Commercial Due Diligence

Commercial due diligence includes a review of various commercial factors (including those outlined below) and should result in a detailed assessment of the Target’s positioning within its sector.

- Market structure, size and conditions specific to the sector;
- Sector specific legislation (including that which may be implemented in the future);
- Key competitor analysis, market share and positioning;
- Barriers to entry;
• Customer and supplier feedback;
• Health of customer relationships/customer satisfaction;
• Credibility of the business plan;
• Business plan achievability and limiting factors.

Operational Due Diligence

Operational due diligence gives attention to non-financial matters of a Target, which may encompass:

Review and appraisal of systems and processes (including IT systems and the internal controls environment);
  • Review of the key management team and senior staff;
  • Staffing levels and other HR matters;
  • Insurances and risk assessment.

Operational due diligence highlights aspects of a transaction, which can foster improvements in productivity and profitability for the acquirer. Specifically, it can help in quantifying the cost and benefits of implementing efficiency improvements and the resultant impact on price.

Legal Due Diligence

Legal due diligence is as important as financial and commercial due diligence in ensuring the success of a transaction.

The process entails an investigation of any legal risks associated with the rights and obligations of the Target. Areas covered under the scope of an engagement typically include:

• Asset and property ownership;
• Intellectual property (IP);
• Loans;
• Securities;
• Employment;
• Corporate governance;
• Customer or supplier disputes and any pending litigation.
A number of fundamental areas should be covered as part of the legal due diligence process, including:

- Incorporation and existence of the Target;
- Legal and ownership structure;
- Existing contracts (for instance - customers, suppliers, management);
- Adherence to regulations (including a history of any breaches);
- Insurances (including a review of any past claims)

### Human Resources (HR) Due Diligence

The emphasis of due diligence into areas of human resources should be on:

- Compliance with employment laws;
- Employee contracts;
- Employment related liabilities (such as redundancy payments and social taxes);
- Other issues likely to be outlined in a due diligence checklist.

Organisational, culture, and other people issues should ideally be investigated in face-to-face meetings and interviews with key management and other key members of staff within the Target so as to provide an idea of cultural fit between the acquirer and the Target.

Consideration should also be given to post-deal matters and the integration plan from an HR perspective in terms of retention of key talent, communication and integration of company cultures.

A key priority (before the due diligence process commences) is to ensure whether the acquirer is required to file details of the potential acquisition with the relevant competition authorities and if so, whether there is any risk of a potential negative ruling or any requirements for partial asset divestitures, for instance.

### Environmental Due Diligence

Environmental due diligence is an increasingly important part of the due diligence process.

Environmental liabilities can be substantial and difficult to uncover – thus presenting the possibility for an acquirer to be subject to unforeseen costs. Unrecorded liabilities relating to land or water contamination, for instance, can cost an acquirer significant amounts, which can be disproportionate to the overall transaction size in a worst-case scenario.

While there is a downside in failing to consider environmental factors during the due diligence process,
there is also the possibility that environmental liabilities may have been erroneously over-stated by the Target. This could result in key investment opportunities being missed, especially in relation to contaminated land, where recent changes in legislation may have made redevelopment projects viable, for instance.

A careful examination of the assumptions underlying existing environmental liability estimates (if applicable) is essential to the due diligence process and may result in unforeseen upside benefits for the acquirer.

**Asset Versus Share Transaction**

When considering acquiring a Target there are two possible methods of acquisition: one is to acquire the shares of the company which owns the assets; the other is to acquire the assets comprising the Target.

If shares in a company are acquired, all its assets, liabilities and obligations are acquired (even those a prospective acquirer may not know about if they have not been identified through the due diligence process).

If only the assets are acquired only the assets (and liabilities) which the buyer specifically agrees to acquire are identified in the sale purchase agreement.

Due to the limited transfer of liabilities under an asset transaction, the scope of a due diligence engagement could be significantly reduced – saving both time and money. However, an asset transaction is often more complex than a share transaction due to the need to transfer each of the separate assets which comprise the Target and to obtain approvals of any third party contractors or funders. However, a share purchase is often the subject of more detailed acquisition documents because of the acquirer’s need for warranty protection and tax covenants in respect of any unrecorded liabilities within the Target.

The key difference between an asset and share sale lie in the nature of what is acquired:

- **Share Purchase** – acquirer will acquire a company owning a business and running it as a going concern, with the contracts in place and continuing under new ownership (subject to any change of control provisions).

- **Asset Purchase** – contracts or existing trading arrangements will not automatically transfer (other than employment contracts in a relevant transfer) to the acquirer, and these will need to be amended or assigned to the new owner, which will require the co-operation of the contractor.

The tax issues which both parties need to consider will also be important factors as to the appropriate method of acquisition of the Target. Generally, the tax advantages to a seller in a share transaction will be greater than the tax advantages of a share transaction to the buyer, and an asset purchase will often be more tax efficient for the acquirer than the seller.
Pricing the Engagement

When using external advisors to perform due diligence, it is important to define the scope of the work required in the letter of engagement, in order to be clear on the costs to be incurred and to specify what the deliverable will be – i.e. a summary “exceptions based” report, or a detailed document covering every aspect of the Target. A summary exceptions based report is usually advisable since it focuses on any key risks identified and is more reader-friendly.

When asking external advisors for engagement proposals it is important to provide as much detail as possible to those you are putting the due diligence engagement out to tender with (of course, being mindful of any confidentiality issues) in order for the advisors to put together a realistic and comprehensive quote. Any time sensitivities should also be communicated so these can be accounted for in proposals.

If the Target is considered to be “small” there is a risk of not receiving due attention from larger advisors. In addition to pricing the immediate due diligence engagement it is advisable to ask external advisors to quote for performing a closing review (for instance – a review of completion accounts or target working capital/net cash/net debt positions).

It is important to ensure that when comparing proposals from external advisors that you are looking at the same scope of engagement – essentially, “comparing apples with apples” and that there are no hidden extras you will become exposed to cost-wise further into the engagement.

If possible, request a comprehensive service package (often covering financial, tax, legal, HR) since it is much easier to deal with one external advisor. In the case of a major transaction, such as one requiring investment bank involvement, a “lead advisor” could be used to coordinate/project manage the due diligence process and any appointed external advisors. In addition to using a single advisor, it is also common to appoint external advisors to cover the areas of financial and legal due diligence and to cover commercial, HR and operational due diligence in-house.

If working with external advisors it is important to ask for details of past deals/projects the advisors have worked on (ideally in the in the same sector as the Target). A specialist corporate finance advisor (often referred to as a “boutique”) may wish to be considered – for instance, one working exclusively in the TMT sector if the Target is a technology company. A strong understanding of the sector in which the Target is based will maximise the chance of the advisor(s) flagging up key issues, price reducers or potential deal breakers.
**Figure 3 - Suggested Sections of an Exception Based Report**

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<thead>
<tr>
<th>Area in Scope</th>
<th>Observations / Findings</th>
<th>Recommendations</th>
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<tbody>
<tr>
<td>• Fixed assets</td>
<td>• This section of the report provides an overview of key findings from the due diligence process and identifies any risks requiring attention/further investigation pre-deal.</td>
<td>• This section of the report outlines suggestions for any further investigation which may be required and/or what protections the acquirer may seek from the seller (in the form of warranties and indemnities, for instance).</td>
</tr>
<tr>
<td>• Inventory</td>
<td></td>
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<tr>
<td>• Receivables</td>
<td></td>
<td></td>
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<tr>
<td>• Payables</td>
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**Preparation**

As early as practically possible the acquirer should form and begin briefing the due diligence team. A team should consist of skilled financial and legal advisors (all preferably with M&A experience – ideally in the sector of the Target but not essential) as well as being subject matter experts in all key areas falling within the scope of the due diligence engagement.

Team member’s responsibilities should be clearly defined and a due diligence timeline should be drafted.

External advisors should be considered if the acquirer lacks any of the required expertise necessary for a successful transaction – for instance, lawyers, accountants, consultants and/or investment-bank.

Since the due diligence process requires a strong element of project management, it is advisable to appoint one of the selected external advisors to assume a project manager role.

Furthermore, it is advisable to involve the integration team (if applicable) in the early stage of the transaction to allow them to become familiar with the Target and work more efficiently should the transaction complete.

**Due diligence checklists should be drafted** to cover the areas in scope (typically financial, commercial, operational, legal, human resources and other such as regulatory and environmental). These lists should be comprehensive and tailored to the particular risks associated with the Target.
Data requests should be prepared and shared with the Target (and their advisors) once the scope of the due diligence engagement and price has been agreed. Items typically requested include information relating to the Target’s corporate structure and history, statutory financial statements and supporting management information, details of key management, operations, real estate and facilities (including finance and operating leases), intellectual property (IP), key contracts and agreements, employees, suppliers, customers, current/pending litigation, tax issues, insurance issues, regulatory and environmental issues.

The acquirer should negotiate and sign a confidentiality agreement/non disclosure agreement (NDA). This is typically issued by the Target and facilitates the exchange of sensitive information while restricting the acquirer from sharing information with third parties.

Consideration should be given to establishing a physical or virtual (online) data room for the collating of confidential documents (a virtual data room is cheaper and more efficient, accessible via secure log-in and depending on the data room chosen allows for users to be provided with differing access rights).

The Due Diligence Process

A detailed internal and external communication plan should be devised, setting out what can be said across the due diligence engagement, during deal negotiations and into the integration phase.

The due diligence team will be working to confirm the Target’s representations, validate the valuation agreed in the LOI, investigate any legal, regulatory and compliance concerns, and confirm anticipated synergies and integration plans. It is also necessary for the team to consider the “soft” aspects of the Target, such as its corporate culture so as to assess its fit with any of the acquirer’s existing group companies.

Key questions the due diligence team should be mindful of include:

- Are there any problems with the Target, which would force you to abandon the deal, even given a significant price reduction;
- Are there any issues that should bring about a change in the structure, terms, or price of the transaction?

To form a conclusion on the above points, and therefore, to establish whether the transaction should proceed on the terms agreed in the LOI, on amended terms or not at all, the due diligence team will need to ask questions such as:

- Do the Target’s financial statements accurately reflect the company’s financial position?
- Would the integration of existing operations with those of the Target have any adverse effect on profitability?
What is the Target’s outlook in terms of its customer base and concentration, its competitive positioning, and its ability to preserve or increase its profit margins?

Is the Target exposed to any significant and unexpected regulatory, governance, or liability risks?

Have future costs (for instance – a pension deficit) been figured into the acquisition value?

What is the composition and expertise of the Target’s key management team?

Do any clashes of culture exist, which could adversely affect integration of the Target with existing group companies?

Are there any issues associated with long-term sustainability (for instance - availability of raw materials, environmental factors) which could affect the Target’s future?

Who are the Target’s key, value-creating employees, and will they be retained?

If the transaction is cross-border, do any cultural, legal, tax, accounting, employment, merger-control, corruption, or environmental concerns exists, which may impact on a successful transaction being achieved?

The due diligence team may be so focussed on reviewing their individual sections of the engagement that they miss the “big picture”, so it is important for the project manager to bring the team together each day so they can share their findings and adjust the key areas of focus, if necessary.

Due Diligence Etiquette – Key Considerations

The amount of interaction with the Target – in particular, key management and employees;

Whether the potential transaction has been communicated to the employees of the Target (and therefore, whether a “cover story” is required for any on-site fieldwork conducted);

The role of external advisors (lawyers, accountants, corporate finance, consultants, investment banks);

The expertise and availability of internal resources (such as legal and tax advisors);

How much time is available for the due diligence engagement and whether either side has set a deadline for the transaction to complete by;

Request periodic reporting of findings during the process, deal breakers must be highlighted immediately as they are being discovered so that the appropriate remedying action can be taken.
• It is important to advise the Target about the burden of the due diligence process and the resources needed to complete the engagement. In smaller transactions it is possible that key staff of the Target will be overwhelmed with work as they respond to due diligence enquiries – however, no business should be lost because of the due diligence process.

• Aim to combine management Q&A and site visits with third party advisors for reasons of efficiency (avoiding repetition of issues being discussed);

• Coordinate external advisors so that all parties know each other and all important findings are being shared with everybody;

• Schedule regular catch up meetings/conference calls so that all advisors are on the "same page";

• All areas of due diligence provide important input to transaction documentation, including ancillary agreements, seller(s) representations and warranties, escrow/bank guarantee requirements, liability caps (if any) and any specific indemnifications.

**Working with Virtual Data Rooms (VDRs)**

A virtual data room (VDR) is an online store of information that is used for the collating and distribution of key documents in the due diligence process. Physical data rooms (PDRs) have traditionally been used – however, for reasons of cost, efficiency, logistics and security, virtual data rooms have widely replaced physical data rooms.

A VDR is set up as the central repository of documents relating to the Target. A VDR enables the acquirer to view information relating to the Target in a controlled environment where confidentiality can be preserved.

A VDR is designed to have the same advantages as a conventional data room (controlled access, viewing, copying and printing, etc.) with fewer disadvantages. Where possible it is advisable to have documents in electronic format – particularly if the data room index is to be used as a basis for the disclosure letter. Everyone involved in the due diligence process should be mindful of this from the outset in order to track the documents reviewed.

As the due diligence team progresses through the engagement it may find it needs to make additional information requests of the Target (corroborating evidence). Using a VDR, requests for information (and subsequent analysis of this) can be made virtually. However, it is notable that on-site fieldwork (including contact with key management/staff) is also fundamental to appraising the Target and its potential fit.
Benefits of a Virtual Data Rooms (VDRs)

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<th>PDR</th>
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<td>Concept</td>
<td>Digital</td>
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<tr>
<td>Location</td>
<td>Online</td>
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<tr>
<td>Document Format</td>
<td>Digital</td>
</tr>
<tr>
<td>Data Storage</td>
<td>Online Server</td>
</tr>
<tr>
<td>Data Acess (Single or Multiple)</td>
<td>In Parallel - no waiting is required to access information</td>
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- **Added Security** — documents are usually kept in audited data-centres and encrypted during both storage and transfer phases. Documents can be password protected and watermarked (or made available as read-only if desired by the Target). As the administrator, the Target has the power to control security settings — therefore providing them with assurance over who may review confidential information;

- **Detailed Reporting** — both the Target and acquirer may receive email alerts about file activity and follow detailed audit reports back to the source;

- **Advanced Tools** — VRDs often allow users to drag and drop files and sync account folders;

- **Ease of Use** — there is no training necessary, and the cloud-based format means you have no additional hardware requirements.

Recently, thought-leading acquirer companies have turned the tables around when it comes to the due diligence process. They, as acquirers, have started to invite the Target to their own buy-side platform to answer due diligence questions and upload relevant documents — rather than sending the due diligence questionnaires to the Target and relying only on the Target’s provided VDR for information exchange.

A buy-side Due Diligence platform, such as Midaxo, significantly reduces the buy-side team’s workload and provides them with right material at the right time during the due diligence process. It is often much easier for the Target to produce material to order, than for the Target to interpret existing material designed for other purposes. Sellers, too, have praised the change for increased efficiency and enhanced collaboration between the parties, provided by a shared platform such as Midaxo.
VDR Advantages
- Cost Savings - travel cost are saved
- Time Savings
- Comfort
- Transparency

VDR Disadvantages
- Reading Documents Online (preference may be paper)
- System Speed may cause limitations
- Information may not exist in digital form

How to Report Findings & Negotiate the Transaction

Once the findings of due diligence have been reported, their impact on the transaction can be discussed and the acquirer can form a clear view of the options to manage any issues apparent with the Target.

- Draft reports should be circulated internally for additional questions and comments;
- No reports should be given directly to the Target's management – however, key findings will be discussed and negotiated with them;
- It is advisable to organise a physical meeting with the due diligence team for insightful and comprehensive feedback.

There are four main approaches to addressing issues identified during due diligence:

Price Reduction

- If the initial offer for the Target was predicted on the basis of “subject to due diligence” it may be appropriate to revisit the offer. If this is the case, it is important to document the reasons for the change of position since the original offer outlined in the LOI.
- Any change of offer should be linked back to evidence uncovered during due diligence – for
instance, loss of key customer contracts or impaired fixed assets (particularly relevant if considering an asset based transaction).

All due diligence areas could have implications to the pricing of a transaction but key areas are financial, commercial and legal due diligence (historical and future performance, synergy benefits and integration costs and litigation costs). Of course, collectively, other areas provide very useful information to support an argument in favor of any price negotiations sought.

**Legal Protection**

Legal protection should be used in instances of uncertainty or for risk mitigation. Warranties and indemnities are all common outcomes of the due diligence process. Typically these will be included in any Share Purchase Agreement (SPA) with the Target providing representations at the point of sale. Should the Target refuse such provisions, the acquirer may have to be prepared to walk away from the transaction.

**Closure**

The due diligence report may (i) give the Target the “all clear” (ii) identify misrepresentations made by the Target’s management team or (iii) uncover other issues which could complicate the transaction or render it impossible.

If the due diligence team has exposed unexpected risks these can serve as a basis for (i) reducing the offer for the Target (ii) modifications to the representations and warranties required of the Target and/or (iii) changes in the section of the share purchase agreement addressing post-closing adjustments and damages.

**Post-deal**

Some issues such as inadequacies in financial reporting cannot be addressed pre-deal, despite the risk they may present to the acquirer. These can be dealt with using a post-deal plan, whereby the Target and acquirer work together post-deal to validate pre-deal assumptions, develop integration strategies and commence the delivery of short term goals.

In the worst case, due diligence can result in so called “deal breakers” being discovered and the transaction failing.
Common Due Diligence Mistakes

• The due diligence team may misidentify the risks associated with the acquisition or may become so focused on their individual functions that they miss the "big picture";

• The team may overlook the “soft” but important elements of the Target’s corporate culture;

• The team may disclose anticipated synergies associated with the Target to the Target (leading the Target to increase their asking price to capture this value, for instance);

• The team may rely solely on virtual due diligence and never conduct on-site fieldwork;

• The team may be so focused on spotting risks that they overlook opportunities;

• The team may so keen for the transaction to succeed that they ignore key risks identified in due diligence and proceed with the transaction anyway

Points to Remember

• Understand exactly what you are acquiring;

• Valuations need to be underpinned by effective due diligence;

• Effective due diligence requires a team which knows what it is looking for – therefore, it is important to appoint team members who can see what others may miss – both in issues and opportunities. If you lack the requisite in-house resource, reach out to external advisors;

• Consider “deal-breakers” or “deal-amenders” – look for problems with the Target that are fundamental deal-breakers, forcing you to abandon the transaction. Similarly, look for issues that can bring about changes in the structure, terms, or price of the transaction;

• Consider both “hard” and “soft” aspects of the Target;

• Give due attention to the retention of key staff;

• Consider due diligence as the first phase of the integration process. The understanding gained during the process is key to integration;

• If the due diligence team uncovers problems be prepared to walk away from the transaction.
Key Terms

**Warranties** — a typical share or asset purchase agreement (SPA) will contain many warranties. These are statements about the Target, which are given by the seller for the benefit of the acquirer. Warranties usually cover all matters relating to the Target, including specifics relating to financial matters, employees, real estate, and intellectual property.

Warranties serve two purposes: firstly, they provide the acquirer with a remedy (a claim for breach of warranty) if the statements made about the Target later prove to be incorrect, and the value of the company is thereby reduced. Secondly, they encourage the seller to disclose known problems to the acquirer — as the seller will not be liable for any matter to the extent that proper disclosure is made against them. Essentially, the effect of the warranties should be to “tease out” potential problems about the Target.

**Indemnities** — an indemnity is a “promise” made by the seller to reimburse the acquirer in respect of a specific liability, should it arise post-transaction. The purpose of an indemnity in an acquisition is to transfer the risk of a particular event or matter to the seller, and to allow the acquirer to recover on a $ for $ basis in respect of that matter or event.

Indemnities are often used where a warranty may not allow the acquirer to recover damages: for example, because the buyer had knowledge of the matter before signing the SPA or because a damages claim may not be available.

A seller will sometimes provide indemnities covering specific risks, which are of particular concern to the acquirer. For instance, where the Target is involved in any on-going litigation, the acquirer may demand the seller bear the risk of the outcome of the litigation in the form of an indemnity.