An Eye for Detail

By Mano Mahadeva, CPA, MBA | Column Editor

Congratulations! You have identified a company that offers you a platform to expand your strategy. You hire an adviser to help with this transaction. Your legal team drafts a letter of intent, which is sent to the target company for acceptance of your proposed buyout. Euphoria permeates in the board room with a great feeling of accomplishment!

Next begins the process of due diligence, a mysterious amoebic process. This takes many shapes and forms and typically includes: a quality of earnings exercise; tax, legal and regulatory due diligence; a series of meetings between the management teams and key board members; and the earnest scrutiny of many thousands of documents associated with the target and its recent history.

A high-quality strategic due diligence is a key component of a successful M&A strategy – it assesses the heart of the deal and helps answer questions of your investment thesis, such as: Is there truly a return on your investment? Is the potential realizable? Is the overall goal attainable? It really is an integrity check on all aspects of the target's business model and its sustainability, team, product and plans. A well-managed due diligence process can also offer greater insight toward a seamless integration of the target into your company.

So, as a hive of activity begins on due diligence by teams of specialists, such as the quality of earnings exercise, many hundreds of calls between lawyers, consultants, owners and advisors, and several pairs of eyes poring over thousands of documents, does the acquiror spend sufficient time observing the activities of the target at its locations? This includes walk throughs and visits with personnel as part of the evaluation. If not, why not? Below are examples of why these activities are important and why they should be given fair time.

Company Culture. Sometimes we simply ignore, defer or underestimate the significance of people issues during the deal process. As a result, understanding the culture of the organization and the roles and responsibilities and attitudes of people may be cursory, at best. But we need to understand post-merger morale before we close to understand the collective attitude of the prospective employees to assess what they think about this deal and if they are pleased or scared about their future. Is the result a poor attitude that could undermine efforts to change the organization?

Customer Service. What about watching the activity around the reception desk? Are the receptionists focused on customers or are they playing with their smart phones? Do they greet customers well and courteously with a smile? When you walk through the administrative offices, do you see employees treating each other with respect? Do they seem focused on their activities or do they seem harried? These behaviors could provide more clues about the work environment and culture.

> **"A STRATEGIC AND COMPREHENSIVE APPROACH THAT INCLUDES A CLEAR "VISION" WILL HELP YOU DELIVER ON THE RIGHT PRICE!"**

Asset Values. When we price a transaction based on a multiple of EBITDA, this would imply that the assets on the books generate the cash flows for some number of future years. What if the equipment is old and needs to be replaced immediately? Was the equipment bought as part of a prior transaction and revalued and restated on the books at an artificially higher asset value, creating a potential write off soon after we close the transaction?

One site I visited had fresh paint on equipment manufactured in 1970 to portray new equipment to its customers! What if the sites need a major facelift now? When does this get done and who pays for it? What about inventory? Would you change your mind about value if you went on site and saw unmarked, unlabeled items scattered across a site in various closets?

Compliance and Security. Think of a medical office – what if you walked through the clinic and found patient information lying around with the possibility that any person could pick up the patient information easily? What if you see laptops logged in, but the user and owner nowhere in sight? Would you have thoughts on discussion of protocols and procedures if you see specific treatments being given to patients with no physician seen in the room or proximity? What if you see used needles thrown in regular trash bags and not placed in special containers?

You get the idea – no amount of document reviews, phone conversations, in-person management conversations, disclosure statements or reps and warranties will provide such insights as described above. This can only be obtained by personal observation, interviews and walk throughs, critical in any due diligence, by experienced finance personnel.

The examples shown above will impact the way we think about valuation, due to additional capital outlays, expenditures for training and education, process and procedure realignment, and costs related to change management. A strategic and comprehensive approach that includes a clear "vision" will help you deliver on the right price!

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