

JUNE 2016

FINANCIER
WORLDWIDE corporatefinanceintelligence



MERGERS & ACQUISITIONS

Due diligence is the mother of good luck

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Mergers & acquisitions (M&A) can be expensive. While M&A may make sense for strategic, competitive or growth reasons in the long term, transaction costs, including numerous fees to outside parties such as bankers, lawyers and consultants, can quickly add up in the short term. Moreover, in the case of failed transactions, management of would-be acquirers or target companies may find such expenses particularly painful to explain and justify. One type of expense, however, can quickly reap dividends – financial due diligence. While potential acquirers, in order to save costs, may sometimes skip third-party financial due diligence, the latter may be critical not only to avoid unpleasant surprises down the road, but also to enable the negotiation of a lower purchase price of the target company itself. Similarly, sellers can also benefit from third-party financial due diligence. As Benjamin Franklin famously said, “diligence is the mother of good luck”.

An acquirer or seller may engage a financial due diligence firm to perform several tasks, including a review of the target’s historical ‘quality of earnings’. This review may identify and explain non-recurring or non-cash revenues or



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expenses and include a calculation of adjusted EBITDA, a measure of a company's recurring earnings which are likely to generate cash. In addition to adding back to net income the impact of interest, taxes, depreciation and amortisation, calculations of adjusted EBITDA often include addbacks for 'non-recurring' items such as restructuring charges, M&A expenses and foreign currency gains and losses. Adjusted EBITDA can provide a useful, enhanced understanding of corporate earnings, and both acquirers and sellers often apply multiples to adjusted EBITDA to assess the potential purchase price of a target company.

Investment banks often provide their own calculations of adjusted EBITDA. So why is there a need for a financial due diligence firm? For the would-be acquirer, the potential problem arising from relying solely on the calculations of an investment bank is obvious – an investment bank hired by the seller may have an incentive to modify (i.e., increase) adjusted EBITDA to make the target look more attractive. Adjusted EBITDA is not a term defined under US Generally Accepted Accounting Principles (GAAP), so investment banks may apply their own subjective judgment to calculate adjusted EBITDA. For example, some parts

of the East Coast experienced a particularly harsh winter a couple of years ago, which resulted in business interruption and other losses for many companies. Whether, and to what extent, an investment bank adds back such losses in a calculation of adjusted EBITDA depends on the judgment of the investment bank. If an investment bank has included such losses as a 'non-recurring' addback, most potential acquirers are presumably sophisticated enough to assess whether the totality of such losses are, in fact, non-recurring, or if a portion of such losses might recur under normal winter conditions.

Consider, however, less transparent issues. For example, consider a target that manufactures and sells widgets. The target capitalises, rather than expenses, the third-party costs of the design and engineering of the widgets. The efforts of a third-party diligence firm should enable not only the discovery of the target's capitalisation policy, but also the quantification of the impact of the policy on the target's financial results. Or perhaps an acquirer is considering a high-tech target that generates revenues based on licence fees, and in fact, the acquirer and seller are negotiating the purchase price as a multiple of revenues. A diligence

firm could provide critical assistance in both discovering and understanding the target's revenue recognition policy and how that policy affects the timing of revenues (and thus the purchase price). Further, if the diligence firm were to recalculate the target's revenues and earnings under an alternative revenue recognition policy, such an analysis could be a critical negotiating tool that an acquirer could use as an argument for a lower purchase price. In this manner, the cost of hiring a diligence firm can quickly be recouped.

Moreover, a diligence firm's work isn't limited to analysing accounting issues. The diligence firm can also help an acquirer consider the financial implications of alternative economic scenarios. For example, the price of crude oil has dropped precipitously over the past couple of years, resulting in significantly lower fuel costs for airlines, shippers and other transport or transportation-related companies. If an acquirer is considering a company that incurs heavy fuel costs, the acquirer might want to consider having the diligence firm calculate the company's profits if fuel costs were to rise.

As an acquirer, performing thorough financial due diligence is part of getting to know what you are buying. When an acquirer does not fully understand



the nature of the target's business or how that business is reflected in its financial statements, unpleasant post-acquisition surprises or worse, litigation, can ensue. Consider an acquirer that purchases an IT consulting shop based in Asia, with the purchase price based on a multiple of disclosed EBITDA. The acquirer later discovers that the IT shop did not properly apply US GAAP (as the acquirer had believed) and that revenues and earnings, if calculated in conformity with US GAAP, would have been much lower. The acquirer then sues the seller for misrepresentation. Whether or not the acquirer wins the lawsuit (and obtains damages), the acquisition cannot be undone; the acquirer now owns a business that it may not have bought had it known the target's revenues and earnings calculated in conformity with US GAAP. Unfortunately, this and similar stories are not just hypothetical examples but do come to pass. In those cases, the cost of litigation is often a multiple of the cost of hiring a diligence firm.

Moreover, earn-out provisions are not a replacement for thorough due diligence. Because of the uncertainty

of future financial results, many purchase agreements contain earn-out provisions, in which the purchase price of the acquired company is based in part on the acquired company's future earnings following the date of acquisition. Earn-out provisions, however, can themselves result in litigation when the financial results in the earn-out period exceed or fall below the range of either party's expectations.

So far it seems like hiring a diligence firm benefits the acquirer. But can a seller also benefit from hiring a diligence firm? The answer is yes. First, a diligence firm can help a seller prepare the financial documents usually requested by potential acquirers' diligence firms. This preparation helps potential acquirers' diligence processes run smoothly, so that the target can be sold without delays. Second, a seller may sometimes hire a diligence firm to understand what potential acquirers' diligence firms are likely to find. This helps the seller anticipate potential acquirers' concerns, and the seller may even provide a diligence report to a prospective acquirer as part

of its disclosures in the sales process. Moreover, the seller can then point to its own diligence report if a potential acquirer brings one to the negotiating table.

For a would-be acquirer, obtaining a third-party financial due diligence report is like obtaining a third-party inspection report prior to purchasing a home. Some of the cracks in the house are obvious, but an expert can assess if the foundation is slipping. Maybe the house doesn't leak but an expert can say if the roof needs replacement. Or maybe the seller's carpet looks nice but an expert can expose dry rot and a nest of termites. Knowing these problems and assessing the cost of repair is often well worth the cost of the inspection report, and the acquirer can also use the report as a negotiating tool, thereby recouping its cost through a lower purchase price. Similarly, thorough financial due diligence can help put both the acquirer and seller of a target company on the same page and make the sales process more transparent, smoother and less prone to delays or unpleasant surprises. ■