Unpacking Investment Banking

The importance of due diligence

BY RICHARD MANGI

INTRODUCTION

Since time immemorial, Zimbabwe has witnessed shareholder changes in companies through Management Buyouts ("MBOs"), Mergers and Acquisitions ("M&A") and in some instances Joint Venture arrangements ("JVs"). In recent times, the announcement of the Indigenisation and Economic Empowerment Act (IEE) and rebalancing of investment portfolios by investors, in light of the changing Zimbabwe economic environment, gave impetus to some of the transactions. Not all MBOs, M & A or JVs have been successful. Some of the companies that had a change of shareholding eventually went on to collapse or are still facing viability problems post execution of the transactions. The worst cases include shareholders acquiring shells, stripped of assets, working capital and saddled with debt.

There are a number of reasons why MBOs, M & A and JV transactions have not been successful. Reasons for failure of transactions post closure range from the following; miscalculation of risk and reward, inadequate capitalisation and information about the status of the company being acquired of which information is normally collected from a properly structured due diligence exercise. External factors often cited include a change in the economic environment, adverse interest rate movements, currency changes and change in government policy.

The starting point in avoiding failures after MBOs, M&A or JVs transactions is to acquire adequate and substantiated information from the incumbent counterparty through an independent due diligence process. Independence in a due diligence process is necessary in order to separate emotions from fact and avoid undue influence from the party that is subject to due diligence.

There are four critical areas that are normally covered in a due diligence investigation. The following factors are the key elements of a due diligence exercise:

- Technical due diligence;
- Legal due diligence;
- Financial due diligence; and
- Commercial due diligence.

Information emanating from the exercise is presented in a Due Diligence Report. It covers the above mentioned areas and usually extends recommendations on the course of action to the party commissioning the due diligence.

The Report also forms an important input to the valuation of the target entity as it provides both historical financial data, current status of operations and future plans of management and shareholders.

WHAT IS A DUE DILIGENCE?

Due diligence is a structured and focused investigation of a business entity or counter party in a transaction. This is mainly to confirm all known facts before entering into an agreement or a financial transaction. Due diligence is an important and necessary process done before execution of various types of transactions which include MBOs, M&A, JVs and lending transactions.

It is carried out for the purpose of getting a deeper understanding into the status of the other party involved in a transaction before the execution of a deal. The due diligence process that is properly done establishes an understanding of both the risk and opportunities of a target entity. In the case of an M&A transaction, a due diligence is usually performed by the buyer but in JVs both buyer and seller require the investigation of the counter parties. In lending transactions, the lenders usually do an extensive due diligence on the prospective borrower whilst the same exercise executed by the borrower is usually limited to verifying authenticity and capability of the lender.

A due diligence contributes significantly to informed decision making by enhancing the amount and quality of information available to decision makers. The extent of the due diligence exercise is also informed by the size of the potential transaction as well as the availability of monetary resources to be dedicated to the exercise.

TECHNICAL DUE DILIGENCE

A technical due diligence exercise is primarily focused on investigating technical aspects related to a target company. Typically, a technical due diligence exercise seeks to document the mechanical aspects of a company which may include an understanding of the company's equipment in terms of age, condition, value, technology, processes, maintenance programs, replacement plans etc.

In MBOs, M&A and JV transactions, a technical due diligence will assist in providing information about machinery and technical compatibility as well as the condition of the target company's machinery. This exercise also helps decision makers to evaluate whether the target company's equipment will materially impact on productivity and performance going forward. Equipment replacement is usually a huge capital expenditure for an entity and as such a technical due diligence becomes important in verifying equipment life span and maintenance records. This information will usually indicate whether the acquiring company will need to spend more money to replace equipment in the future.

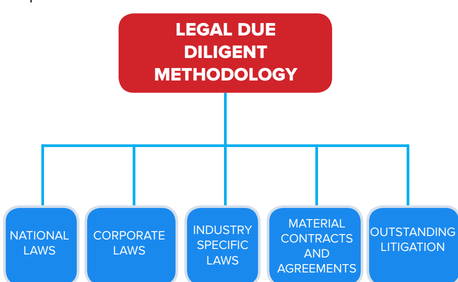
Investors usually appoint an independent entity with the technical expertise within the respective industry to carry out the due diligence and interpret the outcome for purposes of decision making.

Many companies that failed to do a proper technical due diligence have been left holding on to obsolete equipment while the previous owners walked away from the equipment replacement burden.

The Zimbabwe Independent article of 25 January 2013, highlighted a classic case of the pitfalls of inadequate technical due diligence in which a Zimbabwean bus operator who in 1991 bought the luxury coach service, Express Motorways from Unifreight International. Post-acquisition, the nearly obsolete fleet of buses started presenting technical challenges that eventually collapsed the entire business.

LEGAL DUE DILIGENCE

Legal due diligence is an investigation of all the agreements, contracts, legally binding commitments, past and outstanding litigation pertaining to a company. Legal due diligence also reviews the legal and regulatory environment that a company is operating in. The focus of a legal due diligence investigation is multi-pronged as depicted below:



Agreements and contracts which may relate to trade, financing, supply, employee engagements, equipment purchase, collaboration and JV agreements will need to be reviewed by a competent person to establish their impact on the transaction at hand.

A good example of the need to review legal agreements relates to long term funding or lines of credit for businesses like real estate development or cotton and tobacco merchants. These companies enter into financing agreements with lenders that stipulate that any material changes in shareholding without the consent of the lender may be viewed as an event of default. This can be the basis of the calling up of the loan by the lender. Without a complete review and understanding of this agreement, a new shareholder may be faced with various loans being called up, thereby affecting future business prospects.

It is important that parties to a transaction have a full grasp of guiding laws within an industry. These may be statutory regulations, industry specific regulations as well as procedural and compliance requirements within an industry or country. Non-compliance with legal frameworks usually compromises the prospects of concluding an MBO, M&A or JV transaction. In Zimbabwe, compliance with Reserve Bank of Zimbabwe's Exchange Control regulations, the Competition and Tariff Commission's ("CTC") directives and Indigenisation Economic Empowerment constitute some of the regulatory frameworks which may result in penalties which eventually may make a transaction unviable, usually with loss of value for the shareholders. In some instances, agreements have been withdrawn due to non-compliance with regulations.

In November 2014, Innscor was forced to withdraw from a transaction in which it sought to acquire a 59% stake in Profeeds through Irvine's Zimbabwe when the Competition and Tariff Commission, deemed Irvine's and Profeeds to have entered into an exclusive dealership arrangement. The deal was considered by the CTC to have the effect of excluding competitors from accessing the services of a key distributor, Profeeds. Whilst the CTC proposed some remedies that would see the transaction proceeding, the parties decided to walk away from the proposed transaction, in the process time and money had been lost.

COMMERCIAL DUE DILIGENCE

The objective of a commercial due diligence is to investigate all the commercial aspects of a company. A commercial due diligence therefore is a broad investigation that seeks to review a company's attributes relating to production processes, competitive advantages and limitations, distribution networks, sales channels, products and product development, sales strategy, pricing structure, demand, sourcing of raw material etc.

A commercial due diligence also takes a critical look at the business model of the company and its efficacy noting scope for improvements and modifications of the model. In order to put all of the commercial aspects of the company into perspective, the commercial due diligence also reviews the industry structure and the market share structure of industry players. Various tools such as the BCG matrix, SWOT analysis, PEST analysis, Porter's Five Forces Analysis, Value Chain Analysis and the Ansoff Matrix can be utilised to analyse the various commercial aspects of the company.

The Harvard Business Review of July 2014, documents the impact of inadequate commercial due diligence processes. In 2008, Bank of America ("BoA") acquired Countrywide Financial ("CoF"), a mortgage lender which had been one of the leaders in home mortgage originations for USD4.1 billion. Just as the deal was being finalized, the mortgage market collapsed, triggering the Subprime Mortgage Crisis. As it collapsed, BoA realized that the quality of the mortgage assets had been grossly overstated and that CoF had engaged in dubious marketing and underwriting practices.

A review of human resources issues is another important aspect of a commercial due diligence investigation noting that human resources usually form a major cost component in an enterprise. A human resources due diligence review will typically focus on the company's employee manning levels, remuneration, staff turnover and reasons thereof, recruitment policy, labour issues, skills gaps and training arrangements.

Organisational culture has become an important aspect of human resources' due diligence reviews. A 2006 Economist Intelligence Unit ("EIU") white paper showed that 67% of survey respondents had found cultural integration to be the most critical success factor in M&A deals.

The 1998, USD36 billion transatlantic merger of Daimler Benz (Germany) and Chrysler (USA) is considered a classic example of the pitfalls of inadequate human resources due diligence focusing on organisational culture. The structural and financial merits of the deal were considered ideal for the merger; however a hierarchal approach to doing business by Daimler Benz management team against a risk taking, entrepreneurial approach by Chrysler management team resulted in friction between the American and German management teams. After nine years of disappointing results of the merged firm, the deal came to an end when the Chrysler Division was sold. A due diligence covering cultural aspects of the two entities could have led to a different change management approach.

Inadequate analysis of the operating environment using the various tools identified above often leads to parties in a transaction facing the wrath of shareholders, investors and the market. Failure to recognise changing market and industry trends during a due diligence often results in the merged entity failing to achieve the intended goals. In 2004, Time Warner and AOL merged with a view to create a communication powerhouse of traditional and electronic media. The merged AOL –Time Warner started to face competition from the advent of new technologies such as broadband, DSL and other, faster Internet gateways, and resultantly AOL lost subscribers to competition and the merged company went on to lose 80% of its value and eventually AOL assets were disposed of at a loss.

FINANCIAL DUE DILIGENCE

A financial due diligence review investigates issues relating to the finance and accounting aspects of a company. In essence, this investigation will interrogate the accounting system, accounting policies, accounting entries, the systems used and how requisitions and payments are approved and made.

Furthermore, and more importantly, a financial due diligence will make a critical review of the financial statements, which are the statement of comprehensive income, the cash flow statement and the statement of financial position. It is therefore typical that information relating to audited accounts prepared over a reasonable period such as five years are requested in a financial due diligence. Another important aspect that is critically reviewed in a financial due diligence relates to the tax standing of the company, particularly historical tax payments. In cases where the historical tax position of a company is not investigated and cleared in an acquisition transaction for instance, the acquiring company may be saddled with the tax liabilities of the target company.

The complexities of financial information and financial systems coupled with the ever changing regulations such as International Financial Reporting Standards, has often seen parties to an MBO, M&A or JV transaction. In return this brings in accounting experts to provide a better analysis of financial information presented and identify creative accounting techniques if any. Creative accounting techniques capitalize on loopholes in generally accepted accounting principles in order to disguise financial performance, such as keeping debt off a balance sheet.

In an RBZ report dated 24 January 2006 on troubled banking financial institutions, the RBZ aptly documents creative accounting in a merger transactions in which CFX Financial Services whose merger with Century Holdings Limited eventually resulted in the collapse of the merged entity, CFX Bank Limited. The RBZ report notes that the collapse of CFX Bank post the merger transaction partly emanated from "manipulation of computer generated financial statements in order to conceal accumulated and monthly losses……… and creation of fictitious assets in order to conceal the losses and funding gaps on illegal foreign exchange deals". The extent of the problem was not identified in the due diligence phase of the transaction and the merged firm, CFX Bank Limited was later to be placed under curatorship on 17 December 2004, just four months after the merger transaction.

On the international scene, one notable case of inadequate financial due diligence oversight was the acquisition of Autonomy Plc by computer maker HP in 2012 in a USD11.2 billion acquisition transaction. HP intended to acquire Autonomy to diversify from hardware to software computer business. Inaccurate income statements, balance sheet and cashflows statements resulted in HP writing down USD8.8 billion as HP was made to believe that the growth and sales of Autonomy were stronger than they actually were. HP was later sued by shareholders in a Federal Court for not performing adequate due diligence.

DUE DILIGENCE AND COMPANY VALUATION

Once a due diligence is complete and parties to the transaction agree on the status of the company, the big discussion will centre on the valuation of the company. Due diligence reviews are often a precursor to valuation of a target entity. Information garnered from a due diligence forms the base of various aspects of valuation models irrespective of the valuation methodology to be used.

In circumstances where Discounted Cash Flow ("DCF") valuation methodology is considered the most appropriate method to value the target firm, information from a due diligence review forms the basis of the assumptions in the DCF valuation model. Information about historical performance, production processes, company cost structures, competition and economic trends in relation to the company's operating model, provide a credible basis of establishing the financial projections of the company on which discounted cash flow and continuing value of the entity will be based.

The information from a due diligence therefore forms the basis of the valuation models, which if properly taken into account, assists in the auditing of the valuation model by both parties in a transaction, thereby reducing areas of disagreement in transaction negotiations and pricing of the target entity. In subsequent articles, we will focus on the various valuation methodologies that may be employed to determine value of a company.

CONCLUSION

Performing a thorough due diligence is a very important and prudent exercise that enables a company to have sufficient information for decision making before executing a deal. As highlighted above, due diligence reviews, especially for large transactions involving companies with complex operations and sometimes cutting across jurisdictions, require experts, notably, technical, commercial, legal and financial personnel. A thorough due diligence often leads to informed choices by both parties to a transaction. Information emanating from the due diligence review generally determines the future of the company hence a due diligence is an important building block in determining the value of a company.

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