Diamonds in the rough: What to look for during due diligence

This article is the third of five in our 'Diamonds in the rough' series and explains what to look for during the due diligence process when considering the purchase of a distressed business.

After identifying a distressed investment opportunity, swift due diligence needs to be performed on the business to quickly determine whether turnaround strategies can be implemented to drive profitable growth and create a 'gem' of a business.

Discovering valuable diamonds

Discovering the true hidden value of a distressed company (or a discrete business segment) often relies on engaging independent third-party advisors with experience in conducting due diligence in special or distressed situations.

While the due diligence process is critical in any M&A transaction, it can be particularly challenging when looking at distressed opportunities as you often face limited timeframes and need to prioritise the areas to focus the due diligence on. Invariably the priority is always on what is the short-term restructuring plan, how much will it cost and who is going to implement it. Anything beyond this will only be possible if time permits.

What to look for

Prior to committing to a distressed transaction, a buyer should focus its due diligence effort on understanding where the business has been, what drove the distress (for example, was it a one-off event or more of a systemic issue such as slow economy, low commodity prices, failing product lines, market share or mismanagement), and ultimately how the business can be improved in the future. Listed below are some of the key focus areas in any due diligence process:

Financial

Buyers will need to quickly obtain clarity and comfort over a target's historical performance, financial forecasts, and turnaround prospects. Consider:

- What restructuring actions have been taken to date and why were they unsuccessful;
- What are the turnaround options available to the buyer post-acquisition to deliver an improvement in performance and what level of investment will be required;
- What is the short-term cash flow for the business and how certain is it;
- Are the forecasts realistic and achievable and what are the key sensitivities;
- What level of working capital is required to operate the business and what investment in capex is needed to stabilise and grow the business;
- What cost savings or synergies can be extracted post-acquisition; and
- What is the ability of management to drive a turnaround and deliver the required performance improvement outcomes (who may need to be replaced, who is critical)?

Key agreements

Conducting a review of key agreements and contracts relevant to the target's operations is another critical part of the process particularly as to how they may impact any short-term restructuring plans. Key contracts to quickly understand include:

- Customer and supplier contracts;
- Loan agreements;
- Equipment leases;
- Property lease agreements;
- Employment agreements;
- JV or partnership agreements;
- License, franchise, agency agreements;
- Exclusivity agreements; and
- If there has been any prior M&A activity, the past sale and purchase agreements.

Buyers should also determine if any key agreements impose restrictions on the right or ability of the target (or buyer) to compete in any line of business, or geographic region. Be on the lookout for changes in control provisions which may complicate a sale process – be proactive during due diligence and seek to quickly obtain counterparty consents to secure contracts post-acquisition.

If acquiring less than a 100% interest in a business, understanding the rights and obligations of shareholders under a shareholder agreement is important. If you intend to rely upon 'drag along, tag along' terms to eventually acquire a 100% interest, ensure you understand the mechanism for invoking these provisions.

Customer and sales

Buyers need to understand the company's existing customer base and future sales pipeline, particularly where there may be past performance issues. Contacting key customers to ensure they are not in the process of disengaging is highly recommended.

This includes identifying dependence on one or a small group of customers, potential customer retention issues post-completion, seasonality of sales, general sales terms and conditions, sales staff compensation arrangements, and the stability of relationships with both employees and customers.

Management and employees

An assessment of a target's employees is critical to understanding the commitment and focus of existing management and staff. In distressed situations, it is common for management to be focused on survival and maintaining liquidity, rather than delivering on strategic growth options available to the business.

It will be crucial to carefully plan interactions with management and focus on key issues impacting the business. Whether key personnel have the required skill set and capability to deliver a turnaround, or whether you'll need to supplement or replace key personnel are genuine issues to overcome.

Decisions will also need to be quickly made on whether the target's employee base requires reducing. New owners will inherit liability for employee entitlements such as accrued annual leave and long service leave. Recognition of employee entitlements, particularly contingent entitlements such as long service leave, can be a key risk area. Buyers should ensure a fair deduction is provided at transaction settlement.

Suppliers

As with customers, understanding what significant supplier relationships exist and where there may be dependency issues are key. Again, in a turnaround situation supplier terms may have been stretched and relationships may be strained, so understanding what is needed to get suppliers back on side is imperative.

IT systems

Buyers need to be comfortable that a company's IT system can operate smoothly post-completion and/or be integrated into their own IT platform.

Consider the level of external IT support required and whether existing systems are capable of generating meaningful information for management decisions during a turnaround.

Intellectual property (IP)

Buyers should understand what IP exists (or is pending) and be satisfied that IP assets are properly registered and belong to the business.

If IP is not owned, ensure adequate licensing agreements are in place, or if there are any IP litigation proceedings in progress.

Tax

Due diligence will determine if a company has correctly calculated, recorded and discharged historical tax liabilities. It also gives the buyer an understanding of the company's historical tax compliance and possible future tax position.

Insurance

A review of key insurance policies is critical to ensure existing cover is adequate to support the business moving forward when implementing post-acquisition restructuring and turnaround strategies.

Tips to help you find a real diamond

1. Check for its potential shine. If you think you have found a distressed business to acquire, analyse historical information sufficient to inform you of post-deal projections. Know the numbers and conduct a sensitivity analysis to model the potential impact of post-acquisition restructuring initiatives.

2. Look for sharp edges. Due diligence in distressed situations should quickly identify a target's sharp edges i.e. what drove the decline, what can be changed and what will be outside your control. Distress can create unique opportunities and challenges for a buyer to make its mark on a business and improve performance.

3. Check for toughness. Consider how the management team has responded to trading pressures and declining performance. Honest, reliable, resilient, trustworthy and competent management teams are crucial to operating a business and delivering on a turnaround plan.

Swift due diligence in distressed investment opportunities enables potential buyers to quickly evaluate whether the target business is a suitable investment. With the right advice in determining price and associated terms, buyers may just find themselves uncovering a diamond in the rough!

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