Mergers, Acquisitions and Corporate Restructuring
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Lecture - 10
Acquisition Search and Due Diligence - 1

Hello friends, in this session we will continue with the due diligence process that is taken care in M and D which is very vital process. In the previous session we talked about acquisition search and also, we introduce the diligence we defined the diligence in the previous session. In this session we will be discussing more about due diligence and different steps involved different aspects covered as part of due diligence.

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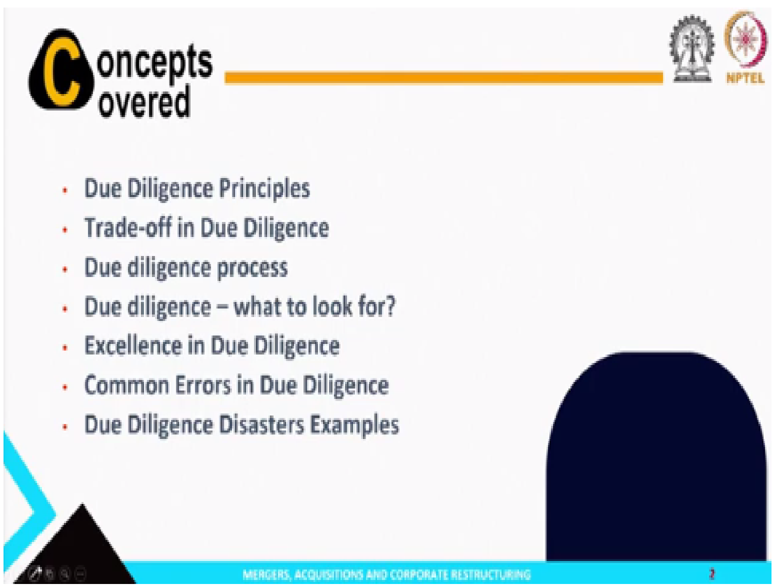

So, the outline the concept that we are going to cover is due diligence if the principles then what the trade-off in due diligence. When somebody does what they trade of that takes place or the due diligence process then we have what to look for due diligence what are the different things that you are look for in due diligence. Then we will have how to have an excellence in due diligence.

We will also talk about the common errors the companies might be doing or making while doing due diligence. We also have one or two examples about due diligence disasters. How the companies could not do, the possibly did not do the designs properly and that led to post mundane problem for those companies.

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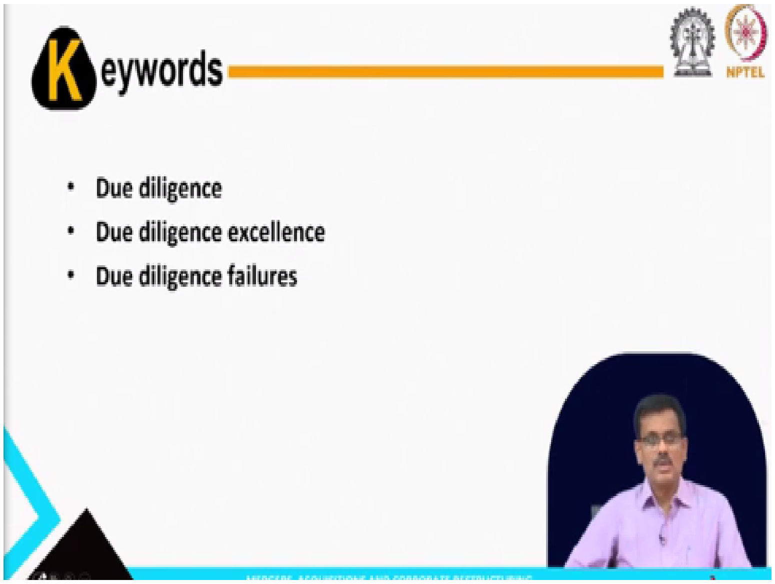

And the keywords you have here due diligence, due diligence excellence and due diligence failures.

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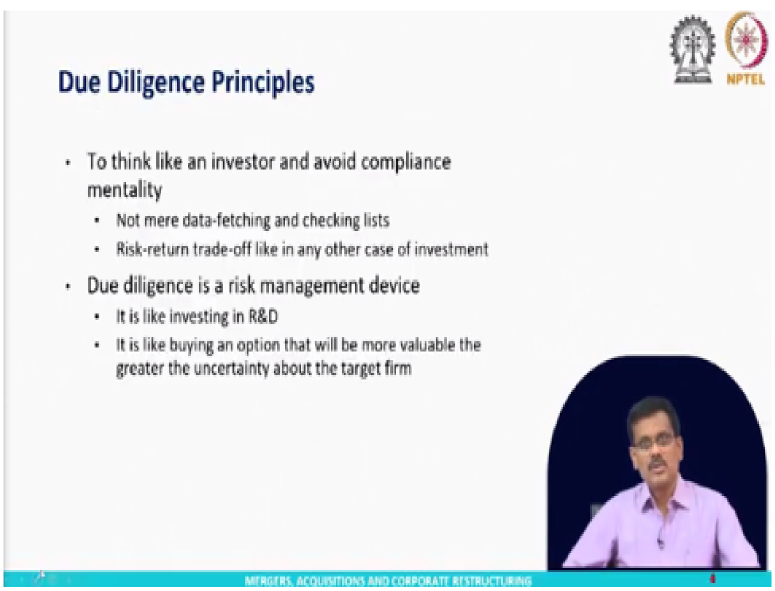

Going back to the principle that you are continuing with the previous session is a due diligence the acquiring company has to think like an investor. When you are doing an investment for that matter whether it is organic or inorganic you have to look at different opportunities involved zero down on certain things, yes, we look at different aspects. We look at different avenues then we look at this, particular target may be useful.

And also, you look at that what the risk return trade up there how much risk you are taking by acquiring this particular company. And whatever return we are going to get access like any investment we have tradable risk and return it has to be their assets, it is not just you face the data and make a checklist. It is not like that is beyond the checking making a checklist while doing due diligence it is a very involved process and it involves lot of things to say assets.

So, in that case due diligence like you know a risk management device, that means if you have taken care well then post **(()) (02:45)** the problems are going to be lesser or not going to be there for that matter typically in during integration you are prepared for certain problems. because you have done the due diligence very well. So, due diligence can given guidance that yes, something has to be done at the time integration.

So, then we will be prepared for that. It is like investing in a recession development R and D companies spend lot of money but nobody can guarantee that yes, they are going to be successful. But without R and D companies cannot survive, particularly certain sectors for that matter may be inference technology may be in pharmaceutical sector whatever R and D is an important driver. The company has cannot have a choice not to have racism development.

They must have R and D and all R and D may not lead to a product or change in process. Several R and D efforts can also be unsuccessful just because you would want successful, we cannot stop spending around this. Similarly, so you do not know what is going to happen the future and post time **(()) (03:49)** whether it is uncertain about that but we cannot say, will not due diligence. Because there is no uncertainties it is always better to do the due diligence assets.

So, it is like you in financial market we say you have an option to buy an option gives a right to the option holder to do something or not do something. It is an obligation it may it means so you have an option to do something. So, due diligence option you may not do but finally it is the acquiring company he is going to pay for it if there is a problem assets.

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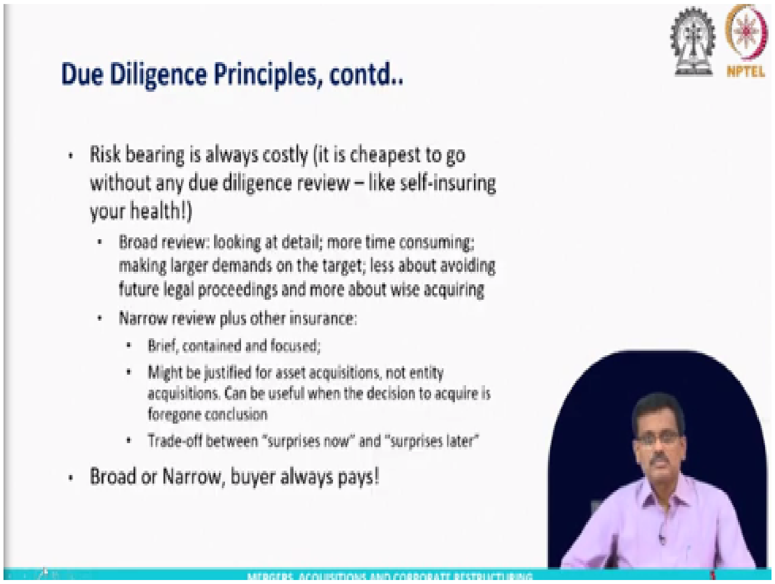

So, due diligence has to be done very carefully and yes risk bearing is very costly always no doubt and one can also go for an acquisition without the religions it is a foreground conclusion like in your personal life one may not go for any medical insurance for our health insurance and one may say that we will meet the medical expenses at that point of time when there is a problem access.

That is also possible or if somebody has gone for a health insurance possibly, they can meet the obligation meet the expenses much better. Because you do not know what is the amount of expense will be incurred in the that product if our health problem. So, it is like self-insurance you do not do an due diligence as such in broad. One you can have very broad view of due diligence where you have look at every detail it is lot of time consuming.

And you have to ask for so much information for the target you give this information give that information it may be irritating for them. But you still ask for information because that is the policy that is the desirable assets and but if you are aware about the company much better. Now possibly there will be less legal complications in future and you are going to be your equation more wise acquisition for that matter that is there in broad one.

Narrow one yes, you can be looking at certain aspects of due diligence in certain aspects the business may not be look that. But you can brief and can be focused also but this narrow due diligence is suitable for acquisitions which is a foregone conclusion. Suppose the top management has decided that we will go for it for whatever reason then you will be doing limited due diligence.

And similarly suppose you are acquiring an asset not acquiring a company suppose you are acquiring a building or plant or facility for an expansion not acquiring a company. Then you just look at that particular asset and then do due diligence and that is enough for us, enough for the company. So, at the end of the day if you do the due diligence now properly you get the surprises about the target now.

Otherwise, surprises is there you will definitely get it later no doubt about that whether you do a broad due diligence or narrow due diligence it is the acquiring company the buyer has to pay for it. They only will be sold it is like we say in the market scenario in the law commercial law also. We say the buyer be aware so it is a buyer who has to see that what they are buying seller may not be that concerned about it.

Because they are going to dispose of their company or sell the company for that matter is a buyer who has to be aware about the what they are actually buying assets.

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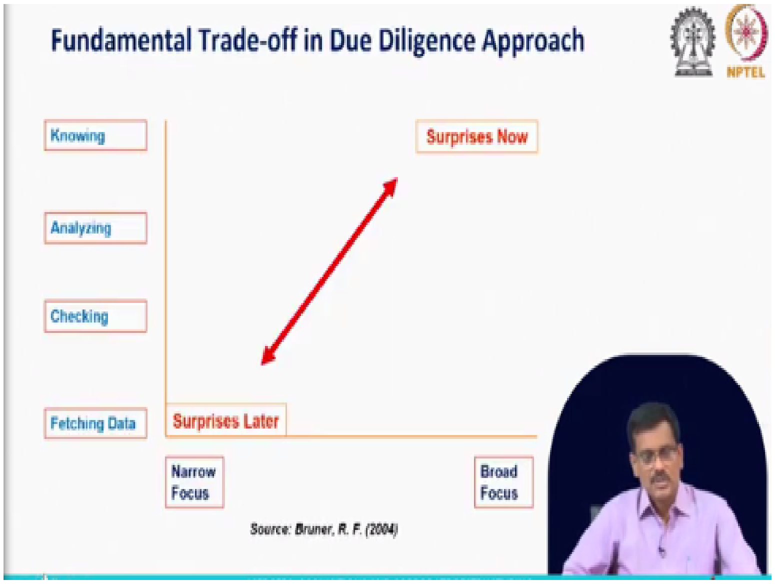

So, and this is the process we have this is a diagram talking about that yes you may have surprises now or surprises later. So, if you are focusing only fetching the data and making a checklist then tick tick mark then it is something like that yes, you will get the surprises tomorrow, later maybe after the internal integration starts. But if you are doing fetching the data checking for the veracity checking about the data also then analyse the data with use of certain ratios certain other concepts.

You analyse the data then derive some knowledge out of data for that matter out of that analysis some key insights you get in knowledge then you get everything today. So, it is whatever surprise there about the company you get today or surprises now. So, if you go for broad focus of due diligence then you get the surprises good, bad, ugly about the target today. If you do not do that then you get those things tomorrow means later where the thick is might be quite late to actually undo your decision also.

So, that is desirable that you company should go for a very broad due diligence process where they should get insights about the target and then accordingly make some recommendations.

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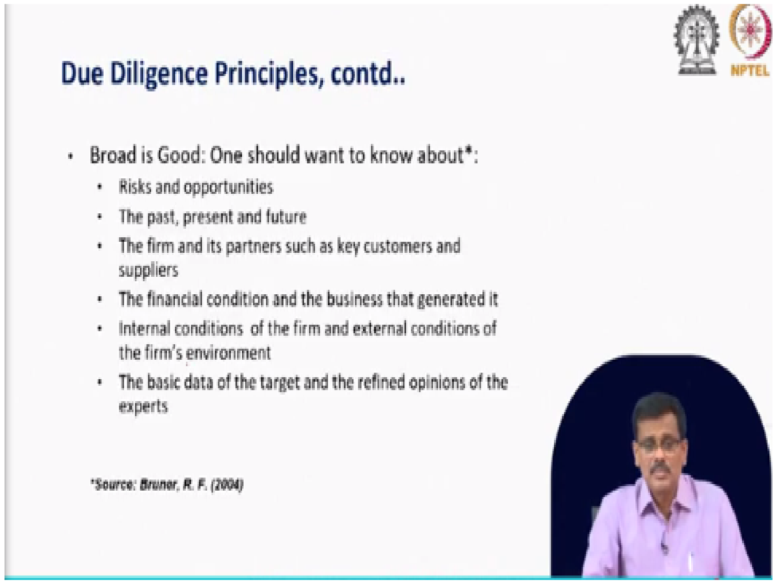

Then yes, as we discussed broad is always good the company should know about the what the risk involved? What is the operation is there in the target? What is extra is there bearing by going for that? What has been the history of the company? Where the company has operated? Who has been the management? Where they started? What are products they have introduced? Have they gone for new products or not?

What the present status? Who are the markets today? Who is the buyer for them? Who are the suppliers? And what is the future holds for this particular target? Is it going to be a profitable sustainable is going to add to the wealth of the company an acquiring company? Is going to go to good revenue or not although the future also has to be looked at? So, both all the things past present and future has to be looked at when you due diligence.

Then look at the firms customers who may be key customers for this company for the target. Who are the key suppliers? And what is the financial condition are they doing good profit, returns? Are they turnover is good the astronomer efficiency? All these ratios one can adapt and find out, what this and this stock company saying? The company is making generally good cash flow good profit, what is this driving this good cash flow good profit?

What business is it the sustainable business is the recurring revenue which is driving more or something non-recurring for that matter. Then if its non-recurring there is a question mark assets because recurring revenue is actually sustainable revenue. Then what are the internal condition? Who are the management there also? Then external condition for how the company operas, we discussed in acquisition search we talked about porters five forces model we talked about a short analysis.

So, all those things look at and say yes, the company is external condition is also good suitable if not good then what can be done by us, so that is to make it good also. So, that we take advantage of that or you can be all prepared if this condition is not good. Still, you are going to acquire this company then how do you prepare the company for that matter. Then get the basic data and also get the opinion of different experts.

It is not that, you are the expert you can know everything as such you may rely on different other people of the maybe consultants maybe, investment bankers. So, look at their investments look at them talk to them consult them and get the basic things about the company.

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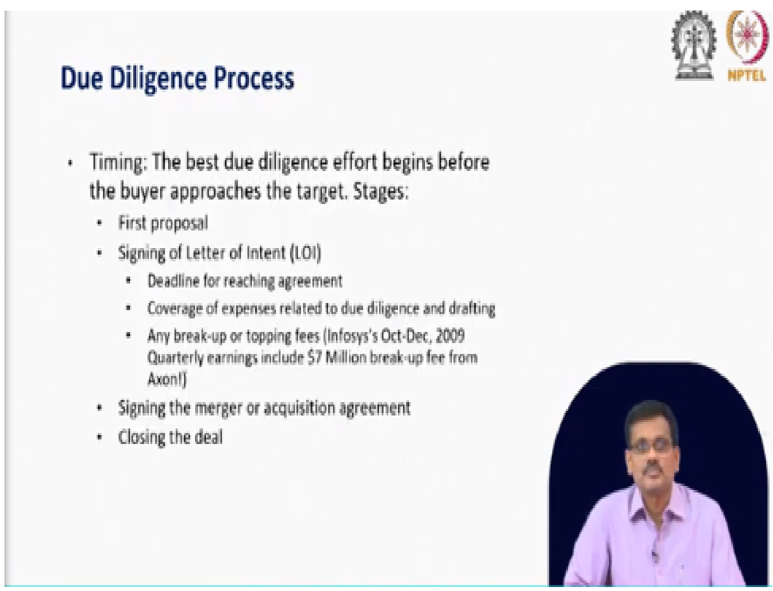

What happens in the driven process is that it is a friendly acquisition so two companies have come together and there are different stages first proposal is sent by the acquiring company target we like to be soliciting you, so that you can we can like acquire their company. Then there could be an acquisition agreement letter of intent with letter maintenance gentleman **(()) (11:20)** buying and buyer and this acquiring company and the target company.

And you can also have certain milestones when we are going to finish this particular discussion process that the target can be acquired, then the deadlines could be there. Then we will also have what is the expenses are going to be incurred in duration process, who is going to bear that whether buying company is going to bear or target company is going to bear assets. Then there could be some provision of breakup fees like we discussed in our act take our attacks and defense we talked about breakup fees.

So, that suppose the company works away no why not further discuss about it we will close this now will not go for the deal then top breakup fee can be given by the one of the working of a party like we know how Infosys had that in case of a action deal. Because Infosys supposed to buy the company they are already gone for decision. But other some other another company came and accident went for this action had to pay 7 million dollar breakup fee into Infosys.

Then next is signing the merger agreement then you close the deal. And this is the typical process involved which involves due diligence as one of the important aspect.

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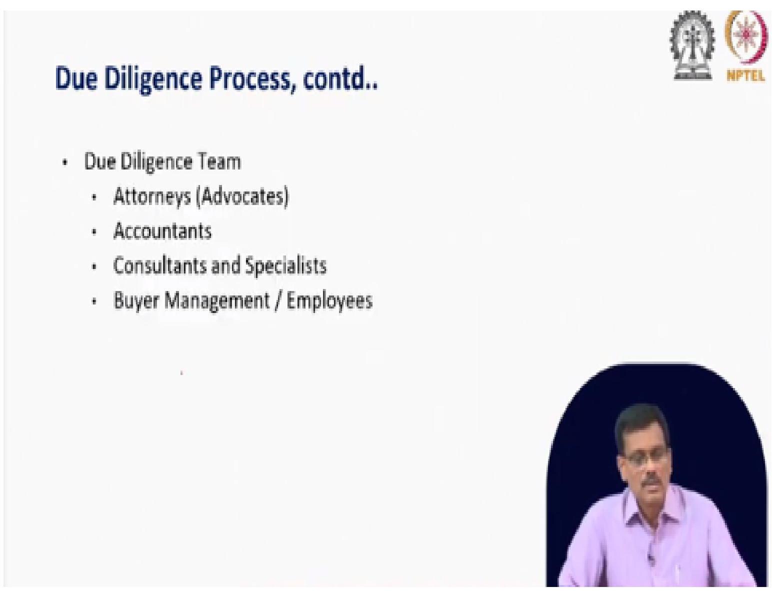

Your team can be consisting of attorneys and advocates for that matter you will have accountants to help you. You will also have consultancy specialist will give opinion about different aspects of the business the targets business. They will be even buying companies management employees can be involved in selling company in a management employees also can be involved, you can also take that opinion when you are copying due diligence assets.

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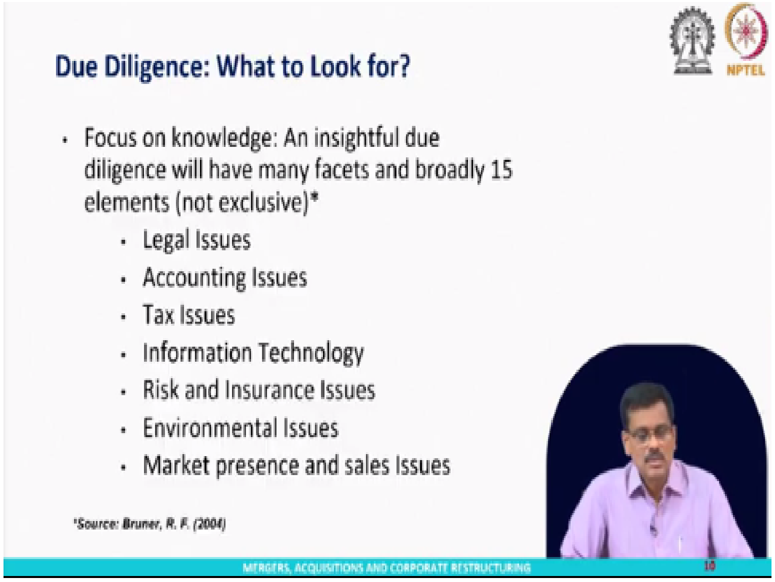

So, your as you discussed in that graph yes you have to if you want to have surprises today not later you should have lot of knowledge about the company. So, this is 15 elements as well Bruner 2000 and 2004 book if they have, he has given some 15 major aspects. It is not exclusive there could be some more issues also. But this is very good culmination of different points assets this is the 15 points the company acquiring company has to look at.

The first one is the legal issues. legal issues talking about that the legal status of the business is it a privately held company, limited liability company is a publicly company, what has its objectives of the business like in memorandum assessment of the company you have objectives. So, what are the object of the company what are the liability the capital. So, like the company's legal entities status because companies may also go for acquiring a company which is closely held.

So, that will be different scenario a company is going for a company which is a publicly wide held then different strategy has to be there because you need slot of information for that. Then accounting issues. What has been accounting policies? Because in accounting has got lot of subjectivity lot of principles followed, for example if your revenue recognition different revenue recognition policies are suppose you look at depreciation, different depreciation methods are followed.

So, accounting which is talked about what are the different significant accounting policies the company is followed look at their financial statements, balance sheet income statement, cash flow statement, how they are prepared they are audited. And if there is any significant change accounting policy, we save is our policy the acquiring company policy. In that case what will happen you may have to recast the income statement based on your accounting policy.

And find out the company strength and weakness when investment assets if there is a difference asset and if there is accounting policies actually frequently changing in they can target, that is actually one red flag. So, that company may not be suitable for us because they are changing the accounting policy so frequently. So, it can give an indication that is come there may be something wrong with its company.

So, it may not further go further discussing about the company you may walk away no this is enough. Because his accounting policy is so different from our company, we may not go for it also because it is going to be a lot of problem integration. So, as I told you when you are doing this product duration process the company should ready to walk away. That if they find something wrong which cannot be reversed which cannot be changed post acquisition.

It is better even if you spend lot of money going for duration process is better than you walk away from the deal, no we are not going to pursue this acquisition further. Let us stop the discussion here and if there is a breakup fee, let us pay it and leave the table. Then come your tax issues, taxes could be your income tax, corporate tax it could raise it through indirect taxes what has been the how the company's tax planning.

Similarly, are they avoiding taxes look at that other any tax obligations, any tax due, anything pending everything company in the court of law. So, those things have to be there into access. Then IT, what IT is one of the backbone of the business, IT can be policies their companies has their own policies IT company kind of IT in IT also includes hardware software is this company depending on the software made by themselves or their depending on the companies which provide software to them.

Some of the company has ERP enterprises are planning and they may be having their own ERP or they may be relying on the outside vendors for that matter. So, in that case the acquiring company is using one particular IT model or ERP model. The target is also having another different model then a post-merger integration is going to be not that easy is going to be little difficult.

So, you have to prepare for that because you may have to go from for the more licenses because you are going to have in another entity added to that. So, you may have to go for this vendor of the Erp you have to go for more licenses for them. Similar if it is supposed to be the same and then then also if it is a different ERP vendor for the target company. You have to change it assets and is changing it and integrating two different software's is going to be difficult and not go to the easy.

But you have to prepare for that so do you also tell you that integration time. This is one of the aspects has to be looked at is not that do not stop there, but be prepared for it. Risk and insurance, the company may be exposed to lot of risk it could be related to production, finance, market everything it will related to intelligent property also. But how much coverage the insurance coverage the company has.

So, it is not the risk as risk will be there in any business, but whatever instance the company has gone for, is it adequate? No is adequate is not adequate then you have to prepare that because our insurance policy may be risk taking policy may be different than the targets policy. So, accordingly prepared that the target is coming to our fold you have to also apply our policy to them. So, it may lead to more insurance coverage and lead to more insurance cost for us also.

Then comes to the another important is depending on the particular company industry environmental. Is it environmental friendly company? Are they company which is into the polluting? If there are pollution involved in this particular let us says a chemical company you are targeting and the pollution involved have, they gone for pollution control measures or not what we do as a acquiring company are they following those rules regulations and practices.

So, those things have to looked at is there any case spending against them in the court of law. Because they are violated environmental laws then comes the very important aspect the business revenue the market presence. What is the presence in market? Where are they? What are the niche segment? What different products they sell actually? Are there any sales issues? What are the sales coming from? Are they present across the globe across the country?

What is the retail network? All those things to have with you which particular product gives them more revenue. Maybe less volume, but more value maybe they have constant product which is very Niche segment. They are able to charge a very high price, so that you will focus on them. So, because finally all this will do the company is not making sales there is no point pursuing it also these sales is not going to be sustainable they know point pursuing that.

So, what the market? What the customers? What are the custom like? What is the customer feedback about these products? Whether the ultimate thing for the survival of the company access? So, that is looked at in market presence and sales issues.

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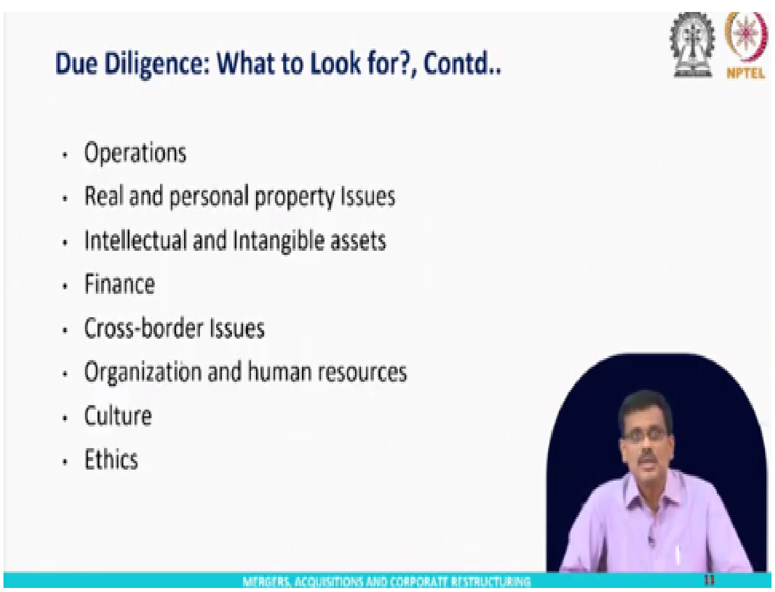

Then we look at operations, operations could be from your plants facility how they operate, what they do and then the policies like there could be shifts or do they have a general shape do they have three shapes or the continuous process for that matter. Whatever things they are doing or they have the best of technology in that particular industry today or you are going to operate technologies further. So, that you are again spend for them when you integration takes place.

So, all those things have been looked at in operations who are the key people in operations also, then comes the properties real and as well as personal properties. The personal property is going to the companies developed by them. And they have the properties real assets could be there like building plans, what are the condition, what the legal condition are they there do they belong to them is there no problem with that legal title.

Those things taken care what the condition physical condition these properties also. Plant fuzzy where the last overhauling has done last maintenance was done. All those things looked at because if dot done then you have to spend for it in future. Then comes there may be some intellectual properties intangible assets of this company which drives the business drives the revenue how sustainable, are they good, how old are there are, those intellectual properties commercially viable.

Because company may have lot of patents and copyrights but they might have any commercial utility. So, they may have 100 patents and copyrights but out of the 10 may have commercial utility. So, look at them is it commercial utilities the legal life can be there but commercial life may not be there. So, look at those things. And intangible assets need not be only common integers equal to good HR good skill set of the company good knowledge of the company also.

So, look at them. Then comes finance, a finance means talking about like, how this company finance is this company, more finance by mode date is more risky than financial labour or it is less there. So, that you can still go for additional debt and fund this company for the growth and what has been the financial performance, what has been the liquidity performance, what has been the solvency, what has been turned over how this company is doing is the company profitable.

So, all those things to looked at in finance and if the company is like to go for further loan do not have the collateral all this you looked at in finance issue. A cross border issues comes when the target company has foreign presence may be in terms of collaboration may be in terms of customers they have. And if there is a then we look at what the if the correspondence is there if there is a customers outside foreign currency.

What is the revenue from the foreign currency? What is either foreign currency involved? What type of ins hedging they have taken done as far as foreign currency exposure is concerned? And cross border is also can have cultural problem. So, then we have what something called organism human resources. What type of human is? What if organization is this? Is old organization legacy? Is there or not is a new organization? Who are the key people manning this?

If it is very old organization then you know people are there as such it is it may very stable. They may have very good organization policies the success and policy organization policy could be there. HR what are the HR rules regulations? Even simply HR policy like a company have five-day week working policy or a six day working policy. The company together is going to be difficult.

Suppose you are acquiring company which is a five day work policy then you are having six day then those employees may not stay back. Like we also discussed about some this case in golden parachute policies there in this company, because we talked about in the takeover attacks on defense. And then what are the leave rules? What are the guidelines? What are the employee guidelines?

Is there any union in the company with whom agreement as a company for the wage negotiations they are when was last done? So, that you have renovated with them then the company's culture. Culture is very difficult to define assets, there could be some company which has a culture of cost consciousness. They will not like to do not the comprehensive quality with the left and least cost. Some companies could be there the pre-eminence.

That we want to be the number, one number two in this particular sector. Some company would be there, culture could be we are very much customer service oriented. So, in that case but acquiring company may have a different culture. So, the cultural integration meant possible in that case it could be a problem. So, if there is going to lot of diversity in two cultures then you may not go or if you go for also then you go for training and assimilation program for suffix subsequently.

So, that these two groups of people from two different companies were together for the common purpose of the combined company. So, if you prepared what is the culture according to that. And then comes ethics, ethics can be anyway it can relate to any effect they talked about interrelated accounting it related to legal problems. Because company may be good at law but they might be following the ethical policies also.

It will be related to HR it could be related to the environment pollution, because anything for that matter. Ethics is not good is not acceptable the acquiring company even if you have done all the due diligence everything is the business is good all those things. But still, you are going to get the company its culture to you and you are going to have employee's assets and there is a ethical problem the policy is not.

In consonance with what they are our ethics are concerned then it is maybe company may not go for that particular target. So, all this thing we are talking about 15 aspects yes, we will go for that these are the things that regulation has to take care.

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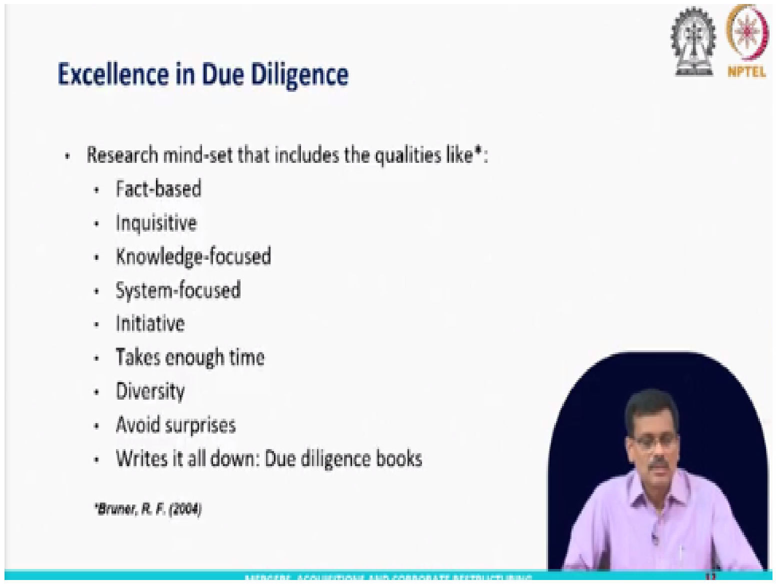

Then yes it will have no excellent in due diligence have to look at the fact, you have to very inquisitive what is there, what is the number behind the number or you have to go for knowledge not just check box tick like that. And driven service system, that means you look at different aspects and one aspect may lead to some other aspect also. An accounting due diligence will lead to finance diligence also you may get some insights or finance also.

The HR policies can lead to ethics related issues, so it is a system focused asset. Then lot of initiative taken by the acquiring company it takes a lot of time you will be prepared for that diversity. Because different things have to be covered you have to avoid surprises today and make or make a big note of all the notes of what is happening assets.

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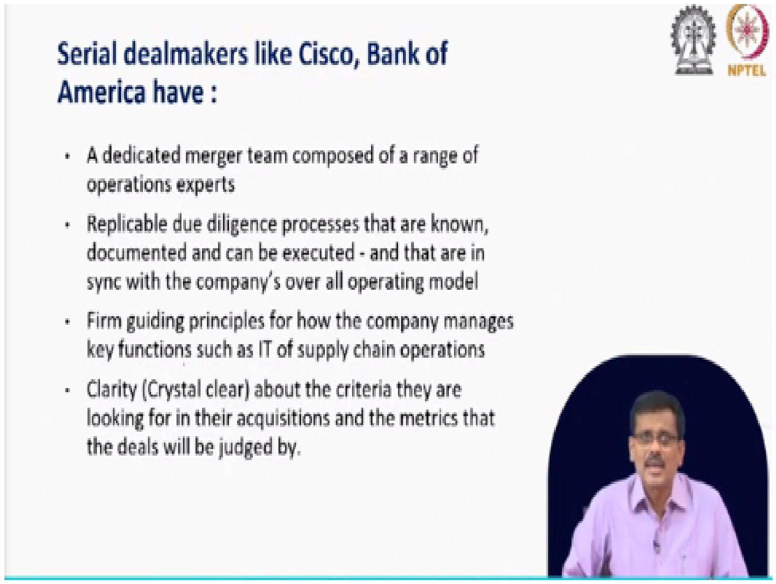

So, in companies like this you have like one example, you have Cisco, bank account they have a dedicate model team who have got experts, who do the diligence s as such. So, that they have replicable diligence process and they have documented. So, that they can use it for any acquisition then they have got certain guiding principles how the company has to manage its key functions they give me IT or supply chain for that was an example.

And they have to very crystal clear about the criteria, they are looking for the acquisition. So, that this metrics they also they have if they are metrics are made then they can they will go further, otherwise they will not go for assets.

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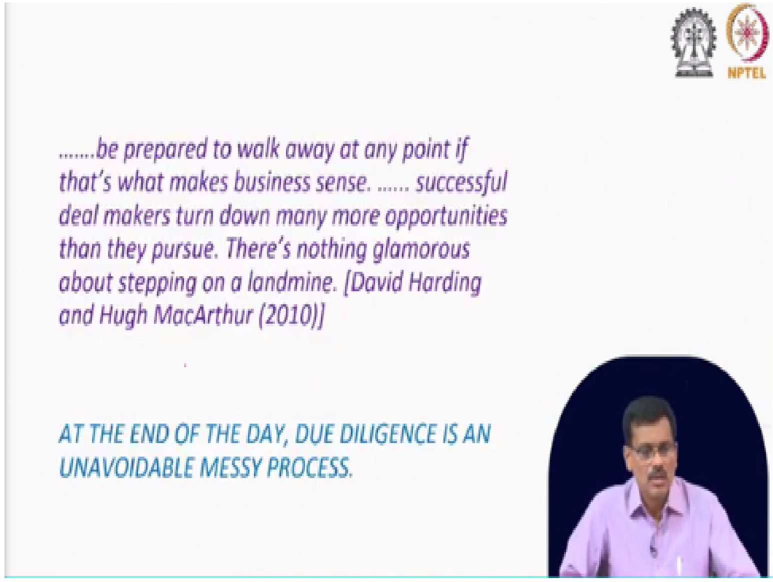

So, at the end of the day one has to prepare also to walk away at any point. Because which does not that makes business sense because business senses that no it is not good further to pursue. So, successful deal makers are there they torn down many opportunities because they found some problem in their due diligence the acquiring target company may be good maybe from products point of view, may from the market point of view.

But there are so many inherent problems inside the company this is always better that they do not perceive further it is going to have a bigger problem in the future. So that is why somebody said the **(()) (27:41)** another author told in the article that there is nothing glamorous about stepping in a landmine. If they finally target is going to land mine there is no glamour nothing glamorous about it.

At the end of the **(()) (27:53)** words at the end of the day due diligence is in unavoidable messy process it is not a very pleasant process as it is also unavoidable and you have to endure that as an acquiring company team.

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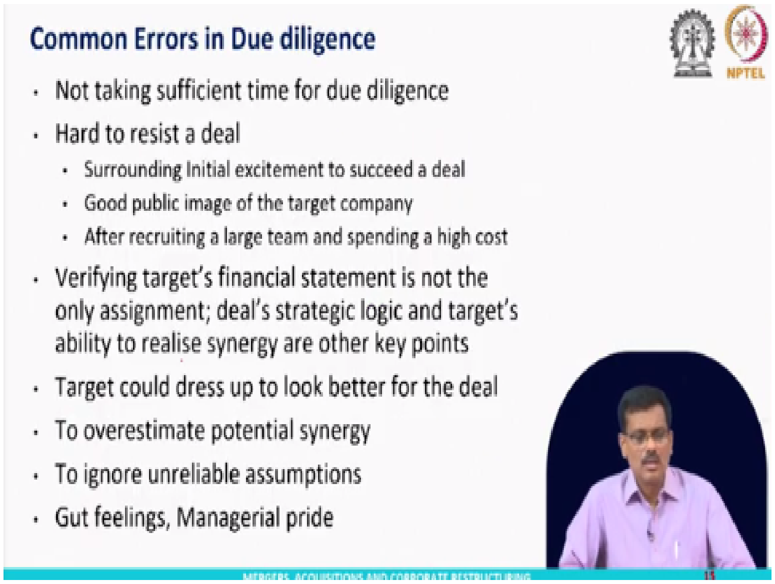

Yes, there are certain common mistake that companies do like they do not take sufficient time to due diligence a lot of time will involve, then they got a very good deal, so they are resist. So, they got maybe surrounding was very good the company target has a very good public image and because you have spent so much money. So, I do not want to run walk away because I spent so much money but that is like a strong cost.

One should not be spending more just because they have spent something earlier. And they do not verify the target set final statement properly or if they verify they only do that. So, they should look for this strategic logic they should look at what synergy the company is going to **(()) (28:51)** if the company is talking about synergies. Then synergies is going to come from this some of the dividends will tell about that.

Then target may also dress it up better, so that will be attractive it may misleading actually. And you overestimate the potential synergy but is very careful. If somebody says synergies explore may be auto downgrade. So, now it is maybe 0.5 X crore for that matter do not look at X because it may be something different. Then you may go for some unreliable assumptions also. And then because you have decided to go for this target then your managerial pride the **(()) (29:24)** will be in whatever I will go for it then nobody can help asses.

So, the gut feeling could be there, but the gut feeling may not be actually the right for the company. So, this is because of the there could be errors and that can lead to a disaster in post **(()) (29:37).**

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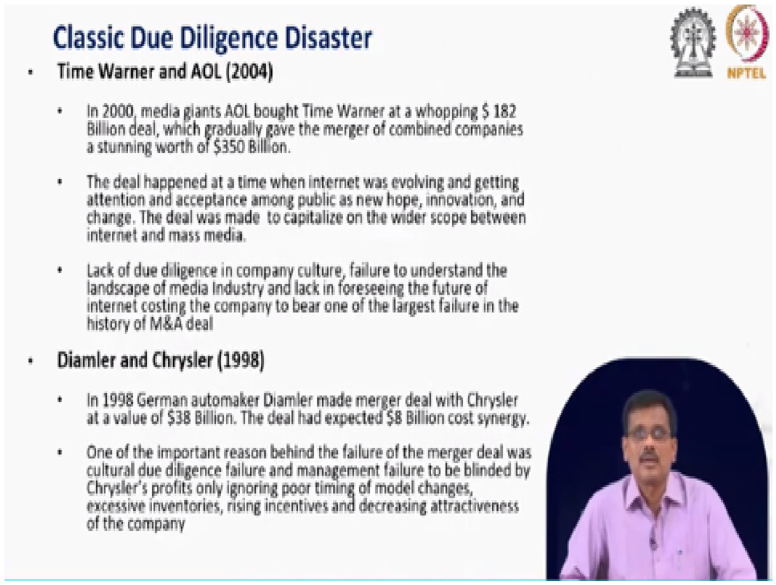

So, two examples that you have time one American 2004 so that in this first case we talk about that yes there is a lack of divisions in the culture they fail to understand the media industry how it is going on and they could they fail to foresee the future of internet. So, that lead to failure in one of the documented case. Similarly, you have a Daimler and Chrysler the automobile sector a European company and your American company came together.

And they also expected some 8 billion dollar of synergies, but the problem of the culture because the two continents they belong to there are different two different cultures. So, the management failed to anticipate that this could be a problem as such and they also timing a model changes from operations point of view, some in excessive inventories where they are incentives are also increasing.

So, in that way the attractiveness of the company is actually not there as well. So, that actually led to failure further they finally broke up they became two different companies subsequently.

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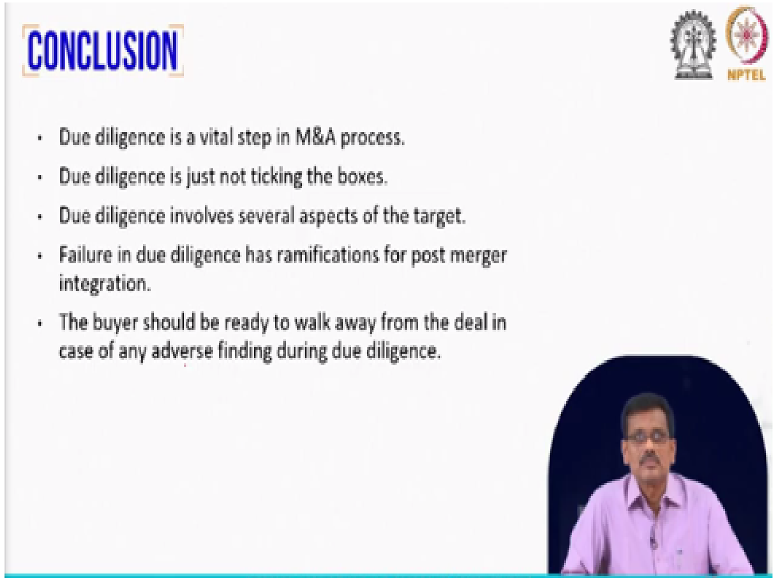

So, these are two cases, yes **(()) (30:45)** in conclusion due diligence is a very vital process in M and A, it is just not taking the boxes look at the data fed the data do the analysis. And half insights about the company some knowledge about the target it has to be that several aspects from finance, operations, market, culture, ethics everything is involved during this process. And due diligence has ramifications for post-merger integration.

So, we have to very careful about it and the buyer the acquiring company should be ready to walk away from the deal at any point. If they found there is some adverse finding which is going to be adverse for the combined entities. So, buying company acquiring companies would think twice about that because, just because they have spent lot of money and time, they should not pursue further if they found something problem.

So, it is better than to walk away from the deal at that point of time and not pursue further. So, it is mentally prepared access it may be painful but still one should mentally prepared for that.

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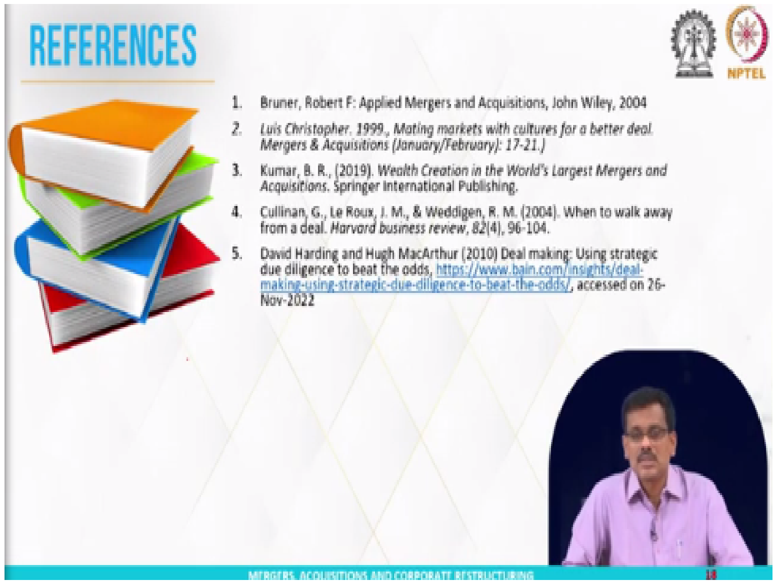

So, with this we end this session and the subsequent classes will start with the valuation of the company. Thank you and happy learning.