Private equity due diligence

Mitigate uncertainties and invest with greater confidence

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Due diligence

Mitigate uncertainties and invest with greater confidence

In a time of historically heightened competitiveness in the private equity industry, and with an increasingly constricting credit market, generating strong returns on your investment is more challenging than ever. Increasing seller expectations, shorter timelines to close, and the return pressure created by high multiples mean that a robust diligence and post-close planning process are essential to high returns.

Appropriate and tailored due diligence will provide you with an exhaustive understanding of the target company — its market strength, customer relationships, and financial performance — and close a deal at the most favorable transaction price. While we cannot eliminate risk, we can help maximize opportunities for success in an effort to generate the highest ROI.

You already know how to make deals work. Our team will help you find the competitive edge to make deals work better.

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Financial & tax due diligence

Mitigate transaction risk and discover potential "skeletons in the closet"

The main goal of financial and tax due diligence is to mitigate the risks associated with a transaction. It provides the buyer an opportunity to discover potential "skeletons in the closet" prior to an acquisition.

As a starting point for any investment analysis, you must assess and verify the seller's financial performance and tax compliance history. While the concept is basic, the processes involved are anything but straightforward and require careful analysis.

Financial due diligence

Financial due diligence is typically the most thoroughly examined aspect of the due diligence process, but don't let familiarity obscure the task at hand. A thoughtful and holistic approach is required to truly understand the potential risk areas and their corresponding implications on the transaction.

1

Assess capabilities

As a starting point, your target must be able to produce timely and consistent financial statements.

It's vitally important to analyze the numbers with an eye toward inconsistencies and deviations from generally accepted accounting principles. Compare expenses against those of known competitors: Do they fall outside acceptable averages? If so, determine the reasons for the performance swings.

2

Examine position

Examine the target company's position in the marketplace, noting trends that could impact recent performance.

For instance, take a transaction involving a petroleum retailer. Financial performance could appear exceptional, though a closer inspection could reveal inflated industrywide margins due to uncharacteristic oil pricing activity. A return to average pricing could significantly deflate performance metrics, and thus valuation, commensurately.

3

Determine future impactors

Finally, look carefully for any obscured events or decisions that can influence future post-integration earnings:

- An owner that hasn't taken a salary
- Compensation levels for staff and management
- Healthcare and other benefit costs
- Legal issues, including settlements, that directly impact expenses
- Unpaid tax liabilities, including IRS liens and other issues caused by poor cash management controls
- Dated ERP applications that don't provide sufficient or even accurate financial metrics, such as inventory and WIP

Four additional considerations

While each company and transaction is different, some consistent traps to avoid include:

1 INVENTORY COSTING AND VALUATION

2 POOR CASH MANAGEMENT CONTROLS

3 COLLECTABILITY OF ACCOUNTS RECEIVABLE

4 INEFFECTIVE SYSTEMS AND PROCESSES

Tax structuring, due diligence, and planning

You should view the tax implications of a proposed transaction holistically. Tax structuring and tax due diligence are necessary to ensure your long-term tax objectives are achieved.

TAX STRUCTURING

Tax structuring seeks to identify the optimal tax structure for a transaction, preferably one that achieves a step-up in the tax basis of assets.

Possible ways to achieve a step-up may include:

- Direct asset purchase
- Deemed asset purchase (e.g., Section 338(h)(10) or Section 336(e) elections, purchase of a disregarded entity)
- Purchase of an ownership interest in a partnership or limited liability company that's classified as a partnership for tax purposes
- Unilateral Section 338(g) election to treat a stock purchase as an asset purchase

TAX DUE DILIGENCE

Tax due diligence should be tailored to your target entity's tax classification (C corporation, S corporation, limited liability company, or partnership) as well as the structure of the transaction from a tax perspective. To the extent that you'll assume historical tax exposures given the legal form of the transaction, potential tax exposures should be addressed in the transaction documents as well as post-close.

In certain instances, tax exposures may be so significant that they cause the tax structure of the proposed acquisition to be altered. You may be subject to state and local successor liabilities laws even in transactions structured as direct asset purchases.

Common areas of focus during due diligence may include:

- Failure to file required tax returns
- Missing elections or forms (e.g., reporting of a transaction, accounting method changes, safe-harbor elections, transactions between related parties)
- The validity of the S corporation status of the target company
- Related-party transactions (arm's length)

- Previous acquisitions, dispositions, or legal reorganizations
- Timing of deductions and revenue recognition policies
- Payroll withholding taxes and the misclassification of employees as contractors
- Executive compensation, golden parachutes, and bonus structure/ incentive plan.
- State sales and use tax issues

TAX PLANNING

Your deal team should recognize the interplay between tax structuring and tax due diligence when planning a transaction. In doing so, historical tax exposures may be mitigated, and costly future tax compliance mistakes will be avoided. Additionally, the potential impact upon ROI may be minimized, and deal proceeds will be maximized upon future exit.

Commercial & supply chain due diligence

Evaluate risk and determine future growth potential

Commercial due diligence, especially involving your target's customer base and supply, is critical for obtaining an accurate view of their operations and position in the marketplace. The underlying goal must be one that presents a realistic view of the acquisition's future growth potential, an assessment that relies on three distinct analyses: operational stability, market strength, and forecast validation.

Without a thorough review of each, you risk assuming vulnerabilities that can frustrate the most well-intentioned projections, dragging down earnings, and ultimately ROI.

Commercial due diligence

While financial due diligence delivers critical details about historical trends, it's important not to overlook an examination of recent business performance, which can yield important insights into projected future earnings. To that end, the due diligence process should include a strategic, commercial analysis to understand the qualitative aspects that drive corporate performance.

Consider these five areas:

1

Customer counts

The true value of a company's future earnings is directly tied to its customer base.

To assess the strength of the seller's customer list, analyze the customer base. Disproportionate revenues coming from a select few clients indicates the customer list may be less stable than if sales were spread evenly over a number of clients.

The durability of customer relationships is critical for meeting future expectations. As such, it's important to understand the level of intimacy with the top purchasers, as well as the employees responsible for maintaining those touchpoints.

2

Product line strength

No matter the strength of your customer base, you risk compromising their loyalties without a quality product line.

Examine the seller's portfolio carefully to gauge product stability, paying close attention to new offerings, and weighing those against the seller's skill set and alignment with future customer demands.

As to the seller's skill set, verify whether those self-professed attributes are capable of delivering the results that they promise. If not, you'll need to determine whether those skills are easily obtained elsewhere — and at what cost.

3

Sales projections

If sales are spiking higher, look to see whether the increase is organic or attributable to risk-related events.

If the latter, distinguish risks that are fleeting or long-term risks in order to gain an appreciation of likely disruptors.

Assess whether forecast projections are logical in the context of your target's customer relationships. For instance, if sales with a tech startup are projected to triple, due diligence will flag that projection and perform a more realistic assessment.

Perform a comprehensive industry analysis to understand short- and long-term trends, noting any uncertainties. Some industries in particular bear close scrutiny, including healthcare, energy, telecommunications, and manufacturing. You need to look no further than the case of Blackberry to understand how quickly technology evolves and the importance of reviewing current consumer trends and performance data to predict future performance.

4

Sizing up the competition

Assess the seller's marketplace position and value propositions against those of its competitors.

Like the Blackberry, look for factors (technology, consumer preferences) that could threaten long-term financial health while charting the growth (or decline) of their market share. If there's been recent M&A activity among competitors, that could also impact future earnings.

5

Salesforce dynamics

Explore the fundamentals of the seller's sales organization to understand how business is secured and retained.

This can reveal hidden, though important, business relationships. For instance, certain industries offer ongoing price reductions. If so, make sure the seller has been accommodating these unique expectations, to ensure your post-integration projections are accurate.

Supply chain due diligence

At a time when supply chains have evolved to become truly global and borderless, the risks for disruption have never been greater.

Market fluctuations, volatile foreign exchange rates, political turmoil, labor unrest, and natural disasters all present risks that can interrupt the supply chain, causing part shortages and production slowdowns (or even shutdowns). In some instances, they can impact cash flow and trigger financial instability.

Recognizing the sizable risks the supply chain can pose, a critical element of your commercial due diligence should include a thorough review of the acquisition's supply chain. As such, performing a comprehensive review of the supply chain is critical for properly measuring your target's risk, stability, and even potential for future growth.

RISK MITIGATION CONSIDERATIONS

Consider spend concentration

Look carefully at the spend concentration among suppliers, particularly for highly strategic/critical commodities and categories. If there doesn't appear to be a balance of qualified suppliers in critical categories, this could be pointing to potential risk with supply chain disruptions.

Note any products that are procured from a single source. Such an arrangement may present profound risks, depending on the supplier's stability, whether it offers backup facilities, and its sphere of operations.

Determine the supplier's footprint

Assess the footprint to understand any known or probable risks, such as those related to geopolitical, disaster, political, economic, or environmental factors. And especially when the target has relied on a single supplier, understand the availability of other qualified suppliers, should an event compromise supplies from the primary source.

Review contracts

For suppliers that provide exclusive products or materials, the weight of the target company's contract can impact fulfillment. That is, if the company presents a very small percentage of the supplier's business, delivery during a supply chain event may face a greater chance of disruption than if they represented a larger percent of the supplier's business.

Examine supplier performance

Next, review all supplier relationships, assessing their performance and strength. The former is tied to specific metrics — cost, quality, and delivery — while the latter addresses more subjective dynamics based on trust, collaboration, and efficiency. Understand which suppliers are thriving and where there are opportunities for improvement.

Assess management processes

Finally, while the target may (and should) maintain robust supply chain monitoring, does the supplier offer the same? Assess, if possible, the supplier's qualifications and management processes of their supply chain. Such an analysis will provide a truer picture of the total supply chain risk.

IT due diligence

Uncover issues and prepare for action

There's perhaps no segment of business operations that's evolving and changing as rapidly as information technology (IT). As IT impacts nearly every business function, it's imperative to conduct a thorough due diligence of the target company's information technology systems and operations to understand what you stand to inherit with your acquisition as well as what you may need to do to address significant gaps and issues that may inhibit future growth.

Additionally, since effective operational data is needed to begin any operations improvement, it's vital to engage in IT due diligence quickly to ensure an effective and efficient transition.

NOT FOR EVERYONE

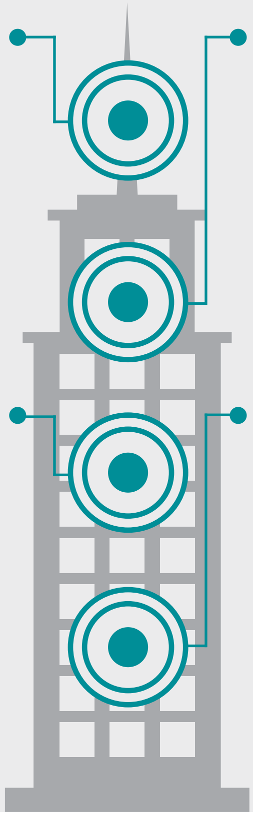
Many companies overlook IT due diligence, either because they fail to recognize its value, or because the target is relatively small. However, size alone should not determine whether you conduct IT due diligence. We recommend performing IT due diligence if the target meets any of the following criteria:

$30M threshold

If the target is a manufacturer, distributor, or service organization with revenues of at least $30 million and for whom technology plays an important aspect of the business (inventory control, traceability, etc.), it merits IT due diligence. At such a size, scalability and technology management create an increased risk and cost for the acquiring firm.

Tech-related

If the target's core assets or service offerings are technology-based, conduct IT due diligence, irrespective of revenues. Custom developed applications for the marketplace can introduce unique risks to an acquiring firm. Ensuring Software Development Lifecycle (SDLC) standards are in place and followed enhances the likelihood of quality solutions.



Consumer facing

If the target organization facilitates business to consumer transactions, then perform IT due diligence. A company that conducts online sales transactions and handles credit card data, for instance, faces significant compliance risk as well as future scalability concerns as the organization grows.

Regulatory compliance

If the target company operates in an industry that is subject to regulatory compliance (FDA, ITAR, DOT), there are elevated risks if technology solutions are not appropriately deployed. Evaluating current processes and tools will identify potential gaps in the existing transactions and outline potential costs to resolve existing gaps.

Three principal considerations

There are three principal considerations associated with your target's information technology: gaps, risks, and costs. The goal of any comprehensive IT due diligence process should be to identify and assess their impact.

1 GAPS

Assess the target for any technology, staffing, or licensing gaps that you may need to address over the next three to five years, with a firm understanding of their underlying costs and potential impact on the business.

2 RISKS

Understand the risks related to the IT environment. Are adequate safeguards in place related to employee training and access? Do processes align with best practices, or at a minimum, do they comply with industry standards? Is there existence of custom developed business applications or business solutions that are no longer supported by the vendor? Elevated risks could impact your purchasing decision.

3 COSTS

Determine the IT costs, both recurring and nonrecurring, over the next five years of a potential hold period. For instance, if the target employs 100 people who each work at an old computer running outdated software, replacing the hardware and software will bear a substantial cost.

Three assessment areas

We recommend reviewing three core elements during the IT due diligence process: business applications, traditional IT components, and IT governance processes.

1 BUSINESS APPLICATIONS

Business applications help "run" the business and include ERP solutions and business intelligence.

Both must be current and fully supported by their software vendor. Beware of companies whose business applications are common (i.e. Excel); despite their ubiquity, they may not provide sufficient visibility into the company's performance.

Determine whether the applications include the requisite licenses and contracts. Pirated software (copied applications that are in violation of copyright laws) is illegal and noncompliant with licensing requirements. As such, it presents a significant legal risk to you as well as a steep replacement cost.

Additionally, if there is a goal to assimilate the new target company to an existing portfolio, then special consideration will need to be placed in evaluating how redundant applications will be handled. Maintenance of multiple ERP solutions typically increases cost of support staff while reducing efficient reporting capabilities.

2 TRADITIONAL IT COMPONENTS

Traditional IT applies to a company's IT infrastructure and includes networks, servers, security, communication software, and staffing.

Assess these components to determine if the performance, size, and capabilities are appropriate for the target's business and its requirements. Note whether there are elements that need a refresh or capital investment. For those items that require software maintenance patches, analyze their refresh schedule to make sure it's dependable and that all updates are current.

Review documentation and logging of all hardware, too, including servers, switches/routers, and security devices. Finally, examine the basic IT hardware, especially computers; while a laptop may function for a decade or more, we recommend a refresh cycle of three to five years. Anything older and you should consider its replacement cost in your final valuation.

3 IT GOVERNANCE PROCESSES

IT governance concerns how the target makes and administers IT decisions.

For some, this may include a forward-looking strategy for IT, with a project oversight office that's in close contact with IT to approve IT funding. Additionally, IT governance controls how the target supports its end users. Some organizations maintain a help desk that manages hardware and software issues of the company's employees. Review what, if anything, the target has in place, and consider what you may need to contribute to the post-integration entity.

Critical acquisition risks

Three additional areas to consider

The due diligence process for target acquisitions should extend beyond what's evident — financial performance, tax liabilities — and cover those elements of business operations and holdings that present tangible implications for the post-integration entity.

This section considers three critical, though often overlooked, areas fraught with risk:

REAL ESTATE

EMPLOYEE BENEFITS

INTERNAL CONTROLS

Real estate

With so much attention directed to your target's finances and performance trends, you must not overlook the land and buildings involved in any prospective deal, as property can have a substantial impact on the performance of the post-integration entity.

As part of the initial due diligence stage, assess the target company's real estate portfolio. Will you be inheriting a lease agreement or purchasing real estate as part of the transaction?

If you stand to inherit the lease, there are a number items to factor into your valuation. Determine your rights and duties versus the landlord's rights and duties, including any obligations regarding maintaining mechanical systems, parking lots, or restoring the facility back to its "original" state. Include scheduled rent escalations into your ROI projections, and don't forget details regarding termination provisions or renewal options, including the timing of notice provisions. The type of lease (triple net, absolute net, modified gross, gross, etc.) may also carry unique financial considerations. Finally, perform a mark-to-market assessment of the real estate, categorizing them as above, below, or at market.

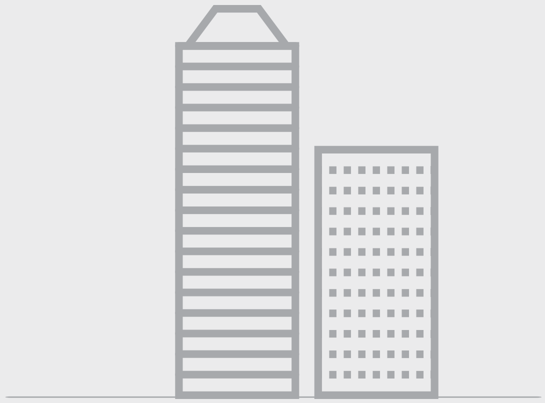
If you're inheriting the real estate portfolio as part of the acquisition, consider a facility condition assessment to uncover deferred maintenance or deficiencies of the facility. Additionally, as you consider the growth potential of the post-integration company, consider a sale-leaseback arrangement of real estate. Such a vehicle can generate immediate funds to pay down debt or expand operations, while affording you the opportunity to reposition the asset.

Whether you inherit a lease or the actual facility, investigate existing incentive agreements on a state and local level. These agreements can exert a tremendous liability on the post-integration entity, necessitating an exhaustive due diligence review. If they exist, review any clawback provisions of the agreement. Does the incentive agreement coincide with your long-term vision? Will the facility location need to be consolidated or relocated? If so, determine whether you can rework the incentive agreement prior to closing as you may lose leverage to modify it afterward.

THE PATH TO SUCCESS

Inheriting a lease agreement?

- **Determine** your rights and duties versus the landlord’s rights and duties
- **Include** scheduled rent escalations into your ROI projections
- **Perform** a mark-to-market assessment



Inheriting a real estate portfolio?

- **Uncover** deferred maintenance or deficiencies
- **Perform** a mark-to-market assessment
- **Consider** a sale-leaseback arrangement

Employee benefits

According to the U.S. Bureau of Labor Statistics, employee benefits average in excess of 30 percent of the total costs for employee compensation for the private sector, with costs in some industries averaging much higher. Therefore, it's easy to see the importance of conducting a thorough review of employee benefits costs for your target company.

The impact of employee benefits on future earnings can be considerable, especially for major legacy expense items such as pension obligations and OPEB (other [than pension] post-employment benefits) liabilities such as healthcare benefits, life insurance, and disability. These liabilities can extend beyond the target company following a deal. In fact, a recent court ruling found multiple private equity funds managed by a major private equity firm to be jointly and severally liable for unfunded pension liabilities owed by a bankrupt portfolio company. When looking at a financial statement, review its long-term liabilities carefully, as the actuarial assumptions and methods prescribed to establish OPEB financial statement liabilities do not provide an accurate reflection of the actual long-term impact on cash flow.

WHEN LOOKING AT A FINANCIAL STATEMENT, REVIEW ITS LONG-TERM LIABILITIES CAREFULLY,

as the actuarial assumptions and methods prescribed to establish OPEB financial statement liabilities do not provide an accurate reflection of the actual long-term impact on cash flow.

Finally, evaluate other employee benefits-related items, including those tied to IRS and/or DOL compliance, employee reactions to anticipated benefits changes, potential need for preemptive negotiations with union representatives, and potential union pension withdrawal liability. All of these can impact the performance of the post-integration company, which must be addressed prior to finalizing the purchase.

Internal controls

With significant focus on quality of earnings, the due diligence process for target acquisitions often fails to identify deficiencies within the target company's internal controls environment — key factors that pose post-integration risks.

Family-owned target companies are especially prone to these internal controls shortcomings, with a lack of resources to deliver accurate financial information.

In order for you to address this risk, in addition to performing the necessary due diligence on the target's financial records — its quality of earnings and balance sheet health in an effort to assess EBITDA and calculate a valuation — special attention must be directed at your target's internal controls. It's one of the most effective ways to ensure that the financial information is reliable.

For instance, if your target lacks controls to correctly determine whether a recorded sale is a valid sale (or worse, inflates the transaction to boost earnings), the earnings assessment will produce inaccuracies. Additionally, a lack of proper controls can also result in complacency at the expense of sales efficiency (timeliness) and accuracy (proper recording). Both of these scenarios pose significant risks to achieving your post-integration performance goals.

CONSIDERATION OF THE TARGET'S REPORTING SYSTEMS, METHODOLOGY, AND EFFICIENCY WILL BE A KEY DETERMINATE IN A SUCCESSFUL ACQUISITION.

As you evaluate your target's internal controls, we encourage assessing the capabilities of your target's existing finance team. As you consider the proper forward-looking strategy for your target, having a solid financial reporting function is key to maintaining and supporting organizational growth and change. Is the current finance team qualified and capable of handling your reporting demands and requirements? Assessment of the finance team may also include revamping your target's financial reporting framework. Consideration of the target's reporting systems, methodology, and efficiency will be a key determinate in a successful acquisition.

For more information, please contact:

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