HWB managing director and joint head of corporate finance, Alan Williams

Do investors undervalue due diligence?

The corporate finance market has experienced an upturn in recent years with record numbers of mergers and acquisitions. So why do a surprising number of deals not achieve the anticipated returns to investors?

A recent survey showed that between 50-75% of acquisitions failed in their aim of adding value.

For enterprising business owners, acquiring a new company can provide the opportunity for realising high rates of return on their investment. However the biggest opportunities often come with the higher risk. There is therefore a need to minimise these risks in order to realise the greatest rewards. Without undertaking adequate due diligence, the buyer may not be fully aware of all the key financial, legal and commercial aspects of the business that they are buying.

Any person selling their business will try to present as positive a picture as they can to support the price they are seeking for their business. Without examining the acquisition target in detail, assumptions and representations relied upon by the purchaser may be wrong. The due diligence process is therefore necessary to ensure this does not happen and enables any potential "deal breakers" to be identified at an early stage.

Once a deal has been agreed between the parties and heads of agreement have been signed, the due diligence process will commence. At this stage the vendor and purchaser consider that "the deal is done" and completion should be able to be achieved in a short space of time. Unfortunately the due diligence process can often take time to complete and can cause frustration to both parties. Reducing the time spent on due diligence to save time and money is however a false economy, and the consequences for the purchaser can be far reaching.

The use of independent experts in the field give the purchaser increased comfort regarding the transaction, highlighting not only potential risks but also opportunities, which the purchaser would not have been aware of without the work being carried out. The process also produces invaluable backup for use in price negotiations.

Southampton-based chartered accountancy firm HWB – one of the largest independent firms on the south coast – has seen an increase in the demand for its services due to the level of acquisitions being undertaken.

Managing director and joint head of corporate finance, Alan Williams, said: "When an investor purchases a company, they are not only buying the assets, they are also taking on the liabilities. Some of those liabilities may not be known unless detailed due diligence is undertaken.

"Due diligence work is vital, so that all key areas are considered and investors are aware of all aspects of the business. This provides reassurance and helps establish a true value of what they are buying."

There are usually three types of due diligence undertaken:

- Financial
- Legal
- Commercial

The service is not "one-size-fits-all", as it is tailored to the specific needs of individual transactions.

Fundamentally financial due diligence collects and analyses information and identifies any financial risks involved allowing the purchaser to make an informed decision before proceeding with any purchase.

Key questions which can be answered by the financial due diligence process include:

- Is the price being asked by the vendors realistic?
- What factors are there that will have a significant impact on the results and cashflow of the business and what would happen if the business doesn't achieve expectations?
- Is the information provided by the target reliable?
- What are the key drivers and performance indicators of the business?
- What are the potential future earnings of the business, and are these sustainable in the long term?
- Are there any "hidden" liabilities not recorded on the balance sheet?
- Are there any tax issues arising from past transactions or actions?
- What protections, in the form of warranties and indemnities, should be sought in the legal documentation?

Legal due diligence will be undertaken by the solicitors and is also a vital part of the process to ensure there is no significant exposure to problems after the acquisition has been completed.

Commercial due diligence is not always undertaken but does provide useful evidence and comfort to the acquirer from third parties about the business being acquired.

"To assume that the information provided by the vendors is 100% reliable and not undertake adequate due diligence is very risky," said Williams.

"Even in a management buy-out, there are still matters that have been highlighted in the due diligence process which the management team were unaware of even though they had been involved for many years in the running of the business."

HWB recently carried out the due diligence work on a £2 million acquisition of a company operating a Devon-based nursing home.

Belmont Care, owned by a consortium of 16 investors, was seeking to acquire another nursing home to add to its existing portfolio of homes and enhance its profit stream. The company has a strategy of expansion with target rates of return, so due diligence is regarded as an important part of their acquisition process.

Williams said: "We received instructions to carry out detailed financial due diligence and our work identified a number of areas which proved useful in the negotiations for our clients.

"Lee Wilkins of The Commercial Law Practice undertook the legal due diligence and we worked closely with her to ensure that all the relevant issues were identified for the shareholders.

"It was a thorough process, but it was an important one necessary to the success of the deal. When you buy a company you not only buy its future but its history too. The figures speak for themselves. The low success rate with mergers and acquisitions is largely down to the failure of adequate due diligence and placing too much reliance on assurances from the vendors."

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