



# VIEWPOINT

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## DEAL OR NO DEAL: SURVIVING DUE DILIGENCE

By Laura Kevghas

*As M&A activity in the middle market continues at a robust pace, due diligence is a pressing topic on the minds of company leaders who want to time their exit to take advantage of today's positive market conditions. For CEOs and CFOs who have not been through this process before, anticipating what it will take to jump through all the due diligence hoops can cause many a sleepless night.*

*While eliminating all of the angst associated with due diligence for sellers is impossible, being well informed about what to expect when you enter the due diligence arena can reduce the anxiety level...not to mention improve your chances of getting a deal done at the price and with the conditions you desire.*

*This article will help you understand what a prospective buyer will want to learn about your company during due diligence. It will also alert you of common due diligence hazards that you should strive to avoid.*

It is important to recognize from the start that due diligence is not just an audit. It is the buyer's chance to identify the opportunities to create value through the transaction as well as the areas of potential risk. (See our [March](#) and [April Viewpoints](#) on "Creating Value: Understanding Risk and Opportunity" for a thorough discussion on the factors buyers consider when evaluating opportunity and risk.)

### WHY THIS MATTERS:

- *If your company can't provide clean, consistent due diligence information, or if the buyer's due diligence turns up negative information, your deal can evaporate.*
- *Negative due diligence information being uncovered by the buyer—as opposed to readily revealed and properly positioned by the seller—can result in the buyer seeking a purchase price reduction or asking for a significant escrow account.*
- *The information you present during due diligence can make the difference between a buyer being willing to do a stock or an asset transaction.*

The deals being done in today's market feature a return to due diligence basics. Buyers want deals that are based on sound financial principles, and they want to identify potential problems as soon as possible in the process. The better prepared you are in advance to make a strong financial case for your company and the more forthcoming you are about any potential negatives about your business, the better your odds of closing the deal will be.

In other words, pulling together the information you will need to present during due diligence is definitely not something that should wait until you've signed a term sheet. As we advised in our [July Viewpoint](#), "Preparing Your Business for Sale," getting your business ready for buyers should begin months or even a year or two before you actually anticipate going into the M&A market.

"The best advice I can give to an entrepreneur is to get your ducks in a row and be prepared going into due diligence so you can streamline the process and make your company look good," says Barry Osherow, a principal at Technology Investment Capital Corp., (TICC) a publicly traded firm in Greenwich, CT, that provides capital primarily to technology-related companies. "Take time to prepare your data and present it neatly. This gives the buyers less reason to feel that they need to question everything."

Osherow likens the due diligence process to peeling back the layers of an onion, trying to learn as much as possible at each layer. "I'm looking for red flags or things that might not be coming up quite as truthful as what might have been represented," he says. "Sellers have a tendency to exaggerate the truth, so it's my job to separate fact from fiction or fact from partial fiction."

## MAKE IT EASY FOR THE BUYER TO SAY YES

"Put yourself in the shoes of the acquirer and ask yourself what they are going to want to see," recommends Adele Hartwick, VP, treasurer and controller at Advanstar Communications Inc., a worldwide media company where she has been involved in both buying and selling companies. "Above all, get your accounting records in order. Make sure you have a solid accrual-based accounting system in place that separates your personal activities from the business's activities. Have an accountant look at your financials and help you prepare them using GAAP accounting rules. This is so important, adding credibility to the seller. We've found that only about 50 percent of the sellers we deal with bother to do this.

"When we're selling a business, we have a data room filled with five years of information taking it all the way down to the detailed general ledger level," adds Hartwick. "In addition, we give the prospective buyer detailed information on such things as our top 100 customers and vendors. It makes it easier for them because now that we've done most of the work, all they have to do is verify the numbers with testing. They can spend more time performing analysis, rather than creating data. That's what every seller should strive to do."

"It's amazing how many people are unprepared for due diligence," says Osherow. "That makes the process harder. If, for instance, it takes a seller two weeks to give me a list of their customers over the past three years and the dollar volume for the top 20 customers, it makes me wonder if they know what they're talking about and how much monitoring they have done historically. Then I have to ask more questions."

## THE DUE DILIGENCE LINE-UP

Exhibit I identifies the key business areas covered in due diligence. For more detailed information, we've provided a comprehensive due diligence list at [www.merger.com/research](http://www.merger.com/research).



Exhibit I

Keep in mind that, although the key topics will remain the same, each buyer's specific due diligence list will vary slightly. "We start off with a standard check list, but inevitably we figure out what are the most critical pieces within a particular business and focus most of our attention on those," explains Osherow. "For example, in our recent purchase of Ai Squared, the competitive landscape was not terribly difficult since Ai Squared is the undisputed market leader in screen magnification software. But in other situations we may spend more time understanding the competitive landscape and the associated risks."

## POTHOLES ON THE DUE DILIGENCE HIGHWAY

Let's look at where mid-market sellers can get tripped up in due diligence and what the likely consequences are if things go awry in specific areas. Knowing where problems typically crop up can guide your due diligence preparation and help you avoid hazards to the degree possible.

- **Corporate Records:** If there is a problem with your company's incorporation or a cloud over share ownership, a buyer may require an asset purchase instead of a share purchase.
- **Hard Assets:** If any assets are owned personally by the shareholder(s), such as computer equipment, artwork or furniture, that won't be sold with the business, they should be identified as such during the due diligence process and preferably also in the Purchase and Sale Agreement (PSA). If any of these assets are used in the business (particularly computers or other equipment), the buyer may require you to include them as part of the sale.

- **Real Assets:** A buyer may be concerned if your company does not have enough space to handle the projected business growth. Alternatively, they will be concerned if the amount of real property seems excessive, particularly if it involves long-term leases at rates above the current market level.

IF YOUR FINANCIAL STATEMENTS HAVE NEVER BEEN AUDITED, IT IS ADVISABLE TO HAVE AN AUDIT PERFORMED OF THE LAST YEAR'S RESULTS AT A MINIMUM.

- **Inventories:** A large amount of obsolete inventory may lead a buyer to question the quality of your company's management team—not just in this area, but in all areas.
- **Accounts Receivable:** A high level of old receivables can cause a buyer to ask two troubling questions: 1) Are customers not paying because something is wrong with the company's products or services? 2) Is the company's customer base financially weak and, therefore, is this an unattractive market?
- **Intellectual Property:** In some cases, your company's intellectual property may be the value driver for the entire transaction. In such cases, a problem that arises about IP during due diligence could kill the whole transaction.
- **Material Contracts:** Long-term vendor agreements can be positive or negative. If a vendor provides a product or service that is easily replaceable, having a long-term contract in place removes the buyer's ability to negotiate price or terms or change vendors. However, if a vendor is not easily replaceable, or if the agreement provides some competitive strength to the seller, then a long-term agreement could be a plus. On the customer side, the presence of long-term agreements is a plus, as it provides some revenue stability for the buyer.
- **Customers, Distributors, Representatives and Agents:** Revenue dependent on a small number of large customers raises a red flag because the company's performance can be

significantly damaged by the loss of a single customer. The best picture to be able to present is a history of growing revenue across a broad customer list.

"When it comes to analyzing the customer base, one of the things we perform is a churn analysis," says Hartwick. "We want to understand

customers' buying patterns. Are they loyal or do they buy once and never return? You must have a good handle on what each customer's activity has been, how much they spent and what products they bought."

- **Licenses and Regulatory Matters:** Any potential liabilities the buyer uncovers can result in a renegotiation of the purchase price, or result in the buyer asking for part of the purchase price to be placed in escrow to cover the potential liability.
- **Indebtedness:** Due diligence may uncover liens or other security interests that a seller will have to get released before a transaction can be consummated.
- **Financial Information:** It is critical to ensure that all of your supporting ledgers (sales, accounts receivable, accounts payable, general ledger, inventory) agree to the balance sheet and income statements provided. If your financial statements have never been audited, it is advisable to have an audit performed of the last year's results at a minimum. This will enable you to correct any reporting or process issues before it becomes an issue for the buyer.

If your financial statements are not prepared according to GAAP, expect that the buyer will request information to enable it to recast your financial statements. This could result in financial performance significantly different from your reported numbers, which, in turn, could result in a purchase price renegotiation or even in the buyer walking away from the transaction.

## A SELLER'S PERSPECTIVE

When Mirus client Ai Squared went through the due diligence process a few months ago prior to its successful acquisition by TICC, Ben Weiss, founder and president, was the man behind the due diligence eight ball. Here's his perspective on the process:

"Going into it, I was primarily concerned about the volume of work that might be involved. I was concerned that it might pull me away from the day-to-day running of the company. What surprised me was the number of requests from the buyer's accountant, the buyer's attorney, and my own attorney. Everybody had different lists. We'd never get through a list without one of those parties generating a new updated version of it; they were coming at us on a daily basis. It felt like I'd never get through it. I was fortunate to be working with investment bankers who worked even harder during the times of drudgery – managing the process of financial due diligence, legal due diligence and contract review – so that I never felt abandoned during any step of the process.

"If I set up a new company, I would have as much of the record keeping in digital format as possible. During due diligence, I was dealing with a lot of paper. So if I went into this again with the intention or possibility of selling, I'd do that differently."

Any pipeline reports should be presented with a view towards supporting any forecasts provided to the buyer. Identifying any off-balance sheet or unrecorded liabilities is critical because these will need to be identified in the PSA. If this isn't done, it can result in a breach of the representations and warranties in that agreement.

"Sometimes people run their businesses as their personal checkbooks," says Osherow. "So we have to figure out what expenses are real and which ones are going to go away after the sale. Very often you get this adjusted EBIDTA (earnings before interest, depreciation, tax and amortization) number and you have to figure out if these are true adjustments or not."

- **Tax:** Any potential tax liabilities that are uncovered during due diligence may result in the buyer requesting funds in escrow for a period of time to meet the potential liability.
- **Litigation:** Any potential liabilities uncovered could have an effect ranging from a request for an escrow, a reduction in purchase price or even in the buyer not completing the acquisition.

"Don't try to hide things," advises Osherow. "If you have a lawsuit pending, bring it up. Sellers are always hoping we're not going to find these things, but we always do and that makes the situation worse. We're going to be that much more skeptical because it brings the credibility of management into play. What happens when people try to hide things is that instead of the process being a partnership to get the deal done, it becomes people working on opposite sides of the table."

- **Insurance:** Escrow agreements may be requested if insurance coverage wasn't sufficient. A significant increase in the buyer's operating costs because of the seller's bad claims history may cause the buyer to renegotiate the purchase price. Concern about past under-insured claims may prompt a buyer to choose to do an asset transaction rather than a stock transaction.
- **Labor and Employment:** It is critical that the employee

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**– BARRY OSHEROW, TECHNOLOGY  
INVESTMENT CAPITAL CORP.**

list ties in with any organization charts provided to the buyer and that total compensation looks reasonable when compared to compensation found on the General Ledger. Any potential employee-related liabilities identified by the buyer can result in a request for an escrow.

"We often see excessive salaries or pension contributions because a business is family owned or owned by an individual," says Hartwick. "You need to be able to carve this type of expenditure out, or better yet, stop doing it a few years before you intend to sell.

When someone is doing due diligence, they want to see how the business has performed over a period of time. Eliminating these items makes the analysis less confusing."

- **Pensions and Benefits:** If the buyer's employee benefit plans are significantly less generous than yours, it can result in either higher-than-expected costs for the buyer, or unhappy employees at your company when their benefit plans are reduced after the sale. Since employee benefit plans indicate what a company's culture is like, this can create red flags for the buyer when planning integration.
- **Information Technology:** If the buyer believes your company's IT infrastructure is not sufficient for the projected growth, their going-forward cost structure is affected. While not generally a deal breaker or a cause for purchase price renegotiations by itself, this could be the proverbial straw that breaks the camel's back if numerous other surprises have cropped up during due diligence.

## THE OUTCOME IS WORTH THE INVESTMENT

"Sellers complain about the length of time and the process of due diligence, but it really rests on their shoulders to streamline it," says Osherow. "I can get a deal done within a matter of weeks if a company is well prepared. Gather your data in advance and be prepared for intelligent, insightful questions. You are trying to realize an exit on an illiquid asset that is the result of a life's work. It should take time, but you're going to realize a big pay off so it's time well spent."

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*Laura Kevghas is a principal at Mirus Capital Advisors, Inc. Mirus is a middle-market investment bank that specializes in advising companies on strategic mergers and acquisitions. By combining a proven process, industry and transactional expertise, creative thought, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Mirus is a registered broker-dealer and NASD/SIPC Member. For more information, visit [www.merger.com](http://www.merger.com).*

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