Baker Pacific
Corporate Development and M&A

By David M. Shanberg

## The Basics of Mergers & Acquisitions Due Diligence

In advising companies that are acquisition candidates, two of the questions that I most frequently receive are:

1. What should I expect from the due diligence process?
and
2. How can I best protect my confidential information while still moving the process forward?

Of course, the due diligence process varies widely based on a number of characteristics of both the acquiring company and the target company, including size, maturity, process-orientation, public vs. private, and competition for the deal. However, it is possible to provide a general answer to the two questions above.

### 1. What should I expect from the due diligence process?

Generally, the information that an acquirer expects is broken down into the following categories:

- General Corporate Matters
- Financial, Accounting, and Taxes
- Technology and Intellectual Property
- Product / Service Offerings
- Operations
- Sales and Marketing
- Human Resources and Personnel
- Legal and Regulatory

Within each category, there tend to be two distinct types of requests: document requests and questions to be answered over the phone and in meetings. Often, it possible that there will be a "priority" due diligence checklist early in the process and a more detailed one later.

Also, a savvy acquirer will want to see projections, reports, and other documents actually used by the company, as opposed to specially-created projections and reports just for the M&A process.

Ultimately, anything that could be material enough to affect the valuation of the business is fair game. Since the potential acquirer doesn't know what is material until it asks, the initial due diligence list can be overly long, with a number of requests that are irrelevant. So, don't panic when you see the list for the first time – a number of the requests may be able to be disposed of quickly.

Usually, the potential acquirer will want to visit your offices and speak with most of the top management team. Balancing these demands with the need for secrecy, while being reasonable and maintaining a good relationship with the potential acquirer, is certainly one of the challenges of the due diligence process.

### 2. How can I best protect my confidential information while still moving the process forward?

Potential acquirers are typically trustworthy and sincere in their intent when conducting due diligence, with making an acquisition the goal rather than gathering competitive intelligence. However, some may enter the process with both goals, and a few may actually have bad intentions.

With that in mind, there are three actions that a company can take to decrease the odds of wasting time and unnecessarily parting with sensitive information, while not overly encumbering the acquisition process:

A. Gauge the seriousness of the potential acquirer
B. Stage the flow of information
C. Be on the lookout for warning signs

<u>A. Gauge the seriousness of the potential acquirer</u>

In addition to the *intentions* of the potential acquirer, judging their *seriousness* at the beginning of the process and throughout can save a target company lots of time and frustration. In my experience, frequently a company would like to make an acquisition but simply is not in a position to do so.

There are number of easy ways to test for this, including the following.

Evaluate the company's financial ability to make an acquisition. Do they have the cash to make a cash deal? Do they already carry a large debt burden, or do they have the ability to borrow to finance the deal? In the case of a public company, it is feasible to consummate a stock deal? The company should be able to provide a clear and realistic plan on how they would structure and finance the deal.

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Evaluate the means of initial contact. Was it through a senior executive or board member, or through a person with less authority? If it was through an intermediary, how credible is the intermediary, and is it formally representing the company?

B. Stage the flow of information

Staging the flow of confidential information based on the overall progress of the transaction is one of the best means of protection. Early in the discussions, less sensitive information is shared, and as the potential acquirer progresses and shows that it is serious, more sensitive information is shared. It forces the potential acquirer to “earn” the most sensitive information, and limits the number of parties that will see the most highly confidential documents.

While an NDA provides the legal protection, this method adds practical protection. Implementing this method involves staging due diligence into at least four phases of information sharing, although there’s not necessarily a defined break point between each phase.

(1) The first phase consists of the high-level, pre-NDA information, such as a “teaser document” and information that is already contained on the company website.

(2) Following an NDA is more detailed information on all aspects of the company (see Part 1 above for details). This information is typically heavier on current and historical information than on forward-looking projections. Quite a bit of confidential company information is disclosed in this stage, but very little that is competitively sensitive.

(3) The next phase involves the most sensitive company information, including projections, customer information, and any other requests from the acquirer deemed too sensitive to share earlier in the process. The process should be far along and the acquirer clearly serious before sharing these “state secrets.”

(4) Finally, the accounting and legal due diligence is frequently at the end of the process. This phase is last more for reasons of cost and the larger number of people involved than for confidentiality reasons.

C. Be on the lookout for warning signs

Throughout the process, it’s key to continually evaluate the potential acquirer in a number of areas. Most important is overall trust. If they have been honest and straightforward in the negotiations, that’s a good sign for their integrity overall.

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While the seriousness of the acquirer is discussed above, it can be even better judged as the process continues. See if their actions are those of a serious acquirer: how big is the team, how much time are they spending, and are they spending cash to evaluate the transaction (e.g., investment bankers, attorneys, accountants).

An experienced acquirer should understand the staging of information described above. If they are unreasonably frustrated at having to wait, that could be a red flag.

Does it feel like they're just fishing for information that's not critical to the deal but could be important to a competitor? The focus of the due diligence can vary depending on the acquirer, but everything should track back to understanding the business, assessing its value, and avoiding risk.

Which groups from the potential acquirer are involved? Typically, there is mostly corporate-level involvement early in the process, and more operational people and specialists later. Think about the groups at the potential acquirer that are the biggest competitive threat, and if there is a disproportionate number from those groups, make sure you understand everyone's role as it relates to the M&A process.

There is obviously a lot more involved in running a productive due diligence process, but the topics in this article cover some of the important basics regarding expectations and protection.

*David Shanberg has led communications, Internet, software, and other technology mergers, acquisitions, strategic alliances, venture investments, business development, and finance activities for the past 16 years, completing transactions totaling over $90 billion. He also has a previous 4 years of experience in technology consulting.*

*Baker Pacific specializes in corporate development strategy and M&A transactions for technology companies. Baker Pacific is especially well-suited for situations where a company finds itself contemplating or facing a significant transaction (such as a sale of the company or an acquisition) and needs additional expertise and bandwidth to be successful.*

*Baker Pacific's philosophy is not to just do deals, but to do the right deals. Its orientation reflects the impartiality and deeper industry understanding of an internal strategy and corporate development executive, as opposed to a transaction-oriented outside advisor. Baker Pacific is not afraid to advise against doing a deal.*

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