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DUE DILIGENCY IN MERGER AND ACQUISITION

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ABSTRACT

In India, mergers and acquisitions are governed by the Companies Act, which serves as the primary legislation. The definition of a merger under the Act is the amalgamation of two or more organizations into a single entity. This process is regulated by the Act under sections 232 and 234. The objectives of mergers and acquisitions (M&A) transactions can encompass a company's aspiration to enhance its market reputation or that of its stakeholders, gain access to novel product lines or technological advancements, reduce operational expenses, diminish the number of competitors, augment market share, increase manufacturing capacity, procure new suppliers, diversify its operations, and so forth. However, it is important to note that most of these transactions fail to achieve their intended objectives. In this context, the due diligence and integration process assume a pivotal role.

Due diligence teams usually follow well-established legal and financial processes. If an acquirer has a professional and skilled M&A team that uses situation-specific legal and financial checklists and evaluates the target company from a legal and financial standpoint, the combined entity can achieve its deal goals. But the importance of corporate culture and integration processes is often overlooked. This study says that cultural due diligence and integration processes are just as important as financial and legal due diligence for M&A transactions. Incompatible management styles or ego conflicts between CEOs have caused many failed M&A deals in the past.

INTRODUCTION

Mergers and acquisitions (M&A) constitute a substantial component of corporate finance. Investment banks facilitate M&A transactions, which entail the merger of distinct companies to

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establish larger entities. The fundamental principle underlying the acquisition of a company is to generate shareholder value that exceeds the combined value of the two companies. M&A is based on the belief that a combined entity is more valuable than its parts. Before an M&A, companies evaluate the potential of the acquired company. This evaluation helps us decide if the transaction should happen and figure out the right price for the company buying it. The most common way to do this is called due diligence. The due diligence process can be a lengthy and disruptive undertaking, especially for intricate organizations. In such cases, it can span several months. The primary concern with this process is its lack of standardization. Different organizations and experts may adopt varying approaches to due diligence when evaluating a merger or acquisition.

Mergers and acquisitions (M&A) can be pivotal to the healthy expansion of business firms as they evolve and progress through different stages of growth. For a firm to successfully enter new geographical markets, it may necessitate M&A activities at some point to facilitate its own development and expansion. Containing activities as Takeover, Corporate restructuring, corporate control, Change in ownership of firms. As some experts have posited, mergers and acquisitions (M&A) can enhance the value of shareholders. Conversely, others maintain a skeptical perspective, asserting that the acquired firms are already mature and that mergers have no substantial impact on shareholders.

How does a merger occur? A horizontal merger involves two firms in the same industry, like two wood factories. A vertical merger integrates different production stages. A conglomerate is a type of M&A that merges unrelated companies into a single holding company.

DUE DILIGENCE ACTIVITIES IN AN M&A TRANSACTION

An exhaustive list of potential due diligence inquiries must be addressed. Additional inquiries may be necessary for industry-specific mergers and acquisitions (M&A) deals, while fewer inquiries may be required for smaller transactions.

Due diligence is the process of thoroughly examining a potential purchase to ensure its alignment with expectations. This can be a cumbersome process for sellers, akin to a root canal for businesses.

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It typically involves gathering extensive documentation and processing it, often requiring multiple rounds of follow-up questions, especially for larger businesses.

To streamline this process, sellers can organize their due diligence items into folders accessible through platforms like Dropbox or Google Drive. There are also off-the-shelf products available that provide intra-links, ideals, and other tools specifically designed for this purpose.

As a seller, you will likely receive a request from the organization chart to provide financial information for the last three years, including profit and loss statements, income statements, cash flow statements, and tax returns. Additionally, you will be requested to provide customer lists, top customers from each of the past three years, and the total volume of their transactions.

The due diligence process can take several days, weeks, or even months, depending on the size of the deal. Before the advent of the internet, this process was conducted in physical locations called deal rooms or war rooms, where boxes filled with documents were stored.

Despite the complexity and potential pain involved, one way to mitigate these challenges is to thoroughly understand the due diligence checklist and map out what the buyer will be seeking. This process of organization can also facilitate negotiations and improve the overall sales process.

IMPORTANCE OF DUE DILIGENCY

Due diligence aims to reveal potential risks and opportunities in a proposed transaction. Thorough examination of details helps companies identify these aspects.

The due diligence process is both time-consuming and intensive for both buyers and sellers, yet it is also absolutely critical to a successful merger and acquisition. The investigative process conducted during an acquisition provides both parties with an opportunity to validate their assumptions about each other, and it is exceptionally important for an acquirer to fully comprehend the company it is purchasing. Due diligence provides insight into the target business's revenue and profit claims, and buyers should thoroughly identify risks, liabilities, and business problems before finalizing the transaction.

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A thorough buyer will also evaluate a seller across all aspects of the business. A rushed or inadequate due diligence process can have significant consequences; research suggests that as many as 90% of acquisitions fail to meet their pre-acquisition goals. To ensure that you are obtaining a comprehensive view of the company before a merger and acquisition, it is important to review the financial statements, but you should also assess the culture and people involved.

A common issue in mergers and acquisitions (M&A) is that buyers have key assumptions about the seller, but these assumptions are not always communicated to the newly acquired company. In the due diligence process, key merger assumptions can be tested to ensure that everyone is on board, increasing the chances of M&A success.

TYPES OF DUE DILIGENCY

Financial Due Diligence

Financial due diligence is the meticulous examination of financial records, akin to Sherlock Holmes's detective work, to uncover clues and assess a company's financial health and stability. It involves analyzing a company's financial statements, cash flow, debt levels, and profitability to gain a comprehensive understanding of its financial position.

Legal due diligence

Meet the legal eel of due diligence, ensuring all legal IIS are dotted and Te's are crossed. This involves reviewing contracts, licenses, permits, and any legal disputes to identify potential risks and ensure compliance with all applicable laws and regulations.

Operational due diligence

The operational due diligence expert, a member of the efficiency team, conducts a thorough analysis of a company's daily operations. This analysis focuses on understanding how the business manages its processes, supply chain, technology, and key personnel. By doing so, the expert identifies any potential operational risks or inefficiencies.

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Commercial due diligence

In this area, the market god of due diligence focuses on comprehending the market landscape and a company's competitive position. It also involves analyzing industry trends, customer base, competitive landscape, and market share to assess the company's growth potential and long-term sustainability.

NOTE: By integrating these diverse types of due diligence, you obtain a holistic perspective of the opportunity, thereby minimizing risks and augmenting the likelihood of success.

PERFORMANCE OF DUE DILIGENCY

Conducting due diligence is a fundamental aspect of any mergers and acquisitions (M&A) transaction. It is a protracted and arduous process that involves multiple parties and phases. To effectively conduct due diligence, one must thoroughly analyze the entirety of the business before making any informed decisions. This process is typically undertaken by a potential buyer prior to engaging in any business transactions. Each M&A transaction is distinct, incorporating unique characteristics such as the size of the acquiring company, the nature of its business owner and leadership personalities, its cultural environment, and the industry in which it operates. The conduct of due diligence on a company varies depending on the transaction type, but certain steps are common to all deals. Generally, the larger and more complex the transaction, the more due diligence is required.

Consider it important

A due diligence process is akin to the thorough examination conducted when purchasing a house. The seller is legally obligated to disclose substantial information pertaining to the property's condition and history. Consequently, it is the buyer's responsibility to gain complete awareness of any past issues before finalizing the transaction. Unlike a superficial "check the boxes" exercise performed between deal negotiations and official signings; due diligence is a comprehensive process that requires careful consideration. If the due diligence process yields unsatisfactory results, it may necessitate the cancellation of the deal.

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"Right size" the team

How many individuals should be assigned to the diligence team? What is the estimated time commitment for this project? It is imperative to recognize that due diligence is a demanding task that requires significant effort from both the buyer's and seller's teams. Overcommitting to due diligence may hinder normal business operations. Conversely, insufficient time and resources may compromise the quality of the assessment. Therefore, it is crucial to carefully evaluate the size and complexity of the business before determining the appropriate team size and duration for the due diligence process.

Confidentiality

A due diligence project is typically an intensive undertaking that may involve extended hours and frequent travel to various locations, such as airports, train stations, and potentially public spaces like Starbucks. When discussing sensitive information during a confidential meeting, it is advisable to select a more secure and private setting to ensure the confidentiality of the discussion.

Good checklist + good brain

You will not be the first team to conduct a thorough assessment of the expertise of those who have preceded you. There are general checklists available, as well as industry-specific ones. However, it is important to consider that the company you are investigating is unique, and you should collaborate with your team to identify potential risk areas. A useful tool for this purpose is the failure modes effect analysis, a concept originating from the field of project management and six sigma. This analysis involves brainstorming "worst-case scenarios" that could potentially go awry and rating them based on their impact and likelihood.

Solid documentation and report out

Following the completion of site visits, document reviews, and interviews, take your own time to compose a thorough report summarizing your due diligence findings. In the executive summary, if the due diligence process was successful, include a statement such as "in our opinion, based on the review conducted, we did not find any material defects or risks that would prevent the transaction." This statement should be accompanied by a detailed explanation of how you arrived at this conclusion. Additionally, include a list of your sources, cross-reference your documents,

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and provide a chronological record of the individuals you interviewed and the dates of your conversations.

Mitigate incomplete information

What information does the target company fail to disclose? It is crucial to pose a substantial number of open-ended questions, such as "What additional information should we be aware of regarding your service delivery process?" or "Are there any other concerns or open cases pertaining to the environment, health, and safety?" These types of questions help underscore the seller's obligation to disclose all relevant information. It is advisable to reserve a portion of the total acquisition sum until the deal is signed. This way, if any material issues arise later that should have been disclosed during the due diligence process, you can withhold payment until the problem is resolved. This approach prevents the need to seek compensation in court for information that was intentionally withheld, potentially misleading.

Common Due Diligence Challenges

Consider a business that is plagued by problems and particularly concerning are persistent issues that remain unresolved due to concealment. This principle applies equally to due diligence processes. If you approach us and acknowledge the possibility of a founder who is a part of the business being on a cap table but has not disclosed this information, or if you have any other pertinent or intriguing details that may not be the most favorable aspects of your business, we would appreciate it if you shared them with us promptly. Failure to do so may diminish our impression of the time and effort we invest in due diligence, only to discover information that could have been disclosed on the outset.

Additionally, we may encounter concerning issues during due diligence. One common problem is unexplained or concealed tax liabilities. For instance, a company may not have yet paid any debts owed to the Australian Taxation Office (ATO), or it may have unpaid superannuation contributions for its employees. We conduct a thorough investigation and seek to understand the missing information and outstanding obligations.

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Another issue we frequently encounter is director or shareholder loans. As investors, we typically prefer to convert these loans into equity to achieve complete alignment among shareholders. We generally avoid situations where our funds are solely used to repay the founders who have personally lent money to the business.

Certain red flags may indicate a lack of transparency and potential issues. A poor attitude towards finances is a significant concern. We have observed businesses where the founders have direct control over the financial records, rather than maintaining a professional and sophisticated approach. While this may be acceptable if the business is their personal property, we prefer to see them manage their finances in a responsible manner, either drawing a wage or paying a dividend.

Lying during the due diligence process is a major red flag. While minor discrepancies may be overlooked, outright lying is unacceptable and serves as a poor indicator of future trustworthiness. We will not tolerate such behavior and may terminate the due diligence process.

Due diligence is an in-depth process that requires a comprehensive understanding of the business and its operations. It is essential to thoroughly examine all aspects of the business to ensure that it meets our investment criteria and aligns with our long-term goals.

FAILURE OF DUE DILIGENCY

In the realm of merger and acquisition, numerous failures occur, and several factors contribute to these outcomes. Firstly, the absence of an effective communication strategy between the merging parties poses a significant risk. Without a clear understanding of the objectives, it becomes highly probable that expectations will not be met, and stakeholders will lack proper coordination.

Another common cause of merger and acquisition failures is cultural clashes. Even if one company possesses an exceptionally talented team and the other boasts a remarkable culture, the integration of these two entities can be detrimental to the success of the merger or acquisition.

Finally, overvaluation is a major factor that can lead to the failure of merger and acquisition deals. When one party overestimates the value of the other, it can result in long-term problems and ultimately culminate in failure.

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In conclusion, before entering any merger and acquisition deal, it is crucial to ensure that all parties are aligned and have realistic expectations. Failure to address these factors can have severe consequences for all involved parties. However, this should not deter you from pursuing merger and acquisition opportunities. With proper planning and preparation, you can significantly reduce the likelihood of failure.

Nevertheless, it is essential to approach any deal with caution and be prepared to terminate it if circumstances do not favor the agreement.

HOW LONG IS DUE DILIGENCE PERIOD

Determining the optimal level of due diligence during road mapping can be challenging. While thoroughness is crucial, it should ideally be completed within a 30 to 60-day timeframe. To make this happen, we'll put together a team of superstars from different parts of the business. Our goal is to speed things up without compromising on accuracy.

Some investigation issues cannot be anticipated.

• Project Goal: Maintain high energy, efficiency, and quality while adhering to the due diligence deadline.

• Potential Challenges: Some challenges may emerge during integration and potential benefits may not be fully realized.

CONCLUSION

Due diligence in merger and acquisition is the process or efforts undertaken by the buyer to thoroughly investigate the target business to gain a comprehensive understanding of its operations, financials, and potential risks. This process involves considering various factors, including ensuring compliance with applicable laws, analyzing financial records, evaluating business operations, and examining key contracts with customers, suppliers, and employees. Additionally, a balance sheet is reviewed to assess assets and liabilities.

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By conducting due diligence, the buyer can gain a better understanding of the target business, enhance its bargaining power during negotiations, and identify and mitigate potential risks. It is advisable to appoint legal and accounting professionals to oversee the due diligence process to ensure its thoroughness and compliance with legal requirements.

Neglecting due diligence can lead to unforeseen consequences, including exposure to risks with customers and suppliers, potential lawsuits for failing to disclose known information, and overpaying for the business, which may not be valued.