WHITEPAPER

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Preparing for Due Diligence

THIS WHITEPAPER EXPLORES:

We'll discuss how to prepare for the due diligence phase to help ensure a smoother transaction process. We'll highlight common deal breakers, provide strategies to mitigate risks, and offer a preparatory checklist to help sellers navigate this critical stage successfully.

COLDSTREAM

Preparing for Due Diligence

It's estimated that approximately half of all business sales fall apart during the due diligence phase[1]. This can be demoralizing for a seller that has spent countless resources on positioning the company for sale, polishing the marketing materials, and negotiating the Letter of Intent. The transaction process takes an abrupt turn when the parties enter due diligence; the sellers begin sharing more information, the buyers often "go dark" during review, and the communication between the parties may become tense due to misinterpretation of messaging or frustration with the lack of direct contact.

Some of the most common reasons for a transaction to fall apart during due diligence are summarized below with a preparatory due diligence checklist to follow.

Common Deal Killers

1. Decrease in Revenues or Profitability

This is an exceedingly common situation when sellers represent themselves. Managing the due diligence process is a full-time job; the combination of gathering data with the time constraints of ongoing negotiations often results in ownership taking their focus away from the operations of the company. A drop in either sales or profitability may prompt repricing discussions or an adjustment to the terms of a deal.

2. Slow Response Times

Hesitancy to provide data or slow responses to requested data can lead to mistrust on behalf of the buyer or suggest the selling party has staffed a poor management team. Proper preparation for the diligence process can greatly alleviate slow response times.

3. Inaccurate Data

Financial statements that are not professionally compiled or reviewed may lead to accuracy problems during due diligence. Data provided during the due diligence process should reinforce the marketing materials used to secure the Letter of Intent. Financial projections should be reasonable and supportable with appropriate capital expenditure projections as well as staffing and occupation requirements.

4. Lack of Transparency

Uncovering new information during the due diligence review may delay a transaction as the buyer absorbs the data. Discovering major contracts that expire soon, or non-transferrable agreements will likely negatively impact negotiations. While confidentiality is critical during a sales process, the buyers will need to be made aware of circumstances that may materially impact their analysis of the company. Selling parties must be transparent, when appropriate, and prudent with disclosing surprises before a buyer discovers these items.

5. Constant Negotiating

Over negotiation most commonly happens when a selling party maintains strong and/or growing profitability through the sale close date. The sellers believe they've over-delivered while the buyer believes the strong performance simply supports the premium pricing of their original offer. Once a seller agrees to the terms of an LOI and enters the due diligence phase, the selling party should not expect additional value (except for rare circumstances).

[1]https://www.forbes.com/sites/richardparker/2016/09/16/surprises-are-great-for-parties-but-they-can-kill-the-sale-of-a-business/

How You Can Prevent Deal Killers

Now that we've identified common reasons for a deal to fall apart, the question is how do we prevent these occurrences? Being properly prepared will greatly streamline the due diligence timeline, reduce many of the buyer's concerns, and minimize the risk of a seller exposing their classified information only to have a buyer back out of the deal.

While it's impossible to fully prepare for the due diligence process (each buyer's process is unique), we can predict with some certainty the types of data that will be requested:

Financials

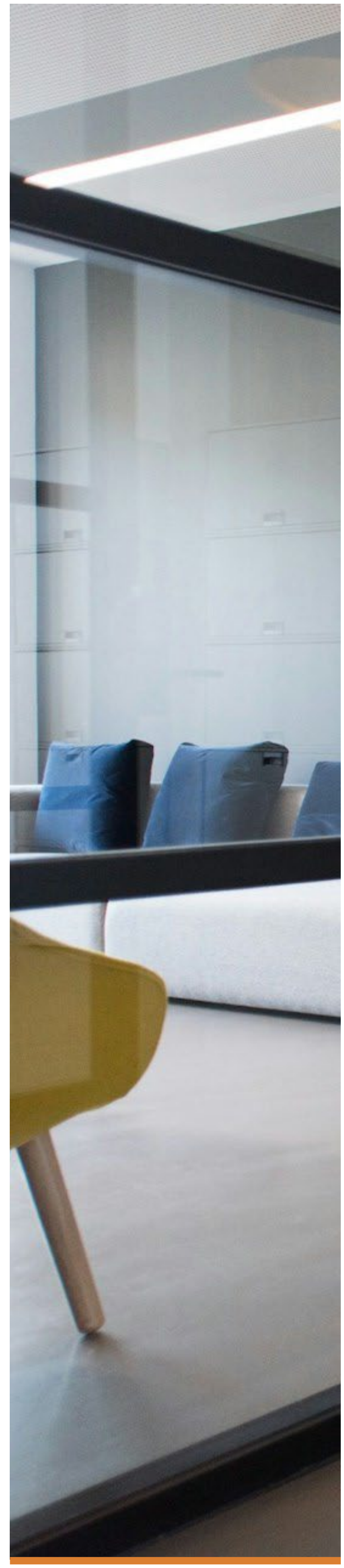
- 3 – 5 years of historical financial statements (audited preferred)
- Financial projections, with growth supported by expense and capital expenditures
- Financials by division (or major revenue source)
- EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) adjustments
- Listing of assets

Legal

- Organizational documents (bylaws, articles of incorporation, business license, etc.)
- Shareholder agreements and stock register
- Board minutes
- Buyer and supplier contracts
- Litigation (completed, outstanding, and pending)
- Environmental reports

Employment

- Organizational chart
- Employee count by department
- Key employee profiles
- Compensation and bonus structure
- Benefit plans
- Employment agreements



How You Can Prevent Deal Killers (cont'd)

Tax

- 3 – 5 years of tax returns (Federal and State)
- Audit reports (completed, outstanding, and pending)
- Policy and procedures of reporting for tax purposes vs. financial statement purposes
- Revenue recognition policies

Operations

- Management reporting presentations
- Key operating metrics
- Reports on Top-20 buyers/suppliers
- Details of operating facilities (square footage, capacity by operation, year built, etc.)

Contact Us

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