DTP VIEWS

Summer 2016

Financial due diligence

– Andy Roskell Director, DTP

To merge or not to merge – that is the question. It's a quandary faced by many RPs at present with the stakes and the potential rewards both equally high. Get it right and you have the potential to create an organisation which is greater than the sum of its parts – one which is both more efficient and more effective.

In a previous blog I touched on the importance of getting the cultural fit right to ensure a merger succeeds. The new organisation which emerges has to bring together two cultures while at the same time creating something new. Neglect this at your peril.

But analysing whether another RP is a good fit for your organisation of course also requires rigorous financial due diligence. Your potential partner has to be willing to open up their books and let you in on how they've been doing – and how they expect to do in the future. You have to make a cool analysis of their overall judgement, performance and effectiveness. And you have to use that information to make a rational decision about your merger partner's suitability. It's perhaps obvious but effective and thorough financial analysis is best undertaken by professionals (either in-house or external) with relevant experience.

My advice is to start the process off by looking back into the past and forwards into the future at the same time. Historic analysis of financial performance can help you identify useful trends in financial performance including any areas of weakness in the business. This can raise an important question: have these weaknesses been overcome? It's essential that your due diligence process gathers the information you need to provide reassurance (or not) on this. To give the green light to a merger you must be confident weaknesses are in the past – or that measures are in place to consign them there.

Meanwhile, future projections in the business plan can identify challenges which might lie ahead. An example might be where projected cost savings are essentially assumed – they have been modelled but are by no means certain. Such assumptions must be supported by achievable plans if they are to be seen as credible and rigorous. Likewise, forecasts for sales income should be backed up by clear evidence of recent sales history and current projected demand.

As you go over these forward projections and assumptions you are looking for a couple of key things in my view. What's needed is evidence that your prospective merger partner's planning assumptions are reasonable and conventional. There might be sound arguments for not following conventional assumptions – but you need to know clearly what they are and be persuaded by them.

The due diligence process then requires a moment of reflection in my experience. You've met the key people, digested the information they have provided you with, now comes the time to make a judgement call. I call this 'business assurance' and it involves asking yourself a crucial question: 'what does all this amount to?' There's some overlap here with the cultural due diligence I mentioned earlier, and it is at least on a par with the analysis of the financial and operational performance of the business.

Up until this point, due diligence can perhaps be characterised as a slightly dry, academic exercise. Critical though this is, our approach is to follow it up with a process of opinion forming.

So what does it involve? At its heart it is about making an assessment of the performance of the executive team. How well is it managing the business and dealing with the problems which it faces? Do the executive team and the board work well together? Clues can be found in the minutes of executive team meetings and in the details of reports they provide to boards. Look for issues such as fraud, contractual difficulties, disputes with third parties (and the potential liabilities associated with this), overspends against budget and failures in statutory compliance. Where these have arisen has the governance structure risen to the challenge? Have the people got on top of these problems? You might not find a 'smoking gun' but you may well find evidence which raises a question mark about the effectiveness of management and the culture of the organisation you plan to merge with.

What else might raise concerns? There are a number of things I would look out for including the late submission of VAT returns and associated fines and any signs that the accuracy of internal reporting has been called into question.

A judgement call has to be made about what all this tells you about the organisation you plan to merge with. Does it call into question their ability to carry out the basic tasks expected of them – by lenders, the regulator …? Are there serious underlying problems which should call a halt to proceedings? Or are these legacy issues – which have been banished, overcome and, crucially, learned from?

The key personnel who we engage with during this part of the exercise are usually the chief executive and the finance director (or equivalent). What we are looking for is clarity on matters not fully explained by the data which has been provided.

When we bring all this together into a report it's crucial that our opinions are based on solid evidence. With this in mind we opt to share our draft with the organisation we have been examining to ask them for their views on its accuracy. At such a sensitive stage in the process this is essential as any misinformation could create tension among the prospective partners.

Next we put together an action plan which sets out any work which is needed pre-merger or post-merger. This is then consolidated with the other party's financial due diligence action plan and is combined with the legal due diligence to form an important element of the business case for merger.

Keeping boards in the loop is essential. They must have the opportunity to be able to review all due diligence reports and need the best advice possible on all matters arising. That's not only crucial to the process but also a current HCA requirement. Other parties may also wish to see these reports once the boards have approved them, funders, for example, will often seek copies of them and will pay close attention to them.

As for the question of whether to merge or not to merge, that ultimately requires an analysis based on fact and informed opinion. Due diligence – even the cool headed financial variety – has to combine both to be effective in my view. It's as much art as it is science. But by asking searching questions and going beyond the data you stand a good chance of making the right call.