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Scrutinizing a target’s viability has been part and parcel of the process of buying companies since its inception. In today’s world, where deals can run into hundreds of billions of dollars, however, ensuring that your due diligence process is up to scratch is increasingly becoming paramount. If it isn’t, it can end up costing companies, both in terms of cash and reputation. HP, for example, is still feeling headaches over four years since its $11bn acquisition of Autonomy.

Not only has its importance increased alongside deal values – the way the process is run has also changed through technological advancement. Particularly within the past 10 years, the development of online activity, data rooms and other analytical software has enhanced the amount of data companies can crunch, as well as vastly reduce the time it takes to conduct due diligence.

Yet even with the increased importance placed on the process, as well as the improved technology, due diligence still remains very much a holistic task. Company-by-company, each has its own priorities, methods and timeframes depending on the situation. But are any more prevalent than others?

With this in mind, RR Donnelley, in conjunction with Mergermarket, is pleased to present the Due diligence roadmap, a report outlining which decisions factor into corporate due diligence processes. Key findings include:

• Companies are focused on quick processes with fewer people. Sixty-four percent say the priority in due diligence is getting it over quickly in order to capture deal synergies early, and 60% use fewer than 20 internal employees when conducting due diligence.

• Dealmakers prefer to start early. Sixty-eight percent started their last due diligence process either upon signing the confidentiality agreement or during the targeting process.

• Financials rule all. Eighty-two percent said that financial information was in the top three facets of a target to review during due diligence, while 50% said financial reviews were one of the major things in due diligence that add to deal value.

Due diligence has clearly been transformed in the last decade, as facets such as culture and data have come to prominence. However, even as the technology and tools change, many of the fundamentals remain the same.
Other respondents were keen to sing the virtues of researching information on targets right from the beginning, and involving due diligence team members in that process. “Right before we started the deal we started the due diligence process; we usually do this before any deal,” says a managing director of a financial advisor. “Our team is informed and they start looking up all important details related to the company.” The advent of technology has helped to make this “desktop due diligence” much easier to conduct in recent years. Resources such as Companies House, for instance, allows anyone with an Internet connection to access information about UK companies, including current officers, previous names and insolvency information.

Almost two-thirds of respondents would prefer to get the due diligence process done quickly to capture deal synergies early (64%), while 36% said that expanding the due diligence timeline is favorable.

Speeding up the due diligence process makes sense when it comes to maximizing the potential value of the deal, as merging the two companies more quickly can, in theory, lead to synergies being captured earlier. “We wanted to expand our capabilities, start producing for a cheaper amount and expand our business,” says a managing director at a corporate. “For this reason we tried to carry out this process quickly to capture the market and ensure we got the benefits of the deal early.”

For the most part, companies are not too set on starting the due diligence process either early or late. Seventy percent chose to begin it either during negotiations or upon signing the confidentiality agreement. Just over a fifth (22%) start doing desktop due diligence during the targeting phase, while 8% admitted to only starting due diligence when signing their last deal.

Starting due diligence when the confidentiality agreement is signed can help to ensure minimal legal ramifications down the line. This is a particularly acute point when handling information deemed by the target to be private. “We had to sign a confidentiality agreement before we started the process,” said a VP of strategy and corporate development for a corporate. “We were dealing with very sensitive data and the company would not comply with us if we did not sign a deal.”

“We do not mind taking our time – if we are expanding into a new region, we need to have a good understanding of the company, the risks involved and how to adjust.”

M&A director, financial advisor
When it comes to completing the due diligence process, what would be your priority?

- **64%**
  - Getting the process done quickly to ensure deal synergies are captured early

- **36%**
  - Expanding due diligence timeline to investigate as thoroughly as possible

How much internal resource does your company put toward due diligence during an M&A transaction?

- **60%**
  - Average number of resources (10-20 people)

- **40%**
  - Significant number of resources (above 20 people)

By contrast, more cautious respondents said they are prepared to take longer, digging deeper into the details in order to preserve long-term value. “We expand this process, as we like to investigate thoroughly into the company and look at its assets completely,” explained a VP of corporate development at a corporate. “If we do not, there is a chance we may overlook some crucial information that would cause problems in the future.”

Taking more time can become even more important when considering cross-border transactions. “We do not mind taking time — if we are expanding in a new region, we need to have a good understanding of the company, the risks involved and how to adjust,” said an M&A director for a financial advisor. “It is very crucial for us.”
WHAT ARE THE MOST IMPORTANT THINGS TO HAVE ON A DUE DILIGENCE CHECKLIST TO REVIEW? (SELECT UP TO THREE)

- 82% Financial information
- 32% Physical assets
- 42% Company’s organization and standing
- 30% Products and service lines
- 38% Tax situation
- 4% Employees
- 26% Litigation issues

Key:

- 0-33%
- 34-66%
- 67-100%
Interestingly, despite the fact that most respondents look to complete due diligence quickly, 60% said their company uses between 10-20 people from internal resources to help with it, compared with 40% who used more than 20 people.

Breaking down these results further, a small pattern emerges showing a split between companies willing to commit time and resources to due diligence and those that are not. Of those who said they wanted to get the process done quickly to ensure that deal synergies are captured early, 68% only used between 10-20 people from internal resources to do so. By contrast, of those who expanded the timeline to be more thorough, 55% used above 20 people to help with it.

Some respondents noted that technological advances have lessened the need for active boots on the ground when it comes to due diligence. “We do not put in too many resources in the process, in fact the team has up to 10 people at a time. We have advance systems, which help our team,” says the managing director of a financial advisor, whose firm preferred to get the deal done quickly. “We also do not feel we need more than this many people.”

Others taking a more detail-oriented approach by utilizing more internal people for due diligence suggested they value caution above all else when it comes to the process. “We have quite a big team,” says another managing director of a financial advisor, whose company prefers to expand the due diligence process and use more than 20 internal people on due diligence. “We are very careful and try to make sure the diligence is successful and that the companies involved can get the best out of the deal.”

Despite the rise of areas such as technological and cultural investigations, financial information was by far the most important thing to review during due diligence, according to 82% of respondents. The closest facets to financial information were company organization and standing (42%) as well as the target’s tax situation (38%), both way back but still garnering responses from over one-third of those surveyed.
Just over a fifth said that due diligence’s main function was to gain a better understanding of the target, while smaller percentages felt the main goal was to get better payment terms (16%), change legal structures of deals, or confirm business plans and post-merger integration plans (both 12%).

Finding and quantifying risk is still critical to due diligence, particularly with investor capital on the line. “For us the biggest purpose of a due diligence process is to find any potential risks that we can face,” says the managing director at a financial advisor. “There are many risks involved and finding these out can be really important, as it has a huge impact on their business. There is also a lot of money involved from our shareholders and the company that is investing that needs to be looked into.”

Taking a more positive look, using the investigative period to understand how the target and acquirer would work in the future in terms of strategy can help to realize what the deal would look like at a macro level. In particular, it can help to give an idea of how integration may go. “We wanted to understand the business better and how well it would fit in with our strategies, as we wanted to have a good integration and be able to do business and not make losses during the integration process,” says one VP of strategy and corporate development at a corporate. “We were very careful about that, as it could affect us in a big way.”

Reviewing company financials is one of the main keys to maximizing a deal’s value, according to half of respondents, while 36% believe the quality of earnings is also vital. Financial performance and quality of earnings provide “a holistic understanding of the company’s management capability,” said a managing director at an investment bank.

Digging into the financials can certainly bring dividends when it comes to a company’s purchase price. Take the example of UK-based Hikma Pharmaceuticals in its offer for Boehringer Ingelheim’s US generics business in February: After due diligence revealed lower-than-expected 2015 earnings at Boehringer, Hikma lowered its price by US$535m, Reuters reported.

Financial information is still the foundation of any deal’s value, several respondents said. “We always look for the financial data and if there are any irregularities in and the performance,” said one managing director at a bank.

Many of the issues on the checklist are linked, several respondents noted. The same managing director from the bank, for example, illustrated how irregularities in one category can lead to damage for a company’s image. “The tax situation can cause problems with the government,” he said. “Tax defaulting can be bad for the company’s reputation and can lead to a lot of legal problems.” Defaulting isn’t the only issue surrounding taxes, either. Recent public furor over specialist tax arrangements, particularly inversions, has seen many deals scrutinized or pulled in recent years.

When it comes to defining the main purpose of due diligence, its traditional task of finding potential risks is still the frontrunner, according to 38% of respondents.
WHAT PARTS OF DUE DILIGENCE DO YOU THINK DO MOST WITH REGARD TO A DEAL’S VALUE? (SELECT UP TO TWO)

- **Financial reviews**: 50%
- **Product/service lines**: 40%
- **Quality of earnings**: 36%
- **Customer references**: 36%
- **Analysis of target’s competitive position in the marketplace**: 24%
- **Compliance issues**: 14%

Forty percent of respondents said looking at company products/service lines is crucial for attaining value, while 36% believe customer references are important. As one CFO at a corporate pointed out, these two elements of a company go hand-in-hand: “A company with satisfied customers and a strong market name and product line will be valued at a higher amount compared with its peers,” he said. Assessing a company’s products is especially vital in a sector like technology, where innovations often generate buzz but do not always meet a clear market need.

Just under one quarter of respondents think analyzing the target’s position in the market is one of the top two things to consider for deal value, while only 14% think the same for compliance issues. Regulatory concerns are more closely linked to deal value in specific sectors such as energy, which has “many strict laws that can hamper our business,” said a corporate CFO.
PART TWO: RISKS AND CHALLENGES

With mounting pressure on companies to do deals quickly before being outbid by competitors, receiving access to data on time is one of the biggest challenges when conducting due diligence, according to 44% of respondents. “Getting access to all key information can be tough, and trusting that data is also difficult,” said a managing director at a financial advisory firm.

Tight deadlines can be a major obstacle, but they are more straightforward to address than gaining trust with the acquisition target (named by 44% of respondents as a barrier in due diligence) or looking at areas outside a company’s financials (named by 40% of respondents). Indeed, vetting a company for issues other than EBITDA or cash flow can hinder

WHAT ARE THE BIGGEST CHALLENGES WHEN CONDUCTING DUE DILIGENCE? (SELECT UP TO TWO)

- Gaining access to key information on time [44%]
- Ensuring confidential information is not leaked [44%]
- Looking at areas outside of the financials (culture, etc) [40%]
- Managing parallel workstreams [32%]
- Gaining trust with target company [22%]

22% percentage of M&A deals involving rated insurers since 2000 that received a negative outlook

Source: Standard & Poor’s
progress on even the most high-profile deals. Merger talks between conglomerates UTC and Honeywell, for instance – companies with combined revenue of US$95bn – broke down in early 2016 partly due to a conflict between the two management teams over who would lead the new firm, according to Bloomberg. 

Forty percent of respondents singled out information security as one of the biggest challenges in due diligence, while 32% said managing parallel workstreams proved to be one of the most difficult issues. One financial advisor said that keeping data out of the public eye can be a struggle despite careful precautions. “We usually sign a confidentiality agreement with the company we engage, but it can be tough to make sure no information leaks out,” he said. “This affects the whole deal and can lead to huge legal problems.”

A majority of respondents (58%) said they were most afraid of overlooking the risk of pending legal issues, while just under half of respondents expressed concern about failing to notice company culture issues (48%), financial problems (48%), and negative synergies (46%). For an acquirer, unresolved legal issues at a target firm could affect its bottom line or business reputation, and the problems may transfer to the acquirer after the deal is complete. “As a buyer, you may be buying the target company’s past liability,” said Bass Berry & Sims partner Thaddeus McBride in an interview with the FCPA Report in 2015.

The pitfalls of culture mismatches and negative synergies are well-documented in M&A deals. Perhaps the most infamous example came in the US$165bn merger of AOL and Time Warner in 2000. Employees of the two media giants clashed, and the swift decline in AOL’s user base erased the promised synergies for Time Warner, leading to the two companies’ divorce in 2009. One head of strategy at a corporate said culture is especially vital, since it is often hardwired into the company. “The future risk we are most afraid of is culture issues. A company’s culture is something pre-existing in its genetic code and this can affect the working pattern of the business,” he said.
As for financial problems, a poorly checked balance sheet can cause major grief down the line. “Even though we look thoroughly into the finances, we are always worried that we may have overlooked something,” said a managing director at a financial advisory.

Respondents were also split on the best tools to use to minimize risk. Thirty-eight percent felt that rep and warranty insurance was the most important tool, while escrows/holdbacks (32%) and indemnification (30%) were not far behind. Many respondents noted that they employ all three legal methods at various times.

All three tools are designed to limit potential liabilities stemming from undisclosed tax, legal, or other penalties, but each is more or less appropriate depending on the nature of the deal. Rep and warranty insurance has been rising in popularity in recent years, with the value of RWI policies increasing 50% in 2013 to reach US$1.5bn, according to insurance broker Aon Transaction Services. However, the insurance is best-suited to mid-market deals up to US$2bn in value.

Holdback escrows, meanwhile, are a relatively common way for all types of buyers to defend themselves against unforeseen liabilities. Statistics compiled by the American Bar Association indicate that about one third of private-target deals include holdbacks, with a median of 9% of the purchase price placed there. “We always invest in escrow accounts as they are quite a safe bet,” said a managing director at a bank.

Some dealmakers prefer a stricter form of risk mitigation, however, such as that provided by indemnities. “Holding back is a simple and effective way to handle a situation, but the best would be through indemnities,” said one managing director at a financial advisory firm. “This is a very effective tool, as it comes as a breach of contract and this is a very strong legal claim.”

Fifty-eight percent of respondents deemed the use of confidentiality agreements one of the top two methods for mitigating privacy concerns, while 56% said keeping the number of involved parties to a minimum was key. Only slightly fewer respondents favored using a pre-deal clean team (44%) or a secure online data room (42%).

The relatively even split among respondents can be explained by the fact that dealmakers often utilize all four approaches in a transaction. “We usually involve..."
a pre-deal clean team, so that they can deal with any problems that may be a hindrance to the reputation of the company,” said a managing partner at a financial advisory firm. “We also keep the number of people to a minimum and have them sign agreements to make sure they do not leak any data. They know the consequences would be severe.”

The importance of deploying these confidentiality strategies quickly could be seen in Valeant Pharmaceuticals’ US$15.4bn acquisition of Salix Pharmaceuticals in February 2015. After Valeant received a call from Salix, the company “sprang into action … and a confidentiality agreement went into effect that same day,” The Wall Street Journal reported after the deal went through. “Salix opened a data room two days later to give Valeant access to documents, and less than a week after that, the companies’ senior executives, investment bankers and lawyers gathered in a room for due diligence.”

One bank managing director called data rooms his tool of choice when it comes to safeguarding deal information. “When we transfer data, we try to make sure it is done in a way that it won’t be easy to leak,” he said. “We use secure online data rooms for that reason.

“We usually involve a pre-deal clean team, so that they can deal with any problems that may be a hindrance to the reputation of the company. We also keep the number of people to a minimum and have them sign agreements to make sure they do not leak any data. They know the consequences would be severe”
Managing director, financial advisory firm
FEATURE COLUMN: HOW TECH HAS CHANGED DUE DILIGENCE

Just a decade ago, the world of technology looked antiquated compared with 2016. Twitter had just a handful of users. Facebook’s audience consisted primarily of US college students. And Apple’s iPhone had not even been invented yet.

The tools used by M&A practitioners in 2006 also paled in comparison to modern-day instruments. Software and online resources such as virtual data rooms (VDRs) have reshaped the way dealmakers conduct due diligence, jet-propelling the process of sharing sensitive documents. The VDR industry saw average growth of 17% per year from 2009 to 2014 and earned an estimated US$880m in revenue in 2014, according to market research firm IBIS World.

According to most respondents, the central advantage of technology is increased efficiency. In place of a physical data room at a lawyer’s office – which requires security, a complex system for filing and record-keeping, and an industrial-grade photocopier – electronic tools can all be accessed on laptops and tablets. “Technology has made the whole system more efficient,” said the head of M&A at an investment bank. “We can carry out the whole process faster and there is higher accuracy. With the current tools in place, we don’t have to do too much work.”

New technology often suffers growing pains, especially when it comes to compatibility – think about the enduring problems between software for PCs and Macintosh computers, for instance. But M&A tool providers have managed to keep these differences to a minimum. “We all run on similar platforms and that makes the whole integration process better,” said one corporate VP for strategy and corporate development.

Respondents said technology has reduced human error, decreased costs, and pared down the number of people required to manage the due diligence process. Thanks to online tools, audits are also easier to conduct and asset valuations simpler to obtain, respondents said. “Technology has played a vital role in the due diligence process by helping to understand the company’s position in the market, by helping investors assess investment opportunities, and to select the potential winners in the market,” said the chief strategy officer at a corporate.

As VDRs and due diligence software have gained prevalence across the industry, some are wondering: What is the next frontier for M&A technology? One tool that VDR providers have begun to exploit is artificial intelligence, which can speed up the diligence process. Many envision an expansion of this technology going forward. “Lawyers are now wondering when artificial intelligence will be applied to the legal profession and potentially the M&A sector,” wrote three Roschier partners in a Lexology article in March. “This development will impact on the practice of M&A by inspiring the parallel development of intelligent data-crunching systems.”

Technology has reshaped the modern face of due diligence – and history suggests the evolution of M&A tools will continue in the years to come.
The current mix of generally sluggish economic growth, commodity price uncertainty and the cheap availability of capital has helped to spark an M&A boom in terms of deal values.

On top of this, the explosion of technology over the last decade has brought about a number of opportunities through dealmaking, as sectors become disrupted, new tools emerge and even new industries are created.

These sea-changes in the M&A landscape have had fundamental impacts on the way due diligence is conducted, from what aspects of a target are investigated to which tools are used to actually undertake the process.

This shift hasn’t been lost on our respondents, who are well aware of how due diligence can add value to a transaction as well as destroy it.

In particular, our research has shown that dealmakers are keen to start due diligence as early as possible, even to the extent of researching prospective targets using available online resources.

They also understand that financials still count as the backbone of the process, yet are cognizant of more nuanced and modern issues such as cultural clashes and the importance of intellectual property in the modern business world.

Here are three key facets to bear in mind going forward when conducting due diligence:

- **Follow the money.** The reasons why due diligence is important may have increased over the last few years, however proving the financial integrity of the target is still the most fundamental principle. A great cultural match, excellent product line and reputation count for little if the numbers simply don’t add up.

- **Challenges come in all forms.** Problems in due diligence can come up from several places. It is important to give attention to each possible bump in the road, therefore, and not have a one-track mind. Focusing all your efforts on getting information on time, for instance, may affect other areas such as confidentiality and trust.

- **Technology has changed the game.** The advent of tech in due diligence has increased immeasurably the amount of data that can be crunched, as well as the pace of processing. Dealmakers need to keep on top of any technology changes in order to increase the efficiency of their diligence as well as build deal value.

“These sea-changes in the M&A landscape have had fundamental impacts on the way due diligence is conducted, from what aspects of a target are investigated to which tools are used.”
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