

## M&amp;A

# Due Diligence in Business Acquisitions: Thriller, Drama or Happy Ending?

By **Bart Steenmeijer**

Due diligence is a much-feared subject in business acquisitions. Many entrepreneurs believe that buyers are looking for a pretext to considerably lower the purchase price or wriggle out of the deal. Marktlink has investigated whether they are right. The result? Of 25 reviewed acquisitions in 2016, 24 were continued after signing the letter of intent. In 38% of these cases, the purchase price was slightly adjusted.

## What is a due diligence?

After a letter of intent concerning the acquisition of a company has been signed by both parties, the buyer is given the opportunity to verify the business information provided during the preliminary stage in a due diligence investigation. Specialists, engaged by the buyer, perform this due diligence. Sellers often fear that previously made agreements are at stake, or that the deal will be cancelled entirely.

## Why a Due Diligence?

A due diligence is of major importance for both parties. The buyer wishes to verify the provided information and to establish whether he is willing to continue the transaction under the same conditions. For the seller, howev-

er, due diligence also has a great significance. In general, for anything a buyer has verified during the due diligence, the seller no longer needs to provide guarantees.

## Deal or No Deal

To establish whether the fear of a due diligence is justified, Marktlink consultant Bart Steenmeijer reviewed 25 recent due diligence investigations they assisted in in 2016. Of these 25 reviewed transactions, 24 were completed successfully after signing the letter of intent. The only process not to pass the due diligence is currently on hold and will most likely be concluded at a later date. In conclusion, the fear that a deal will be called off because of the due diligence appears to be exaggerated.

## Adjustments

A vast majority of all transactions crosses the finish line after signing the letter of intent. Adjustments in the agreements made should be taken into account however, for example, in purchase price, transaction structure or acquisition balance sheet. In 87% of the 24 completed transactions, a final amendment was made with respect to agreements in the letter of intent. In 38% of the transactions, the purchase price was adjusted. The reason usually being that profitability in the year of



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transaction departed from the issued forecasts. Although downward adjustments are more common, in two cases it was adjusted upwards. On average, the adjustment of the purchase price amounts to approximately 4%, including a few outliers of more than 20%. Thus, adjustments of the purchase price after a due diligence are rather modest.

A significant portion of adjustments concerns transaction structure rather than purchase price. An example of an adjustment in the transaction structure is to make part of the agreed purchase price conditional to future earnings (an "earn-out"). A different option is an adjustment in ownership structure. The transaction structure was adjusted in 9 out of 24 transactions (38%).

In addition to purchase price and transaction structure, the acquisi-

tion balance sheet is the third item frequently subject to adjustments. In most transactions, a business will be delivered based on a balance sheet, free of excess cash and debt. The exact debt position is not always straightforward and therefore often subject of debate. In 48% of the transactions, an element of the acquisition balance sheet was adjusted.

The most common issues in the reviewed due diligence investigations:

- Derogations with regard to profit development / achieving forecasts
- Working capital
- Contracts (e.g. change-of-control clauses)
- Margin pressure
- Debt position
- Stock and stock records

Profit development and realisation of the forecast proved to be the most common issue. Buyers are cautious to purchase 'a pig in a poke'. Not achieving a forecast is regarded an indicator for poorer results in the next few years. Consequently, the buyer expects this to be taken into account in the transaction. Our advice to a seller is there-

fore to issue a realistic forecast, and to make sure the business performs at its best in the year of transfer.

## Preparation

A solid preparation is crucial to prevent a due diligence from becoming the final stage of an acquisition process. This begins with an assessment of common problems at the start of the process. Issues with staff, pensions or contracts may be solved right away, avoiding difficulties later in the process.

One of the most important next steps is providing accurate information to the buyer. In general, it is wise to provide potential buyers with the relevant information prior to them submitting their bids. Possible discussions will then take place in an early stage in which several candidates are still involved. This way the targeted buyer is spared any unpleasant surprises. Besides, since no exclusivity has been granted at this stage, the seller benefits from a stronger negotiating position.

Timely provision of information limits the risk of termination of the process. Finally, a well-structured data room is vital, ensuring a smoother and shorter process.

The due diligence is an intensive stage in an acquisition process. Assessment of their own company by external specialists renders many entrepreneurs uncomfortable. With the right specialists and consultants involved, however, fortunately a due diligence only rarely leaves anyone empty-handed.

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