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Due Diligence Matters to Be Taken Into Account

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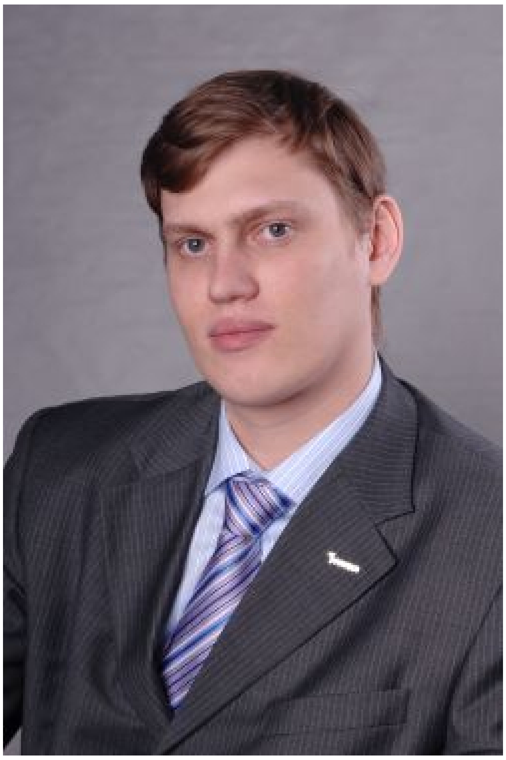

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I would like to share in this article some experience of accompanying equity transactions, particularly, I will address due diligence matters that should be taken into account.

Suppose you are examining very appealing financial statements of a company you want to buy shares in. You like the figures in the statements, and you see a financially stable and very lucrative company.

Yet financial statements (especially in Russia) quite seldom provide their users with a full picture about many aspects of business activities, the understanding and analyzing of which is essential for acquiring stakes in businesses.

Let us consider the following example.

You have been offered to buy a plant (it does not matter what it manufactures). According to the financial statements confirmed by a reputable auditing firm, the plant's annual turnover amounts to $100 million, the balance sheet totals $30 million, and net profit is $10 million. This offer is worth only $20 million.

In addition, engineers have visited the plant, examined the facilities and have confirmed that everything was working properly. In brief, this is a very appealing property that is subject to acquisition.

But buying a plant with those financial figures can mean buying nothing if the plant's operations are structured in a certain, untraditional way.

It may turn out that all of the production equipment and/or property is carried by a separate legal entity that leases out those assets under short-term lease agreements, but the plant itself operates on a give-and-take basis, and all its staff is assigned to a third company. Apart from that, the plant's financial performance is high and this fact can be verified, as confirmed by the audited financial statements.

Consequently, when performing due diligence, it is instrumental to understand the structure of business activities of the company to be acquired, and the existent rights to main business assets. And, of course, it is necessary to make sure that the seller has the shares of the plant, respective share rights, and that there are no restrictions on transactions with those shares, e.g. pledges.

Of course, this hypothetical plant's structure is quite primitive and is easily identified. Similar structures were developed earlier in order to protect businesses from hostile takeovers, and, as a rule, the seller does not try to sell a void legal entity but fully discloses all business operations.

Other things can be shady: for instance, tampered revenue and financial performance.

For example, when selling a company from a holding, the seller can "play" with the transfer price so that the company to be sold will appear more lucrative than it actually is. Surely, after it is sold the financial performance will not be the same as indicated in the statements because very few would buy the goods at unreasonably high prices.

Thus, when performing due diligence, it is instrumental to examine the company's financial management system, the structure and dynamics of the company's income, compare the company's prices with market prices and analyze the structure of expenses and cash flows. It is also important to verify the identity of suppliers and buyers of the company, whether they are affiliated with management of the company to be acquired, and the company's pricing system. It is necessary to understand the structure of assets and liabilities and make sure that the company does not have any undocumented liabilities or contingent liabilities that can become apparent after the transaction. For example, it is common for companies to have their top executives replaced after the transaction. Thus, it is necessary to verify whether labor agreements with top executives contain prearranged provisions for "golden parachutes."

The aforementioned procedures will allow you to identify the most material financial risks.

In addition, properly conducted due diligence can become a powerful tool for adjusting the transaction price.

Our firm has seen some sellers reduce the transaction price three times pursuant to due diligence.