Zachary Scott

TRUSTED ADVISORS

IN$IGHT

PERSPECTIVES ON THE CAPITAL MARKETS

REPRINT

SUMMER 2018

Due Diligence: Investigate What Matters

Investigating every little fact does not equate to thoroughness.

by Mark Working

We have written at length about due diligence from the seller's side ("Preparing for a Successful Transaction – Beyond the Diligence Checklist", IN$IGHT January 2013, and "Due Diligence – a Survival Guide", IN$IGHT October 2012). Over the years, we have taken pride in preparing our clients for the onslaught of questions and data requests from buyers. Our goal has been to make the job easy for the buyer, thereby not letting the process of collecting information or new findings derail or divert initial transaction parameters. Observing how buyers differentially approach the due diligence process has informed us that there is not a universally accepted approach. In some cases, extremely granular investigations to turn over every molecule of the business have not yielded a successful outcome while what appear to be limited scope reviews have produced great results. The point is not to suggest due diligence doesn't matter, but rather to suggest that checking every box on a due diligence list does not equate to thoroughness.

TRADITIONAL BUYSIDE DUE DILIGENCE

The traditional buyer process begins with the business team becoming interested in a specific acquisition or investment because it meets their defined criteria. Following some level of research, meetings with the target management team to ask questions, viewing the company's operations, and agreeing on value with the seller, a conclusion is often made that the business and the deal make sense subject to "verification" due diligence.

Verification begins with an extensive information request. Most law firms and investment banks have versions of the same basic request list, which has been developed over time to contain every conceivable question about a business. This list, often without modification to fit the company, is given to the buyer.

Donald Rumsfeld famously talked about known-knowns (things that we know we know), known-unknowns (things that we know we don't know), and unknown-unknowns (things that we don't know we don't know). Unfortunately, verification typically only focuses on known-knowns, running to ground whether the information that was provided by the seller is accurate and complete. As information is received by the buyer, it is often directed to topic experts in finance and accounting, tax, legal, insurance, equipment, environmental, and information systems, each of which reviews the requested data and evaluates them relative to what their experience tells them is standard or acceptable. When complete and no discrepancies have been detected, due diligence is complete. If you have ever experienced this process as a participant, it is hard to think that the buyer has been anything but thorough in its review.

INVESTIGATE WHAT MATTERS

Despite every attempt, it is not possible to know all about a business and what will impact a business's future performance. The famous criminal Willie Sutton was once asked why he robbed banks, and his response was simple, eloquent and humorous: "Because that's where the money is." That is the sort of prose that can only arise from clear thinking.

To apply the same clear thinking to due diligence, it is necessary to first determine those attributes that will drive investment success. We believe the way to start is with a concise investment thesis that defines specifically the assumptions about the company, the necessary ingredients required in a transaction, and the conditions that lead to a "no-go" decision or an adjustment to the proposed valuation. The due diligence process then becomes a process of inquiry designed to answer three critical and important questions:

1. Is the investment thesis valid?
2. Are we (the buyer) getting what we think we are buying?
3. Do we still want to make the investment and, if so, is the valuation reasonable given all relevant facts?

THE INVESTMENT THESIS

> *The investment thesis is the core set of reasons for making an investment. It states the critical presumptions and expectations that, if true, would make the business successful and, therefore, justify the investment.*

The investment thesis is unique to each buyer and company. At its root is the presumption that the business will continue to succeed following the transaction in the marketplace in which the company competes. Often it can be broken into five parts.

- The market will continue to grow at a certain rate and the segment in which the company competes will retain its importance in the value chain, indicating that the company's reason for being will continue.
- There are no identified external threats that will change the company's market position.
- The company has attributes (assets and capabilities) that will allow it to compete effectively and earn attractive (or acceptable) margins and returns on capital.
- The company's management and organization have the skills, abilities, and systems to deliver continuous and sustainable performance.
- The transaction structure will not interfere with any of the desirable dynamics and attributes.

The investment thesis establishes the framework understanding for how the business competes in its industry and why it will continue to do so. It provides specific expectations for the assets and capital required to support the thesis, revenues, profits, and returns expected to be earned, and how collectively these assumptions affect valuation.

Interestingly, some of the most important areas demanding investigation may have more to do with what environment the company operates in than how the company operates (known-unknowns). Those are questions that rarely can be answered from information received as a result of a due diligence request list.

ALLOCATE PRIORITIES, RESOURCES, AND TIME TO THE BIGGEST QUESTIONS

The investigation should have a priority for each area of inquiry with an understanding of how important it is to the overall thesis and the boundaries for when a discovery is meaningful or not. Those issues that have the greatest probability of becoming showstoppers or could meaningfully change the outlook on the investment should be emphasized.

When questions are tough to answer, get help. It's easy to collect information about the internal operations of a business but that effort

(continued p. 2)

may exclude the most important drivers of success. Here are some areas we have seen that are critical to the success of the investment but are sometimes shortchanged because they are hard for an internal due diligence team to answer and would cost money to investigate otherwise.

- What trends are likely that could alter the existing value chain? An obvious recent example is the impact of the internet on how goods get from producers to consumers. Very profitable retailers have been left in the dust.
- What is the overall projected market demand and how does that compare to existing and projected capacity? Margins and value can erode as the balance between the two change.
- What attributes will determine winners and losers? Is it lowest cost? Highest performance? Convenience? How does the target company stack up to its competitors? A rising tide doesn't lift all boats equally.

If each area of inquiry could be weighted relative to the degree of importance it will have on the investment outcome, thoroughness would be measured as to whether the effort matched that weighting, rather than whether the effort was spread equally over all items on a list. This is a worthy aspirational, yet challenging, goal. **ZS**

Zachary Scott

TRUSTED ADVISORS

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

Brian Bergsagel
206.838.5527
bbergsagel@zacharyscott.com

Frank Buhler
206.224.7383
fbuhler@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Mike Dannenberg
206.838.5531
mdannenberg@zacharyscott.com

William Hanneman
206.224.7381
bhanneman@zacharyscott.com

Ray Rezab
206.224.7386
rrezab@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Kapil Sharma
206.224.7387
ksharma@zacharyscott.com

Mark Working
206.224.7382
mworking@zacharyscott.com