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Due Diligence—a Survival Guide

When selling a business, everyone's patience will likely be tested during the due diligence process. Here's how to keep cool and make it to closing.

by William S. Hanneman

Buyer due diligence is a standard part of every business sale. The primary goal of a due diligence investigation is to gather and analyze all of the information necessary to enable a buyer to fully assess the target business and address any material concerns. By design, it is an intrusive process.

Buyers take this investigation very seriously, typically inundating sellers with an exhaustive list of questions. Because owners are intimately familiar with the risks inherent in their businesses, they are often surprised, and sometimes offended, over concerns buyers express. Sellers might conclude that their judgment is being questioned and might even feel harassed. However, the buyer is simply trying to pull together an accurate view of the company before they seal the deal. In the worst case, tensions rise, dissipating what initial goodwill that may have previously existed.

After coaching hundreds of clients through diligence processes over 20 years, our experience shows that most businesses are unprepared to support a full-scale due diligence effort without some amount of stress. Here are a few tips about how to navigate the due diligence process while leaving the deal, and the condition of the business, intact.

Prepare Thorough preparation is the most effective inoculation against a due diligence fiasco. While preparation can be a hassle, it is nowhere near as painful as a poorly organized, on-the-fly approach. With a small amount of advanced planning, due diligence files can be created that contain most of the information buyers will need to evaluate the business and that can be used to document the transaction. Organizing in advance to provide prompt and comprehensive answers to a buyer's questions gives the buyer confidence that risks are addressed as a matter of ordinary course. The quicker the information can be made available, the sooner the transaction will close.

Disclose everything Most sellers underestimate the depth of due diligence inquiry and the need to provide precise answers. Sellers often resist releasing information until requested by the buyer, forcing the buyer to follow a rabbit trail of disclosure. This creates an adversarial relationship that persists throughout the sale process. Sellers are advised to go into the diligence process with the intention of releasing as much information as possible at the beginning of the process. Proactively disclosing any negative or controversial information upfront sets a tone of cooperation and transparency that will yield benefits throughout the investigation. Obviously, proprietary information should be shared only after the terms and conditions of a purchase and sale agreement have been negotiated.

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Don't take it personally Throughout the diligence process, sellers should expect disagreements over projections, expenses, personnel practices, accounting methods, and a variety of other matters. This represents a form of professional disagreement based on each party's training and experience, but all deals endure this standard dance. It is a mistake to allow these minor skirmishes to create a detour away from the objective of closing the sale. Like raising children, certain issues deserve a battle and others should be allowed to pass. Get over it.

No shortcuts If inconsistencies and errors appear late in the diligence process, previously accepted terms, and even price, could be called into question. Furthermore, a lack of thoroughness erodes credibility and sows distrust, which once established, is a difficult position from which to recover (and can open the door to future litigation).

Exercise patience Transactions conclude only when money changes hands and that won't occur until the buyer (and its advisors) have gained complete and total satisfaction that the investigation is complete. No matter how prepared for due diligence, the buyer's demands will eventually start to wear the seller's patience thin. Keep in mind the buyer's framework and their need to know everything that could be known before parting with the purchase price. Exercise patience; in a few months it will all be over.

WHEN TO INVOLVE STAFF?

The most efficient and effective diligence processes invariably engage key managers in all functional areas. Most businesses can't prepare for due diligence unless the functional experts are involved. However, because the mere rumor of a potential sale can disturb employee harmony, deciding on when to involve non-owner employees can be a real dilemma. The answer is to make planning for a due diligence effort part of normal business practice. Tie up loose ends, document procedures, catalog documents, and generally practice good housekeeping. If those practices become routine, it will be possible to avoid alerting employees and distracting them from their regular jobs until the later stages of a sale process.

PLANNING IS REWARDED

While the bulk of the diligence revolves

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around the investigation of how the business has operated, due diligence often crosses over into what the future is expected to bring. Obviously, expectations can only be based on assumptions. The more detailed and logical the assumptions are, the more influential forecasts will be for a buyer and any lenders that may get involved. Comprehensive and detailed planning efforts tend to be rewarded.

FOREWARNED IS FOREARMED

Due diligence represents the most vulnerable aspect of any deal. Designed to ferret out the naked truths about the business, it tests a buyer's uncertainty about actually buying the business and exposes the real reasons why the entrepreneur has decided to sell. To that emotional mix, add third party advisers that will invariably have professional differences. Stir, and the result can sour what previously looked like a sweet deal. Businesses that prepare to support a buyer's due diligence in advance will greatly improve the probability and timing of closing. ❖

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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, please go to ZacharyScott.com.

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