“Trust, but Verify”

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Editor’s note: this post is part of a series on the six steps towards successful mergers and acquisitions.

We all enjoy surprises in our personal lives: birthday parties we didn’t know were being planned for us; unexpected visits or calls from friends with whom we’d lost touch. Surprises occur in business too, but when they do, they may not always be pleasant ones.

At no time are surprises less welcome than during the moments leading up to the acquisition of a printing company. Surprises can scuttle deals, especially when they undercut information or assumptions previously believed to be reliable. The step known as due diligence is all about keeping these disruptions from happening in the first place.

The concept of due diligence originated in the securities industry, where—in contrast to the printing industry, in which most firms are privately held—disclosure of business information is required by law. As the phrase implies, it involves making the best possible effort to obtain all pertinent information about the company that has been targeted for acquisition. Buyers have to be thorough, and sellers have to be transparent—this is what assures that everything with a bearing on the outcome of the deal has a basis in fact.

Only with verifiable facts in hand can the buyer decide whether or not the acquisition truly makes sense. This means being willing to ask hard questions about the seller’s worthiness as an acquisition target. Even a company with an attractive P&L and a strong balance sheet may have underlying flaws that the buyer would inherit upon closing the sale. If they exist, due diligence exposes them for both parties to confront and resolve.

This is why the full scope of due diligence examines what are known as the four Cs of business practice: customers, competitors, costs, and capabilities. The process usually begins at about the time that basic negotiations have been concluded. In a deal for a smaller company, the process may be over in several weeks. The larger the company, the longer due diligence will likely take.

In all cases, the supreme virtue is candor. New Direction Partners urges our clients to tell us everything—the good, the bad, and the ugly—that is relevant to closing the deal. Eventually, all such details come to light in properly conducted due diligence. It’s better to have them on the table now than to see them obstruct or even kill the deal later on.

Due diligence usually is thought of as an exercise for buyers, and it’s true that buyers are primarily responsible for reality-checking the particulars of the companies they want to buy. But, performing a “reverse due diligence”—an examination of one’s own company in preparation for being acquired—is also a smart strategic step for a seller.

By doing so, the seller anticipates questions and potential objections from the buyer and is in a better position to answer them. Preemptively clearing the roadblocks goes a long way toward helping the seller receive maximum value for the company.

Seller-side due diligence addresses the caveat vendor that arises in transactions in which payment may be made in installments over time rather than in full at closing. Transactions sometimes also include some form of seller financing. The question is, in deals of this kind, will the buyer be able to meet the ongoing payment obligation? The seller’s answer often lies in performing due diligence on the buyer’s financials, similar to what the buyer performs on the seller’s.

From the buyer’s perspective, the object is to document and revalidate everything that needs to be in place in order for the deal to close. Due diligence also helps the buyer to set a walk-away price—the most the buyer would be willing to pay at the conclusion of negotiations. Things to scrutinize in a comprehensive due diligence exercise include, but aren’t limited to:

• *Financial statements.* The seller should be prepared to provide annual, quarterly, and monthly financial statements for the last three years. Some buyers may want to see audited statements.

• *Indebtedness*. Disclose terms and repayment schedules of all outstanding obligations as well as any debts guaranteed by the seller.

• *Business liabilities*. If the deal is not an asset-based but a stock-based transaction, the buyer acquires the seller's existing business liabilities along with the stock. These situations obviously need to be understood in full.

• *Real estate issues*. Title, zoning, building code compliance, and environmental mandates are on the due diligence to-do list whenever real property is part of what is being acquired.

• *Account concentration*. A $10 million printing business that owes 20% or more of its sales to one customer is normally considered to be over concentrated in that account. This is a potential red flag to a buyer—there is no guarantee that the customer will want to continue to do business with the company under a new owner.

Retention of key personnel. Identify the management team that must remain in place to assure a smooth transition, including the selling owner if necessary. Define their roles and assess the likelihood of their remaining on board on post-sale.

• *Sales staff loyalty*. If the seller cannot invoke non-compete agreements with its sales representatives in the event that they leave the company, large amounts of business could leave with them. Buyers must find out whether such agreements are in place.

• *Equipment appraisal*. A certified appraisal reveals the age of equipment, amount of usage, and can include its mechanical condition and the quality of its maintenance.

In diplomacy, the motto for negotiators and peacemakers is "Trust, but verify." The advice applies to M&A transactions between printing companies as well. Get the facts, confirm the understandings, and be open about everything that the process discloses—that is the way to give due diligence its proper due.

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