

Mergers and Acquisitions Due Diligence to Support Higher Valuations

Presented by

Frank Wisehart
RGL Forensics

Mark H. Davis
Gordon & Rees Scully Mansukhani, LLP

29 October 2015

Sponsored By

RGL Advisors

RGL Advisors, LLC is the corporate finance division of RGL Forensics. Securities offered through RGL Advisors, LLC. Member FINRA/SIPC. www.RGLAdvisors.com

Objectives of Session

- 1 Financial Due Diligence
- 2 Key Drivers of Value
- 3 General Themes
- 4 Selected Specific Topics



Today's Speakers



Frank Wisehart MBA, CPA, ABV, CFE, CVA

RGL Forensics

With more than 20 years of experience in business consulting, Frank Wisehart is a valued advisor on the financial implications of strategic transactions and business disputes. His experience includes forensic accounting, business valuation, family law, financial and transactional due diligence, bankruptcy and reorganization and expert witness testimony. Frank's depth of experience in business consulting encompasses a variety of clients ranging from individuals to large public corporations.

Today's Speakers



Mark H. Davis Esq.

Gordon & Rees Scully Mansukhani LLP

Mark Davis is Chair of the Business Transactions practice group of Gordon & Rees LLP. He has been an attorney for more than 30 years and has a diverse business practice with a focus on corporate securities and mergers and acquisitions. Mark represents a broad array of emerging growth and closely-held companies in a wide variety of industries. He advises his clients regarding choice of entity, jurisdiction, formation, private debt and equity securities offerings, venture capital financings, stock option plans and executive compensation plans, mergers and acquisitions, general intellectual property counseling, and commercial transactions in general.

1 | Financial Due Diligence



Due Diligence: The Key to a Successful Transaction

- Business due diligence consists of the following:
 - Financial and accounting diligence
 - Legal diligence
 - Environmental diligence
 - Valuation
 - Intellectual property evaluation
 - Human resource diligence
 - Engineering diligence
- Detailed project plan, timeline, procedures, checklists
- The nature of the deal will drive types of diligence procedures and depth
- Avoid relying on representations, warranties and indemnification clauses

Financial Due Diligence in the Current Environment

- Quality of information
 - Increase rigor of validation
 - Risk of both financial fraud and misappropriation of asset fraud
 - Scrutiny is now on a “micro” basis
 - Monthly vs. annual or trailing twelve months viewpoint
- Focus on quality of earnings and cash flows
 - Identify all possible adjustments
 - Trending of revenues and significant expenses
 - Identify revenue recognition issues
 - Determine and explain the relationship between earnings and cash flow
 - Identify differences between “GAAP” accounting and cash
 - Test sustainability of cost cuts

Financial Due Diligence in the Current Environment (Cont.)

Possible Key Areas

- Customer quality
- Supply chain
- Hidden liabilities
- Employee benefits
- Taxes
- Information technology
- Internal controls

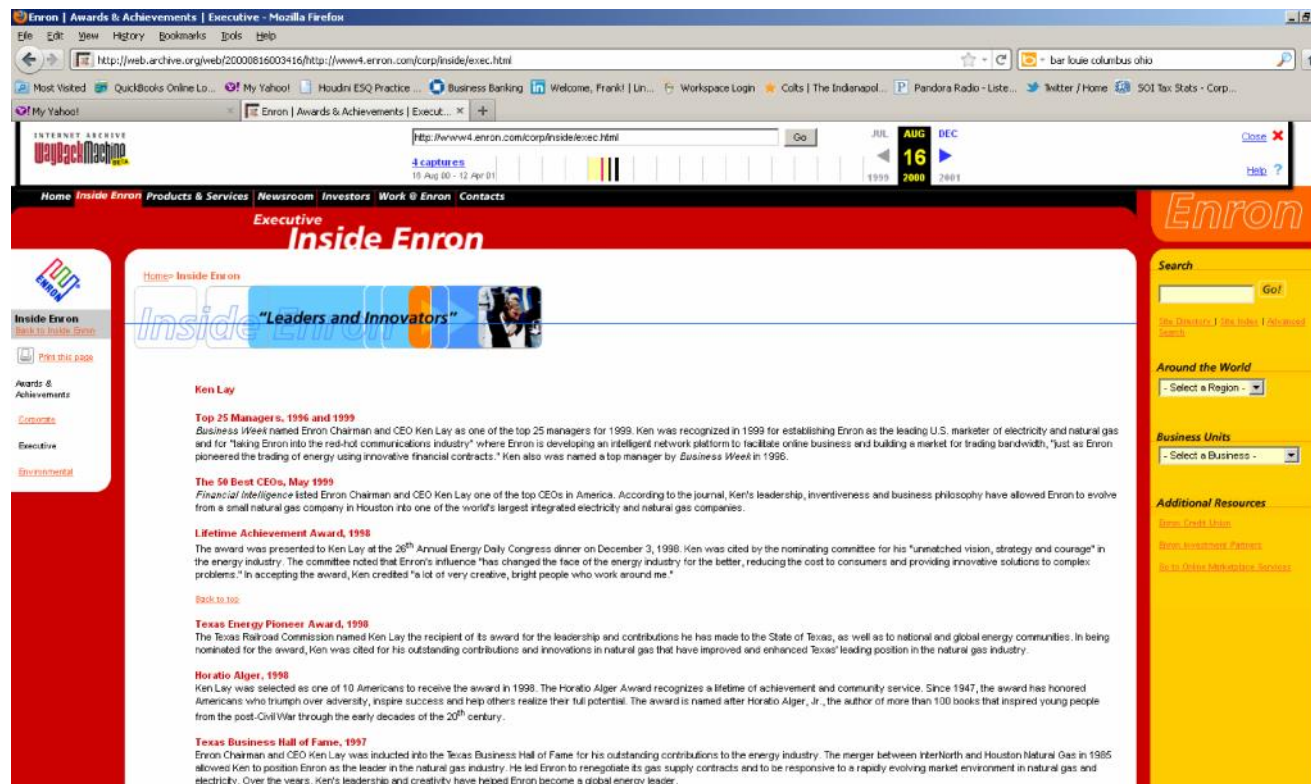
Working Capital Considerations

- Cash and receivables necessary to fund the business on a day-to-day basis
- Who controls the working capital?
- What incentive is there to maintain working capital?

Insurance Due Diligence Considerations

- Workers' compensation rates and experience?
- Professional liability / E&O claims?
- Environmental liabilities?
- Pending litigation?
- General and automotive liability?
- Adequacy of self-insurance loss reserves?

Wayback Machine – Enron August 16, 2000



www.archive.org

2 | Key Drivers of Value

Key Drivers to Value

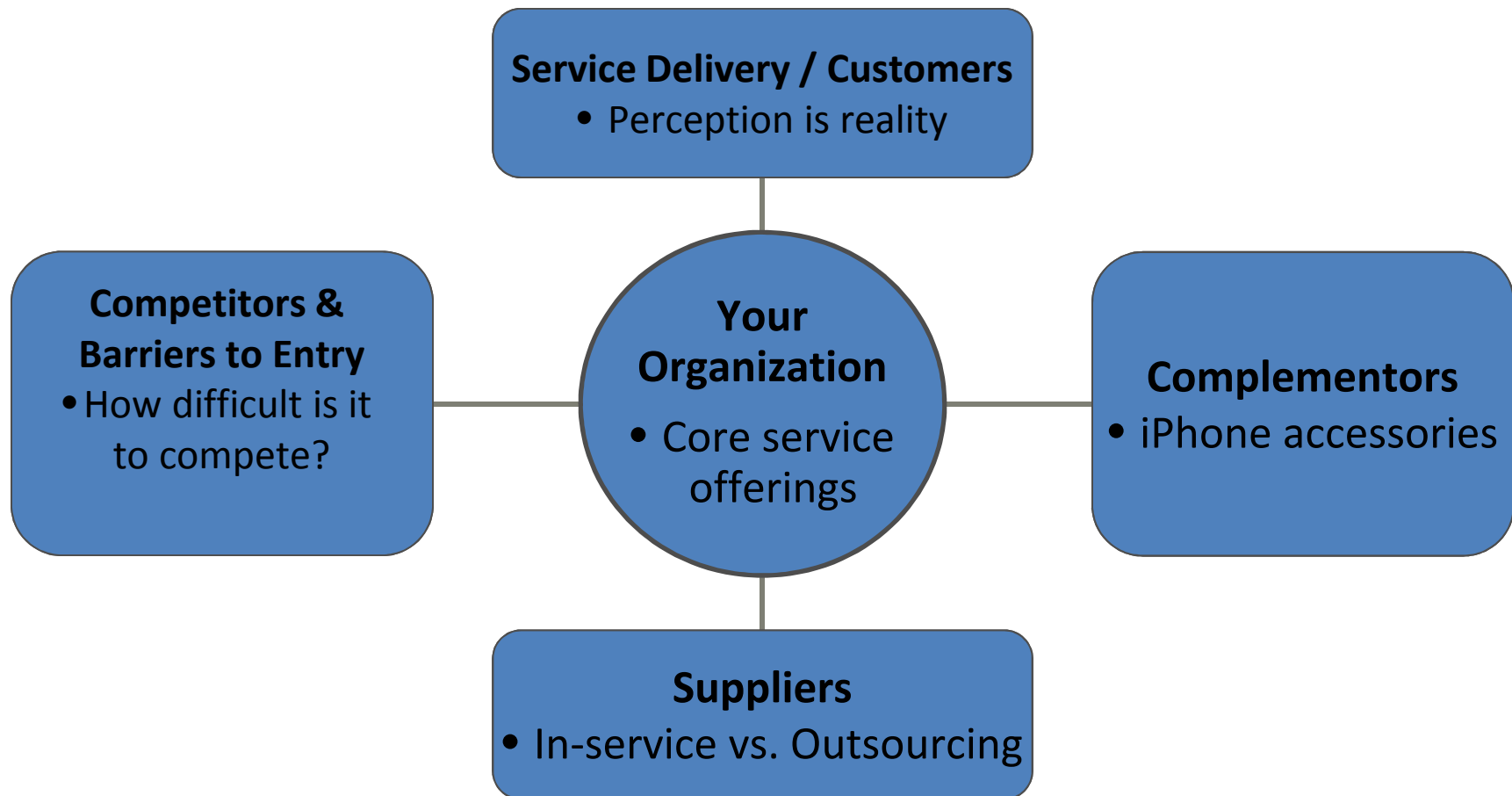
$$\text{Value} = \frac{\text{Benefit Stream}}{\text{Risk rate} - \text{growth}}$$

Median EV/EBITDA Multiples by Enterprise Value

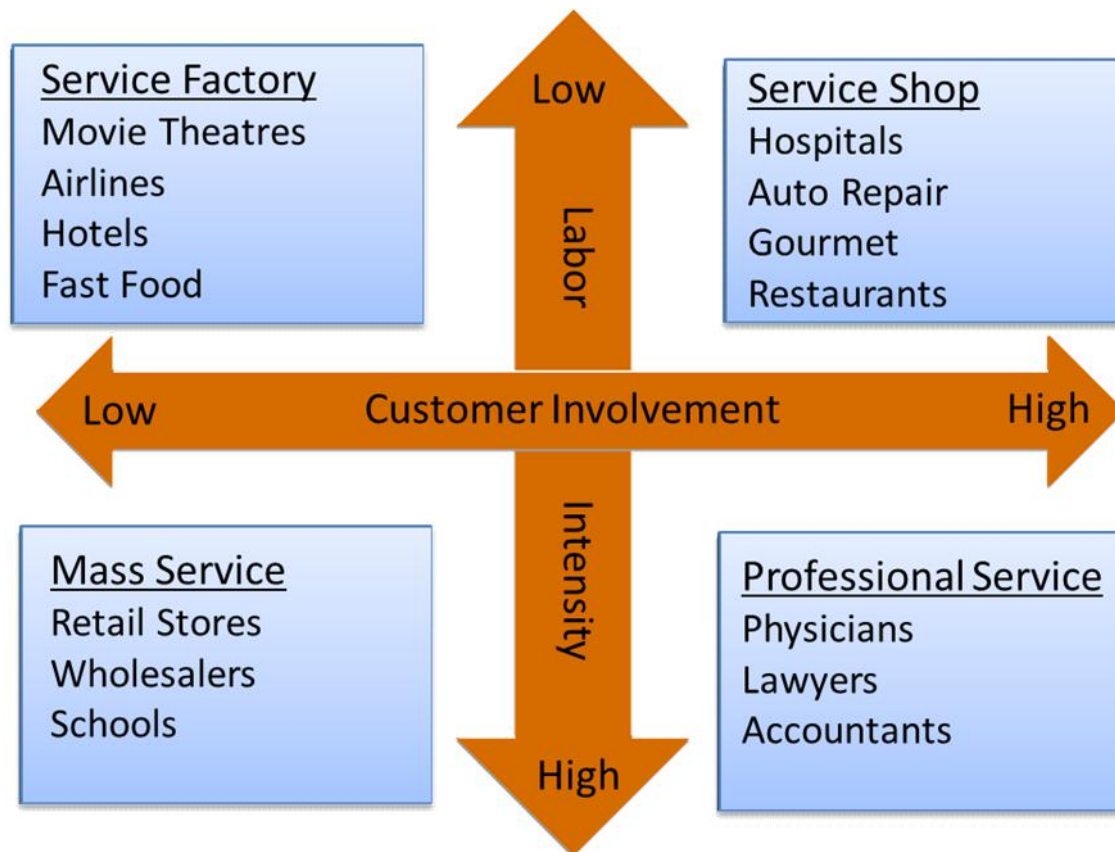


Source: PitchBook

Positioning for Success



Compatibility of Service Models



Key Drivers to Value

	Historical	Normalizing	Financial Control	Strategic Control
Sales	\$ 10,000	\$ 10,000	\$ 10,000	\$ 10,000
COGS	6,000	6,000	6,000	(200) 5,800
Gross Profit	4,000	4,000	4,000	4,200
Selling	1,200	(100) 1,100	(200) 900	900
G&A	1,500	(200) 1,300	1,300	(300) 1,000
Owners Compensation	900	900	(600) 300	300
Non-Operating	100	(100) -	-	-
Total Expenses	3,700	(400) 3,300	2,500	2,200
Operating Profit	\$ 300	\$ 700	\$ 1,500	\$ 2,000
Operating Margin	3.0%	7.0%	15.0%	20.0%
Valuation Multiple	5 x	5 x	5 x	5 x
Business Value to Whom	\$ 1,500	\$ 3,500	\$ 7,500	\$ 10,000

3 | The Legal Perspective: Selected General Themes and Specific Topics

General Themes

- Role of Attorney vs. Client Team in Due Diligence
 - Reassess for each deal
 - Cost / efficiency considerations
 - For smaller deals, generally must rely a fair amount on client team, but counsel should stay involved and provide guidance

General Themes

- Use of Virtual Data Rooms
 - Huge Improvement over previous approaches
 - Stage it if feasible – sequential as buyer gets more interested or as finalists remain after bid process
 - Make sure NDA is agreed to upon entering – some aren't automatic on that
 - Keep track of reputation for security
 - If competitors are bidders or if a competitor is the acquiring company, have anti-trust counsel at hand if pricing / competitive information being shared

General Themes

- Doing Due Diligence on the Buyer
 - If purchase price includes Buyer Securities, full securities law considerations
 - Legal due diligence on appropriate exemptions and securities issues
 - Proxy rules, even for privately held companies
 - If Seller management team is intact, how will it be to work for the Buyer?
 - Fit and integration

General Themes

- How Long to Allow Due Diligence to Go On?
 - Sell-side wants to shut it down early
 - Buy-side wants to keep it open until Closing; can be used to gouge value on purchase price

Specific Topics

- Asset Purchase. Can you focus just on the assets you are purchasing?
 - Limited Successor Corporate Liability, but they still will try
 - Which Pay-Off letters should Buyer Require?

Specific Topics

- Gating Items
 - These are key. Generally, plan for quick close as time can be the enemy
 - Material Contracts. Assignability and Change of Control
 - Government Contracts? Federal and State. GSA?
 - Other Regulatory Permits?
 - Is Landlord on board?

Specific Topics

- Regulatory Concerns
 - Understand full regulatory regime at LOI stage
 - How regulated is Target?
 - Foreign Corrupt Practices Act
 - ERISA
 - Environmental

Specific Topics

- Material Contract Review
 - Not just for assignability, but also for integration and for impact on business
 - Look for Most Favored Nations pricing provisions. Whether Target or Acquiring company have such provisions, assumption of material contract can have unintended consequences and depress value.

Specific Topics

- Employment Agreements
 - What if Target's executive agreements have more generous terms?
 - Choice of Law and non-competition clauses (sale of business or post-termination)
 - Due diligence on personnel files

Specific Topics

- A Word on Sarbanes-Oxley
 - Determine early if Suitor might be a public company
 - Financial controls / systems
 - Committees

Specific Topics

- Sandbagging
 - Buyer angle
 - Seller angle

Post-Closing Integration Considerations

- Integration needs to be planned prior to the closing in order to make the acquisition successful
- Need to consider all aspects of the business
 - Financial
 - Administrative
 - Sales and Purchasing
 - Operations
 - Engineering
 - Human Resources

Thank you

Frank Wisehart MBA, CPA, ABV, CFE, CVA
RGL Forensics
Director - San Francisco
T (415) 593-1323
fwisehart@rgl.com

100 Bush Street, 20th Floor
San Francisco, CA 94104

Mark H. Davis, Esq.
Gordon & Rees Scully Mansukhani LLP
Partner - San Francisco
T (415) 986-5900
mdavis@gordonrees.com

275 Battery Street, Suite 2000
San Francisco, CA 94111