VIRTUAL ROUND TABLE

CORPORATE LiveWire

DUE DILIGENCE 2014

MEET THE EXPERTS

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Chris Deaton, Founder of Clarity, began his involvement in the due diligence industry over a decade ago by marketing products to the alternative investment industry and assisting clients with developing and implementing procedures designed to limit their exposure to risks and satisfy their fiduciary responsibilities. He then transitioned to a direct role in the production of investigative products. In his 14+ years of experience, he has personally conducted thousands of investigations for clientele including major accounting firms, multi-national corporations, investment banks, pension funds, private equity firms, fund of funds, government agencies and other business. He founded Clarity Diligence Services in 2013.

Clarity is a commercial research consultancy with the primary aim of mitigating financial and reputational risk through the use of background and investigative due diligence services in the U.S. and abroad.

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Chris is managing partner of the Moore Stephens office in Guildford. He has been in practice for 28 years during which his main focus has been in delivering services to business clients. He advises clients in the areas of audit, accounting, tax and business development. His main focus is in delivering services to owner-managed businesses and seeking structured solutions to the challenges that they face.

Chris also provides a wide range of advisory services to clients which includes developing businesses as well as those where the owners are considering an exit strategy.

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Jillian Alexander has more than 25 years Management and ClientService experience working with market-leading and trend-setting companies, ranging from Fortune 100 corporations to early-stage start-ups in diverse industries.

From her experience, Jillian has developed proven approaches and tools incorporating Design-Thinking, Systems-Thinking, and leveraging big data to rapidly identify opportunities and risks; create and execute growth, acquisition, exit, risk management, and other strategies; conceive new ventures; design new products and services; devise operating models; document business plans; source, assess, value, structure, negotiate, and manage acquisitions, divestitures, joint ventures, licensing deals, and other strategic alliances; produce effective corporate and brand marketing campaigns; assess and improve performance; and plan and manage business transformation. Clients leverage these to expand market share, grow revenue, improve performance, increase profitability, and enhance enterprise value.

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Robert W. (Rob) McLeod is a senior financial executive and CPA with extensive experience in financial analysis, merger and acquisition due diligence, restructuring and turnaround advisory, budget and business plan assessment/development, cash flow forecasting/management, and alternative scenario and strategic options analysis. As a trusted business advisor to global corporations, financial institutions, and private equity firms, Mr. McLeod excels at analyzing details to drive critical insights, leveraging his broad and deep exposure across many significant business transactions to identify issues quickly and advise instinctively. He is a dedicated, people-oriented leader, consistently recognized for his enthusiastic and energetic approach to problem solving and ability to communicate effectively amongst divergent constituent groups to drive successful conclusions.

MEET THE EXPERTS

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Pete is a Partner and Head of Transaction Advisory Services at Grant Thornton specialising in financial due diligence. He trained with Grant Thornton, becoming a full time Transaction specialist in 1997.

Pete has been actively involved in transactions for a significant number of Private Equity houses and viability and funding reviews.

Pete also has significant experience acting as reporting accountant with both main market and AIM listings, having helped a number of companies through the flotation process and their subsequent acquisitions and disposals.

He has also managed a significant number of cross-border transaction assignments and has experience of working on transactions in over 20 countries.

Due Diligence 2014

In this roundtable we spoke with five experts from around the world to discuss the importance of Due Diligence. Our chosen experts summarise the main challenges in the due diligence process, discuss methodology and outline its role in M&A activity.

1. Can you outline the benefits of employing effective due diligence?

Deaton: Due diligence covers a wide array of subjects ranging from accounting and operational reviews to in-depth research of legal and regulatory histories. From our perspective, focusing on background research related services, effective due diligence mitigates the chance for financial and/or reputational loss and increases your knowledge of the key players in any transaction. Today, unfortunately, no one can simply rely on the responses to a due diligence questionnaire or assume that any "issues" have been truthfully or fully disclosed. You have to check. And that check has to be thorough enough to give you peace of mind, which is one of the single largest benefits.

Goodwin: Financial due diligence is a critical aspect of transaction planning as it can affect the consideration for a transaction and be a major factor in deciding whether to enter into a transaction. The process aims to validate the key assertions on which a transaction is based which is essential in the context of an acquisition where external finance may be sought and the ongoing business is committed to financial obligations and measurement criteria. This is equally important for vendors who may be seeking to address any issues a potential acquirer may have and to avoid unnecessary disruption to the business.

Alexander: When considering Mergers & Acquisitions, Joint Ventures, Licensing, Outsourcing and other strategic alliance deals, effective due diligence reveals aspects of the targeted company that are ideal and aspects ripe for improvement. You will know how effectively and efficiently time, effort, money, and other assets are used due to existing strategy, operations, know-how. You will have a good understanding of the quality of the assets as well as degree of risk and magnitude of liabilities, including the human ones.

This provides the foundation for cultivating realistic expectations of post-acquisition integration and repositioning efforts and duration, developing a reasonably close to accurate financial forecast, and quickly conceiving purchase price adjustment arguments.

By conducting comprehensive due diligence effectively, you will know whether or not the target is a good fit, what it will take to maximise benefits gained via deal, and at what price it will be accretive.

Dawson: Due diligence is an independent investigation and assessment of a business which provides detailed information upon which an investment decision can be based. From a financial point of view, benefits to the client can include identification of key risks, forecast achievability, quality and maintainability of earnings to name but a few. However, due diligence can be more than just financial and we increasingly incorporate tax, commercial, IT and operational assessments. Diligence outputs effectively inform clients in making key decisions such as whether or not to proceed with a transaction, price negotiations and contract terms. From a seller's perspective, a vendor due diligence report can add significant value to a multi-party sale process by identifying issues up-front and enabling bidders to be provided with the same detailed, independent report on which to base their offers.

McLeod: Effective buy-side transaction due diligence – i.e., the systematic process of challenging a seller's representations regarding the acquisition target and the investor's critical assumptions underlying decisions on price, value, and whether or not to move forward with a deal – enables a buyer to make a well-informed investment decision, mitigate risk, maximise value, and avoid surprises. On the flip side, effective sell-side transaction due diligence – i.e., the process of preparing a business for sale and proactively anticipating buyer due diligence needs – can dramatically help a seller preserve value, accelerate the transaction timeline, minimise disruptions, and enhance credibility.

2. What are the main challenges in the due diligence process?

Deaton: One of the biggest challenges my particular industry has faced over the last several years is managing the huge increase in data. I'm not talking about new data sources or advances in information gathering tools, I'm referring to the increase in the actual amount of litigation and other derogatory records we

routinely locate when conducting due diligence research. Whether this is attributable to a more litigious society in general or because the recent recession forced more people into courts to fight over every last cent is a question for another time, but it's definitely more of a challenge than it once was. A "clean" report is a true rarity these days.

Goodwin: The due diligence process is based on co-operation and agreement by all parties involved. It seeks to consider historic performance, future expectations, consideration of underlying processes and controls, together with identification and evaluation of factors that will impact on the business being acquired. Alongside the process itself runs the fundamental principles of confidentiality and the aim to avoid undue pressures on both the acquirer and the target business and to manage the expectations of the parties involved. There are a number of parties involved for whom information is required in a timely manner to meet schedules and avoid potential problems during the process.

Alexander: In my experience, there are four main challenges in the due diligence process:

1. Validating information is current, complete and accurate.
2. Avoiding disruption to day-to-day operations.
3. Gaining access after commissioned advisors have advocated to limit due diligence scope due to their personal interest in closing the deal now.
4. Preventing disclosure of possible transaction.

Dawson: A key difficulty often encountered relates to obtaining information from the subject of the diligence. The level of information required to get comfort over areas in our scope can be considerable and those collating the information are typically doing so in addition to their day job. A significant proportion of our fieldwork relates to establishing what data is available, obtaining it and analysing it on a consistent basis. This can only be achieved through establishing sound relationships with those assisting us, being dynamic and flexible in our approach and regular communication to ensure that all parties understand what is required and that their expectations are aligned.

McLeod: The due diligence process is frequently mined with familiar challenges such as poor and/or incomplete information, tight timelines, and limited access to target personnel. We've found, however, that the key overarching challenge is aligning the efforts of multiple due diligence work streams to focus on the key transaction value drivers. Deal team decision makers typically need input across multiple functional areas, including market, financial, commercial, legal, regulatory, tax, operations, technology, human resources, real estate, and environmental, not to mention industry- and jurisdiction-specific expertise. A siloed approach simply doesn't work. A strong deal team – and especially a trusted transaction advisor – knows how to keep everyone navigating in the same direction.

3. How can you successfully manage risk?

Deaton: Without a doubt, risk is inherent in any transaction. Speaking from our point of view only, there are a number of things that can assist in mitigating it. Some of those are:

1. Confirming that you're dealing with a legitimate business and not a suspended, dissolved or unregistered entity.
2. Checking for civil litigation history. Not only for instances where your subject might have been sued, but also looking for patterns of excessive litigation as a plaintiff. This is often overlooked, but the last thing you want to do is partner with or invest with someone that has sued everyone they've ever known.
3. Check for undisclosed liabilities, such as unsatisfied judgments or tax liens.
4. Research the business history of the Principals and look for patterns of repeated business closure or failure. Your subject may be a serial entrepreneur, but has everything they've ever done failed?

Clearly, this is not an all-inclusive list and there are numerous other areas that should or could be reviewed depending on the transaction in question.

Goodwin: Risk is always going to be a factor in terms of maintaining value and minimising post-completion risks. Whilst there is no mechanism to avoid the risks inherent in any transaction, effective management of the due diligence process plays a significant part. This includes early identification of the possible issues and agreement of scope, combined with ongoing updates and discussion to avoid unforeseen elements and aid re-direction if appropriate.

Alexander: Conduit Consulting professionals prepare for and conduct due diligence in a manner which minimises

disruption, avoids disclosure of transaction being considered, and protects confidential information. We begin by to anticipating all risks, then advising clients of methods and tools to eliminate or reduce exposure.

We advise Buy-side clients to conduct comprehensive due diligence during the deal-making phase. This accelerates mitigating issues and often makes it possible to be prepared to begin integration or transformation activity on the first day after deal closes. This practice generally results in happy employees, shareholders and other stakeholders.

Engaging an independent Management Consultancy having extensive strategic positioning and operational improvement successes plus deal-management expertise, such as Conduit Consulting, to lead and conduct due diligence, can pave the way to gain access and obtain pertinent information without divulging to the workforce or other stakeholders that a transaction is being considered.

Dawson: One of the areas of focus during a diligence assignment is to identify risks that our clients may be exposed to should they decide to proceed with a transaction or investment. In order to ensure all material risks are identified our teams always comprise qualified and experienced diligence professionals. In addition we have detailed checklists and procedures to ensure all relevant areas are assessed fully and all our projects go through a thorough multi-level internal review process.

McLeod: To successfully manage transaction risk, a savvy deal team, supported by trusted advisors, conducts focused, detailed due diligence and proactively utilises the findings to (i) adjust the purchase price accordingly, (ii) seek protections (e.g., purchase price adjustment mechanisms, representations, warranties, and indemnifications) in the sale and purchase agreement, (iii) prepare integration and synergy-realisation plans, and (iv) decide to walk away from the deal, if necessary. Another effective risk mitigation technique is to tie the seller to the business for a period of time post transaction, such as via seller financing, an earn-out (i.e., additional purchase price achieved if the business meets certain profit or other objectives), or a hold-back amount (not released to the seller for a period of time; available to fund undisclosed liabilities or other matters).

4. Can you talk us through your methodology?

Deaton: At Clarity, we take a customised approach to each assignment, so our processes can vary from case to case based on the requirements of each client. At the core though, all research begins with a thorough review of any documents or information provided to us at the outset, such as verification of identity, confirmation of research parameters, the current and former location of operations or residence etc. From there we take a layered approach including in-courthouse record research, the use of multiple database services and direct inquiries to create as complete a picture as possible of a subject's history. No one "methodology" or process fits every situation completely, so flexibility is key.

McLeod: We first make sure to understand the basics: the transaction background (i.e., the target, its industry, and the market dynamics impacting both) and the transaction rationale (i.e., the main strategic drivers, the perceived risks, and the proposed structure). Next, we gain a more in depth understanding of the key transaction value drivers – those commercial, financial, operational, synergistic, and regulatory matters deemed most critical to the investor – and co-develop a due diligence plan focused on them. Then, we leverage our extensive experience to execute the work plan, driving deep into areas we are primarily responsible for, while remaining always cognizant of matters impacting other work streams. Finally, we deliver practical, fact-based considerations and recommendations.

5. Can you reference a particular case study which highlights best practice?

Deaton: I can say that, after having conducted thousands of due diligence investigations first hand, there really isn't anything I haven't seen. From hedge fund managers in personal foreclosures, investment advisors and brokers not disclosing significant derogatory records to regulators, falsification or exaggeration of education and work histories to research subjects that are completely clear of any derogatory findings. All of those instances, whether clear of negative findings or full of them, point to the fact that the real best practice is to simply make sure you do the research. Because, regardless of the results, you truly know more than you did before, right? I will add, though, that our experience has shown that you cannot rely on merely one information source. You have to take a multi-source approach to due diligence, otherwise you will be left

with too many holes where potentially damaging information could hide. I'm routinely amazed at the number of investors and firms that still neglect the investigative due diligence aspect and continue to rely on word of mouth alone or just a check of SEC or FINRA registration records.

Alexander: When performing due diligence on a Biotech M&A deal where the acquirer had identified financial performance thresholds that the combined entity must be expected to achieve at Day 1 and had anticipated this would be achievable via improved business practices and processes as well as redundancy reductions, team members concurrently evaluated operating strategies and efficiency, purchasing strategies and controls, cash management, workflow efficiency, human asset quality and management, intellectual property and rights management, infrastructure, and other factors; design the post-acquisition organisation; and perform valuation analysis. On the third day, I was able to identify that the anticipated cost savings would not transpire and politely explain the reason the client's initial expectation was vastly different from reality.

McLeod: We recently teamed to advise a global strategic acquirer headquartered in Europe on its acquisition of a global manufacturer based in North America. Our client assembled a diverse due diligence team to comprehensively address the key transaction drivers, which included (i) penetration into a new industry, (ii) revenue and profitability expectations associated with "booked" business, and (iii) separation of the business from its parent. The group was comprised of strategy, investment banking, financial, tax, and legal advisors, working in concert with the client's very experienced internal team. Collectively, the team delivered significant value, including: (i) identification of adjustments resulting in a large purchase price reduction; (ii) mitigation of significant stranded-cost risks through inclusion of protections in the purchase agreement and development of transition services agreements; and (iii) successful settlement of post-closing disputes.

6. How do you maintain confidentiality during a due diligence engagement?

Goodwin: The maintenance of confidentiality during the process is of paramount importance and whilst it is possible to put physical barriers in place for some elements, like secure storage, document tracking, electronic deletion and sharing arrangements, it is not possible to completely discount the human factor. Most parties to a transaction are aware of the need to maintain confidentiality and are bound by ethical standards and guidelines stipulated by professional organisations. This is not all encompassing and it is therefore appropriate to clearly define and identify what is considered to be confidential information and the circumstances in which such information can be communicated and to whom. The implementation of a policy and appropriate sanctions for breach will need to be considered.

Alexander: Every Conduit Consulting team member fully appreciates the need for confidentiality and is committed to maintaining it.

We recommend limiting knowledge that a transaction is being considered and access to deal files to deal team members only, limiting the number of client and advisor deal team members to as few as necessary, minimising transmission of information over wire line and wireless systems and attached devices, refraining from discussing the deal in public or other locations which discussion may be overheard by a non-team member.

When Seller is client, we prepare and place encrypted electronic document files in high-security virtual data rooms, limit access to files, and monitor viewing. And, when representing Buyers, we expect Sellers to do this.

Dawson: Due to the nature of transactions confidentiality is key a consideration throughout our assignments. We, as employees and partners are bound by professional confidentiality standards in respect of our work and clients. This is enforced through the use of project names, secured systems and restricted access areas of networks, securing documents when sending them, the use of data rooms and so on. Confidentiality clauses are also included in engagement terms for those that we work with.

McLeod: Maintaining confidentiality in a due diligence engagement is critical to protect from unintended disclosure about the transaction itself as well as to safeguard against leakage of competitive or personal information that could result in harm to the buyer or seller and/or regulatory violations. Appropriate use of technology is of utmost importance. While virtual data rooms significantly enhance the dissemination and analysis of information in a due diligence process, appropriate security measures must be employed. Use of code names

for transactions and targets should be the norm. Above all, though, vigilance in every-day situations is paramount: don't review confidential information in public places, limit conversations to a "need to know" audience, and double check for use of correct addressees and participants on emails and conference calls.

7. How detailed should the checklist be for the completion of financial due diligence?

Goodwin: The extent of a financial due diligence exercise will vary from assignment to assignment and whilst certain aspects will be common to most, the extent of any enquiries will be driven by the requirements of the acquirer (or vendor in the case of vendor due diligence) which are set out in a letter of intent. This will then form the basis on which a checklist is prepared in response to the specific characteristics of the transaction in terms of purpose, funding requirements, sensitivity and constraints on the availability of information. A checklist should therefore seek to encompass potential risks and valuation considerations. Typically this will include operational and financial considerations, legal and tax compliance, contractual obligations, underlying assets and liabilities.

Alexander: Due diligence should be comprehensive; far more extensive than just financials. Financial reports are limited to only current and historic facts that can be stated in monetary amounts. As such, they only shed light on monetary aspects of the business, and the most important elements remain in the dark. Operational, Talent, and Legal due diligence are very important, and the findings often result in adjustment to valuation and purchase price.

Acquirers and joint venture partners need to evaluate not only whether or not the financials factually represent the current operations and workforce, but also operations and talent capabilities, scalability, the current degree of waste or underutilisation, and many other factors. They need to evaluate not only pending lawsuits and financial commitments, but also liabilities and risks pertaining to every aspect of the business ranging from C-level issues like intellectual property rights to manufacturing work floor issues like regulatory compliance.

McLeod: While checklists have their merits, adhering solely to one is almost assuredly a recipe for failure. For example, one could have a world-class checklist for analysing the historical quality of earnings of a transaction target, including such typical steps as reviewing non-recurring and unusual income and expense items, challenging the target's pro forma adjustments, and comparing profitability by customer/product/geography/etc. But what if the target in question recently changed its business model? Or acquired another business? Or restructured its operations? Here, the "checklist" model falls down. The best approach is to start with traditional work steps based on experience and professional standards, adapt them to the situation, and adjust based on findings made during the process.

8. How should a firm prioritise tasks within the due diligence effort?

Deaton: I'll take a different approach with this question. As a provider offering due diligence related services to our clients, we place much of our early emphasis on identifying the "deal killer" first. After consulting with our client regarding their largest or particular areas of concern, we attempt to quickly identify whether any deal killers exist as early in the process as possible. This could be a bankruptcy, multiple unsatisfied lien filings or an extensive criminal record for some clients. For others, their deal killers may be regulatory fines or even divorce cases.

So for me, a firm such as my own, or even other similar providers, should prioritise their due diligence efforts by being fully engaged with their clients. We're experts at what we do and all of the appropriate data will be reviewed, but I have no interest in wasting a client's time by forcing them into a cookie cutter process.

Goodwin: The prioritisation of tasks is dependent on the principal risks identified during the scoping exercise. The identification of information required by other advisors involved in the transaction will provide an initial guide to timetabling activities. It is also likely that certain aspects are perceived by an acquirer to be significant in terms of the transaction and an early assessment of these elements is essential in providing direction and for revision of the plan if appropriate.

Alexander: Conduit Consulting's efficient due diligence process is organised into phases to minimise risk of news of the deal being leaked, disruption to target entities day-to-day operations, and client costs.

As different buyers prioritise different criteria, we start by ensuring the Executives, Board and other deal decision-makers agree on deal goal and deal

breakers. Then we devise a prioritised due diligence workplan. Typically, we initiate due diligence in the areas which will either confirm or invalidate deal-breakers existence and where it may be toughest to accomplish due to time schedule or other anticipated challenge either at the same time or just prior to initiating due diligence in other areas.

Our value-oriented holistic approach results in clients avoiding wasting valuable time and effort on bad deal prospects as well as all parties rapidly agreeing to transaction terms including price and payout structure as well as post-transaction roles and responsibilities, including transitional services and liability indemnifications.

Dawson: It is crucial to determine upfront before embarking on a due diligence what the main areas of focus are for the client. These can vary significantly depending on the client's interests be they a private equity house, corporate, bank etc., their existing knowledge of the business and the sector, their investment strategy. Where there are anticipated aspects of the investigation that could be deal-breakers for the client, then these items are given priority. Planning is critical.

9. How can due diligence be used to ascertain the appropriate purchase price in M&A activity?

Goodwin: There are a number of factors involved in a valuation exercise and from a pure financial reporting perspective, valuation models are utilising historic data to identify a potential range of values. There is always uncertainty in a valuation exercise due to the variables and limitations imposed by the extent of available information. The due diligence process seeks to improve the position through identifying the key factors that could affect the performance of an acquisition target which may then influence the valuation exercise. The outcome should reflect the robustness of the historic financial information and enable an assessment of the sensitivity of future expectations.

Alexander: When done right, comprehensive due diligence reveals hidden pitfalls and treasures.

Discovering a risk and determining the magnitude of exposure and likelihood of occurrence provides the opportunity to assign the liability stemming from that risk to the seller, while determining which workers will no longer be needed prior to deal closing enables the buyer to avoid severance expense by never employing those workers. These are costs the buyer can avoid.

Conversely, some aspect of the target business may be very valuable to the buyer, even though it is presently underutilised due to sellers' short-sightedness or other limitation. The buyer would not offer a premium to the seller, yet the insight gained via due diligence often secures the sale.

Dawson: A key focus of financial due diligence is invariably a trading and quality of earnings review. Existing contracts, customers and revenue streams are assessed to determine if there is any risk that the revenue may be lost in the future and how maintainable or "sticky" the revenue and associated profits are. Similarly, income and costs that are exceptional or not part of the ongoing trading of the business are adjusted for as part of this exercise. The adjusted profit figure that is reached is intended to reflect the underlying ongoing performance of the subject and is often the basis of the headline pricing or enterprise value of the transaction, to which a multiple is applied by the acquirer/investor. In addition, our SPA Advisory specialists assess and advise on the adjustments to arrive at the final equity value such as net debt and working capital and the final completion price adjustment mechanism.

McLeod: Due diligence is essential to calculating a fair market enterprise value for any business subject to a transaction event. The enterprise value – usually derived via analysis of discounted cash flows, comparable companies and transactions, asset values, or some combination thereof – plus or minus adjustments for indebtedness to be assumed, non-operating assets to be acquired, and the level of net working capital to be delivered with the business, comprise the typical purchase price elements. Effective due diligence tackles each element (e.g., quality of earnings analysis to validate the enterprise value, balance sheet analysis to assess indebtedness and net working capital, etc.) and also incorporates verification and identification of synergies and integration plans, both of which can significantly impact the price a specific buyer is willing to pay.

10. Following M&A activity, how can due diligence be used to effectively integrate talent acquisition?

Alexander: Effectively integrating talent requires a Big Picture perspective.

Preferably due diligence and decisions with respect to talent retention, staffing, compensation, and all other employee

matters are made pre-deal, rather than post transaction. Either way, gaining understanding of individual employees skills, knowledge, capabilities, aspirations, degree of engagement, and work environment and rewards preferences is extremely useful when envisioning the combined companies' future organisation design, planning migration and on-boarding of workers, as well as identifying workers who will lead, influence or undermine competitive repositioning and development of the new business model.

More specifically, talent due diligence itself can be used as a tool to cultivate enthusiasm for deal and change, as well as uncover likely and possible pitfalls due to faulty or inappropriate infrastructure, morale, or other liabilities.

Synthesising findings from Financial, Operational, Legal, and Talent due diligence is useful when:

- refining competitive strategies;
- planning efficient workflows;
- building teams;
- devising career paths and succession plans;
- developing a comprehensive transition, integration, and transformation plan;
- And crafting messages included in all forms of corporate communications and marketing collateral to build support for and gain buy-in and loyalty to the combined company by employees, shareholders and other stakeholders.