

A new twist on due diligence

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Test before you invest. That's the golden rule of prudent M&A investing.

The more sure you want to be of paying a fair price, the more carefully you need to do the due diligence. If you're lucky you'll uncover a few skeletons to get the price down or at least persuade the vendor to offer a larger warranty.

On the other side of the deal, before going to the market, a smart vendor will commission its own due diligence to ensure nothing emerges from the woodwork to bite it during negotiations with bidders.

But changes are afoot.

Vendor due diligence is starting to take off overseas and now it's reached Downunder.

Vendor due diligence is where the due diligence on behalf of the bidders is initiated by the vendor.

Bidders, whose expressions of interest are accepted by the vendor, are then handed copies of the due diligence report along with a letter of engagement from the party which completed the report acknowledging its duty of care to the bidders.

"The objective is that the purchasers do not need to undertake their own due diligence," Deloitte Touche Tohmatsu corporate finance partner Tim Staples says.

His firm recently co-ordinated the due diligence on behalf of British stationer and bookseller WH Smith when it sold its holdings in Hong Kong (WH Smith), Australia (Angus & Robertson) and New Zealand (Whitcoulls) to Pacific Equity.

Vendor due diligence has several advantages according to Staples and his colleague, Deloitte tax partner Stephen Conder.

For a start, Conder says, it streamlines the process for the vendor.

It has only one due diligence team to deal with rather than a succession of parties, all potentially asking for much the same information. Not having to commission their own due diligence will also save the bidders money, he says. However, the vendor may well attempt to recover its costs from the proceeds of sale.

Staples stresses there is no question of a vendor commissioning a soft report or failing to disclose anything material.

"The vendor has to be prepared to disclose everything. If you're an adviser, it's in your interests to have everything disclosed, otherwise the buyers will come after you."

He adds although the vendor commissions the report, the adviser's duty of care is to the bidders.

A further advantage is vendor due diligence enables the bidder to retain more control of the sale process. Staples believes it could reduce any discount a bidder might seek as compensation for uncertainty of information.

"If you have all of the issues out on the table, there should be less negotiation over price," he says.

Deloitte's practice with due diligence reports is to send in an independent team rather than the firm's usual contact firm for the client.

“You have to put yourself in the bidder’s shoes and ask what they would want to know.”

Being too close to the vendor could make that difficult.

While vendor due diligence has clear advantages, Staples says it’s not suitable for every deal. “This sort of report is tailored to a more sizeable transaction,” he says. However, Robert Bogers, head of corporate finance at ABN AMRO, asks if that need be the case.

“I think it has some merit, especially where the tolerance of the bidders to absorb those costs is low.”

Minter Ellison corporate commercial team partner, Joe Windmeyer, another old hand at M&A work, makes the point that vendor due diligence may not be as innovative as it appears.

“There has always been a degree of vendor due diligence. The vendor invariably gives a warranty and also a disclosure letter regarding the warranty. But to permit you to give a warranty and do a disclosure letter, the vendor has to know what’s going on,” he says.

He suggests what’s new is not so much the process itself but where it replaces the bidder’s due diligence and, secondly, the duty of care the adviser engaged by the vendor owes to the bidders.

That said, he notes with some public offerings, a vendor may be required to address its due diligence report to the buyers.

One adviser also questioned if vendor due diligence might not sometimes work against the vendor. Not all bidders will uncover the same information or arrive at the same conclusions. So, the more thorough a bidder’s due diligence - depending on what is uncovered - the greater the potential to negotiate the price down. With all bidders being equally well-informed, the vendor loses this opportunity to exploit any bidder’s knowledge gap.