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How to Approach a Target and Perform Initial Due Diligence

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Business is good for many middle market operators and investment capital is generally plentiful. Are you an investor whose capital is industry agnostic, or does your capital need to be targeted at add-on investments that build on a pre existing business platform?

All business investors are "financial" investors - the real question is how "strategic" is their ability to leverage the assets of the target. Providing practical guidance on approaching a business target and conducting initial due diligence depends on the investor's criterion, competencies, and execution bandwidth.

In this article we assume you have identified a target or group of targets and you are attempting to learn enough about the target to determine whether to proceed with developing a meaningful indication of interest. Of course, an active seller is likely prepared for the sale process and represented by an advisor who is postured to provide the financial and operating information necessary for investors to quickly determine the suitability of a deal (i.e., a pitchbook and defined protocols for communication and information access).

However, many desirable targets may not be seeking a sale because business conditions are favorable, and their businesses have been managed to provide options to the owners regarding continued independence and turn-key ownership and management succession. If the former, you, as a prospective buyer may have already pinged on the radar of the seller, and if the later, you have mined for target opportunities and are ready for the next step to accomplish an acquisition.

Our focus here is to summarize some practical considerations for approaching and vetting an identified target.

First Contact

M&A is not easy. For every transaction that is announced a very long list of items for both the buyer and seller were satisfactorily addressed before two parties entered into a merger or purchase agreement. For the acquirers, first impressions matter a lot. There are no second chances to make a good first impression.

How a target is contacted can be pivotal to achieving receptivity and obtaining a critical mass of information. In cases where market familiarity or professional collegiality already exist, it can make sense for an investor's senior leadership to make direct contact with the target's senior management and/or owners.

In cases where the target is not familiar to the investor, then following a respectful and empathic set of protocols is key. Investors using professional advisors and/or who involve their senior decision makers are likely to be taken seriously by the target. Peer-to-peer contacts too far down the chain of command are more likely to be dismissed.

Owners and senior managers are keen to prevent the rumor mill from derailing business momentum and disturbing internal calm. A mindful and considerate process of first contact and initial discussions that is highly sensitive to the discrete nature of exploratory discussions will increase the probability that initial discussions and diligence can proceed to the next phase as a relationship based on trust develops.

In our experience, contacting a target through a financial advisor has an important signal function that the potential acquirer is serious and has initiated a process to prioritize and vet targets. Diligence procedures will be thorough and well organized; deal consideration and terms will be professionally scrutinized. Alternatively, some business owners and investors who initiate a process may be perceived as canvassing to see what sticks to the proverbial wall. This can inadvertently serve to inflate seller requirements and expectations assuming the initial inquiry is successful.

Initial Due Diligence

Once the initial contact is established, it is important to follow-up immediately with an actionable agenda. Actions and processes include:

- Non-disclosure agreement;
- Information request list;
- Clear set of communication protocols involving specified individuals;
- A centrally controlled and managed information gateway;
- Establishment time frames and target dates for investigative due diligence, IOI, LOI, pre-closing due diligence, deal documentation, and ultimately closing.

Organization begets pace and that pace culminates in a go or no-go decision.

Preliminary Valuation

Procedurally, our buy-side clients typically request that we perform a valuation of the target using a variety of considerations including the standalone value of the target and potentially the value of the target inclusive of expected synergies and efficiencies.

A properly administered valuation process facilitates an understanding of the target's business model, its tangible attributes, its intangible value, its operating capacity, its competitive and industry correlations, and many other considerations that investors use not only for the assessment of target feasibility but as an inward-looking exercise to assess the pre-existing business platform.

For first-time buy-side clients, our services may also include building leverageable templates and processes for future M&A projects. Additionally, our processes may also be critical to the buyer's Board consents, the buyer's financing arrangements, and other managerial and operating arrangements required to promote target integration.

Concluding Thoughts

Conducting target searches, establishing contact, and performing initial due diligence are critical aspects of successful buy-side outcomes. In general, there are as many (if not more) consequential considerations for buyers as there are for sellers.

Some buyers covet the conquest and go it alone without buy-side advisory representation. Conversely, even seasoned investors can benefit from third-party buy-side processes. Unseasoned acquirers may find their first forays into the M&A buy-side world untenable without proper guidance and bench strength.

As providers of litigation support services, we have seen deals that have gone terribly wrong as if predestined by inadequate buy-side investigation. As providers of valuation services, we have valued thousands of enterprises for compliance purposes and strategic needs. As transaction advisors, we have rendered fairness opinions, conducted buy- and sell-side engagements and advised buyers concerning a wide variety of deal structures and financings. If you plan to take a walk on the buy-side, let Mercer Capital's 40 years of advisory excellence guide and inform you.