

Due Diligence Issues

What is due diligence?

Typically incorporates:

- i. commercial / operational due diligence;**
 - ii. financial due diligence;**
 - iii. tax due diligence;**
 - iv. legal due diligence;
 - v. human resources due diligence
- Evaluating a target firm's business model and prospects, including identifying the market, whether or not the firm has an attractive target, and assessing their competitive situation. Transferring this knowledge and understanding how it will benefit the buyers existing business.
 - Determining whether or not company accounts are consistent, evaluating the real situation of assets, liabilities and tax risks. Understanding the necessary adjustments, normalisation adjustments to get to the real situation, to get to the best valuation.

M&A Landscape

- Deals are happening faster; there is more competition amongst buyers; there are more “buyout” activities amongst buyers; in certain sectors, buyers such as strategics are paying more for assets; vendor due diligence reports are becoming more frequent; sale and purchase agreements (SPA) warranties are coming under pressure; more regulation & good governance are driving transaction decisions.
- Strategic buyers vrs private equity buyers
 - What is the buyer’s objective/s, what do they want to get out of the acquisition?
 - Use due diligence to evaluate your investment hypothesis:
 - Cost synergies, what’s the timeline?
 - Brand value – how do you exploit the brand, enhance shareholder value?
 - Market share, market penetration, new markets
 - Product and / or servicing offerings
 - Asset lifecycle: growth mode, how did it grow (organic, inorganic)
 - Portfolio effect
 - Deal frequency
 - Exit options (timeline to exit)

Due Diligence Issues

Adapting the Due Diligence Approach - New Decisions, Solutions

- Phased DD approach (red flag reports, stage II detailed DD)
- Industry specialisation, jurisdictional knowledge, anticipate buy-side opportunities, better use of data and analytics
- No longer just a focus on just top line growth:
 - Operating focus: change management, improvements during DD
 - Appoint good advisors and challenge them:
 - The vendor will have professional advisors do you?
 - Augment FDD and TDD with industry experts, traditional advisors are good at identifying gaps, problems but how did the gap come about? Where is the upside?
 - How do we fix the problems?
 - How do you benefit from the upside? How do I get certainty that my objectives are achievable?
 - Balanced teams based on DD experience, industry / sector experience, jurisdictional knowledge

Due Diligence Issues

- Cash Flow – Target in the construction industry 7% EBIT margin, working capital (WC) build up over three years, due to poor collection culture, additional WC required for trading could not be financed resulted in insolvency.
- CAPEX – Target in the O&G industry, buyer did not understand CAPEX, maintenance requirements generally, achieve growth targets, comply with lender covenants.
- VDD report / management meetings - the numbers are the numbers, focus on management's message:
 - What is the motivation of the seller “dressed up for sale”:
 - Curtailing CAPEX (includes headcount), investment in the right area
 - Inventory write-off (retail acquisition (electrical goods))
 - Lifestyle branded, manufacturing company (cosmetics sector, distribution channel stuffing)
 - Pharmaceutical sector (sales department, commission based business, anti-bribery and corruption)
- Retail – Target was a retail business, several loss making stores closures, one-off events or repeatable, reflection on management decisions.
- Services businesses – closures of new jurisdictions.
- Logistics – finding the value, hotly contested (6 or more bidders), offer was a “knockout blow”, sale leaseback was the hidden value.

Tax - Purpose and key objectives

Why perform tax due diligence work?

Relationship between tax and valuation

- Historical tax risks and exposures
- Go forward impact on ETR
- Can deferred tax assets be realized in the future or should they be excluded from valuation
- Identify opportunities to improve tax efficiency of target

Implications of not properly taking tax into account

- Lower after tax investment return
- May lose bid (if it is a competitive bid)

Approach to tax due diligence work

Hong Kong / China targets

- Full scope vs high level approach – make sure you do actually modify your work to reflect the scope

Multi-jurisdiction targets

- Phased approach
- How to involve overseas offices

Asset vs Share Deal; Equity vs debt deals

- Should our approach / scope of work change?

Vendor due diligence

Common tax issues

Transfer pricing

- Minimal regard to transfer pricing requirements
- Lack of support documentation
- Tax world is changing and getting TP right is a must!

Permanent Establishment risks

Selling to the US

- Risk of sales being taxed in the US

Profit shifting

- HK sales / PRC manufacturing
- Transfer of business operations / part of business operations

China specific issues