FIFTH EDITION | CHAPTER 4

BEST PRACTICES OF THE BEST DEALMAKERS

"Whilst due diligence is indeed a process, it is misleading to suggest that M&A value measurement, when performed by our expert contributors, is anything less than the highest art form."
~ David A. Fergusson

CURIOSITY, LOGIC & PERSISTENCE

HOW DUE DILIGENCE UNLOCKS A DEAL'S TRUE VALUE

David A. Fergusson | Editor

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BEST PRACTICES OF THE BEST DEALMAKERS

Drawing on the experience and expertise of the "best in class" M&A professionals, The M&A Advisor, the world's premier financial leadership organization, together with Merrill Corporation, the leading provider of technology-enabled platforms for secure content sharing, regulated communications and disclosure services, publish the quintessential dealmakers guide series – *The Best Practices of the Best Dealmakers*. Profiling the proven strategies and unique experiences of the leading M&A practitioners, this series is distributed in regular installments for industry professionals in both print and interactive electronic media. Previously published features and chapters are also available in the online libraries of Merrill Corporation and The M&A Advisor.

INTRODUCTION

In the previous chapter of this, the 5th edition of the *Best Practices of The Best Dealmakers* series, "Dealing with the CEO," we focused on the collaborative role of chief executives, corporate development executives and their advisors to compete in a complex global economy. In this, Chapter 4, "Curiosity, Logic and Persistence: How Due Diligence Unlocks A Deal's True Value," we explore the essential processes of due diligence and purchase price negotiations that are employed to ensure a proper valuation of the deal as it moves toward closing.

To research this installment, we called upon an international CEO who is involved in every phase of his company's strategy for global growth through M&A, joint ventures and alliances. We gleaned wisdom on navigating cross-border deals from a business development expert at a company with one of the world's most recognizable brands. And from our stalwart M&A Advisor Faculty, all experienced investors, advisors and counselors in the United States and Europe, we gleaned valuable insight into the art form of value measurement.

In New York, we engaged with Anthony Decicco, a member of the GTC Law Group, who stressed the value, to both buyers and sellers, of being transparent and setting responsible expectations in order to avoid surprises at the closing or beyond. Tony is a trusted expert in intellectual property strategy and has been a valued contributor to M&A Advisor symposiums. From London, Ian Jamieson, founder and ceo of the corporate finance firm that bears his name, shared his wisdom on the intricacies of advising buyers and sellers and the potential pitfalls that can scuttle a deal during the due diligence phase. We called upon Aileen Stockburger, worldwide vice president for business development at Johnson & Johnson, whose company's reputation for quality and integrity stands at the forefront of any transcation they woiuld entertain, to share her valued perspective. Aileen's notable experience in cross-border deal making, including the early pioneering stages of M&A in China, make for interesting reading and insight. Seth Eliot Wilson, founder and managing partner of the private equity firm Headhaul Capital Partners LLC, has provided us with excellent advice on

setting priorities that lead to a productive and efficient deal closing. Also from London, veteran deal advisor Gareth Iley of Clearwater International counseled us on the clear role that he believes that CEOs should play in due diligence, particularly in priority management and major conflict resolution. Finally, the technology industry pioneer Carlos Creus Moreira, founder and ceo of the cybersecurity company WISeKey, shared with us his views of what the leader of a growing middle-market company looks to achieve through M&A. Carlos plays a key role throughout the process, not surprisingly with particular interest in and emphasis on examining the technology of any company in which he may invest or acquire.

In the forthcoming and final chapter of the 5th Edition, we will examine the crucial roles these M&A professionals play in the truest test of the deal – post merger integration.

We hope that this chapter is informative and satisfies your curiousity regarding the perspective of your peers on the due diligence process. We encourage you to share your experience with the application of logic and persistence in this crucial dealmaking stage.

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Curiosity, Logic and Persistence: How Due Diligence Unlocks A Deal's True Value

Part I: CEOs and Due Diligence—A Changing World

"For me, what is faster—to develop a product and bring to it market, do a joint venture, or acquire that company? We look at everything. How do they fit? What's their culture like? What's the language barrier like?"
– Carlos Creus Moreira, Founder, CEO, and Chairman of WISeKey

While CEOs provide the strategic vision and road map for growth through M&A and other business development strategies, the nitty-gritty of getting from the letter of intent to the closing is often viewed as the purview of staff and advisors. This may be true in the elite world of Fortune 500 companies, but in the vast middle and lower-middle market of M&A, where CEOs are often the founders of growth companies, the CEO plays a crucial role throughout all phases of a deal. This chapter of the 5th edition of *Best Practices of the Best Dealmakers* examines how CEOs, corporate development leaders, and advisors work together on the parallel processes of due diligence and price negotiations to consummate a transaction designed as a win-win for both buyer and seller.

Carlos Creus Moreira is Swiss national and Spanish born and resides in Switzerland, from where he operates WISeKey (SIX Swiss Exchange), a leading global cybersecurity provider founded in 1999. Moreira's roots in information technology extend to security work with the United Nations and participation in the World Economic Forum (WEF) during the 1990s as the Internet was morphing from a novelty to the ubiquitous communications and commerce platform that it is today. In 1999, sensing a growing need for businesses to protect their IT assets from a new breed of cyber criminals, he founded WISeKey, of which he is chairman and CEO.

In its first decade, WISeKey focused on research and development of cybersecurity technology and measures aimed at protecting physical assets within businesses and organizations. But in recent years, given the proliferation of cloud computing, smart mobile devices, and the Internet of things (IoT), WISeKey's mission has expanded to developing a cryptographic Root of Trust (RoT) for all interconnected devices. WISeKey has patented

this process in the United States as it is currently used by many IoT providers. Today, WISeKey is recognized by the WEF as a Global Growth Company that is a pioneer in the WEF's Fourth Industrial Revolution.

To get to this point, Moreira employed a trusted process for growth and value creation—mergers and acquisitions. Over the past few years, WISeKey has formed partnerships and joint ventures with technology companies across the globe, including a 2016 deal with Kaspersky Lab that resulted in the release of a special edition of a cyber-resilience app: WISeID Kaspersky Lab Security. WISeKey's biggest deal to date occurred in February 2017, when the company signed a binding agreement to acquire 85 percent of QuoVadis Holdings Ltd., a leading managed electronic signature services company with operations in Switzerland, Germany, the Netherlands, Belgium, the United Kingdom, and Bermuda. The deal is valued at more than $13 million, and WISeKey intends to acquire the remaining 15 percent of QV Holdings based on its financial performance. Moreira said the business opportunity for WISeKey comes not only from QuoVadis's reputation as a Trust Services Provider but also from its enterprise customer base of more than 300 large cap and 3,000 overall customers across Europe, the United States, and Australia. "The integration of QV into the WISeKey Vertical Platform will ensure that users and businesses can use their own national electronic identification schemes (eIDs) to access public services in other EU countries where eIDs are available. It allows WISeKey to create a European internal market for eTS—namely electronic signatures, electronic seals, time stamping, electronic delivery services, and website authentication—by ensuring that they will work across borders and have the same legal status as traditional paper-based processes," WISeKey says in a press release announcing the deal.

"We are driving the process through M&A," Moreira tells The M&A Advisor. "We are expanding our platform by integrating companies that bring new IP, invention, patents, and revenue. We are very focused on strategy." As the middle-market CEO, Moreira plays a hands-on role in all aspects of WISeKey's dealmaking. "For me, what is fastest—to develop a product and bring to it market, do a joint venture, or acquire that company? We look at everything. How do they fit? What's their culture like? What's the language barrier like?"

Unlike in many businesses involved in manufacturing or services, Moreira says, "In the security business, it can take a long time to establish trust with clients. Trust is very important—your DNA, your references, your

"We want strategic investors in the country to help make the integration go smoothly; then we make the acquisitions. That's the preferred model in emerging market countries that are heavily regulated." – Carlos Moreira

experience are all important." In the early years of WISeKey, "We needed to prove that our technology was solid, not hacking. We started installing at many world organizations with operations in Switzerland. That got us exposure to companies like Microsoft and SAS. We raised $180 million before we listed the company [on the Swiss exchange]. This year we've had one acquisition already, and a few are in the pipeline." The company is expanding from 130 employees to 250 with the QuoVadis acquisition, and Moreira expects to have 400 employees by the end of 2017, with more than $45 million in revenue.

With a lean staff and business dealings across many borders, Moreira leans on several M&A advisors, both in Switzerland and internationally. "I formed an advisory board, with some members who are very specialized," he says. "Some have done very big deals; one involved British Telecom. On staff, I have an M&A execution team—four people who help throughout the different stages. M&A is a very distracting activity, so I try to delegate when I can." With each new deal, Moreira said WISeKey builds expertise in-house that proves valuable in future deals. When Moreira, his staff, and advisors identify a potential acquisition or investment opportunity in a new country, he seeks investors in that country. "We want strategic investors in the country to help make the integration go smoothly; then we make the acquisitions," he says. "That's the preferred model in emerging market countries that are heavily regulated."

"I am very close with my advisors," Moreira adds. "During a period of acquisition, they become like staff." Over time, he has developed a team of lead advisors that work on multiple deals. "We define roles and responsibilities very clearly at the beginning and monitor progress through calls and weekly meetings. And we improve as we continue to work together." As a best practice, Moreira cautions CEOs to check references and set the terms for any new advisors before becoming involved in a deal. "Be very clear in the terms, and if the advisor doesn't respond, replace him immediately. Otherwise it will just create frustration on both sides. He may be thinking he's doing a great job, but you don't."

When it comes to the due diligence phase, Moreira says he stays more engaged than many CEOs, particularly given his technology background. The financial due diligence is normally subcontracted to a professional team of advisors, lawyers, and accountants. Meanwhile, "I will be more focused on the technology we are acquiring. I will run a forensic analysis on each piece of technology. Is it good enough? I will also consider how clients are or will be using the technology. I will continue to do this regardless of how big WISeKey becomes. At end of day, you need to be very confident in the technology."

"Due diligence is essential," Moreira adds. "It's always a tool for negotiations. Valuations are always very aggressive at the beginning. When you go into due diligence, you are going to either discover or understand things that were not clear at the beginning. Then you can fine-tune the purchase agreement. I am less concerned about finding deal-breakers, but I want to make sure the company is appropriate and there are no surprises after the closing. One of the main conditions for us to acquire a company is that they show sophistication. We don't want to look at a messy company. That's like looking at the car in the driveway before you look at the house. If the car is messy, you don't go in the house."

What Diligence is Due?

Perspectives from a Veteran M&A Banker and Professor

By Marshall Sonenshine

In the M&A business, due diligence generally refers to the evaluation of a target company by a buyer and its advisers, but the origins of the phrase arose in the Securities Act of 1933 principally involving underwriters of corporate securities (particularly equities) that would be issued to the public markets, meaning diligence by underwriters essentially for the benefit of public investors. The '33 Act was concerned with this particular topic in response to underwriting practices that were inadequately regulated by states and thus led to abuses in public offerings through inadequate investigation and disclosure by issuers and underwriters. That at earlier time was an era of negligence; the '33 Act inaugurated in its place an era of federally mandated diligence, and created an industry and a system of legal and business norms that would grow from that date forward.

To read the complete essay visit page 24

"The process of due diligence is changing because of technological innovations such as virtual data rooms and cloud services," Moreira observes. "Companies are much better organized today. Any company that has done any serious rounds of investments knows how to maximize time with technology. Software lets you do in a few weeks what would have before taken months. I believe that technology—like the ability to remotely run financial models—is going to further improve the M&A process."

"In cross-border deals, advisors become even more important," Moreira notes. "Your strategy in cross-border deals is very different because every country has different laws, regulations, and culture. In France, for instance, they have very strict labor laws. They're very protectionist. You cannot even fire a person for cause. You have to talk to the unions, the government. You have to adapt. Advisors who know the laws and culture of the jurisdiction in which you are making an acquisition can help you adapt. Many cross-border deals fail at the beginning because of these differences."

Part II. A Fortune 500 Executive Eyes Middle Market for M&A Value

"I actually think due diligence is a blessing. It's the opportunity to really learn about the company in detail. The key is to use the opportunity to learn as much as possible about the operations of the company, and—equally important—to determine what really makes this company special and therefore how you can really use it to maximize the value of the combined companies." – Aileen P. Stockburger, Worldwide Vice President for Business Development, Johnson & Johnson.

Johnson & Johnson is one of the world's most recognizable brands. Founded more than 130 years ago, the New Jersey–based corporation is number 39 on the Fortune 500 with a market cap of $325 billion. It has more than 125,000 employees in 60 countries and scores of subsidiaries extending throughout the health care and personal consumer products industries. As with many corporations of this size, much of its growth has come through mergers and acquisitions.

When she went to work on the finance side of J&J 25 years ago, Aileen P. Stockburger was given the opportunity to work on M&A. Over the years, she has worked on scores of deals, the value of which she estimates at more than $70 billion, including the acquisitions of Pfizer's consumer health care business for $16.5 billion in 2008 and of DePuy Synthes, an orthopedics and neuro products and services company, for $21 billion in 2011–12. Stockburger is now Worldwide Vice President for Business Development at Johnson & Johnson, currently heading business development for DePuy Synthes. She oversees the group's M&A activities, including strategy and target identification, deal structuring, negotiations, contract design and review, and formulation of deal terms.

"I look at M&A as a strategic decision, so it's more important to do it right than to do it fast." – Aileen P. Stockburger

Business development at Johnson & Johnson involves strategic planning throughout the year, Stockburger says. "We work with the CEO in terms of helping to set the big-picture strategy. Throughout the year, we plan where we want to be in the future. In business development, we investigate and explore targets and determine the best deals to pursue. Then we go back to the CEO and review our list of targets. We confirm with the CEO that the target meets our strategy."

The amount of information Stockburger's team can glean during the strategic planning process depends on the size of the acquisition target and the nature of its business. If a company is publicly traded, a plethora of information is publicly available. "We explore whatever information we can get in the public domain and do a preliminary analysis. Private companies are different. They're generally smaller and often more of a 'tuck-in' or 'gap-filler' for us. Obviously, a major deal is done at an entirely different level." The smaller deals usually occur out of the headlines. In the past year, Stockburger noted, Johnson & Johnson acquired one lower-middle-market company that produces orthopedic devices used in elective foot and ankle surgery. "We liked their specialty products. They filled a gap for us."

While a perception exists in the M&A community that the time frames for deals have become compressed in recent years, Stockburger says it all depends on the type of deal and location. "I look at M&A as a strategic decision, so it's more important to do it right than to do it fast." Certain aspects of M&A, including due diligence, can be done more quickly using new technologies, such as virtual data rooms and cloud services. However, when acquiring new products and technologies that are outside Johnson & Johnson's core areas, diligence can be a time-consuming process. Some deals in which Stockburger has been involved—particularly cross-border transactions—have taken years to complete.

"I actually think due diligence is a blessing," Stockburger says. "It's the opportunity to really learn about the company in detail. The key is to use the opportunity to learn as much as possible about the operations of the company and, equally important, to determine what really makes this company special.

Therefore, you can learn how to really use it to maximize the value of the combined companies. So we look very hard at the value drivers. We look for the hidden gems because we want to ensure that we don't destroy them in the new organization. It's more important to nurture and enhance those assets."

Because of its size and internal resources, Johnson & Johnson does not typically use investment banks in its M&A activity. "We might hire consultants who have expertise in a certain area outside of our core competencies," Stockburger says. Her team will use external advisors, lawyers, and accountants only in specific deals. "We have a big, experienced internal group that can usually handle all phases of a transaction." Conversely, in acquiring middle- and lower-middle-market companies, her group frequently negotiates with investment banks and advisors. "We got to know the bankers and advisors, but we are also frequently dealing with bankers who are new to us," she says.

It's no surprise that Johnson & Johnson, with its huge global product sales footprint, employs an M&A strategy that includes many cross-border deals. Stockburger says such deals differ from a typical domestic transaction in numerous ways and usually take much longer to complete. "We still follow our same process and criteria in cross-border deals," she says. "That deal is going to compete with other deals throughout the enterprise for funds. But we might modify our deal approach. We're more likely to have advisors on a cross-border deal because we need their local expertise."

Cross-border deals, particularly in the early days of M&A in many countries, call for novel approaches. As an example, Stockburger cites a Johnson & Johnson acquisition of a lower-middle-market Chinese skin care company about 10 years ago—"a state-owned entity [SOE] at a time when China was just beginning to divest many of its SOEs. We had language and cultural barriers. Due diligence was not a well-known concept there. We had quite a number of people on the ground whom we could use to help in due diligence. All the documents were in the local language. Those folks had never done a deal or due diligence before. So we arranged for each person to have a partner who was familiar with the process and coached the local Chinese employees in terms of how to do due diligence. We were able to do that deal with our own employees—it's a luxury we have as a large company." Still, the deal took five years to complete. "It was an extremely long process. A lot [of that time] was working through cultural issues and due diligence. It was working with the

other party in planning for integration. Working with the mirror teams took time. My advice is that you really need patience if you're going to go into a place with a different culture. You need patience and flexibility. That takes time. But we had patience and flexibility on both sides."

Part III: M&A Teamwork: Advisors Helping Corporate Leadership

A. Setting Expectations for Due Diligence and Price Negotiations

"Present the advice they need without getting too deep into the weeds. Know your stuff since you'll have only a short period of time to communicate with them. You're not deciding this for them—you are their advisor and you need to help them make the decision they will need to live with. You are also there to help them reality-check their decision, as their sounding board. You need to give seasoned advice quickly; the only way to get good at this is by doing it." – Anthony Decicco, Attorney, GTC Law Group, Boston

Every day in every time zone, CEOs, corporate development teams, and legions of advisors work together on deals designed to add value to the global economy. These M&A teams completed more than 17,300 deals worldwide in 2016, valued at $3.2 trillion, according to Mergermarket. Keeping the M&A market at work in the global economy requires an industry of professional dealmakers, including investment bankers, private equity investors, independent advisors, lawyers, accountants, technologists, analysts, and many others. The parallel phases of due diligence and completion of the purchase agreement—which are the focus of this chapter—highlight the importance of teamwork in the art of dealmaking. What follows are the views of four prominent M&A professionals on the qualities and best practices that result in not only the closing of a deal, but also in a successful integration to move the combined companies together profitably.

Seth Eliot Wilson is the founder and managing partner of Headhaul Capital Partners LLC, a lower-middle-market private equity firm focused on the supply-chain, transportation, logistics, and distribution industries. He also worked for 20 years on transportation deals at Jefferies Capital Partners LLC before founding his New York–based firm. "Headhaul" is a reference to the highest revenue generating shipping lane between shipper and consignee. Within the transportation industry, the phrase general signals where a company makes its highest level of profit.

"Since we are focusing on the transportation sector specifically, we wanted to signal this to investors and management teams to promote our ability to be a value-added partner," Wilson says. Since founding Headhaul in 2014, his team has completed two acquisitions and has a third under LOI. During his career, Wilson has worked on more than 30 PE platform investments with a combined value of about $2 billion, plus 15–20 add-on acquisitions.

Because of their limited staff, CEOs of lower-middle-market companies "need to be very involved in due diligence," Wilson says. "They should be meeting with the target's management team, seeing the operations, discovering what the major deal and integration topics are. When you evaluate the trade-off of between the CEO's time and the potential impact of an acquisition gone wrong, we have found that erring on the CEO spending more time on the diligence is more effective." While advisory teams need to focus on the details of the diligence and transaction structuring, the CEO's role can become most valuable when disagreements arise. "Whether during the final stages of a closing or during post-closing integration, a more involved CEO can be well-positioned to bridge to a successful outcome," Wilson says. "We've never done a meaningful corporate acquisition without the CEO being involved. One of our existing portfolio companies recently completed an add-on acquisition. Our CEO went there multiple times, was involved in negotiations directly with the owner, walked the shop, walked the yard, kicked the tires. We have a higher level of confidence to proceed when we hear our CEO was on site as opposed to saying, 'My guys were there.'"

Even though financial sponsor-backed companies have partners from the private equity fund on their boards, utilizing outside M&A advisors can be advisable. "In many cases, outside advisors and investment bankers are better positioned to assist in executing M&A driven growth once the management team and the PE professionals have set the strategic direction. We have used investment bankers in the past to generate add-on target opportunities and develop a more formalized process? Outside advisors tend to be more current on valuation trends and deal terms. Even a very good CEO or corporate development person has most likely done fewer deals than an M&A advisor. It's really about imparting your process knowledge to executives You may not know the answer, but at least you can ask the right questions."

Gareth Iley serves as a Partner at Clearwater International, a London-based independent corporate finance house with 200 employees in 15 international

offices. Clearwater has completed more than 1,300 transactions in 31 countries, with a net worth of more than £50 billion. More than two-thirds of these projects were cross-border trade sales, and all were supported by specialist sector teams. Iley is well known to both the corporate and private equity communities and has advised on deals of all sizes.

Iley says the CEO of the company making the acquisition should not get involved in the details of the transaction but should retain an overview of the transaction. “The CEO should not be the project manager,” he says. “The CEO should spend his or her time on a list of key strategic issues that should receive the most emphasis. Ultimately, the CEO is the one who must answer if it all goes wrong.” Iley says the most important issues tend to be commercial and focused on the nature of the business, the market, growth prospects, the potential post-closing synergies, and the future leadership of the combined company. The CEO of the acquired company will be involved in significant aspects of the deal. “Depending on the size of the business, the seller CEO should still be delegating but is likely to be more involved because the buyer will want to spend time with him to understand the business.” As an advisor to an acquiring company, Iley says he normally works on deals with the corporate development team, with less day-to-day involvement by the CEO. “I would want to collaborate with the CEO early on to make sure I’ve got serious buy-in. There are lots of aspects of the deal that the corporate team should be responsible for. However, the CEO should come to the selling company’s management presentations because it’s a real sign of commitment and buy-in and will put them higher up the selling shareholders thinking. The corporate development team should deal with the day to day and keep the CEO in reserve for any real big problems.”

Anthony Decicco is an attorney involved in an increasingly important M&A role—assessing and valuing intellectual property (IP) and technology, including proprietary and open-source software code, which can impact price in many technology deals. He is a member in Boston–based GTC Law Group PC’s IP Strategy, M&A, and Business and Technology Transactions groups. He has worked on well over 200 deals in his career and has reviewed the results of over 1000 code scans. Decicco’s clients range from individual inventors to Fortune 100 companies.

In Decicco’s experience, on the buy-side, CEOs of larger companies play less of a role in the due diligence phase. “But for smaller and mid-sized companies

"The effective due diligence can happen only by fielding an organized team. The CEO needs to organize his teams into the appropriate areas so that the people doing the due diligence understand what they're doing and why." – Ian Jamieson

the CEO is often very involved," he says. "They generally don't have a layer below them. On the sell side, in almost every deal, the CEO is central because it's often their last act for the company. They need to maximize the company's value for shareholders." What's the best way for a seller CEO to be effective? "On the sell side, [the CEO] needs to start well ahead of time preparing the company for the acquisition event. This could be years in advance. Among other things, he or she needs to get the IP house in order, not only minding the technical aspects, such as assignments for patents and making sure there are no open-source code license violations, but also creating an IP narrative that showcases the value. 'What's the story that I can spin behind these spreadsheets?' He or she needs to weave all these aspects into a cohesive story that shows value, as opposed to only going through the motions of responding to a due diligence checklist."

On the buy side, Decicco says the CEO needs to set expectations for the due diligence and purchase negotiations and make sure all members of the team are on the same page. "The last thing you want is to have an internal team squabble in front of the seller. You need a unified front. It's important to have agreement on what needs to be done in due diligence in terms of scope and depth. Have a game plan so that everybody on the team has the same answer here and the target is not given an opportunity to drive a wedge to start chipping away at scaling back the due diligence." To avoid surprises, Decicco advises being transparent from the outset and telegraphing precisely what your expectations with respect to due diligence. "For example, tell them at the outset, 'We are going to do a code scan for open source software in your systems. Here's why we are doing it. Even put it in the LOI.' This prevents the target from later saying, 'No, we won't do the code scan. It's too time-consuming; too expensive.' That way you minimize surprises."

When collaborating with CEOs and corporate development, Decicco says, outside advisors need to exercise judgment. "Present the advice they need without getting too deep into the weeds," he advised. "Know your stuff since

you'll have only a short period of time to communicate with them. You're not deciding this for them—you are their advisor and you need to help them make the decision they will need to live with. You are also there to help them reality-check their decision as their sounding board. You need to give seasoned advice quickly; the only way to get good at this is by doing it."

Ian Jamieson is the Founder and CEO of Jamieson Corporate Finance, an independent advisory firm focused on private equity transactions and private company M&A with principal offices in New York and London. Jamieson established the firm after more than 20 years of corporate finance experience and has completed over 200 deals. He is well known to both the corporate and private equity communities and has advised on transactions ranging from multibillion-pound cross-border mergers to deals at the smaller end of the spectrum.

In advising numerous CEOs during his career, Jamieson observes that the effective due diligence can happen only by fielding an organized team. "The CEO needs to organize his teams into the appropriate areas so that the people doing the due diligence understand what they're doing and why," he says. "Not only financial due diligence but also commercial, environmental, technological—whatever is relevant. There needs to be an effective chain of command. The CEO of the investing company should be the guy in charge. The CEO of a PE firm will delegate to his troops. This should be their bread and butter." Jamieson agrees that the CEO will be more or less involved in details depending on the company's size and market position. "But it's important that the output he gets from his team is balanced with the expectations of his investors. A family-owned business will likely need to have a network of people to make sure it goes right." For effective collaboration with both buyers and sellers, Jamieson says, "understanding from them where the sensitive spots are is key. What is the most effective way to put them in the best light with the other party? It's not spin or advertising. It's making sure that things aren't miscommunicated. There are a lot of situations where things could be perceived to be a problem without proper communication—and in fact they are."

B. Dealing with Pressures of Time and Diligence

"PE firms take fewer risks today than they did 10 or 15 years ago. The advent of the virtual data room has stopped some of this. Fifteen years ago, you didn't get electronic data in real time—numbers and information flashing up. You got paper data. PE firms today are not buying things on a whim as some were pre-2007." – Ian Jamieson, founder and CEO, Jamieson Corporate Finance

Whether deal time frames have become compressed due to competition, technology, or other factors is a matter of conjecture and debate among M&A professionals, but all agree the pressure of getting a transaction completed successfully is intense. Gareth Iley of Clearwater International observes, "The amount of work that needs to be done has increased. Technology is sophisticated, but sometimes it increases the workload. There was a time when people bought businesses before Excel spreadsheets, but now everything is modelled and analyzed in great detail." Still, he says, the challenge for dealing with the time pressures of today's deals is to have real leadership in the due diligence process. "For the buyer, the process of collecting and accessing data has changed dramatically. We used to go physically to a data room and look at the documents. Now it's all virtual. That's a huge help. You can get people all over the world to look at the data. But how do you then collect all the feedback properly into your organization and assess what it's telling you? You've got to have a real data leader and champion who can help you work through it. That's a critical area where the CEO can give direction."

Timetables in cross-border transactions "depend on the countries involved," Iley says. "If you are selling in sophisticated territories—say, the UK to America—the timetables are no different from completing a domestic deal and are relatively short and efficient. Everyone is completely used to dealing with different time zones and face to face meetings are held to deal with difficult issues. But in other places, where there is less experience of transactions, or where culturally the market is different, there will be longer time scales. For example, deals in China tend to take longer as the M&A process is less familiar, although large Chinese companies are now very experienced in M&A. If you want to approach a Japanese business as a potential buyer, the best way is to go to see them first face to face and this will need to be included in the timetable." The chief obstacle to a successful due diligence process, Iley adds, is "information that is unavailable, takes a long time to obtain, or is poor in its quality." He advises that sellers should "get everything ready so you can

deliver everything in one go and get through due diligence quickly. You can accomplish a lot by doing your preparation correctly. The biggest impediment to a deal can be a change in the price or structure due to poor information. A seller should make sure they have managed all the key issues. This will protect the value of the business when it goes through the process."

It is important to correctly calibrate the scope of diligence and create a prioritized "cut to fit" approach to match the timeline and the buyer's risk tolerance, observes GTC Law's Anthony Decicco. "You may be buying a company with 10 products, but two of those products may cover 80 percent of the revenue, and one other product has the potential to be the future of the company," he says. "Prioritize those three products first. Try to collect as much information as you can within the timeline. Remember that diligence can continue even after deal has been signed if there is a split signing and closing. In those situations, there are typically 30 to 90 days between signing and closing. Ask yourself, what do I need to know before signing. You can add covenants regarding continued due diligence and remediation to the purchase agreement to cover things found between signing and closing. That allows your timeline to be expanded giving you more time to complete diligence." Decicco adds that unless there is a competitive bidding situation, the timeline is often driven more by the seller than the buyer. "The seller may be running out of cash, or perhaps the next quarter is not looking as good. You can flip that around to negotiate better terms."

Cross-border deals invariably contain more potential surprises, Decicco says. "There are more likely to be unexpected snags in international deals. Tax issues are common, as are approvals from local government and regulatory bodies that move at their own pace. In addition, there may be more requirements for original documents, lead-times on requests and payments of things like stamp taxes, which may introduce unexpected delays. There are also cultural differences that can thwart your timeline. Some cultures avoid direct conflict, so everybody agrees on the phone, but when you get the markup of the purchase agreement back, you see that significant differences between the parties remain."

Veteran advisor Ian Jamieson doesn't believe that deal time frames are especially compressed. "It's deal by deal," he says. He adds that in his experience, "PE firms take fewer risks today than they did 10 or 15 years ago. The advent of the virtual data room has stopped some of this. Fifteen years

ago, you didn't get electronic data in real time—stuff flashing up. You got paper envelopes. PE firms today are not buying things on a whim as some were pre-2007." The inconveniences and risks associated with deal time pressure can be avoided with dialogue, he adds. "In any sensible deal, there's a meeting of plusses and minuses. They don't have to be absolute; there's interpretation as well—financial and commercial. Dialogue is key to reaching agreement on the interpretation." Jamieson said he has seen deals come apart over inadequate due diligence. "It's usually because people haven't done the work up front in the first place. They didn't know what they were buying. Probably five to ten percent of deals blow up because of this."

Jamieson sees time frames in cross-border deals in a similar light. "The difference is that cross-border deals are more complex and encounter many regulations upon completion. When you buy a global business, you may do the deal in three or four months, but you could be tied up in regulation for at least six months. We've had some that go on for almost a year. You have to plan for that." Potential surprises that could scuttle or hamper any deal, but particularly cross-border deals, include renewals of supply contracts and customer renewals. "These are often critical. They are best negotiated by a joint effort between the buyer and the seller so there are no surprises for either the customers or suppliers. A best practice would be for the seller to go to his customers and suppliers ahead of any announcement and say, 'We are thinking of selling.' This has to be done at the right time of the deal."

Headhaul Capital's Seth Wilson says most of the time pressure in M&A comes from auction processes, "although it's not massive." He prefers execute deals outside of auctions. "We haven't seen much change overall in the diligence process. Banks may push for time compression, but that has more recently been somewhat offset by more efficient pre-auction-launch diligence practices." Advisors have become more astute in preparing sellers for the diligence process and proactively provided more information earlier in the process. "I've seen some sellers hire accounting firms to do quality of earnings reports or environmental firms to complete phase one reports prior to launching a sale process. They are front-loading the work so there are fewer surprises on the back end." Wilson agrees that technology has also speeded the due diligence process. "I remember when a "data room" wasn't virtual and was actually a room at the seller's law firm, and you went in with pad and pencil and read for hours on end and took notes. Today, information is disseminated much more quickly." The biggest drawback to time compression, he adds, is

"a loss of people contact. You don't get as much exposure to the management team you will be partnering with for the next five years. You can't digitize evaluating people and stick it in a virtual data room."

In the cross-border deals that Wilson has experience with they have not been auction processes, "so we have had a bit more time to meander through them." He agrees the top concerns are cultural fits, along with legal and regulatory requirements in different jurisdictions."Sitting in the U.S., cross-border deals have that layer of 'you don't know what you don't know since you have less relevant experience which is why Advisors are important in these situation.' "At Jefferies, we invested in an international tanker business," he says. "At closing, we combined a Singapore-based operation being run by a British ex-pat with an Athens-based operation and had senior lenders from the Netherlands and GermanyAs the financial sponsor we were committed to making sure the communication and right information flow between all these groups was done correctly."

"Twists and turns come from every angle," Wilson adds. "No deal is a straight line. There's always something that pops up, whether in diligence or in the numbers." In one deal in which he was involved, he says, the selling company lost one of its largest customers somewhat unexpectedly. "That obviously put pressure on our interest in and ability to close. If we had known earlier in the process we could have taken it into consideration." Like his peers, Wilson agrees that up-front transparency is the best way to avoid these kinds of mid-deal problems. "It's best to be open and forthcoming and address everything early. Part of the diligence process is establishing trust between the two sides so that the buyer not surprised late in the process." Typically, the seller is in the better position to understand the risk. "Risk-sharing is an excellent way of working through issues as they arise. Earnouts, escrows, specific representations and warranties are excellent mechanisms to deal with post-closing unknowns and still be able to complete an acquisition.'"

C. The Purchase Agreement: Contention and Resolution

"This is the only place where the legal nature of the transaction is agreed upon and documented. Everything else is ultimately irrelevant. Any other discussions you've had or decisions you've made need to be in the purchase agreement at the end of the day—warranties and statements of business." – Gareth Iley, Partner, Clearwater International

"It IS the transaction," says GTC Law's Anthony Decicco of the signed purchase agreement. "It is the culmination of and embodies all of the work on the transaction. It's almost your entire basis for any remedy going forward." The development of the purchase agreement occurs while the due diligence process is under way. The parallel paths should be harmonious, but sometimes conflicts arise that can make the process awkward. As a best practice, Seth Wilson recommends laying out some of the ley terms of the purchase agreement at the letter of intent stage which in some cases is before formal due diligence starts. "When you lay out the major terms early, you can set the expectations for both sides as a baseline. Most likely, diligence will necessitate changes to the baseline but there is a starting point for negotiations."

Ian Jamieson describes the purchase agreement as "where everything is brought together. It's the result of negotiations—thorough negotiation." To resolve conflicts and refine the purchase agreement, buyers and sellers must be willing to give and take, he says. "It's like having a memorandum, and you have to negotiate around it. The negotiations can range around sales projections or anything, really. Are the debtors going to repay? Will the customers stay?"

"This is the only place where the legal nature of the transaction is agreed upon and documented," observes Clearwater's Gareth Iley. "Everything else is ultimately irrelevant. Any other discussions you've had or decisions you've made are irrelevant unless they are documented in the purchase agreement" For sellers, Iley promotes as a best practice "giving the buyer a key set of legal terms early on that can be incorporated into the purchase agreement later.

Further, Iley says the process of setting clear terms in the legal documents early in the deal process generally results in fewer revisions later. "Bringing forth the key legal terms takes contentious areas off the table. You may choose to defer some of the issues till later but the more that can be agreed early the better. If there are big issues to solve I am a huge fan of sitting around the table, agreeing on issues, and handing them back to lawyers to complete the documentation instead of lawyers going back and forth with markups." Iley also sees value in sellers purchasing rep and warranty insurance policies to cover any liability. These policies are much more common now, "they're now tried and tested, provided the policy is written properly."

Headhaul's Seth Wilson says of rep and warranty insurance, "It's been a sea-change event over the past few years. An efficient rep and warranty insurance

market has come up to the point where even investment banks are telling buyers to include it in their bids." He adds that many of the carriers "are staffed with experienced M&A professionals and can move quickly. Historically, negotiations involving indemnification could become contentious. If you can buy rep and warranty insurance to solve a hotly negotiated issue, it just takes another headache off the table."

Regarding the purchase agreement, Wilson says, "You hope you never have to open it again." He estimates, though, that a third of his numerous career deals have "at some point had to go back after the closing and crack open the purchase agreement to figure something out." He adds, "The best way to keep purchase agreement negotiations on track is for the team from the PE firm to be actively involved in the drafting from the beginning. We read the first draft of the purchase agreement cover to cover because we know more about the operations of the target and the people involved than the lawyers do so try to make some business judgements regarding what is or is not important early on. Focus and care and paying attention to the details are very important. In current auction processes, it is most common that the seller provides a draft and asks for comments in conjunction with a second-round bid. There are always going to be changes to the draft as due diligence progresses and deal structures are finalized. The times where I have seen this lead to the most conflict between buyer and seller is when a buyer has received new information which necessitates a change to deal terms which had previously been agreed to. Seller's many times view this as an attempt to re-trade portions of the deal where a buyer might view take the position that they would not have agreed if this information had been available. Having all parties acknowledge early that the purchase agreement is a living, breathing creature and thus subject to change can help managing expectations."

D. The Closing: It's Not Over Yet

"If I had my druthers, every deal would have a simultaneous signing and closing. But it doesn't usually happen.…Many times, it's just not achievable because of regulatory filings or other issues." – Seth Wilson, Founder and Partner, Headhaul Capital

With the completion of the purchase agreement, the deal is done—almost. Because of financial, legal, regulatory, and sometimes even business considerations, the combining companies may have reason or be forced

to close the deal at a later date. . "Almost every seller wants a simultaneous signing and closing," says Anthony Decicco. "The seller wants to walk away from the table with his or her money except for what's in escrow. The buyer may want to split the signing and closing to make the seller satisfy certain conditions while continuing to do due diligence." As a recent headline example, Decicco points to Verizon's $4.8 billion acquisition of Yahoo.com, announced in 2016. Repeated revelations of data breaches at Yahoo after the signing announcement put the deal in doubt. "If you're selling your house, it's great to get your money on the day of the signing, but the buyer will probably want more time to acquire a mortgage or complete a home inspection. In the end, you need to consider having a simultaneous signing and closing vs. a split signing and closing on a case by case basis in the context of your goals for the transaction."

"If I had my druthers, every deal would have a simultaneous signing and closing," adds Seth Wilson. "But it doesn't usually happen. Usually, we have a whole section [in the purchase agreement] detailing how the seller can't do certain things between the signing and closing. If you sign and close at the same time, you do away with all that. You're also taking risk off the table. It just makes life easier. But many times, it's just not achievable because of regulatory filings or other issues."

Jamieson is succinct about the value of a simultaneous closing. "It is a good thing to do because it gets it done. I'm not so sure what stops a simultaneous closing from being possible—a whole lot of regulatory stuff, mostly. Get it done so there's no security leak." Jamieson too subscribes to the use of rep and warranty insurance to mitigate post-closing risk. "Most of our management teams have tried it and use it."

"Always do a simultaneous closing if you can," advises Iley. "The legal drafting is simpler. There's no gap, and you can get on with the next phase. The big issue with a gap is that you have to agree to who's running the business during the gap. What if something happens? Does that mean that the deal is no longer going to complete?" Iley says the most common reasons for a gap between signing and closing are required regulatory or shareholder approvals. "Fundamentally, the repercussion is you have to deal with the period between exchange and completion. These certainly are not insurmountable requirements."

CONCLUSION

The nitty-gritty of M&A is the phase between initial agreement and closing when the teams of corporate executives, bankers, lawyers, accountants, and deal advisors work through the parallel processes of due diligence and the purchase agreement. As in all phases of M&A, the CEO's best practice is to set the expectations for each process. Depending on the size and complexity of the deal, the corporate development team, using selected advisors, will conduct the due diligence. Recent technological innovations such as virtual data rooms and cloud computing services have greatly improved the efficiency and productivity of the due diligence process, as well as reducing time between the LOI and the closing. The process of drafting the purchase agreement, which legally formalizes the terms of the deal, begins with the LOI and—again, depending on the size and nature of the deal—may go through several rounds of markups. In cross-border deals, the time frame from LOI to closing is usually longer—in some cases years—because of differences in culture, legal and regulatory regimes, and even experience levels. When it comes time to close the deal, it's not quite over yet. While most M&A professionals prefer a simultaneous signing and closing, that is not always possible. After the closing—as the final chapter in this 5th edition of *Best Practices of the Best Dealmakers* will explore—comes the true test of the deal: integrating two companies into one. We invite you to share your views and experiences with us on these topics.

AN ESSAY BY MARSHALL SONENSHINE

What Diligence is Due?

Perspectives from a Veteran M&A Banker and Professor

In the M&A business, due diligence generally refers to the evaluation of a target company by a buyer and its advisers, but the origins of the phrase arose in the Securities Act of 1933 principally involving underwriters of corporate securities (particularly equities) that would be issued to the public markets, meaning diligence by underwriters essentially for the benefit of public investors. The '33 Act was concerned with this particular topic in response to underwriting practices that were inadequately regulated by states and thus led to abuses in public offerings through inadequate investigation and disclosure by issuers and underwriters. That at earlier time was an era of negligence; the '33 Act inaugurated in its place an era of federally mandated diligence, and created an industry and a system of legal and business norms that would grow from that date forward.

In the modern M&A trade, the professionals conducting diligence are essentially still acting for third party investors behind their own client company. The corporate officers and their advisers conducting diligence and the directors who will consider their findings are all ultimately acting for the investors (public or private) whose fortunes may be hurt or harmed by the quality of knowledge understood in the decision to acquire a business. Behind every due diligence exercise is an ultimate party not always present but affected, the ultimate investors.

What diligence is in an M&A deal due is mostly a matter of business judgment and trade practice. There is generally no standard manual or statutory or regulatory checklist, though there are pieces of the puzzle that are legally needed – audits, leases, loan agreements, indentures, other corporate documents describing pensions and other liabilities, etc., without which the work of diligence would be on its face negligent. Law firms and accounting firms and banking firms all have well-crafted diligence checklists, reflecting years of practice in various sectors, that provide a starting point for what

diligence to pursue. But the broader work of diligence, beyond these checklist items, will always resist easy categorization because ultimately diligence is about research and investigation, about asking relevant follow on questions based on what information is tendered in response to a written or oral question, and about being shrewd observers of what drives or can bedevil a business going forward.

Thus, diligence, like all investigative work, is ultimately a skill about curiosity, logic and persistence. In this respect, the work of diligence bears similarities to the work of investigative journalists, detectives, government intelligence agents, tax auditors, prosecutors, and academic or scientific researchers. The work of diligence is about inquiry; indeed the Securities Act even speaks of "due investigation." To engage in due diligence is to be a private investigator of what is really inside a company from a legal, business, financial, accounting, tax, managerial, governance and any other relevant perspective. It is to explore diligently the good, the bad, and everything else that may matter. To really appreciate the challenges in due diligence consider the following issues:

- Real World Limits to the Diligence Exercise: There is a tension between broadly idealized diligence and real life. In theory buyers would do well to know everything; in reality they are limited by time, cost and availability of knowledge. Thus, one can only perform diligence well if one knows how to prioritize issues and allocate scarce diligence resources wisely. All things are relevant but only some things can be explored.

- To Assess or to Allocate Risk: There is also a tension between diligence and risk allocation in M&A transaction agreements. Ideally, a buyer should rely principally on his own knowledge, and use contractual risk allocation (through representations and warranties given by the seller) as an additional protection. The buyer that looks to his right to make claims later as a substitute for asking the right questions earlier is over relying on legal rights in lieu of business knowledge. But in reality not all knowledge can be obtained; some risks can only be allocated.

- Diligence and Desire: There is a tension between diligence and desire. A buyer doing diligence likely has already decided he wants to own the target business. He has plans, visions, strategies that the target serves. He is a prisoner of his own desire, of the cognitive dissonance processes that

may encourage him to focus on the things that ratify his decision and underappreciate the things that might threaten it. Among the greatest reasons for disappointment from acquisitions cited by buyside executives are overstating synergies and inadequate diligence – and both flow from the same human tendency to see what we want to see. One can terminate or take the risk of renegotiating a deal in response to diligence – or one can just keep going. One makes judgments.

- Data and Knowledge, or Where can Wisdom Be Found? Finally, diligence is often misunderstood as "data" or "information" when in fact those items are necessary but insufficient ingredients to successful diligence work. The other ingredient is business judgment – knowing how to evaluate the information derived in diligence work. One does not find judgment on a checklist; it resides someplace else.

In the final analysis, diligence requires investigative discipline, as the term was originally conceptualized, and also honest and insightful business judgment. Diligence looks like a checklist but is actually a distillation of value and knowledge – a real business understanding – that must be constructed with limited time and resources, mostly expended after one has already decided in principle the answer one hopes to find. Diligence is not easy, which is why M&A professionals remain in demand.

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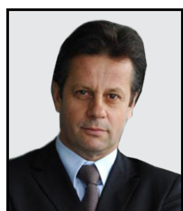
Gareth Iley serves as a Partner at Clearwater International, a London-based independent corporate finance house with 200 employees in 15 international offices. Clearwater has completed more than 1,300 transactions in 31 countries, with a total worth of more than £50 billion pounds. More than two-thirds of these projects were cross-border trade sales, and all were supported by specialist sector teams. Mr. Iley joined Clearwater in 2001. He previously worked at Old Mutual Securities in Birmingham, primarily working with quoted groups on their corporate finance requirements, raising development capital, and floating new companies. He qualified as a chartered accountant at KPMG, where he spent two years working in their transaction services department carrying out due diligence on a wide range of deals in various industries, in particular the retail sector.

Ian Jamieson is the Founder and CEO of Jamieson Corporate Finance, an independent advisory firm with principal offices in New York and London. The firm is focused on management-driven private equity transactions and private company M&A. Jamieson established the firm after more than 20 years of corporate finance experience and has completed over 200 deals. He is well known to both the corporate and private equity communities, and has advised on transactions ranging from multibillion-pound cross-border mergers to deals at the smaller end of the spectrum. Prior to founding the firm in 2005, Jamieson was chief executive of Deloitte Corporate Finance. He is an avid sports fan and a non-executive director at The Oval.



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