



Due Diligence: Risk Mitigation or Opportunity Identification?

After creating an investment thesis, a sponsor typically turns to outside experts to identify any “ailments” and validate the state of the target’s business. This due diligence—which, given today’s conservative deal environment and uncertain economy, focuses on identifying risk—enables dealmakers to show their partners and lenders that they have all their bases covered. My intent, therefore, was to write an article about how effective, comprehensive due diligence improves the risk equation for a potential transaction.

This premise for the article works—assuming that investors equate diligence with risk identification and mitigation. In fact, Wikipedia, the “go-to” resource for explaining all things in the Internet age, defines due diligence using such descriptors as *disclosure*, *risk tolerance*, *compliance*, *liability*, and even *malfeasance* and *nonfeasance*!

In this age of scrutiny, compliance, fraud, fiscal responsibility, litigation, public exposure and forced accountability (giving rise to reputational risk), no sponsor wants to bring a “bad deal” to investors. But, to bring a “good deal” to the table in a competitive deal climate, sponsors increasingly need to differentiate themselves with unique opportunity and value.



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Risk-mitigating forms of due diligence

When most people hear the term, “due diligence,” they think of validation of the investment thesis and thorough financial, legal or insurance and risk analysis—usual and expected forms of due diligence that fall into the “**must do**” tier of the Diligence Pyramid. Only in “fire-sale” situations have we seen these fundamentals compromised—often with disastrous results.

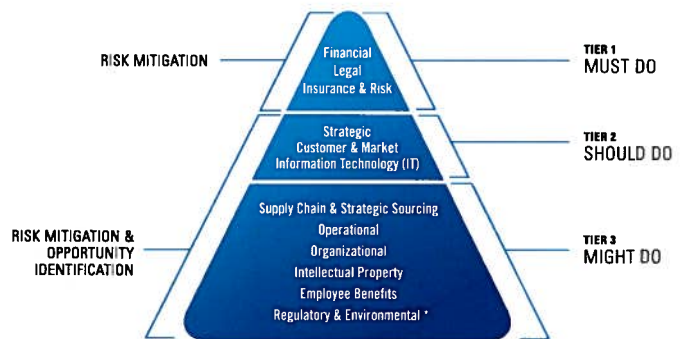
Opportunistic forms of due diligence

Today, progressive investors are employing forms of diligence focused not only on identifying risks and concerns upfront, but also opportunities and sources of potential unique value. Sponsors, limited partners, and lenders increasingly are looking for these value-seeking forms of diligence that build a unique and compelling investment thesis.

Accordingly, two forms of diligence in particular—customer/market and Information Technology (IT)—have gained popularity and now fall into the category of “**should do**” based

on their potential to uncover opportunity in addition to risk. Customer/market diligence seeks to understand how the target company’s current customers and prospects view its brand, products and services. This information helps assess customer-retention risk; identifies opportunities for marketing, product/service development and cross-selling. IT due diligence identifies liabilities or risks inherent in the target company’s systems, data, and infrastructure; but when done well, it can identify opportunities to help the business catch up, keep up, or gain competitive advantage. These, in addition to strategic due diligence for analysis of the business strategy when additional external domain expertise is required, are increasingly common.

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DUE DILIGENCE PYRAMID



* Needed when target business is required to maintain compliance

Finally, there are several other forms of situational due diligence that can help identify both risks and opportunities. Deciding to execute these may depend on factors such as the investment team’s familiarity with the industry, its capacity to conduct such investigations, or the size and complexity of the target company. These are “**might do**” studies (until you’ve been burned before), which include supply chain; operations; organizational structure including leadership and employee talent; intellectual property; employee benefits; and, when required, regulatory and environmental practices and compliance.

West Monroe Partners has completed more than 250 due diligence projects. Specializing in both risk-management and opportunistic forms of diligence, West Monroe Partners’ provides IT, strategic, operational, supply chain, and customer and market due diligence. For more information, please contact Kevin McCarty, managing director of M&A Advisory Services, at 312.980.9440 or kmccarty@westmonroepartners.com

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A HARDER LOOK

THE TURN IN THE M&A
MARKET HAS MEANT A
RENEWED FOCUS ON
DUE DILIGENCE