**Introduction to Due Diligence**

There is massive information asymmetry between the buyer and seller when acquiring a company: The seller knows everything about its own business and the buyer knows far less. Making matters worse, the seller is incentivized to hide or downplay negative aspects of the business and exaggerate the positives.

**Due diligence** is the process by which the buyer solicits information that reduces this asymmetry. Broadly speaking, the due diligence process seeks to aid the buyer in determining whether it wants to proceed with an acquisition, and at what price.

**Due diligence overview**

Naturally, due diligence is primarily done by the buyer on the seller. However, the seller also performs due diligence on the buyer when [buyer stock is used](https://www.wallstreetprep.com/knowledge/how-buyers-pay-in-ma-cash-vs-stock/) as part of the merger consideration. That’s because the seller will now have an interest in the buyer’s business. Sellers may also perform some basic due diligence in a cash sale to [ensure buyer will be able to finance the acquisition](https://www.wallstreetprep.com/knowledge/break-fees-reverse-termination-fees-ma/).

Due diligence is unique to each transaction, but a thorough due diligence process usually involves:

**Financial due diligence**

* Historical financial performance (usually the last 3 years)
	+ Revenue analysis: Customers, products, distribution channels, geography, pricing strategy, key contracts, etc.
	+ Expenses: Analysis of cost of sales, SG&A, R&D, corporate overhead, key suppliers
	+ Analysis of company’s assets and liabilities including leases, plants and real estate assets
	+ Analysis of company cash flows
* Seller assumptions and projections (quarterly over next 3 years)
	+ Review and sensitivity of key assumptions on income statement, balance sheet and cash flow statement

**Business due diligence**

* Analysis of seller’s industry, competitive position, strategic plan
* Analysis of key customers and affiliates
* Review of company products, product sourcing strategy and suppliers
* Review of company’s research and development and marketing and sales programs
* Compensation of management and key employees
* Ownership: Analysis of key shareholders

**Legal, accounting and tax due diligence**

1. Legal: Review of IP, patents, outstanding or potential litigation, incorporation documents, employment contracts, key customer and supplier contracts and loan agreements
2. Accounting: Understanding seller’s accounting policies, controls and cash management
3. Tax: Review of tax attributes (like NOLs) that may be inherited or lost in an acquisition

**Integration and operational due diligence**

1. Analysis of synergies and integration planning
2. Cultural fit, retention and compensation of management and employees and location of offices
3. Impact of acquisition on customers, partnerships and suppliers (i.e. channel conflicts, change of control issues)
4. Treatment of options and other dilutive securities, capitalization table
5. Visits to seller’s headquarters and facilities
6. Meetings and discussions with seller’s management, shareholders and other key stakeholders

**Due diligence: public vs private sellers**

**When the seller is a public company**, the diligence can be thought of as a two-phase process:

1. The buyer can conduct a primary diligence process (sometimes before even engaging with the seller) by using public filings (10Ks and 10Qs, proxy statements) to learn about the sellers financials, operations, and shareholders.
2. Private information is shared. This is provided by the seller once the buyer and seller sign a confidentiality agreement (CA), also called a non-disclosure agreement (NDA).

**When the seller is a private company**, there’s very little due diligence that can be performed (beyond perhaps a sector or industry analysis) until the seller willingly provides nonpublic information. Comprehensive due diligence can only begin once the CA is signed.

**Due diligence process: how information is gathered**

When sellers run a [formal auction](https://www.wallstreetprep.com/knowledge/sell-side-process/), the due diligence process will usually look something like this:

1. The seller (or the [seller’s banker](https://www.wallstreetprep.com/knowledge/investment-banking-industry/)) will reach out to several potential buyers to gauge interest in an acquisition. (When the seller reaches out to a small predefined group of potential buyers it’s called a “[targeted auction](https://www.wallstreetprep.com/knowledge/sell-side-process/).”)
2. For acquirers that choose to engage in the process, an NDA is negotiated and the seller distributes a [confidential information memorandum (CIM)](https://s3.amazonaws.com/wsp-blog-images/uploads/2018/02/15161103/American-casinos-CIM.pdf), also called an offering memorandum (OM). This document contains nonpublic information about the seller, and helps the buyer perform preliminary due diligence.
3. A buyer interested in bidding during this first round will sometimes (but not always) be asked to submit an **expression of interest (EOI)**, which usually contains a purchase price range. At this point, the second round, with a narrowed buyer universe, begins. Interested buyers hold followup meetings and discussions with seller management. A Q&A period begins.
4. Often, the buyer and its advisors conduct physical visits to the seller’s headquarters, facilities and plants.
5. The EOI should not to be confused with the more formal **letter of intent (LOI)**. There’s a point in the process when the seller hopes to receive an LOI from the narrowed potential buyers list. The LOI is either a binding or non-binding agreement that gives more specifics on agreement terms including a specific purchase price and form of consideration. When one or more LOI is received, the buyer will request (and the seller will provide) further details and sensitive private information via a document management system called a [virtual data room](https://www.forbes.com/sites/allbusiness/2016/08/15/the-importance-of-online-data-rooms-in-mergers-and-acquisitions/). The [junior banker’s](https://www.wallstreetprep.com/blog/ma-analyst-day-in-the-life/) role in this process is to manage the data room. He or she will coordinate with lawyers, accountants and management teams to ensure that all requested seller documents are provided and entered into this central repository.
6. Interviews with suppliers and customers are typically allowed by the seller on a limited basis after an LOI has been received.