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E - JOURNAL OF FRTL @ IIM CALCUTTA

September 2024. Volume 12. Issue 2

INDIAN INSTITUTE OF MANAGEMENT CALCUTTA

FRTl
Financial Research & Trading Laboratory

The Power of Due Diligence: Transforming Transactions into Triumphs

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Introduction:

The success and growth of a business are often determined by the quality of transactions it undertakes. However, each transaction demands thorough investigation and informed decision-making to protect the entity's interests. Conducting due diligence is essential to mitigate risks associated with such deals.

Due diligence (DD) has become an essential practice, creating numerous opportunities for professionals across various fields by ensuring thorough evaluation in diverse contexts such as mergers and acquisitions, significant asset purchases, and regulatory compliance. In today's business environment, major transactions like public offerings, takeovers, and mergers require comprehensive due diligence. Buyers and sellers both engage in due diligence, albeit from different angles: buyers assess financials, litigation risks, patents, and other critical information, while sellers verify the buyer's financial stability and commitment to complete the transaction. Achieving growth often involves strategic transactions aimed at scaling operations, expanding geographically, upgrading technology, gaining competitive edges, or meeting cross- border regulatory requirements. However, these opportunities come with inherent risks that may not be apparent through a superficial review of documents, underscoring the need for thorough due diligence to uncover hidden risks and ensure successful outcomes.

This is where the necessity for due diligence arises—allowing a deep dive into the details to uncover potential hidden risks that could jeopardize the transaction. As There are various professionals which are recognized by various regulatory authorities for conducting due diligence, it is crucial to have a thorough understanding of this process. For example, regulatory bodies like the Reserve Bank of India (RBI) in India, the Financial Conduct Authority (FCA) in the UK, and the Securities and Exchange Commission (SEC) in the United States advise banks and financial institutions to engage professionals such as chartered accountants, legal experts, and certified

financial analysts to conduct due diligence, underscoring the importance of this role across various jurisdictions.

Transactions Requiring Due Diligence

Due diligence may be required for varied reasons. The form of DD depends on the purpose for which it is conducted. Few of the purposes of DD is enumerated as under:

In India, due diligence is a critical process across various types of transactions, serving as a safeguard to ensure that the interests of businesses are protected and that risks are mitigated. Here are some key areas where due diligence is required:

1. Mergers and Acquisitions (M&A): M&A transactions in India involve a thorough examination of the target company's financial health, legal standing, regulatory compliance, and potential liabilities. This includes scrutinizing financial statements, tax records, existing contracts, and any pending litigation. The Companies Act, 2013, along with regulations by the Securities and Exchange Board of India (SEBI), mandates rigorous due diligence to ensure transparency and fairness in these transactions.
2. Initial Public Offerings (IPOs): When a company decides to go public, the due diligence process ensures that all financial disclosures are accurate and that the company complies with SEBI's regulations. This involves a comprehensive review of the company's financial performance, business model, management, and potential risks that could affect the stock's performance post-listing.
3. Real Estate Transactions: Due diligence in real estate is crucial for verifying the legal title of the property, ensuring there are no encumbrances, and confirming compliance with local regulations. The Real Estate (Regulation and Development) Act, 2016 (RERA), emphasizes the importance of due diligence to protect the interests of buyers and investors.
4. Cross-Border Transactions: With the increasing globalization of businesses, Indian companies often engage in cross-border mergers, acquisitions, and joint ventures. These transactions require a thorough understanding of foreign regulations, tax implications, and cultural differences. Due diligence ensures that all these aspects are considered to avoid future disputes or financial losses.

Cross-border transactions bring significant complexities that heighten the need for rigorous due diligence. Navigating different legal and regulatory frameworks, such as varying tax regimes and compliance requirements, can be challenging without local expertise. Discrepancies in accounting standards, like IFRS versus GAAP, and cultural differences in business practices and negotiation styles can further complicate matters. Additionally, political risks, currency fluctuations, and diverse enforcement of intellectual property rights add layers of difficulty. Logistical challenges, including language barriers and time zone differences, also require careful management. Comprehensive due

diligence is essential to address these multifaceted risks and ensure the success of international transactions.

Due diligence is a crucial process in global transactions, including mergers and acquisitions (M&A), asset purchases, and public offerings. In India, it involves detailed analysis of financial, legal, and regulatory aspects, ensuring asset legitimacy and company valuation. Similarly, in the U.S. and Europe, due diligence is essential for navigating complex international regulations and tax laws in cross-border transactions. In Japan and South Korea, it focuses on evaluating business culture compatibility and operational standards in joint ventures and partnerships. In the Middle East, due diligence is critical for sectors like real estate and energy, where legal and environmental factors are key. Across all regions, thorough due diligence is fundamental to minimizing risk and achieving successful transaction outcomes.

Reasons cited why due diligence is not a necessity:

The process of due diligence is of utmost importance still businesses fail to recognize its pivotal role during mergers and acquisitions. It is often cited as one of the major reasons for the failure of M&A deals. The reason is a lack of effective and robust due diligence. Businesses know very well the importance of due diligence they tend to avoid the whole process or try to alter the essential steps by citing reasons like:

- Time Taking – Due Diligence as per definition is a form of research, any thorough research would take a specific amount of time, which often is a laborious task to do.
- Huge Cost – Proper due diligence requires analyzing all the internal data of the target company from its financial statements to assessing tangible/intangible assets. Due Diligence requires on-site work, resulting costing a huge sum. This is another reason cited by management for due diligence not being a necessity.
- Industry Knowledge – There are cases where the acquiring company or merging parties do not have prior knowledge of the industry they're entering into. This becomes another reason for them to avoid the process of due diligence.
- No value addition – Some businesses are operating under the vague impression that due diligence does not add any value to the merger. Such perceptions are disastrous for the business entity. Due diligence is the most important process for a successful M&A.

Process of Due Diligence

1. Suitability and Compatibility Aspects

In this initial step, due diligence focuses on assessing the suitability and compatibility of the parties involved in the transaction. This involves evaluating how well the two entities align with each other's goals, values, and operational methods.

- For Acquisitions or Mergers: The buyer conducts a thorough evaluation of the target company to identify any risks that could affect the transaction's success. This includes assessing operational challenges, market position, and existing liabilities. The buyer will look into aspects such as the target company's business model, customer base, and overall strategic fit with the buyer's objectives.
- For Sellers: The seller evaluates the buyer's financial capability and credibility. This involves checking the buyer's financial health, including their liquidity, funding sources, and ability to complete the transaction. The seller may also review the buyer's past transaction history and their ability to honor contractual commitments.

2. Financial Aspects

The financial due diligence step involves a comprehensive review of the financial records and statements of the entity under consideration.

- Fairness of Financial Accounts: This includes verifying the accuracy and completeness of financial statements, such as balance sheets, income statements, and cash flow statements. The due diligence team will look for any inconsistencies, unusual transactions, or potential financial issues that could impact the transaction. This step also involves assessing the company's financial performance, profitability, and financial projections to ensure they align with the seller's claims.

3. Production Aspects

This aspect focuses on evaluating the production capabilities and operational efficiency of the entity.

- Assessment of Production Capabilities: Due diligence in production involves examining the company's manufacturing processes, production capacity, and technology used. This includes evaluating the quality and efficiency of production methods, supply chain reliability, and inventory management. The goal is to identify any production-related risks or limitations that could affect the business's ability to meet its commitments and growth targets.

4. Environmental Aspects

Environmental due diligence involves assessing the company's compliance with environmental

regulations and laws.

- Compliance with Environmental Laws: This step includes reviewing the company's environmental practices and policies to ensure they meet legal and regulatory requirements. It involves checking for any past violations or potential liabilities related to environmental issues, such as waste management, emissions, and resource use. The due diligence process aims to identify any environmental risks that could lead to legal or financial consequences.

5. Technology Aspects

This step involves evaluating the technological assets and capabilities of the company.

- Assessment of Technological Capabilities: Due diligence in technology involves reviewing the company's technology infrastructure, including software, hardware, and intellectual property related to technology. This includes assessing the robustness of the company's IT systems, cybersecurity measures, and any proprietary technologies or patents. The goal is to ensure that the technology is up-to-date, secure, and capable of supporting the company's operations and strategic goals.

5. Legal Aspects

Legal due diligence focuses on reviewing the legal framework and compliance of the entity.

- Legal Compliance and Risk Assessment: This step involves examining the company's legal standing, including its contractual obligations, legal disputes, and regulatory compliance. Due diligence includes reviewing contracts, agreements, intellectual property rights, employment practices, and any ongoing or potential litigation. The aim is to identify any legal risks or liabilities that could impact the transaction or the company's future operations.

Scope of Due Diligence:

The scope of due diligence is a crucial element in ensuring thorough and accurate analysis. Before beginning the process, it is essential to clearly define what areas need to be examined, as this focused approach leads to more effective results. Here's how you can elaborate on the points:

- Transaction Purpose: The first step is identifying the key objectives of the transaction. Knowing the exact purpose, such as mergers, acquisitions, or compliance, helps in setting clear boundaries for the investigation.

- Key Departments and Offices: It’s important to determine which departments, business units, or offices will be subject to scrutiny. This ensures that no critical area is left unchecked.
- Policies and Procedures: Analyze the relevant internal policies, procedures, and guidelines that might affect the transaction. Understanding these will

  clarify whether the company complies with its own regulations and external legal requirements.
- Critical Questions: Prepare a list of essential questions that need answers. These questions should relate to risks, obligations, and other material issues that could impact the decision-making process.
- Books and Registers: It’s important to define the scope of accounting records and statutory registers that will be reviewed. This includes financial statements, ledgers, and records of legal compliance.
- Government Filings: A comprehensive review includes checking filings with government agencies or statutory bodies. This could involve tax filings, compliance with company law regulations, or employment-related filings.
- Sampling Method: Decide on an appropriate method for sampling data. Depending on the scope, professionals might either check all records or use a representative sample to gauge compliance and performance.
- Meetings with Key Personnel: Arrange meetings with people responsible for maintaining records, such as financial officers or department heads. They can provide deeper insights and help clarify discrepancies.

Vertical vs. Horizontal Approach in Due Diligence:

One of the key considerations in due diligence is determining whether to use a vertical or horizontal approach. The decision hinges on the transaction’s purpose:

Vertical Approach:

This is ideal when the due diligence needs to go deep into a specific area. For instance, in the case of a merger or acquisition, a vertical approach allows for in-depth scrutiny of particular departments, transactions, or legal issues. You investigate a narrow scope but with more granularity to capture detailed information.

Horizontal Approach:

In contrast, a horizontal approach covers a broader scope but with less depth. It’s useful for situations where multiple areas need to be reviewed, like in compliance audits. For example, a secretarial audit

requires a check of compliance across various laws, rather than a detailed investigation of one particular area.

Timing Considerations:

Time constraints can influence the choice between vertical and horizontal approaches. If time is limited, it may be difficult to perform a deep vertical analysis, and a more general horizontal approach may be necessary. Conversely, if time allows, a more detailed vertical approach can uncover more specific issues critical to the transaction.

Challenges in Conducting Due Diligence:

Conducting due diligence is often a complex process that presents several challenges, requiring professionals to navigate these difficulties effectively to ensure accurate and comprehensive results. Below is a more detailed and professional elaboration of the common challenges faced during due diligence:

- Non-availability or Incomplete Information: One of the most significant challenges during due diligence is the lack of access to necessary information or incomplete data. For instance, missing evidence related to regulatory compliance or key financial documents can hinder the process. In such cases, the professional may need to employ alternative strategies, such as sourcing information from secondary or indirect sources, analyzing historical records, or conducting interviews with relevant stakeholders. Proactively communicating with the target company's management and emphasizing the importance of transparency can also help mitigate this issue.

- Time Constraints: Time limitations often pose another significant challenge, particularly in high-pressure transactions where due diligence needs to be completed quickly. A professional may not be able to thoroughly review all the relevant documents or verify every aspect of the business. In such scenarios, it becomes crucial to prioritize the most critical aspects of due diligence by confining the scope of the review to high-risk areas. Focusing on key financial, legal, and operational risks ensures that the most important information is covered, even under tight deadlines. Additionally, adopting a systematic approach and leveraging technology to automate parts of the process can enhance efficiency.

- Non-cooperation from Employees: Another challenge that may arise is non- cooperation from the target company's employees, either due to concerns about revealing mistakes or fear of

consequences. This lack of cooperation can delay the due
diligence process and result in incomplete or inaccurate information. To address this, the professional can escalate the issue to the appropriate authorities within the company, such as senior management or the board, to ensure that employees are compelled to cooperate. Fostering a collaborative environment and emphasizing the long-term benefits of transparency for both the employees and the organization may also help in gaining their cooperation.

In short, overcoming these challenges demands a mix of flexibility, strategic insight, and clear communication. By identifying potential issues in advance and using creative approaches to collect information, professionals can navigate obstacles and provide comprehensive and trustworthy due diligence reports. This ensures decision- makers have the critical details they need to move forward confidently with a transaction. Those involved in due diligence must remain agile, adjust their methods when necessary, focus on key areas under time constraints, and secure the cooperation of all relevant parties to achieve optimal results.

Key Factors to Consider When Conducting Due Diligence:

Conducting effective due diligence requires attention to several critical factors that ensure a thorough, well-informed review of the target entity. Below are the important factors to keep in mind:

1. Clearly Define the Scope and Objectives: Before starting the due diligence process, it is essential to clearly define the purpose and scope of the review. Whether the goal is to assess financial health, legal compliance, or operational efficiency, having a well- defined objective helps streamline the investigation and ensures that key areas are thoroughly examined. Tailoring the scope based on the transaction type (e.g., merger, acquisition, or compliance check) also prevents unnecessary time spent on irrelevant information.
2. Understand the Target Company’s Business Model and Industry: A deep understanding of the target company’s business model and the broader industry landscape is crucial. This enables the professional to identify industry-specific risks and opportunities, analyze competitive positioning, and assess how external factors may influence the target company’s performance. Recognizing industry trends,

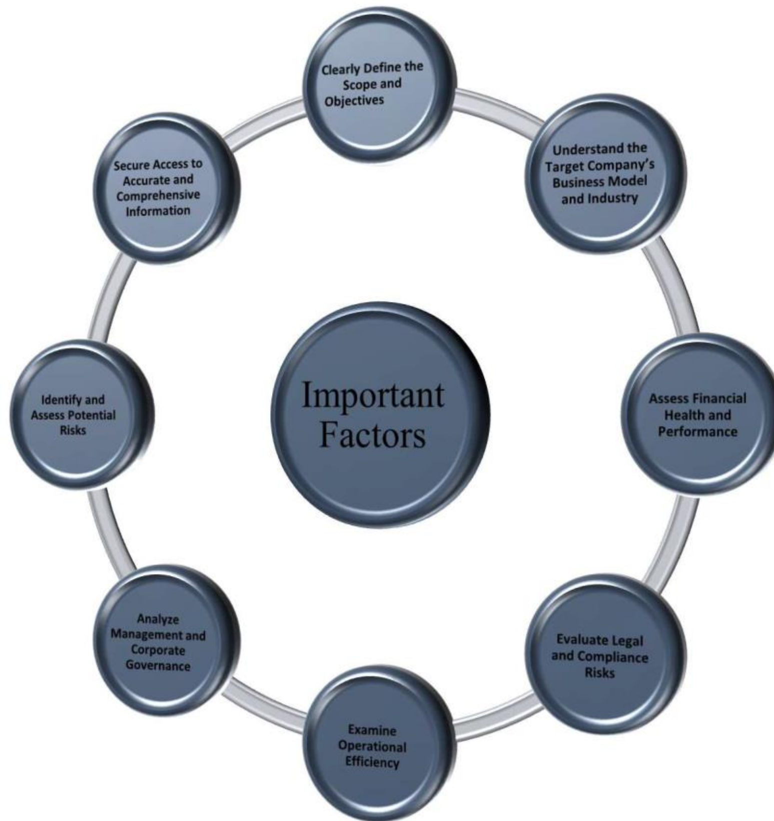
regulatory environments, and market dynamics can provide valuable context to the due diligence findings.

3. Assess Financial Health and Performance: Financial due diligence is a cornerstone of the process. A thorough examination of financial statements, revenue streams, cash flows, profitability, debt

levels, and other key financial indicators is critical to understanding the target company's

4. financial stability and future potential. It is also important to assess the quality of earnings, historical growth trends, and any significant variances that could indicate risks or opportunities.
5. Evaluate Legal and Compliance Risks: Legal due diligence should focus on identifying any outstanding or potential legal liabilities, including pending litigation, intellectual property issues, environmental concerns, and regulatory compliance matters. Verifying that the company complies with all applicable laws, regulations, and contractual obligations helps protect against unforeseen legal risks that could arise post-transaction.
6. Examine Operational Efficiency: Operational due diligence involves a detailed review of the company's internal processes, supply chain, technology, and human resources. Understanding the operational structure, key personnel, and potential vulnerabilities is essential for assessing the company's ability to maintain and improve its performance after the transaction.
7. Analyze Management and Corporate Governance: The quality of the target company's management team and its corporate governance structure can significantly impact future success. Assessing the leadership's experience, decision-making processes, and alignment with shareholder interests provides insight into how effectively the company is managed and whether it is positioned for sustainable growth.
8. Identify and Assess Potential Risks: Due diligence is as much about identifying risks as it is about finding opportunities. Evaluating risks such as market competition, regulatory changes, supply chain disruptions, or economic downturns is critical for making informed decisions. A risk management plan should be developed to mitigate these potential threats.
9. Secure Access to Accurate and Comprehensive Information: Ensuring access to accurate, timely, and complete information is fundamental to the success of due diligence. Incomplete or inaccurate data can lead to misguided conclusions, so it's important to request and verify critical documents, including financial statements,

contracts, regulatory filings, and employee records, to build a full picture of the company.



Risk Analysis:

Due diligence goes beyond simply collecting information; it also involves identifying and evaluating the risks associated with that information. To conduct effective risk analysis, a detailed and thorough examination of the data is essential. A broad, surface-level review may not be sufficient to uncover potential risks. In order to maximize the success of a transaction, it is crucial to assess the risks tied to the specific information being reviewed. The depth of the risk analysis should align with the purpose of the due diligence, providing a clear indication of how comprehensive the evaluation needs to be. When reporting risks, it is important to consider and clearly outline any assumptions made during the analysis to ensure accuracy and transparency.

Document Review

A comprehensive review of all key documents is essential when conducting due diligence. Below is a list of critical documents that must be thoroughly examined:

- MCA Filings: Review of all relevant documents filed with the Ministry of Corporate Affairs (MCA) to ensure compliance with regulatory requirements.

- Company Charter (MOA & AOA): Examination of the Memorandum of Association (MOA) and Articles of Association (AOA) to understand the company’s purpose, structure, and governance rules.
- Statutory Registers: Inspection of statutory records, including the register of loans, charges, minute books, and other registers mandated by law.
- Financial Statements: Analysis of current and past financial statements to assess the company’s financial health and performance.
- Asset and Liability Verification: Verification of the company's assets and liabilities to confirm their accuracy and completeness.
- Legal Compliance: Evaluation of the company’s compliance with applicable laws, including tax regulations, labor laws, and corporate governance requirements.
- Statutory Liabilities: Assessment of any outstanding statutory liabilities that the company may have to government or regulatory bodies.
- Contingent Liabilities: Identification of contingent liabilities that could impact the company’s financial position in the future.
- Operational Review: Evaluation of the company’s operational processes and efficiency, ensuring smooth functioning post-transaction.

Report Writing

One of the most crucial aspects of due diligence is presenting the findings in a well- structured and comprehensive report. The report must accurately reflect the true state of the organization, as a poorly constructed report can render the entire due diligence exercise ineffective. Beyond merely identifying issues, a robust due diligence report should also offer practical solutions or recommendations for addressing those challenges.

The report typically includes sections on general company information, financial data, key business agreements, pending legal disputes, contingent liabilities, and details of

intangible assets such as intellectual property rights (IPRs). It should also cover the company’s market position, internal controls, environmental compliance, corporate social responsibility (CSR) efforts, human resources, and organizational culture.

Additionally, the report should specify the purpose of conducting due diligence, whether it is for statutory compliance, a business transaction, or fact-finding purposes. It must also list the sources of information, detail the documents reviewed, and mention any documents that were unavailable. Where assumptions have been made, they should be clearly stated in the report.

The report should include references to any reliance on undertakings or certifications and should feature a section dedicated to risk analysis. Lastly, it is essential to include a confidentiality and restriction clause, specifying the limited use of the report where applicable. This ensures that sensitive information is protected and the report is used appropriately.

Critical Role of Due Diligence in Mergers and Acquisitions: A Case Study Analysis

- Bharti – Zain Deal

Bharti Airtel’s acquisition of Zain’s telecom assets across 15 African countries faced challenges, resulting in low EBITDA even after five years. Contributing factors, such as the economic conditions in Africa, played a role in the acquisition’s struggles. However, a key issue was the inadequacy of Bharti Airtel’s due diligence, which failed to fully recognize and assess the potential risks. Had the due diligence process been more thorough and comprehensive, Bharti Airtel might have been in a stronger position to navigate the complexities and mitigate the challenges post-acquisition.

- Tata Corus deal

In 2007, Tata Steel acquired Corus for $12.1 billion, including $6 billion in debt, during the peak of the market boom, just before the onset of the Global Financial Crisis in 2008. The acquisition aimed to establish Tata Steel's presence in the UK steel sector. However, global steel demand, particularly in developed markets like Europe, remained weak following the financial crisis. The influx of inexpensive Chinese steel further compounded the challenge, rendering the business increasingly unviable. Over the past decade, Tata Steel has reduced Corus’s production capacity from 18 million tonnes per annum (MTPA) to 10 MTPA and decreased its European exposure by lowering its stake from 100% to 50% through a merger with ThyssenKrupp.

Tata Steel also redirected funds to acquire distressed assets in India, such as Bhushan Steel, yet continued to grapple with high levels of debt. The Tata-Corus deal occurred when commodity prices were at their peak, and despite an auction process and concerns about valuations, Tata Steel paid 30% more than the initially negotiated price, driven partly by prestige. This leveraged buyout lacked a clear plan for

debt reduction, which was crucial for success. A more thorough and comprehensive due diligence process could have better informed Tata Steel's acquisition strategy and financial planning.

ESG Due Diligence

In today's business environment, issues like child labor, carbon emissions, fair taxation, and corruption can significantly impact an organization's reputation. Addressing environmental, social, and governance (ESG) concerns is crucial, as ESG due diligence can either facilitate or derail a deal. ESG considerations have become a vital component of the decision-making process in mergers and acquisitions. This type of due diligence provides insights into how emerging social and environmental trends might influence the business. Given its importance, ESG due diligence may even necessitate a revaluation of the organization during the M&A process.

Conclusion:

Due diligence is essential when undertaking any significant transaction, as it provides crucial security for those involved. Its importance has grown with changes in the business landscape, reflecting the increased risk of fraud that accompanies business expansion. To mitigate these risks, major decisions should be supported by thorough due diligence reports. The effectiveness of due diligence hinges on both the completeness and accuracy of the findings. Incomplete or inaccurate due diligence can be as detrimental as neglecting the process altogether. Therefore, thorough and precise due diligence is fundamental to making informed corporate and business decisions.

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