DILIGENT DILIGENCE

Due diligence used to be an exercise in ticking all the boxes and uncovering any deal-breaking risks. As the buyout market has become more competitive and sophisticated, however, GPs have come to demand more. Real Deals brought together dealmakers and advisers to discuss the widening pool of options available to GPs and the changes to the way firms use due diligence in the deal process.

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At the table:
Simon Hitchcock, Lyceum Capital
Fiona McMahon, ECI Partners
Alastair Mills, H.I.G. Capital
Tom Gladstone, OC&C Strategy Consultants
Chris Goodall, CG Consultancy
Tom Raymond, Armstrong Transaction Services
Peter Warburton, Vista Insurance Brokers
Lizzie Wills, WA Investor Services

As the private equity market has evolved and become more competitive, is it fair to say that the purpose of the due diligence process is changing?

Fiona McMahon: The purpose of due diligence is really to help us find evidence for our key deal hypotheses. So, at the beginning of any deal process we look at the top ten or so things that we need to believe in if we want to make the investment. So, our diligence is very much constructed around trying to answer those questions. I think from that perspective, it hasn't really changed.
What has changed is the level of detail that we go into to try and answer some of those questions. The type of due diligence we are doing is getting more nuanced too. Over the last few years the range of due diligence services in the market has expanded, so we can get a much more nuanced view of businesses and markets.

Simon Hitchcock: How we use due diligence has definitely evolved. The scope of due diligence is more diverse and we are now looking for insight and information that is going to help post-deal in addition to just covering the downside risk. In everything we now do, we look for something that can feed into the 100-day plan post deal.

Chris Goodall: We have also noticed the push to stay on. We are increasingly going in after a transaction to help implement the plans of the new owners or work on some of the points flagged in the due diligence, like managing out legacy software, for example.

Alastair Mills: The best test is to go back and look at investment papers from ten or 15 years ago. They're rather light on analysis! The industry is now much more sophisticated. Due diligence is not just about risk mitigation; in an increasingly competitive world private equity needs insights on upsides.

Fiona McMahon, ECI Partners

Alastair Mills, H.I.G. Capital

Of course, much still hinges on the nature of the sales process, the level of access and the degree to which the sellers have completed comprehensive vendor diligence.

Tom Gladstone: The upside is now much more important than the tick box. The requirement for ever-increasing deep sector or functional expertise is noticeable. I spend a lot of my time working in consumer and retail. A conversation ten years ago would have been: "What do you know about retail?" Whereas now it would be: "What do you know about furniture retail, or jewellery retail?" Private equity houses have also been using diligence not just to get ahead of the process, but to help convince management they're the best partner to deal with.

> **IF YOU CAN GET SOME DEEPER INSIGHTS FROM DOING SOMETHING THAT ADDS VALUE, THE COST OF DOING THAT EXTRA WORK MORE THAN PAYS FOR ITSELF**

Tom Raymond: As a commercial diligence provider what I have observed is that it used to be all about price. "This is our budget, what can you do for that?" We very rarely have those conversations now.

The price differential between an okay piece of work and a really good bit of work is actually relatively minimal. If you think about the change that needs to be made to the future revenue growth, or profit growth of the business, it becomes de minimus.

If you can get some deeper insights from speaking to more customers, looking at parallel markets or doing something that adds value, the cost of doing that extra work more than pays for itself.

The other thing that we've seen a huge amount of in the last 18 months is pre-emption. If a particular provider has worked on a deal in the past, then there's the ability to warm relationships up and develop understanding ahead of other investors.

Lizzie Wills: The scope of the work that we're being asked to do is expanding too. So, before we would do a standard two- to three-week due diligence project. Now we're doing 24-hour turnaround red flag reports. We're doing commissioner analysis at a local level. We're doing long-term market tracking pieces, looking at a particular asset, service, or sector.

Peter Warburton: We provide insurance due diligence and for a long time expectation levels were quite low. A large chunk of deals didn't even have it done. What has happened more recently is that more firms are now doing it on every deal. Those that have done it have been pleasantly surprised at the things that have come out of the process.

Alastair Mills: It is interesting that many investors choose not to engage insurance due diligence providers. It's relatively inexpensive,

and the risks of getting it wrong are quite high.

As private equity firms dig deeper into the detail and spend more time building a fuller picture of target companies, does that create opportunities for a broader range of niche due diligence providers to establish themselves in the market?

Chris Goodall: As a technology due diligence provider we certainly have noticed a big increase in demand for our services. Technology is now a big driver in so many different kinds of businesses, and investors are writing big cheques to acquire tech-enabled companies. They want to get under the covers and form a view of whether the software behind a target company is any good. So, we get asked to do technical projects like code reviews. What dealmakers want has become very specific and that does create demand for specialist due diligence expertise.

Lizzie Wills: We provide political due diligence services and there is no doubt that private equity firms have become much more aware of how political uncertainty can impact the market and asset prices, particularly in politically sensitive or regulated sectors.

The political uncertainty of the last 18 months has driven further interest in political due diligence to the point where I think it is now viewed as a core function of a due diligence process. Before it was just about looking at the numbers and forming an understanding of the financial, legal and tax situation of an asset. Now it's more about looking at that asset in the round and looking at how it's going to do in the future. It has become much more central to the transaction process.

Post-deal work is a trend we have noticed too. We are now often asked to help a management team situate an asset as favourably as possible in the regulatory and legislative space.

> "I DO THINK THERE IS A DANGER IN THINKING DILIGENCE WILL GIVE YOU THE PERFECT CENTRAL CASE. IN REALITY IT MAY HELP YOU UNDERSTAND "WHAT IF" SCENARIOS"

On that point about political and economic uncertainty, is due diligence able to offer some degree of comfort when the possible scenarios are much, much broader than they would have been previously? In times of uncertainty is there value in spending more on due diligence?

Simon Hitchcock: I think the danger is that in seeking to assess future political risk you start to hope for a crystal ball and you end up burying yourself in data to seek to get to only one version of the future. That's a risky approach.

Lizzie Wills, WA Investor Services

If you're using diligence to make you better informed about the business, that's very sensible. You need to synthesise it and work it out, but ultimately you have to make the call and that is what private equity has been doing for more than 20 years.

That exercising of judgement hasn't changed. We've just become much more sophisticated, much more granular. The tools at your disposal extend every year, and we're like any industry that gets more competitive and sophisticated in that respect.

Tom Gladstone: I'd echo that. I do think there is a danger in thinking diligence will give you the perfect central case. In reality what it might help you do is better understand the "what if" scenarios. I think it's slightly disingenuous to say you can predict with complete certainty the exact path things will take over the next three years. What you can do is try and get a view of what range of different things might happen and form a view on the impact of these on a business.

Fiona McMahon: Attitudes to risk have probably changed since the last economic consumer downturn. We are looking to hold a business over a number of years. Even if we're in a relatively benign environment when we're investing, we've got to be confident that the businesses we back are resilient and can withstand whatever unseen events we might not have forecast. I guess the focus is less on trying to predict the future and more on finding out if a business can keep performing strongly if the market does get tough.

Lizzie – politics is an area that has proven especially volatile recently. What do you work to deliver for clients when things are so unpredictable?

Lizzie Wills: It's obviously a hugely exciting time to be working in political risk, because there are so many different scenarios that could play out. Often the question we get asked is: "Can you really add any value, when there are so many different scenarios that could play out?" It is about bringing our insight and understanding of what's gone before and our understanding of the different dynamics at play.

Peter Warburton, Vista Insurance Brokers

Our role is to form a more insightful picture of the range of scenarios, then look at how you can best position the business to withstand any one of those. That is much more helpful than saying: "This is what's going to happen," and staking the farm on it.

Tom Raymond: As Lizzie said, diligence is now about developing multiple scenarios. Let's take the simple example of a recruitment agent providing the staff to a hotel and you want to figure out if Brexit is a good thing or a bad thing. That will depend on immigration control, which will impact the amount of labour and wage inflation. It will also impact the balance of power between the candidate and the employer in the recruitment dynamic. You can paint a range of scenarios from very good – where agent power increases because there is a shortage of labour – to very bad, where the economy slumps and people cut hotel trips or trade down.

What we develop is three or four scenarios. We link each scenario to the market environment, KPIs and provide management with quantified options and recommendations for each scenario.

Is that what you are looking to buy as a GP? A package of scenarios with possible reactions to each one?

Alastair Mills: I don't think it could be much more than that. What we have now that we didn't have, let's say, prior to 2007, is some really valuable data on how a range of companies performed during the downturn. Businesses, of course, will have changed and the further we move away from the real depth of that downturn the less valuable that comparison becomes. But what you can do with due diligence providers is sit down and see why a business performed the way it did and what levers could have been pulled at the time to improve performance.

Is it fair to say that processes then are becoming more bespoke, and that due diligence is becoming less commoditised?

Fiona McMahon: There will be a certain number of areas that will be consistent between deals, but we do put together very

bespoke due diligence for each process too. We sit down with our advisers and talk through what we think the specific deal issues are for that business, and for that market. That dialogue then evolves through the process. As we start to answer some of the initial questions, that throws up a whole suite of different things we hadn't thought about and that helps to hone in on what is really important. It is about forming a partnership with the adviser.

Peter Warburton: Fiona makes a good point about the value partnerships in the due diligence process. If we get a call from one of our private equity partners, and they say: "We're going through a deal process. We're in a competitive tender. Give us an outline of the business. Let's get some details," hopefully we can focus on some areas they can look at, and give some advice on what they should be doing and what insurance they should be looking at.

Chris Goodall: I think that is a fair observation. We have the standard things that we have to ask and check, but when it comes to the investment hypothesis the investor will ask us to hone in on particular areas or look into aspects that are crucial to their plans. Anecdotally, I would say that around 80 per cent of what we do is set, and the other 20 per cent is the tailored bit that we would add into the report as the client requires. That is generally what clients are looking for.

Lizzie Wills: By their very nature political due diligence projects are bespoke. We are reacting to external forces, which are changing all of the time. The questions we're asking for an asset one year might be totally different to the questions we're asking the next year. Obviously there are some questions that will form the framework for any political due diligence, but every project we do is essentially a co-creation between ourselves and the client.

Peter Warburton: I think private equity clients across the board are looking to get more out of the due diligence process. We have experienced people on our team who can bring a much more commercial angle to the due diligence. Rather than just stating the obvious, we can actually give a commercial view about what things will be most important for the business going forward. We can provide insight into the management's attitude to risk and so on. It's far more holistic now.

What I have picked up from the conversation is that all the due diligence streams overlap. Whatever due diligence service you provide, you are working to put together a report that offers a more commercial view rather than a simple, straightforward representation of the facts.

Tom Raymond: Peter makes a good point about knitting together different diligence streams. Ten years ago we might speak to the financial due diligence guys a couple of times during the process. That would probably be it.

That has changed. As an example, we work with the IT diligence providers to work out what data the business has, what it needs, and what systems it requires. I think that overlap and integration between due diligence streams is much greater than it has been in the past.

Tom Gladstone, OC&C Strategy Consultants

Simon Hitchcock: Fifteen years ago it used to be a call to someone like Tom saying: "Here's the deal. You've got four weeks, can you go and do the market diligence." It was literally as simple as that. Over time we've started focusing much more on the hypothesis that we're looking to verify.

We've become very specific about what we'd like people to do. Equally, we definitely have more interaction with the providers than we used to, to make sure that there is a feedback loop during the process and so that questions we didn't originally think about can be answered in the work.

What about when due diligence providers are actually engaged? Is there any evidence to suggest that GPs are bringing in advisers even before an auction starts to try and get a jump on the competition?

Lizzie Wills: Yes, absolutely. People want to be able to hit the ground running when a process officially kicks off. They want to know that they're comfortable with the overall policy environment.

They won't often do a full piece of due diligence before the first round bids go in, but we will do red flag reports or analyses flagging up potential issues.

Chris Goodall: We do a few red flag reviews and quick reports but I would say the norm for us is to come in once things have progressed a bit further.

Tom Gladstone: We have seen more clients come to us a bit earlier. Firms do want to get ahead in a process but the appetite for bringing in advisers does vary hugely depending on the house's appetite for the deal and the size and dynamics around the deal.

If an asset is likely to go into a highly competitive process and a firm thinks it has angle then it will often bring in advice early to ensure that it is in the best position to make a competitive first round bid.

In these scenarios we will do a one to two week piece of work up front and those will be quite focused on specific areas. Then, if things progress, you might do a more conventional piece of work where you have three to four weeks to look over a target.

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We've definitely seen it move in that direction. Not in every deal, but in instances where the dynamics make early work helpful.

I think it is also important to bear in mind that due diligence can serve different purposes. It is there to support the hypothesis of the deal team, as we have discussed, but it is also there to make the case for the deal to an investment committee internally and to put in front of a management team to show that you have plans for the business. What

Chris Goodall, CG Consultancy

Tom Raymond, Armstrong Transaction Services

Simon Hitchcock, Lyceum Capital

due diligence is needed for will determine how and when it is commissioned.

Tom Raymond: What has been interesting to observe is the rise in pre-emptive deals. When a firm wants to pre-empt a sale we are increasingly being called in to do work on that specific target so that the buyer has a strong angle to go in with.

I wanted to ask about how you measure the value of due diligence relative to its cost. How do you decide what to spend on and what not to spend on?

Alastair Mills: The biggest expenditure is on financial, commercial and legal due diligence, everything else of a more specialised nature is relatively inexpensive. You have to keep an eye on costs but when you look at the additional diligence needed to complete the picture, the incremental expenditure is normally worth incurring. At least in the mid-market I don't think investors are generally seeking to limit the scope of work excessively in order to manage costs, the primary aim will always be to obtain the information required. The most important thing is you get the key questions answered.

Simon Hitchcock: We have a uniform approach which is to do a comprehensive suite of diligence on every transaction. For us it is about getting a good quality report rather than being particularly cost focused. That is the most important part.

I had a related question for Peter specifically. Have you seen GPs use insurance as a tool to protect against downside risk rather than plunging into a full on due diligence process?

Peter Warburton: If you can focus on the approach to the management, on the basis that they can take lower retentions, and you can top it up with some insurance, then maybe it will put you ahead in competitive terms against somebody else. Certainly W&I has been used in that context. But I think that if you're expecting W&I to take away the risk of the transaction, then you are going to be disappointed.

Finally, I wanted to go around the table and ask everyone for some closing thoughts.

Lizzie Wills: From a political due diligence perspective, things have changed enormously over the last few years. It has become increasingly important as part of that standard suite and I can't see that interest tailing off. Reflecting the political and regulatory dynamics in a transaction – both buy and sell side – is incredibly important and it's something we know that investors really do value.

Chris Goodall: For me the two big developments have been the bespoke nature of the reports and the importance of relationships. Establishing a good relationship with the firms that we work with has led to post-deal work. The due diligence work is interesting, and that's what we specialise in, but the opportunity to go on and do potentially bigger post-deal projects is an exciting one.

Tom Gladstone: I think due diligence will increasingly be driven by expertise, focused, thoughtful and nuanced in the way it is deployed. That is what the private equity houses want and it is the way the advisory landscape continues to evolve.

Simon Hitchcock: I see due diligence becoming more sector and industry focused, with deep expertise rather than a generalist skill set. Then, in terms of the actual work itself, the balance has shifted to more forward-looking value-add rather than backward-looking risk mitigation.

Tom Raymond: We have talked about the proliferation of different types of diligence. I think that can be very heavy on the management team.

Building relationships between diligence providers and management teams will become more important. At the end of a process you don't want a management team to feel as though they've been through a washing machine.

Alastair Mills: The product is becoming more sophisticated and focused. We are increasingly working with providers to help add something more, for example working with commercial diligence providers immediately post investment to undertake detailed mapping of the competitive landscape, the add-on opportunities and why they strategically make sense.

Peter Warburton: I think working with the business is a key aspect. We put a lot of time into thinking about what recommendations we're going to put into the 100-day plan and for around 70 per cent of the businesses where we do the due diligence, we end up being the broker to the portfolio company. We wouldn't be building a business if we just relied on fees. It's those longer-term relationships that we are really interested in. That's the important part.

Fiona McMahon: Given the backdrop of a competitive environment, having a due diligence provider who can work alongside you to get to a concise view quickly is going to become increasingly important and valuable.

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