Buyouts

Deal Pros See Less Time For Due Diligence

by Ari Nathanson
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Forget the pressure of answering the $64,000 question; today, buyout pros are faced with a multi-million-sometimes billion-dollar question every time they slap down a letter of intent. Did we do enough due diligence on this deal? Today's fast-paced deal market is putting pressure on private equity firms to conduct their due diligence quicker than ever before.

"The due diligence process just happens to be one of the most comprehensive parts of an entire deal," said Mike Brookshire, a partner with River Associates LLC. "And because the sellers are looking to ensure the certainty of a close, there's definitely been more of a push these days to have an accelerated due diligence process."

The private equity market has become a seller's market. Consequently, intermediaries, and the companies they're selling, are able to exert more control over the proceedings. Adding to buyout pros' list of concerns: How to keep sell-side haste from turning into buy-side waste. As such, today's private equity deal makers say it is necessary to clearly define, and hone, their niches in the due diligence process.

"We've been doing this for 16 years. For us, the process to reduce the [due diligence] cycle time while ensuring its quality has been evolutionary," said The Riverside Company's Managing General Partner Stewart Kohl.

To speed things up, Riverside has increased its use of third party operational consultants. By using the same consultants repeatedly, Riverside has also cut down on interviewing time, Kohl said.

But with buyout shops hiring industry experts to conduct their operational due diligence, the price of winning a deal these days can easily break the $1 million mark, a daunting figure that's prompted some smaller firms to pursue more frugal options.

Strength Capital Partners LLC, a firm about to make the final investments from its $30 million inaugural fund, found a way around the potentially deep costs of professional consultants by accessing the industry knowledge of its limited partners.

Mark McCammon, a managing partner with Strength, cited the firm's 2003 acquisition of North Pointe Insurance Co. as an example. "We had an interest in North Pointe, but had very little understanding of the unique accounting practices used in the insurance industry. We turned to one of our investors who once ran a major accounting practice. He came to the due diligence meetings with us and built our confidence that we were making a good investment. Having someone who understands the industry proves to be an invaluable resource."

Pat Haden, a partner with Los Angeles-based Riordan, Lewis & Haden, said the trend of due diligence-on-the-fly is one of the factors that's led the firm to steer clear of the auction process as much as possible. "We think investments are like getting married. And due diligence is an absolutely important courting period. We feel that if you short circuit the due diligence process, you make mistakes."

Though each has a different method of conducting due diligence quickly, all buyout pros agree that they are not willing to sacrifice quality to meet a deadline. "This industry is made up of a lot of sharp people. I wouldn't think that any of them would be willing to skimp on the quality of their research just for the sake of picking up the pace. Ultimately, we all have a fiduciary responsibility to our investors," said Mark Jones, also a partner at River Associates.

Getting Keen On Consultants

In addition to using financial and legal advisors, more firms are hiring industry-specific consultants to conduct more in-depth due diligence. So in conjunction with the nuts and bolts, buyout shops are getting information on EBITDA opportunities, top line growth, working capital, accounts receivable, accounts payable and management critiques from experts in the industry.

Deepak Agrawal, a managing director with Gotham Consulting Partners LLC, said he noticed the shift toward operational due diligence after the bubble burst. Since then, the use of consultants has grown alongside the use of intermediaries.

"Around 70% of deals today are done at auction. In the days of more proprietary deals, firms were able to pay less for deals; they had a greater margin for error to work with if they uncovered some unforeseen problem," Agrawal said. But in light of the competitive deals that are being made on today's auction block, that margin for error is a lot smaller, if it exists at all. "Firms want to make sure they are not buying something that management has dressed something up for sale, only to find out after the sale that something has been hidden from them," he added.

The Help's Feeling The Pressure

Buyout pros are not the only ones getting frenetic from the tighter timelines. The pressure to conduct due diligence at today's speedy deal pace has attorneys and financial advisors feeling the stress as well.

"While investment bankers are pushing hard to get the deals done quickly, buyers-and their lenders-are more cautious today and want to make sure they have uncovered all offbalance sheet and hidden liabilities of the target company," said Meg Gibson, a partner with Kirkland & Ellis LLP. This increased concern has taken shape over the past year as backlash from the slew of large companies coming to light with their major litigation issues.

"We are getting a lot more calls from [buyout] firms saying We need help and we need it immediately,'" Kathy Fields, co-chairman of the Mergers and Acquisition's Group at the law firm of Testa, Hurwitz & Thibeault LLP said, adding, "I have had to hop on more planes this year [than in previous years] to conduct due diligence and oversee negotiations at auction proceedings."

Fields likened private equity attorneys to the "quarterbacks" of the due diligence process; the players that everybody assumes have looked at everything.

But if attorneys are feeling the pressure on the offense, it's the accountants who are feeling it on the defense. "In the amount of time a team gets to do its diligence and come up with a bid, there is certainly more stress, said John O'Neill, Americas Director of Private Equity at Ernst & Young. "There are auctions that take place where [the buyers] have to get their bids in with no contingency for due diligence."

Many deal makers have noted that more sellers are using "staging" tactics when it comes to divulging a company's information-keeping some information hidden from firms until they commit to show enough interest with valuation.

While some private equity pros see staging as just another result of it being a seller's market, O'Neill said that a number of his clients have set minimum standards on the amount of information they'll accept for the due diligence process. If their information requests are impeded upon, "they will either push back at the sellers or walk away from the deal."

In that hard-line school of thought, one buyout pro quipped, "If sellers want to sell their company, they're really going to have to pull their pants down and bare all for us."