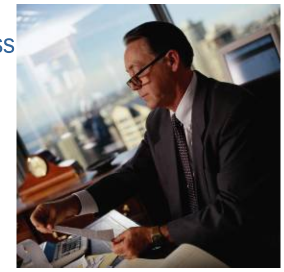
Analyzing the Deal

Performing Due Diligence Before You Buy a Business



There is no situation where the buyer doesn't question if he or she is making the right decision in buying a business. The truth is, every business has its share of both advantages and disadvantages. Regardless of if the seller had disclosed everything to you is why you perform due diligence.

You want to examine a business to find out what are the problems of the business as well as what is driving its value. You also need to discover what the seller has done over the last few years to dress-up the business in order to maximize earnings:

- Frozen expenditures on capital equipment;
- Cut back on marketing research;
- Withheld introduction of new products.

DUE DILIGENCE FROM THE CORRECT PERSPECTIVE

How you as a buyer will perform due diligence on a business depends on what kind of buyer you are.

Investment and Venture Capital Groups

If you're a financial buyer such as from a private equity group, the challenge of performing due diligence might be whether they understand the industry or whether they can be sufficiently be educated in a short period of time.

For example, say you are presented with an acquisition opportunity in which the industry and the particular company's problems were not addressed. The challenge in this case would be to uncover these short comings. You may require the need to retain an industry expert to guide you through the process of due diligence for the business.

As an Industry Buyer

In this scenario, the problems often center on verification of the different elements and resources of the business. In some cases, you may retain the services of an investment bank that specializes in the industry the business in question is in to identify and qualify financially its resources.

Remember when you are looking to buy a business, you are not simply looking at their balance sheet and profit loss statements, you are looking at management/employee capabilities, special skills and know-how. You need to take into account certain erosion of key people leaving, loss of key accounts or delay of new product launches that are placed on hold until the deal is finalized.

Some of the most obvious areas to examine in the due diligences process is as follows:

- Stuffing products in the distribution channel;
- Overly optimistic projections;
- Recurring events listed as extraordinary costs;
- Underfunding capital expenditures;
- Offering free service to boost short term sales;
- Exaggerating their website potential.

Focusing Your Due Diligence

When analyzing the deal, focus on four areas:

Customers

Retention rate of major customers is imperative because major customers historically are the most profitable and account for the dominant product SKUs.

Competitors

Differentiating from ones' peers increases the probability of continued success. Twenty years ago Chrysler emphasized its jeeps, minivans and trucks and gained market share and profitability by letting the other auto manufacturers battle it out in the sedan segment.

Costs

Having a cost advantage whether it is labor, material, overhead, distribution or cost of capital is very meaningful.

Capabilities

Ideally, the target company has the state-of-the-art capabilities, but if not, it is important to assess what investments in technology and people are necessary to buttress existing competencies.