
SPECIFIC DUE DILIGENCE CONSIDERATIONS

On the following pages are considerations in each major area of focus of due diligence. These lists are long and exist for a reason, but the searcher should think about why the item is on the list and how it applies to that particular company. The specifics of the company, the searcher's knowledge of the industry, the company/seller's level of cooperation and ability to produce information, and the terms of the transaction will dictate how extensive the due diligence will be. The searcher's advisors (e.g. lawyers and accountants) can also help the searcher create the relevant list for a specific transaction. The most important thing for a searcher to do when creating his list is to prioritize, bearing in mind the limited capacity of the company to generate the information and the limited capacity of the searcher to absorb information. Sample due diligence lists can be found in Exhibit 15.

INDUSTRY / MARKET DUE DILIGENCE TOPICS

Overall industry/market

- Industry dynamics: size, growth, drivers of growth, profitability, cyclicalities, stage of maturity
- Segmentation of market (e.g. channels of distribution, geographic, functional) and breakdown by segment
- Buyers: who, how, why?
- Buyer power – bargaining leverage, buying patterns, concentration, volume, switching costs, ability to backward integrate, substitute products, price sensitivity, price/total purchases, product differences, brand identity, impact on quality/performance, buyer profitability, decision-making units' incentives and complexity;
- Supplier power - relationship, concentration, manufacturing/marketing process, presence of substitute inputs, importance of volume to supplier, switching cost of supplier, cost relative to total purchases, impact of inputs on cost or differentiation, threat of forward integration, supplier profitability.
- Exposure to external forces (e.g. government regulation, weather, shifting demographics)
- International dynamics, if any
- Substitutes
- Overall industry capacity assessment
- Barriers to entry/exit
- Economies of scale
- Level of technological sophistication and change
- Comparable recent transactions

Competitors

- Level of fragmentation
- Profiles of competitors: size, market share, profitability, ownership, management
- Points of difference between competitors and especially between target company and competitors (inc. product, price, brand, channel and functional differentiation)
- Sales, marketing and product strategies
- Cost structure

- Pricing and profitability landscape

COMPANY-SPECIFIC DUE DILIGENCE TOPICS

Organization

- Organization chart
- Company locations
- Temporary vs. full-time employees vs. contractors; cost of each
- Review of any employment contracts, union contracts, attempts at unionization
- Retention/turnover statistics
- History and cost of any layoffs
- Labor pool: number of employees, local unemployment, level of training

Management

- Depth, breadth, and tenure of team
- Biographies of team
- Compensation: appropriate level vs. market, incentive programs (esp. equity), perquisites, contract evaluation
- Fit with Searcher
- Background checks and reference checks
- Potential role (operating and/or Board) of seller
- Need to provide equity to management team?
- Is the team complete? Necessary additions?
- Risk of concentration of knowledge or power in seller?
- Risk of departure of key managers upon sale of company

Products/Services

- Description, technical specifications, SKUs, etc.
- Value of brand (if any)
- Point of differentiation of products (inc. intellectual property)
- Sales, growth and profitability by product or product line
- Dependence upon limited products/services?
- History of discontinued products/services
- Product recalls or other liability
- New product performance history

Strategy

- Does the Company have a defined strategy and medium-term strategic plan?
- Points of difference vs. competition
- Validate assumptions of growth plan in detail
- Evaluate current and new customer target lists
- Ability to execute historically vs. plan
- Evaluate allocation of financial and management resources

Customers

- Customer concentration
- Nature of relationships (transactional or contractual) and length of relationships
- Number of buying points
- Relative positioning among customers that use multiple suppliers (i.e. Company ranking compared to others)
- Who in Company controls key relationships?
- Profitability of key relationships
- Creditworthiness, outstanding A/R, special terms
- History of any lost customers
- Dependence of key customer upon Company and vice versa
- Major customer interviews
- Review standard customer contracts (if any) or specific contracts of major customers

Suppliers

- Ranking by sales to Company
- Exclusivity or multiple sources? Ability to add sources?
- History and quality of supplier relationships
- Historical costs of key items
- Review all purchasing contracts and agreements, terms
- Quality and consistency of supply
- Extent to which manufacturing is (or can be) outsourced
- Factors impacting commodity prices
- Foreign exchange risk

Sales/Marketing

- Structure and size of sales organization
- Direct vs. intermediary structure
- Hiring and training process for sales team
- Profile of successful sales hires (what skills do the Company's good salespeople have?)
- Concentration of sales by rep
- Compensation and incentives
- Where and how is pricing controlled?
- Location and tenure of sales team members
- Historical execution vs. budgets
- Review agreements with any intermediaries/third parties (independent sales reps, distributors, brokers, licensees, etc.)

Operations/Manufacturing

- Detailed description of processes
- Capacity and utilization analysis
- Fixed vs. variable cost analysis
- Cost accounting system review and analysis of historical variances
- Quality control and good manufacturing processes
- History of process improvements and results
- Evaluation of fixed assets and useful life
- Evaluation of necessary capital investments and return
- Analysis of potential cost reduction opportunities

- Analysis of outsourcing opportunities
- Evaluation of R&D and any proprietary technology
- Level of automation
- History of product recalls, voluntary or mandatory
- Evaluation of lot tracking and recall capabilities
- OSHA adherence; accident tracking

Research & Development

- Annual investment, historical and planned
- Use of outside resources
- Prioritization and financial justification of projects
- Evaluation of any patents or intellectual property
- Assessment of processes and success rates
- Projects in process

Customer Service

- Analysis of key metrics: % on time delivery, % complete order, % perfect order, % complaints resolved within acceptable time, etc.
- Review of historical customer and consumer complaints
- Review of return levels and reasons
- Review major customer contracts regarding right of return

Inventory

- Analysis of current and historical levels
- Aging and turns analysis
- Analyze inventory composition (raw materials, WIP, finished goods)
- Evaluation of quality control
- Evaluation of control systems
- Analysis of shrinkage or spoilage
- Locations: on-site, off-site, third party
- Assessment of ordering and management systems
- Obsolescence criteria and provisions

Information Systems

- Hardware: inventory and expected life
- Software: description and applications in use
- Support: internal vs. external; costs
- Backup and security plans
- Functionality assessment; replacement/upgrade cost

FINANCIAL/ACCOUNTING DUE DILIGENCE TOPICS

Audits

- Historical audited financial statements

- Auditor's letters
- Review change in auditors, if any

Controls

- Evaluate financial controls and separation of duties
- Assess cash management procedures

Income Statement

- Quality of earnings analysis
- Sales trends by product, market, customer
- Margin trends by product, market, customer
- Drivers of change in cost structure; fixed vs. variable costs
- Contribution margin analysis
- Ratio analysis
- Monthly trends; seasonality
- Analysis of add-backs
- Tax evaluation
- Pricing trends analysis

Balance Sheet

- Ratio analysis (current and quick ratios, days' receivable, days' payable, days' inventory, etc.)
- Quality of working capital assets
- Working capital seasonality or other fluctuations
- A/R collection procedures and history
- Accruals
- A/P: Supplier terms and quality of relationship
- Adequacy of reserves
- Inventory valuation, aging, obsolescence
- Evaluation of leasing, other long-term financing; loan guarantees
- Bankability of fixed assets and current assets (A/R and inventory)
- Fixed asset description and evaluation; third party valuation; depreciation schedule
- Capital expenditures requirements: maintenance vs. growth
- Replacement cost and schedule Analyze tax basis of assets and any NOL carryforwards

Cash Flows

- Investment needed to support growth
- Working capital analysis – historical fluctuations and seasonality
- Potential to improve working capital management

LEGAL DUE DILIGENCE TOPICS

Corporate

- Articles of Incorporation
- Shareholder agreements
- Capitalization: type and amount of all equity and debt issued; stock ledger
- Governance: current board, structure, committees
- Minute books and other governance documents
- Review of all historical, current, potential litigation
- Taxes: returns last 6 years; incentives or rebates
- Comprehensive real property audit: title, lessor (if not owned), contracts and deeds, title insurance, closing documentation
- Review all operating and capital leases
- Review of other significant contracts (management, supplier, customer)
- Government licenses and authorizations
- Trademarks: clean and clear?

Personnel

- Review employee history and documentation
- Review all labor and management contracts
- Review option plans, if any
- Review pension funds and retirement plans
- Review all insurance and benefits programs
- Evaluate union state and current relationships/activities
- OSHA and other agency compliance

INSURANCE DUE DILIGENCE TOPICS

Current Insurance

- Current contracts: coverage, cost, reliability
- Loss history
- Analysis of appropriateness of limits
- Workers' compensation
- Pending claims: evaluation of exposure and coverage
- If needed identify new plans and appropriate limits
- D&O insurance
- Need for tail insurance

HUMAN RESOURCES DUE DILIGENCE TOPICS

Note: many HR topics covered in other areas (Organization, Management, Employees, Personnel, etc.)

Current Benefits Programs

- Overview of benefit programs

- Current contracts for group insurance, retirement, profit sharing or savings plans: coverage and cost
- Potential liabilities/underfunding if self-funded

General Human Resource Programs

- Employee handbook/manuals
- Hiring and employment policies
- Training programs
- History of lawsuits
- Compensation & perquisite practices
- Equal Employment Opportunity
- Occupational Safety & Health
- Corporate culture

ENVIRONMENTAL DUE DILIGENCE TOPICS

Phase I Audit

- Assess and evaluate current state of all properties, practices, and procedures: air, water, waste, storage, noise, soil, odors, other
- Research of legacy properties, practices, procedures
- Assess need for Phase II