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Total Due Diligence

It is an often quoted statistic that more than one in every two acquisitions in Asia fails to create the value it set out to. Whilst difficult to empirically verify, this is indeed a sobering statistic and points to a worrying lack of confidence in investors' ability to plan, assess and successfully implement acquisitions in the region.

Is this lack of success indicative of less than effective use of the due diligence process in Asia? Does better due diligence necessarily increase the chance of a successful acquisition? The answer to both questions is undoubtedly, "yes".

A factor influencing the negative perception around the success of acquisitions in Asia can unquestionably be traced to a gap between investors' expectations of the value an acquisition will bring, and what eventuates in reality. Much of the blame for this must come down to poor quality or inadequate due diligence, be it of a financial, operational or investigative nature.

Some of the difficulties that are commonly encountered in due diligence processes conducted in Asia include:

- Corporate governance, i.e. a lack of it;
- The extent of related party transactions;
- Lower quality information;
- A less transparent process;
- A greater proportion of "off-balance sheet" transactions;
- A less formal approach to business transactions and agreements;
- Complicated group structures, often further complicated by family ties;
- Antiquated information systems;
- Cultural issues; and
- Tax, regulatory and legal considerations.

And that is before we even get to achieving an effective integration; an area where substantial value is often missed out.

Whilst many of these issues are common themes in acquisitions worldwide, the extent and quality of investor due diligence in Asia is often not sufficient enough to identify some of the key issues particular to doing business in this part of the world.

This is illustrated by the case of American machinery company Caterpillar Inc's ("Caterpillar") acquisition of ERA Mining Machinery Ltd ("ERA"), a Chinese mining equipment maker. Caterpillar's accounts were subject to a US$580 million write down following the discovery of accounting fraud at ERA. It has been widely reported that insufficient and inadequate due diligence was to blame. In addition, it highlights the growing challenge of reducing risks in cross-border M&A transactions, and demonstrates that not even large multinationals are immune to the dangers of investing in emerging markets.

What is Total Due Diligence?

In today's environment, basic financial due diligence alone is no longer enough; rather, total due diligence is required. Total due diligence involves going behind the numbers presented in financial statements and assesses whether revenue is sustainable; whether earnings can be maintained; whether commercial agreements have value; and very importantly, total due diligence highlights the key local, political and cultural aspects of the target, its industry and operating environment.

In addition, total due diligence includes investigative due diligence, which is becoming more commonplace in Asia following a number of accounting and governance related breaches. By addressing the background, reputation and track records of key personnel and potential partners, investigative due diligence transcends the typical legal or financial review by identifying "off-balance sheet" risks and shedding light on issues which may not be visible from routine reviews. A typical investigative due diligence assignment involves the collation and analysis of information through a wide variety of sources followed by discreet field enquiries and site visits.

Take for instance, a recent case in which a European client in the engineering industry engaged FTI Consulting to examine the background and reputation of a components factory in China, with whom they were considering a partnership with. Our investigation uncovered that the target partner had orchestrated a string of bankruptcies at previous firms and one of the key principals at the firm was under investigation for alleged fraud. As a result, our client subsequently exited negotiations and avoided reputational damage and likely financial loss.

Total due diligence also involves operational due diligence; comprising the testing and analysis of key operating data and assumptions, verification of capacity, utilisation and output, together with a comprehensive review of the target company's supply chain.

Many investors also need to consider Foreign Corrupt Practices Act (FCPA), Bribery Act or similar compliance reviews of their targets as part of their pre-acquisition checklist. Other investors are taking this a step further and seeking governance due diligence to identify weaknesses in the

internal control environment, then using the issues identified as opportunities to improve and enhance existing practices – which to be frank, are often poor in developing markets – as a basis for creating post-acquisition value in the enterprise. Investors would be surprised by the margin improvement that is often obtained simply by cutting out the kickbacks and friendly supply arrangements that are regularly in place in companies in emerging markets.

Due Diligence in Asia

There is, amongst most investors, a greater perceived risk of doing business in Asia. Oddly, however, this is not always reflected in greater attention to a quality due diligence process. There appears to be a much greater tendency in Asia to take shortcuts, to save costs, to get the deal done (applying the maxim that a quick deal is a good deal). As many acquirers have found to their peril, time does mean money and not taking enough time can cost a lot of money.

Brokerage firm Ping An Securities was fined and banned by the China Securities Regulatory Commission ("the Commission") from underwriting IPOs for three months following the discovery of fraudulent activity in Wanfu Biotechnology (Hunan) Agricultural Development Co. As the sponsor institution, Ping An Securities is required to take responsibility for the quality and accuracy of financial information provided for IPO applicants. In this case, the Commission said that the sponsor agency failed to conduct proper due diligence. As a result, the firm has had to compensate affected investors, costing it CN¥76.7 million in fines and the launch of an additional CN¥300 million fund in compensation. This is a prime example of where total due diligence could have avoided both reputational and financial damage.

Asia has been the source of a multitude of due diligence horror stories. For example, an acquirer that identified the potential to substantially grow unit sales only to realise after the acquisition that the manufacturing plant lacked the capacity required. Or where the cost to complete a project simply left out rectification works and time required in relation to what had already been done. Or where there was a competing factory up the road owned by the same vendor who transferred customers to his other factory post sale. These are examples where greater due diligence, indeed total due diligence, may have saved the day.

Some Observations

Some other noteworthy observations include:

- Often due diligence focuses too much on the past and not enough on the future. The success of an acquisition will most often be determined by a detailed understanding of future performance. It is for this reason that a significant part of any due diligence process should be dedicated to assessing the target business' future potential.
- In many cases, due diligence does not properly assess integration issues. Total due diligence not only looks for areas to save costs and create synergies but assesses the impact of merging two businesses together. In Asia, where there are many cultural differences, this assessment is essential.
- There are many instances where the scope provided to the advisor is extremely limited. The advisor may comply perfectly with the scope set out in their engagement letter, however their due diligence report will add little value if the scope of review is too narrow. Limited scopes are unfortunately a by-product of vendors being over-protective and investors being too cost-conscious.
- Too much due diligence is conducted as a high-level audit where junior auditors simply perform a checklist 'tick the box' exercise rather than think about business, commercial and qualitative issues. It is the ability to think outside the box, rather than ticking boxes that sets total due diligence apart.
- There is often a lack of understanding of the business drivers of the target company. Total due diligence examines these business drivers and finds out what makes the business tick. Importantly, and even more so in Asia, this must extend to a thorough understanding of the political, cultural and legal environment in which the target operates. Businesses in many Asian jurisdictions remain strongly influenced by political and family ties – business decisions are often made based more on such long-standing ties than on cold hard economics. It is vital that this is factored into the investment decision.
- Aside from what has already been discussed above, governance due diligence is often lacking from the due diligence process. For cross-border M&A activity in Asia in particular, companies would be advised to ensure that governance due diligence is included as part of the scope of engagement to uncover possible corrupt and improper practices.

Conclusion

There are many good deals to be done in Asia. Asia is a hive of business activity where attitudes are positive and far more conducive to getting deals done than in the West. With continued economic growth expected throughout the region, greater investment and a more open view to business, acquisitions will continue to flourish. Many of these deals will not be successful, but with better, smarter and more thorough due diligence, the chances of a successful outcome will increase substantially.

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AT THE CRITICAL TIME™

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