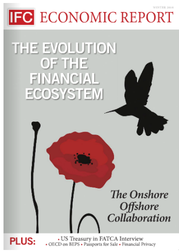

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Due Diligence: M&A Sans Investment Bankers

By L. Burke Files, DDP, CACM, President Financial Examinations & Evaluations, Inc (01/03/2015)

As a CEO you go to an investment banker and you say, "gee I think I am going to acquire a company for US$N per share. Do you think it is a good idea?" What are the chances they say no? If they say no, you get to pay for the lunch. If you say yes, they buy the lunch and collect US$20 million in fees. It's like asking a painter if your house needs paint.

The problem has been that investment bank driven due diligence is about as good as some of the ratings put out by the big ratings houses. They are thoughtful, completely numbers driven, and done by people who sit behind desks. It is not bad, but it is not enough. It is not enough to understand the numbers without understanding the environment in which a business works and the culture of the employee environment. They do not ask all of the right questions and thus fail to see let alone plan for these unseen risks.

M&A has shown to be convincingly a destroyer of value. Those saying that "M&As offer some excellent opportunities for growth". These soothsayers are the Investment Banking Firms, The Consulting Firms and the Auditors – all who make hefty fees – even upon a failed M&A. M&A has become the number one destroyer of shareholder value since hiring CEO's with nick names like 'Chainsaw', 'O', 'Rocky', 'Turd Blossom', 'Max the Axe' or 'Slim'.

Company Boards of Directors are increasingly aware of the downside of M&A. Yet, the idea of a good buy and undervalued assets are a powerful allure. A successful acquisition rockets a company past the competition, unless of course it blows up. The smarter companies understand this and have chosen to establish internal teams to look for and vet opportunities. These companies are seeking acquisitions san investment bankers. These companies seeking to acquire other companies generally have an in house team looking for; complimentary business, supporting or competing technology, and or distribution channels. They hire outside Competitive Intelligence Professionals and Due Diligence Professionals to augment their internal teams and proceed based upon their internal understanding of value and not that of an accounting firm or an investment banker. The transactions are very private, and possess very little risk of information leaking or 'front trading' buying stock before a merger or acquisition.

The value of the investment bankers used to be that they knew all about businesses that a potential buyer did not know. It was this private knowledge that could open doors to M&A discussions. The investment bankers worked a knowledge arbitrage to their advantage to earn fees. I also must say at one time they did actually earn those fees. However, the spread on this informational knowledge arbitrage is narrowing.
I remember when horse races were broadcast with a 10 minute delay. That allowed local bookies and other sharp operators to place a guy at the track who would phone in the winners to the corner bookie giving him an edge on taking or not taking any last minute bets or even offering teasers. It is the same thing for the market. The inside participants knew what business combinations might work and who was anxious to sell and who was anxious to buy. The investment bankers would work the two ends to craft an M&A opportunity. While, to some degree that still exists – it is going away.

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The leverage of traditional investment bankers is diminishing because the information they possess is, for the most part, accessible to all in the world.

The internet democratised knowledge and killed the phone book, travel agencies, mainstream media, your lunch break, traditional cabs, encyclopaedias, and experts (since you can google anything or figure out how do it on Youtube). Amazon killed not just the local book seller, but Amazon and eBay have killed strip malls.

So why should investment banking be any different, why should investment bankers be immune to the democratisation of knowledge? There are enormous databases of patents, trade data with full import and expert information, companies and their markets, lists of key employees, lists of current and former employees, and the ability to find detailed information on just about any person. Companies can seek a suitor or a target with equal ease. So why do you need an investment banker?

The truth is that fewer and fewer M&A transactions are being done with and or through investment bankers with the support of large accounting firms. The new M&A is being done only after exhaustive research by an acquirer of targets. Each target is vetted and contacted in private. The typical initial contact will be between the suitor and the target's law firms. If financing is needed they seek known shadow bankers such as insurance companies, family businesses, and larger hedge funds. The prior due diligence is done by a team of in house and outside experts. The typical teams consists of, Lawyers specialising in corporate law, regulatory law and subject matter experts such as environmental law or intellectual property law, highly skilled CPAs, typically those that have advance experience with internal auditing and mathematical modelling skills.

The company will also seek subject matter experts for any field that requires more insight, such an expert in minerals for a mining company or an expert in medicine for a medical technology company. The entire team is typically led by a senior manager with a broad base of experience, ideally with some certification in due diligence that knows sitting behind a desk is an insufficient referent point to disambiguate true actionable knowledge from informational noise.

Corporations are cutting out the middleman and doing the deals without investment bankers. Corporations are doing their homework, their due diligence and not relying on others. Are the deals better or worse? Well even if they are just the same, they will be better overall as they will be sans the investment baker's hefty fees.

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