Get Better at Due Diligence

10 Tips for Improving Your Due Diligence Initiatives

Due diligence (DD) is a common business activity. It covers the territory from investigations prior to mergers of large companies to signing up a new distributor for a small product line—and everything in between. It's a rather fancy term for a simple activity: *looking before you leap*.

In our practice we sometimes find—usually when it's too late—that a client has failed in its execution of this process in various ways, occasionally with catastrophic results. We're called in to help repair the damage. No doubt it is preferable to have planned and executed an appropriate DD activity than to try to recover from a flawed process. In this vein I aim to share some tips on making your DD projects better.

1. Understand What Really Matters

There are numerous situations in which DD is called for. Here are some of them:

- Acquire a product or product line
- Access a technology
- Strike a deal with a distributor or marketing partner
- Access a new market
- Merge with or acquire another company
- Take an equity position in a company
- Sell a product line
- License out a technology

Each of these situations requires a different set of activities, so it stands to reason that a fixed DD formula cannot work. Your plan should start with identification of *what really matters*. While this is not always obvious at the outset, it's often not that difficult to find out. Once the critical questions are established you can move on to devise the *content* of your investigation. <u>Don't jump ahead to a DD plan until you know precisely what you need to know</u>.

2. Decision, Not Data

It is all too easy to drift into the data collection mode after a DD project gets underway. But you must remember that your purpose is not to collect data but to drive a decision on whether or not to take some action—that's all. If you fail to remember your true purpose, you will work too hard and spend too much. Chief offenders in our experience are financial buyers: VCs, private equity firms and buyout groups. They tend to try to find out everything they can instead of focusing on the two to four categories of information pivotal to their decision. I suspect this is done out of an abundance of caution and concern for litigation down the road because financial investors tend to know less about the market(s) of interest than does a corporate buyer. But in my view the data collection is overdone. If you're a corporate player, keep it simple. <u>Learn just enough to support your decision, and resist the temptation to learn everything</u>.

3. Depth Proportional to Uncertainty

So, how deep do you dive? Well, just deep enough to minimize uncertainty. Some topics will take ten minutes to resolve because you already know all you need to know. Other topics may take weeks to resolve if you know nothing to start, the topic is complex or contentious, or the difficulty of developing credible information is great. Avoid the temptation to show off everything you already know by collecting reams of data. Focus almost totally on the uncertain stuff. <u>Work to minimize uncertainty, then stop</u>.

4. Stepwise Wins

The best way to avoid getting bogged down and spending a fortune is to plan for a stepwise approach. Attack the important and easy issues (if any) first. Shoot for a quick "no" decision. Even if you think you're beyond that decision point, look again. You may reveal a compelling reason to reject the deal. In that event you will avoid disaster, save resources, and emerge a hero. <u>Take it one step at a time starting with the easiest of the key issues to resolve</u>.

5. Engage a Team

Rarely can anyone devote full time to a DD initiative regardless of its importance, so it makes sense to divide the labor among a small number (say, two to four) of internal people. This also offers the benefit of additional perspectives. Consultants can be added to conduct research or lead the process, board members can add their expertise and perspectives, and scientific/medical advisors can add value to relevant initiatives. <u>Share the workload and gain diverse perspectives</u>.

6. Use Experts Sparingly

There may come about situations when a legitimate "expert" opinion would be of great benefit. Occasionally such an opinion can make or break a deal – but not often. If you need one, hire one and expect to pay appropriately. You might also consider hiring two experts to deal with the same issue if the need is sufficiently important. But don't go overboard. Loading up the project with "experts" usually adds more heat than light. <u>Hire an expert or two to add real value, but minimize their involvement and expense</u>.

7. Look Beyond the Numbers

Numbers—especially numbers with dollar signs in front of them—are clearly important. Seldom can a business decision be wisely made without paying attention to the numbers: added revenues, added costs, profit impacts, ROI, market size, market share, licensing fees and royalties, etc. But we find that fealty to numbers is often taken to an extreme. There's too much emphasis on numerical precision, not enough attention paid to qualitative realities, trends, drivers, and risks of many kinds. The qualitative factors will sometimes make a deal worth doing or not. <u>Always look beyond the numbers to reveal the X factors</u>.

8. Adoption Rules

Whenever one is dealing with entry into a new market or entry of a new method, product or technology into an existing market—especially in the medical domain—one must pay special attention to *customer adoption*. It takes a while, not uncommonly years, for clinical communities to adopt new stuff. You must allow for the investment required and the time taken to meet your planned revenue and profit targets. <u>Account for "medical momentum" or risk missing your projections</u>.

9. Customers Rule

How will customers react to the contemplated deal, favorably or unfavorably? It almost certainly matters a lot. Keeping the customer front and center in your analysis is always a good idea. For example, in the case of a pending merger, will customers be pleased, displeased, anxious, confused? Will they need immediate placating, or might they just flee to a competitor? <u>Forget the customer; pay the price</u>.

10. People Rule

Much more often than not, people and their skills and attitudes make a deal happen or not. And, in the long term they trigger its success or its failure. We find this to be true for all kinds of deals—even IP licensing deals. (After all, someone has to teach the technology and interpret its applications and unwritten limitations.) <u>Ignore the key people on both sides of any deal at your peril</u>.

Here's to your improved due diligence projects!

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