Due Diligence —

It's More Than Accounting and Legal Risks

Charles DiLisio
President

D Side Advisors
Strategies for Quantum Growth™

Why Acquisitions Fail —

Acquirors Pay Too Much . . .

. . . Average Takeover Premiums are ≥ 40% .

Overpayment and Value Destruction Arises From:

- Overoptimistic Appraisal of Market Potential and Insufficient Attention to Industry Structure/Risk
- Overestimation of Synergies and Failure to Clearly Identify Where Buyer Can Add Value
- Overbidding or Not Valuing the Deal Based on Realistic Cash Flow Values
- Poor Post–Acquisition Planning and Integration

Letting the Buyer Be Aware!

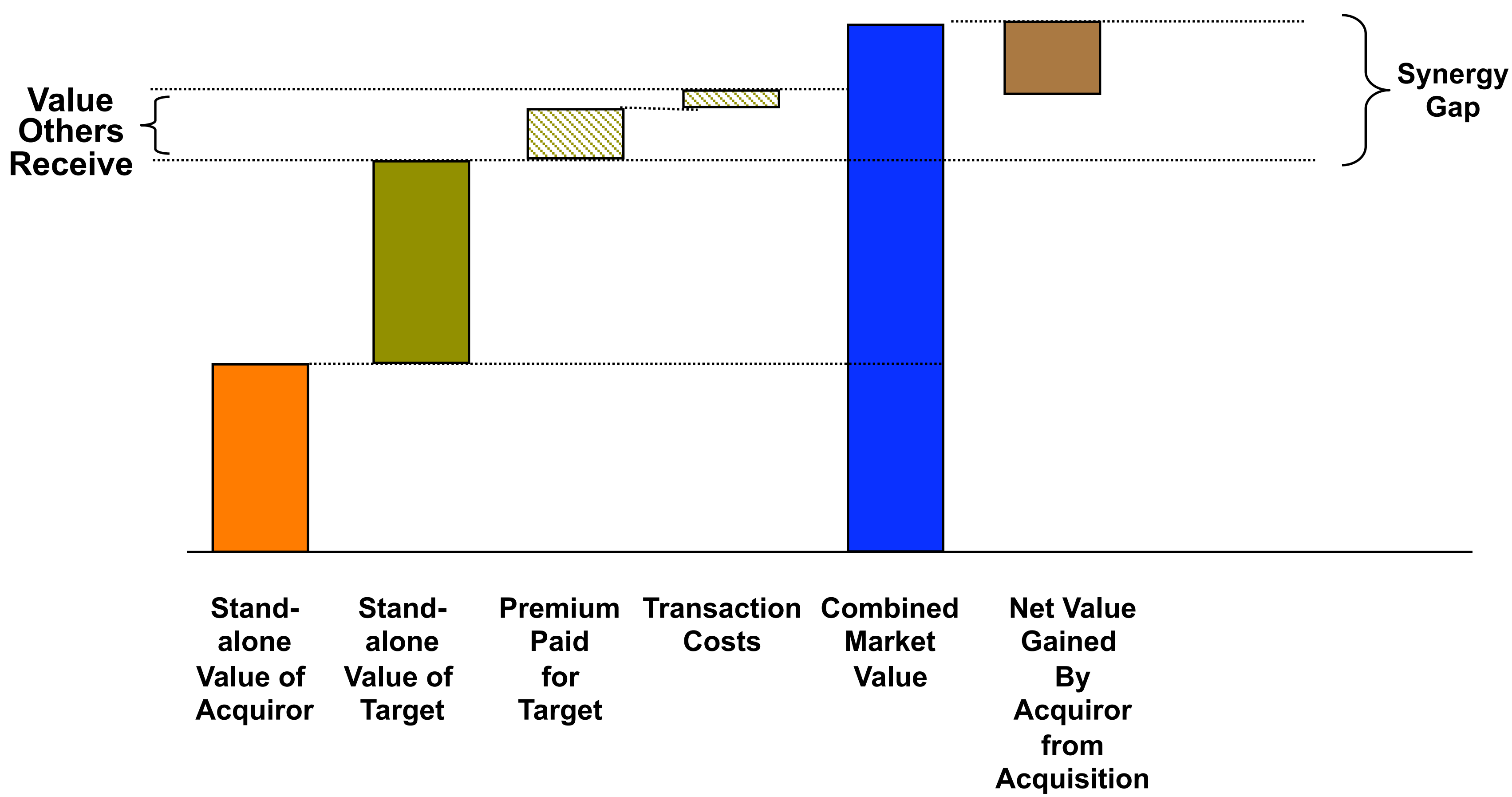
- Due Diligence (Reactive) — A Review and Verification of the Seller's Representations
  - Protects the buyer for severe financial loss
  - A tool to qualify risk and adjust purchase price/terms
- Due Diligence (Proactive) — Identify Areas Where the Buyer Can Reduce the Premium and Enhance Shareholder Value, By Identifying:
  - Ways that the buyer brings value in the transaction
  - Best methods of integration to capture value quickly

You Will Pay a Premium!

- Due Diligence Should Be Used Proactively To:
  - Accurately assess the standalone value of the target
  - Determine where buyer can add value — increasing overall shareholder value
  - Capture more of the “synergistic” value by buyer
  - Uncover potential areas of hidden value
  - Identify integration methods to accelerate value capture
  - Reduce post merger rejection
  - Minimize misrepresentations or improper expectations

Acquisition Value Framework

Analysis for Evaluating the Value of Acquisition



cdilisio@dside.com

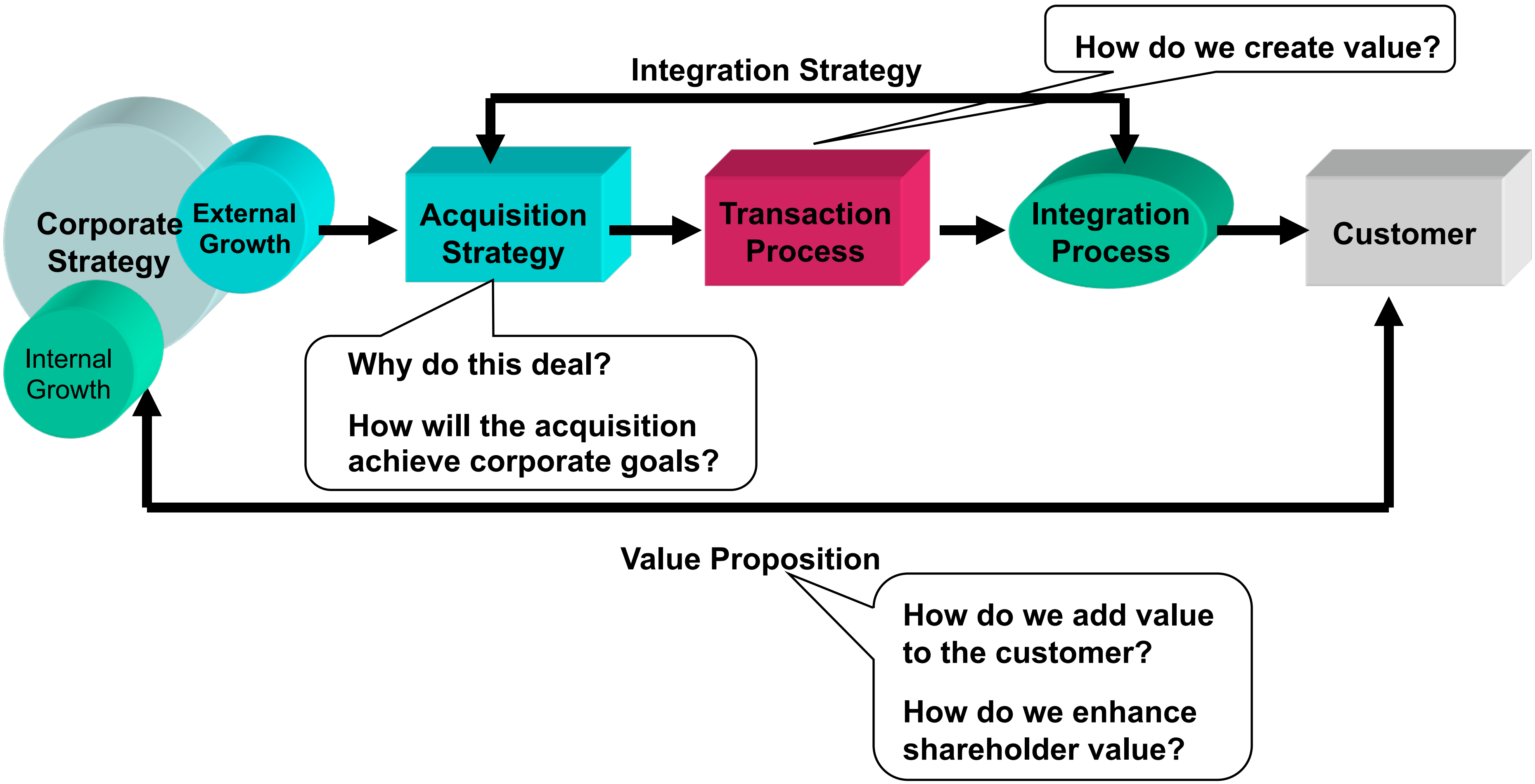
Due Diligence Objectives

- ✓ Understand Business Dynamics
- ✓ Identify Risks and Opportunities
- ✓ Assess Financial Position and Quality of Earnings
- ✓ Evaluate Management and Organization
- ✓ Identify Hidden Costs and Contingent Liabilities
- ✓ Identify Negotiation, Structuring & Integration Issues
- ✓ Identify Deal Breakers
- ✓ Reduce Purchase Price (i.e. Purchase Premium)
- ✓ Identify Purchase Price Allocation Issues
- ✓ Improve Post Merger Integration

Create a Due Diligence Team!

- Build a Multidisciplinary Team — External and Internal Members
  - Marketing & Strategy
  - Operations
  - Technical
  - Finance
  - Legal
- Appoint a Leader — to Drive the Process!
- Identify the Team Before the Opportunity Occurs

Where Do You Add Value?



cdilisio@dside.com

Three Levels of Due Diligence

- Preliminary Due Diligence —
  - Assess target's value to buyer
  - Forms foundation for the purchase price
  - Focus on forecasted income statement
- Precontract Due Diligence —
  - Assess hidden costs and contingent liabilities
  - Forms foundation for the purchase agreement
  - Focus on balance sheet and past practices
- Preclosing Due Diligence —
  - Assess if closing conditions are met
  - Forms foundation for the closing or signing
  - Focus on contract conditions and adverse changes

Transaction Process Stages

Target Selection → Preliminary Due Diligence → Pricing Analysis → Letter of Intent → Precontract Due Diligence → Purchase Agreement → Preclosing Due Diligence → Closing

Market/Strategy Focus

- Does the opportunity fit our strategy?
- Where do we add value?
- Is the price reasonable for the risk?

Output: purchase price

Operations/Tactics Focus

- What are the critical risks?
- What risks can be shifted from the buyer to the seller?
- Can the purchase price be reduced?

Output: material exposures

Legal/Administrative Focus

- Any material adverse changes?
- Are closing conditions met?
- Can the purchase price be reduced?

Output: closing to terms

Preliminary Due Diligence —
Key Questions and Objectives:

- Does the Opportunity Meet Strategic Objectives?
- What is Our Assessment of the Value of the Opportunity Based on Prior Performance and Future Expectations?
- How Does the Assessment of Value Fit Within the Context of the Economic Environment, Industry Dynamics, Market Potential, and Identified Risk Factors?
- How Do We Bring Value and/or Unlock Value?

Preliminary Due Diligence —
Conclusion: Pricing Analysis

- Discounted Cash Flow Analysis of the Target
- Provides a Consistent Method to Summarize the Key Questions and Objectives Through an Objective Model
- Provides Decision to Proceed With the Transaction Process

Preliminary Due Diligence —
Pricing Analysis Components:

Key Model Components

Revenue Model

↓

Gross Margin Model

↓

Operating Expense Model

↓

Capital Expense Model

Important Questions:

- What is the market size and target's share?
- Who are competitors and relative shares?
- What is the sales conversion process?

- What is the mix of existing, new and future products and their respective margins?
- What is the effect of competitive offerings?

- What are the appropriate expenses needed to support the revenue and margins?
- What are comparable expense ratios?

- What assets are needed to support the revenue, margin and expense assumptions?
- What are the working capital (inventory, payables, receivables) requirements?

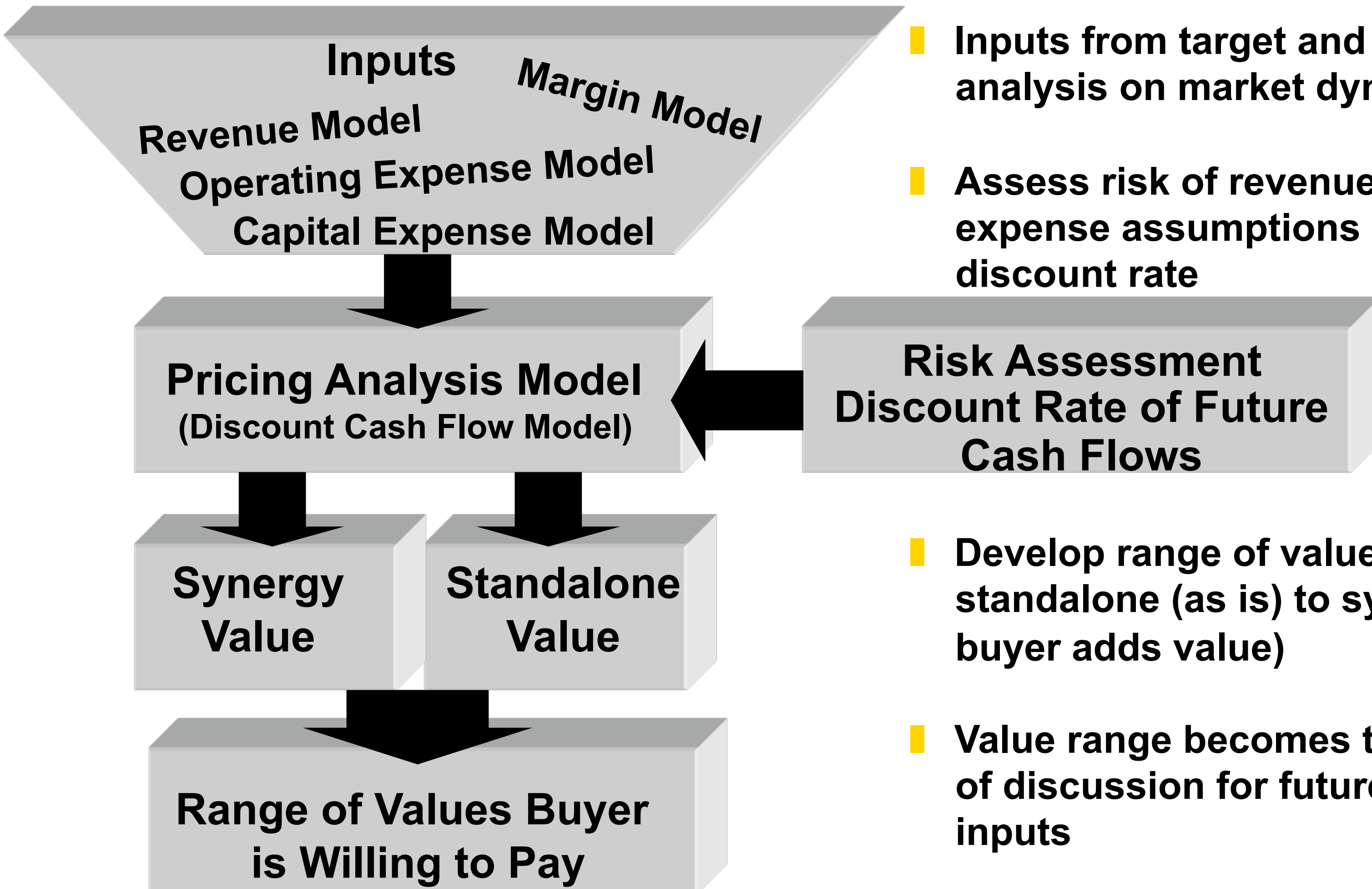
Preliminary Due Diligence — Inputs:

- Publicly Available Information (SEC Filings, Annual Reports, Analyst Reports, D&B Credit Reports, Product Literature, etc.)
- Offering Documents Prepared by Investment Bankers or the Target (Business Overview, Historical Financials and Projections)
- Comparable Public Company Data
- Market Research Forecasts and Competitor Data

Preliminary Due Diligence — Outputs

- Analysis of the Industry, Competitors and Market Potential and Opportunity for the Target
- Independent, Stand-alone Model of the Business and Its Stand-alone Value
- Assessment of How and When Additional Value Will Be Unlocked by Buyer
- Synergy Model of the Business Based on Value Brought by Buyer and the Synergy Value

Preliminary Due Diligence — Pricing Analysis Model Dynamics



- Inputs from target and buyer analysis on market dynamics
- Assess risk of revenue, margin, expense assumptions using discount rate
- Develop range of values from standalone (as is) to synergy (where buyer adds value)
- Value range becomes the foundation of discussion for future due diligence inputs

Preliminary Due Diligence —
Case Study:

Target with current sales of $100M is projecting the market would grow to $500M by 2004. By 2004 Target would command 50%+ market share. Target is planning to introduce new products. The industry currently has 5 competitors of which Target commands a 38% share.

- Industry Average Gross Margin is 50%. Target is at 55%
- Industry Average R&D Spending is 12%. Target Spends 10%
- Industry Average Operating Expense Are 35%. Target Spends 35%

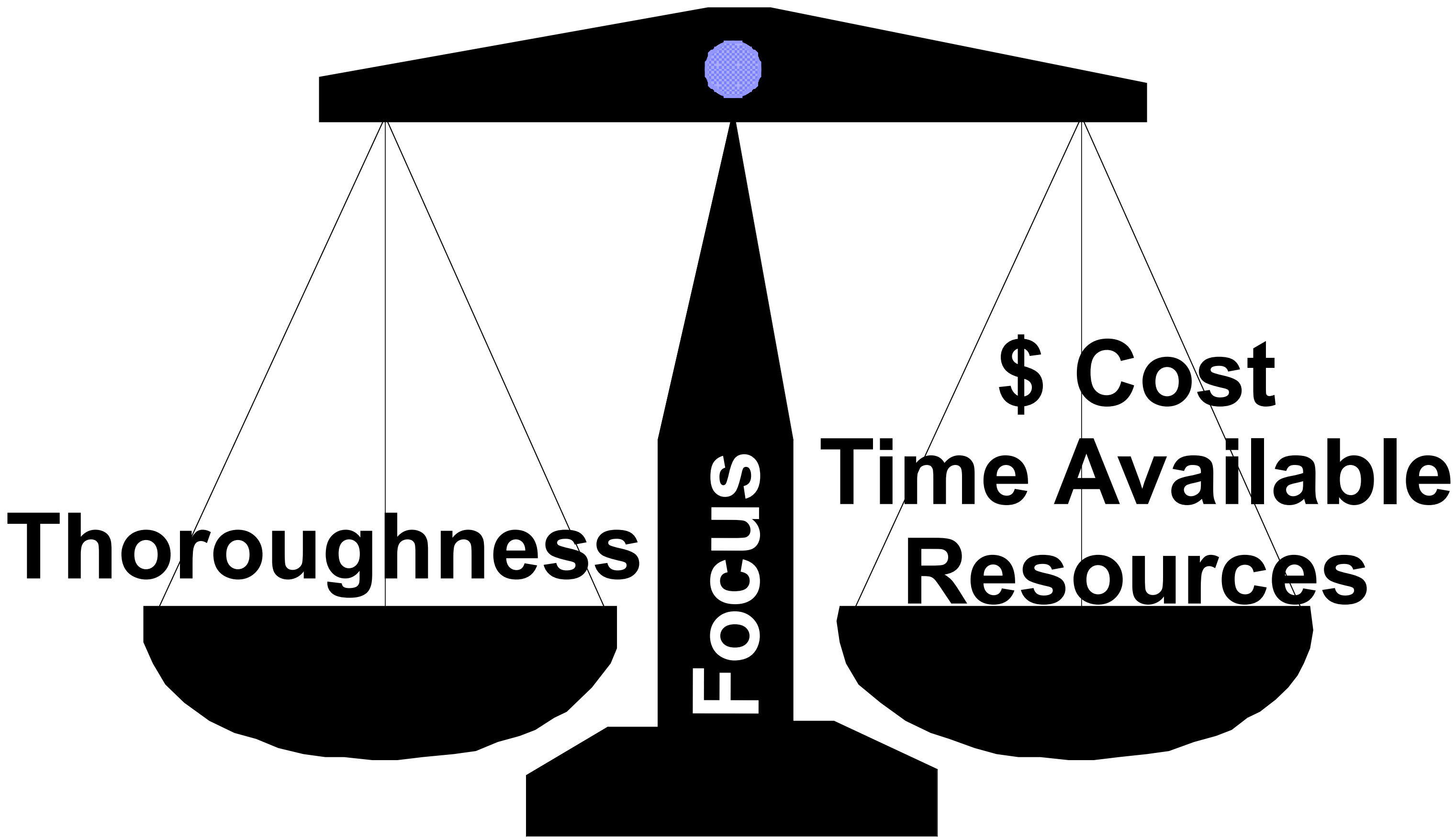
Preliminary Due Diligence —
Case Study Observations:

- The Market is Growing at 38% While Target Must Grow at 45%+ — Is This Reasonable Given:
  - Number of competitors
  - Level of R&D spending is lower that industry average
  - Target is planning to introduce a new product — with lower R&D spending
- How Can Target Sustain a 55% Gross Margin
  - Target R&D spending is lower than competitors. Are they milking the product line?

Precontract Due Diligence —
Key Questions and Objectives

- Opportunity For Thorough Target Evaluation
- What Exposures Or Potential Exposures Does the Target Possess That Could Cripple the Buyer or Make The Existing Purchase Price Excessive?
- In What Areas Should the Buyer Concentrate?
- Requires Detailed, Yet Surgical Review of All Functional Areas and Industry Dynamics
- What Exposures or Potential Exposures Can be Shifted to the Target In the Purchase Agreement?

Precontract Due Diligence —
Careful Balance, Focused Effort



Precontract Due Diligence — Conclusion: Detailed Review

- Detailed Review of All Aspects of the Target Businesses
- Augments the Information Collected in the Preliminary Due Diligence With Data Collected Directly From the Target
- Modifies the Pricing Analysis to More Accurately Reflect Revenues, Margins, Expenses and Risk
- Tends to Focus on The Accounting And Legal Aspects of The Business and What Has Been Reported.

Precontract Due Diligence —
Common Problems & Exposures

- Inventory Distortions (undervalued or overvalued)
- Litigation (product liability, employee)
- “Dressed-Up” Financials (expense deferral, reserves release)
- Receivable Collectability (uncollectable or dated)
- Tax Contingencies
- Unrecorded Liabilities (pension, warranties, etc.)
- Accounting of Investments
- Related Third Party Transactions
- Poor Financial Controls
- Need for Significant Future Expenditures

Precontract Due Diligence —
Inputs: Due Diligence Checklist

- Company History and Background
- Industry Structure and Competitive Context
- Financial and Accounting
- Taxes
- Sales and Collection Cycle
- Expense Cycle
- Manufacturing
- Capital Investment (Existing and Future)
- Other (Information Systems, Environmental, International Operations)

Precontract Due Diligence —
Company History & Background

OBJECTIVE: Gain General Understanding of the Target's Organizational Structure, Product/Services, Business Operations, Facilities, and Major Historical Events Impacting the Target (Acquisitions, Spinoffs, Etc.)

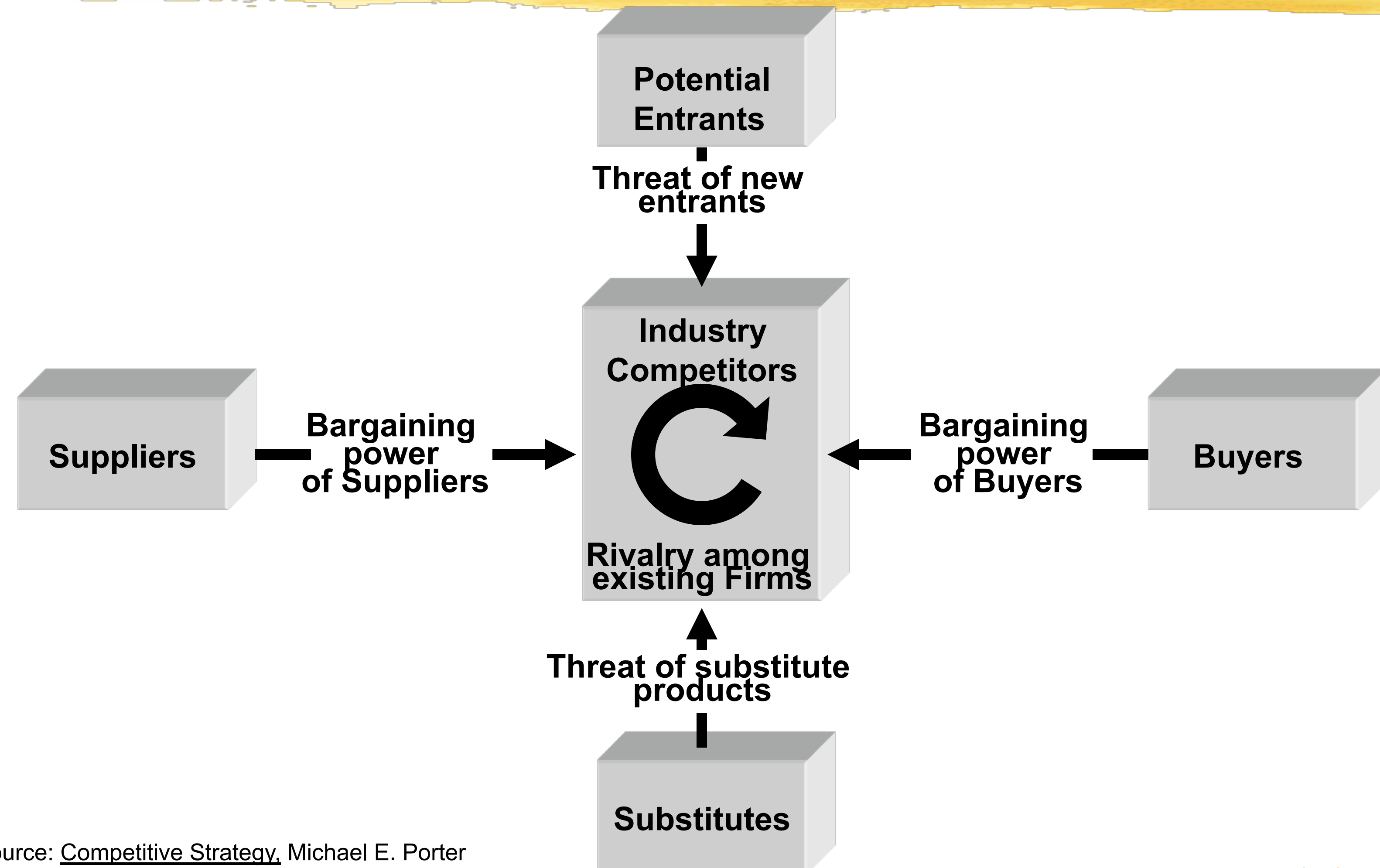
Industry Dynamics
- Identify dynamics: bargaining power of suppliers and buyers; competitive rivalry, new entrants and potential substitutes

Management/Workforce
- Define organizational structure and reporting (formal/informal); management and workforce strengths and weakness; and labor relations

Products/Service
- Review past, current and future products and services. Look at product plans.

Research & Development
- Review the level and type of R&D resources, success and failures of R&D efforts

Precontract Due Diligence —
Industry Dynamics a Model



Source: Competitive Strategy, Michael E. Porter

cdilisio@dside.com

D▲Side Advisors
Strategies for Quantum Growth™

Precontract Due Diligence — Accounting & Financial Review

OBJECTIVE: Review the adequacy and consistency of significant accounting and audit procedures. Identify key financial metrics and perform ratio analysis on Target

- Accounting Principles & Policies
- Audit Workpaper Review
- Internal Controls Review
- Ratio Analysis

- Review the nature and scope of the accounting principles and policies. Look for aggressive accounting principles or frequent changes to accounting principles.
- Gain an overall understanding of accounting methods and procedures. Look for weak record keeping, inaccurate records, unusual transactions, relationships to related parties, aggressive accounting, management overrides of procedures, and controls not followed.
- Identify key financial metrics and perform ratio analysis

Precontract Due Diligence — Key Financial Ratios

Ratio	Calculation	Possible Interpretation
Current Ratio	Current Assets / Current Liabilities	Measure of short term debt paying ability
Quick Ratio (Acid Test)	Cash & Cash Equivalents, Marketable Securities and Receivables / Current Liabilities	Measure of more immediate solvency than the current ratio
Liquid Ratio	Cash + Marketable Securities / Current Liabilities	A tighter measure of solvency than the quick ratio.
Receivable Turnover	Sales (net) / Average Receivables (net)	The efficiency in collecting receivables and managing credit
Days Receivables Outstanding	365 / Receivables Turnover	The number of days on average to collect receivables
Inventory Turnover	Cost of Sales / Average Inventory	The efficiency in the management of inventory and reasonableness of the quantity of inventory on hand
Days of Inventory	365 / Inventory Turnover	The average number of day required to use or sell inventory
Working Capital Turnover	Sales (net) / Average Working Capital	The extent to which a company is using working capital to generate sales
Gross Margin	Gross Profit / Sales	Ability to control costs in relation to sales
Operating Margin or Profit Margin	Operating income / Sales	Profit Margin (before tax) per dollar of sales
Debt to Equity Ratio	Total Debt + Capitalized Leases / Total Stockholders' Equity	Evaluation of Target's leverage

Precontract Due Diligence —
Sales & Collection Cycle

OBJECTIVE: Understand the target's sources of revenue and the process by which revenue is created.

- Customer Base
- Product Mix & Pricing
- Accounts Receivable
- Backlog
- Marketing Channels
- Related Party Transactions

- Review historical revenue and types
- Revenues by customer, geography, lost customers, and significant contracts
- Identify sources of revenue by product
- Look for significant changes in product mix
- Analyze pricing policies, price trends.
- Review schedule of accounts receivable, develop aging analysis and allowance for uncollectible accounts
- Define and analyze backlog
- What sales channels are used? Why?
- How does Target segment market? Why?
- Investigate sales to related entities

Precontract Due Diligence —
Understand the Sales Process

cdilisio@dside.com

D▲Side Advisors
Strategies for Quantum Growth™

Precontract Due Diligence — Expense Cycle

OBJECTIVE: Understand the target's expense structure and what expenses must be incurred to generate a dollar of revenue . Are assets properly stated, amortization reasonable and not heavily illiquid?

- Cost of Goods Sold
- Operating Expenses
- Inventory
- Prepaid Expenses and Other Assets
- Accounts Payable and Accrued Liabilities
- Commitments and Contingencies

- Investigate COGS by product and cost components. Review variances.
- Analyze operating expense as percentage of revenue, units and headcount.
- Investigate inventory by product, calculate inventory turns and inquire about slow moving, excess and obsolete inventory
- Look into securities and investments.
- Investigate goodwill and intangible items
- Investigate the asset accruals and liability recording processes. Are liabilities properly recorded (I.e warranty, environmental?
- Investigate pensions, leases, pending litigation are they properly reserved?

Precontract Due Diligence — Capital Investment

OBJECTIVE: Understand the capital requirements (working capital and fixed assets) to operate the business. Review when capital replacement cycle and the adequacy of capital base to support future growth.

Fixed Assets and Capital Expenditures

- Identify significant individual assets, useful life and remaining life. Asset utilization?
- What is the operating cash flow.

Cash and Banking Relationships

- What are the banking relationships, including withdrawal restrictions and compensating balances
- Identify sources and uses of cash.

Debt

- Summarize short and long-term debt showing rates, terms, holders, and maturity
- Review debt covenants and loan collateral.

Equity

- Investigate the equity accounts and related party involvement.

Precontract Due Diligence — Operating or Free Cash Flow

Start:	Operating Income
Less:	Income Taxes
Plus:	Depreciation and Non-Cash Items
Plus:	Increase in Working Capital
Less:	Capital Expenditures
Equals	Operating or Free Cash Flow

Precontract Due Diligence — Employee Benefits

OBJECTIVE: Understand the Target's benefit program and identify related risks.

Medical Benefits

Retirement Benefits

Other Benefits

- Review all benefit plans and gain understanding of what is offered
- Identify the risks associated with the acquisition of the plans
- Are their unfunded pension liabilities or post-retirement medical benefits
- Are there benefits that are being offered just prior or as apart of the acquisition (stock options, golden parachutes, etc.) What is the impact on the transaction?

Precontract Due Diligence —
Information Systems

OBJECTIVE: Document the Target's information system (IS) environment and determine the effectiveness of IS. Investigate year 2000 issues.

IS Operations

Key Software Systems

Year 2000 Compliance

- How important is the IS operation to the overall business?
- What are the key software systems and are they adequate for future company growth?
- What is the current level of system expertise?
- What systems are due for replacement?
- How do the existing systems fit with the buyers systems?
- What is the level of Y2K compliance? What is being done?

Precontract Due Diligence — Manufacturing

OBJECTIVE: Gain understanding of Target's manufacturing strategy, process, strengths and weaknesses.

- Manufacturing Process
- Customer Service
- Product Cost/Source
- Plant & Equipment
- Organization & Systems
- Engineering & Design

- What is the manufacturing cycle and capacity bottlenecks?
- Review on-time shipment performance.
- Review cycle time from order receipt to manufactured product
- Review product profitability and build cost.
- What is the overhead allocation and how does it compare to buyer?
- Does the plant allow for expansion and have good product flow?
- What is the character of labor relations?
- Is product designed for manufacturing?

Precontract Due Diligence — Environmental

OBJECTIVE: Review the adequacy and consistency of environmental programs. Identify the level of regulatory compliance and potential areas of exposure.

- General Environmental Information
- Management, Policies & Procedures
- Specific Environmental Hazards
- Ratio Analysis

- Identify specific environmental risk areas.
- Obtain an environmental site assessment.
- What environmental and safety procedures, policies, controls, and training are in place? Are these adequate for the risk?
- Have costs been assessed for remediation or litigation?
- What is the level of opposition to the Target from the pubic and regulators? What is the long-term impact of the Target with the greater community?

Preclosing Due Diligence —
Key Questions and Objectives

- Did the Precontract Due Diligence Result in Closing Conditions in the Purchase Agreement?
- How Will Or To What Level Will The Closing Conditions Be Met?
- If Closing Conditions Cannot Be Met Does This "Kill" The Deal Or Can the Purchase Price Be Altered?
- Independent Review of Closing Conditions Critical

cdilisio@dside.com

Due Diligence Benefits

- Tactical — At Contract Signing:
  - Reductions in purchase price
  - Shifting of risk though contract provisions, indemnifications, representations, warranties, and escrows
  - Improved understanding of the business, market and processes
- Strategic — Increased Shareholder Value:
  - Improve methods for post-merger integration
  - Understanding where Buyer will add value in transaction

Critical Success Factors

- Involve an Experienced, Dedicated Team — Define Roles Clearly
- Insist on Full Access to Target
- Identify Potential Critical Exposures and Deal "Breakers" Early
- Time is Always Against You — PLAN!
- Be Persistent and Skeptical — NOT Adversarial

Due Diligence — Conclusions

- Due Diligence Cannot Be Performed by a Checklist — Identify Key Exposures Early
- You Need to Balance Level of Investigation (Thoroughness) Against Cost, Time and Available Resources
- Use a Team Approach — Integrate External Professionals (Audit, Tax, Legal, Market) With Internal Functional Experts
- Don't Assume Anything!