

# Due diligence - avoiding acquisition pitfalls



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The objective of due diligence is to enable the acquirer to.....

- Decide whether to proceed with the acquisition, and at what price
- Bargain with the vendor
- Plan post acquisition integration (due diligence report acts as a useful checklist)
- Decide on representations, warranties and indemnities
- Facilitate the raising of finance/syndication of debt

What “threatens” the investor?

- Quality of information
- Transparency of the target
- Poor understanding of the transaction process by the vendors and target’s management

## Quality of information

- Audit “history”
- Reliable information for analysis
- Accounting system
- Unrecorded\off-balance sheet liabilities
- Timely preparation of IFRS financial statements
- Quality budgeting system

## Transparency of the target

- Beneficiary/ultimate shareholders
- Full disclosure of related and friendly parties
- Full disclosure of counterparties names
- Willingness to disclose “economic” substance of all unusual/non-arms length transactions
- Completeness of loan files

## Risks related to sustainability of cash flows and the customer base

- **Concentration of lending and funding:**
  - Sensitivity to change of ownership
    - related/friendly parties
  - Sustainability
    - individual loans to finance speculative investments into real estate

Different approach used during assets recoverability evaluation procedures

- **Loan impairment allowance (loan loss provision):**
  - Poor compliance with formal credit administration procedures
    - inconsistent policy for collateral acceptance
    - no feasibility studies for project loans
  - Relationship between the bank and the borrowers is more complex than what is reflected on the loan file
    - incomplete financial information of the borrower
    - unclear source of repayment other than collateral disposal

Different approach used during assets recoverability evaluation procedures

- **Fair value of investment securities**
  - Illiquid stock market – low reliance on PFTS quotations;
  - Low transparency of issuers of securities: use of DCF approach is complicated

## “Substance over form”

- **Back to back lending**
  - corporate loans vs corporate deposits
    - inflation of balance sheet
  - interbank – corporate
    - reputation risk
- **Insurance of credit portfolio risks**
- **Window-dressing transactions**
  - swaps
  - investment securities

## Other issues analysed when considering bank acquisition

- Human resources
  - quality of management team
  - transparency of staff remuneration
    - unofficial salaries
    - non arms-length insider loans
  - availability of English-speaking personnel to communicate with the new supervisors
  - retention of key personnel
- IT issues
  - integration of legacy software with IT systems used by the new owner