THE DUE DILIGENCE PROCESS

Jim Cochran, CEO

Mike Craft, CFO

Valley View Agri, LLC

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The Purchase or Sale of a Business

- The *Merger & Acquisition* activity begins at the time a business is offered for sale or a buyer decides to acquire a business.
- The early stages of these activities may involve the use of a business broker, investment banker, or some other party introducing a potential buyer and seller.
- At some point in the M&A process, the buyer and seller will conduct some form of *due diligence* activities.
  - This presentation will focus on the *buyer's* due diligence process.

Primary Components of an Acquisition

- Identify the targeted business
- Negotiation of price and terms
- Execution of various documents
- Conduct Due Diligence
  - Financial, tax, operating, capital, legal and other aspects
- Closing of the purchase

Common Documents Used in the Purchase of a Business

- Letter of Intent
- Purchase and Sale Agreement

Letter of Intent

- Agreement to negotiate
- Generally non-bonding on either party
- Sets forth basic principles of the soon-to-be Purchase and Sale Agreement
- Minimal details of the upcoming transaction
  - Anticipated purchase price
  - Basic terms

Purchase and Sale Agreement

- This is THE agreement.
- Very detailed and usually lengthy
- Specific price and method of payment
- Terms of closing
- Provides for *due diligence* process.
- May not be finalized until some point during or near the end of the due diligence process
  - Even if executed before due diligence, either party may seek to modify it based upon findings from due diligence activities.

What is this thing called *due diligence*?

- Due diligence is a *process* during which a potential buyer of a company investigates that company to gain information to allow it to decide whether to go through with the acquisition.
- Due Diligence is the act of gathering and evaluating information about a target business.

Parties with an interest in due diligence

- All parties involved usually benefit.
  - The buyer for sure
  - The seller in some ways, though the buyer’s due diligence could result in the deal falling apart
  - Other Stakeholders
    - Investors, lenders, employees, customers, vendors, attorneys (lots of fees!) and accountants (more big fees!)

How the buyer benefits

- Buyer gains information to help decide whether to go through with the acquisition.
  - Buyer should have fewer surprises after taking over the business.
- Buyer readies itself to operate the business.
  - After the purchase, buyer can “hit the ground running.”
  - Buyer is able to develop a business plan, determine staffing needs and identify areas needing improvement in advance of taking control of the company.

How the seller benefits

- May allow the closing of the sale to go more smoothly.
- Reduces the likelihood of post-closing disagreements, which could turn into lawsuits, since buyer identified and got comfortable with issues prior to closing.
- Allows the seller to identify tax issues and deal with those before it's too late.

How other stakeholders benefit

- Employees, customers and vendors are aware and included and will feel more secure about the future.
- Investors and lenders are more likely to get repaid later on.
- If a party is involved in the process, it will have a vested interest in helping ensure the success of the business going forward.
- Sets a realistic level of expectations of the new company
- Happy and contented stakeholders make everyone’s life easier.

And most importantly…..

A thorough due diligence process

provides for a better college education

for the children of

attorneys and accountants!

What about a business is important to the buyer?

- Its operations, of course
- The financial strength of the business
- The value of assets to be acquired and liabilities that will be assumed
- Its management and other key personnel
  - Will they stay or go? Do you even want them to stay?
- Tax issues and their effect on the acquisition
- Contracts, litigation and other legal matters
  - What will the buyer have to live with going forward?
- Technology issues
- Environmental issues and regulatory constraints
- Other, especially depending on the industry involved

What else does the buyer need to know?

- All sorts of financial information about the target company
  - Financial statements
    - As many as you can handle – Annual and monthly
      - Audited financial statements are preferable
  - Accounts receivable aging, accounts payable detail, inventory details
- The buyer needs to identify, among other things:
  - what it wants to include and exclude from the purchase
  - what it will cost to buy the company and ow it will pay for it
  - the sources of revenues and the uses of the company’s cash
  - potential risks from acquiring the business
  - the upside of the acquisition

What should the buyer do with all this information?

- Identify and evaluate what it will be getting.
- Identify risks and opportunities of buying the business.
- Develop a prospective financial model of the newly acquired business.
- Project cash flow from the business with the planned equity and debt structure.
- Use it to assist in final negotiation of price and terms of the deal.
- Use it in the final decision as to whether to go through with the acquisition.

The Plan for the Due Diligence Project

- Designed to address the ultimate objective of making an informed decision as to whether to go through with the transaction
- Prepared with the involvement of all key players, including seller to some extent
- Written is better, to help ensure that everything gets done and is documented and communicated to all parties.

Keep it real, folks!

- Must balance risks and rewards with the practical aspects of the investigation.
- The objective is to conduct a reasonable investigation under the circumstances.

The Design of the Due Diligence Plan

- Each plan should be designed to fit the transaction.
- It should address the specific concerns likely to be associated with the target company.
- The plan should identify how the plan will be executed.
  - What will be done?
  - Who will do what?
  - Where will they do it?
  - When will they do it?

The Bottom Line

- Due diligence addresses the need to evaluate the likelihood and amount of future earnings and cash flow.
- Strategic advantage and other reasons for the acquisition should also be considered, but even those ultimately translate to cash.

What should be done?

The plan is intended to:

- Identify and evaluate what makes the business run
- Obtain and confirm data
- Identify and evaluate business-related issues
- Identify and assess risks

Who will do it?

In short, the best person for the task

- The team should include the buyer’s management team, its attorneys and its accountants, auditors and tax advisors.
- Other experts should be used as needed for issues related to environmental, regulatory or other issues
- All participants must be able to maintain confidentiality!

Where to do it?

- At the primary business location, to the extent possible
- At offices of accounting, law and other consulting firms
- Site visits to other locations, for multi-location businesses

When to do it?

- In a timeframe agreeable to the seller
- Should be specified in letter of intent or purchase & sale agreement
  - Beginning and ending dates, acceptable business hours, etc.

The Due Diligence Plan

- Should be agreed upon with the seller and other parties
  - All parties must understand the process.
  - Know what is allowed .
  - Know what is off-limits.
- A written work plan is best.
- It is usually time-consuming and may be expensive, depending on the size and scope of the acquisition.
- Strong representations and warranties in the purchase and sale agreement can help balance the risk, but does not replace the need for investigative work.

The Plan should address all areas of the business

- Operations
- Sales & Marketing
- Financial
- Human Resources
- Legal
- Tax and regulatory compliance
- Information technology
- Issues specific to the target company and the industry

A Typical Due Diligence Checklist

A look at some of the items on a typical checklist

used in the due diligence process.

Due Diligence Checklist:
“Failing to Plan, is Planning to Fail”

1. Identify the overall objectives of the buyer and seller.
2. Understand the financial needs of buyer and seller.
3. Obtain approval from seller for lines of communication with seller’s staff and for conducting discussions with employees and third parties.
   - Sellers are particularly sensitive to the buyer talking with employees and customers.
4. Assign responsibilities for all areas of the work.
5. Line up attorneys, outside accountants and other specialists, and reach an understanding of assistance they will provide.

Due Diligence Checklist: Basic Information

1. Understand the business and its history.
2. Obtain an organizational chart or listing of employees.
3. Obtain resumes of management and key employees.
4. Obtain data of outstanding stock and its ownership, if the transaction will be structured as a stock purchase.
5. Prepare a roster of team members, both inside and third party consultants, to include addresses, phone numbers, email addresses, etc.
6. Obtain industry statistics to serve as a benchmark for the target company's operations.
7. Understand the company's economic prospects, its products and the industry.
8. Determine the countries/states in which company is licensed to operate.

Due Diligence Checklist: Operations

1. Evaluate quality of products and services and determine the effort required to rectify any deficiencies.
2. Evaluate the plant, facilities, warehouses, equipment, offices, etc. to be acquired.
3. Review production, materials-handling, warehousing, shipping, etc. procedures and controls.
4. Determine that the present and potential operating capacity is adequate to support the market forecast.
5. Determine availability and supply chain of raw materials, parts, components, etc. required for the company's business.
6. Evaluate the quantity and condition of inventory, as well as the market for the inventory.
7. Consider the investment needed to support any plans for expansion.
8. Obtain copies of the Company's licenses and permits.
9. Determine safety, productivity and efficiency standards and performance.
10. Obtain summary of OSHA matters for the last several years.
11. Obtain summary of federal and state EPA issues for the last several years.
    - Evaluate the need for and cost of any required clean-up of contaminants.
    - Strongly consider the need for an environmental study.

Due Diligence Checklist: Sales & Marketing

1. Identify major customers to evaluate likelihood of their continuing with the company.
   - Obtain sales volume by year for the last several years.
2. Determine whether the company is overly dependent on any single customer.
3. Identify major competitors and evaluate the company's competitive position (possible SWOT analysis).
   - Identify and understand barriers to entry into the market, as well as the company's competitive advantages and disadvantages vs. its competitors.
4. Determine the company's market share and evaluate whether the company has potential for growth or has reached market saturation.
5. Document the company's advertising and sales policies, as well as the cost of those activities.
6. Explore the company's advertising agency and review its budget and historical spending.
7. Understand the methods of distributing the company's products or services.

Due Diligence Checklist:
Sales & Marketing (Cont’d)

8. Map out the distribution of sales/customers and ensure proper deployment of sales people.
9. Obtain reports on any market surveys and studies completed over the last several years.
9. Evaluate the extent of governmental regulation of the company’s products, including product safety and recall records.
10. Determine the order backlog is reasonable and believable.
11. Identify any strategic alliances and evaluate their effectiveness.
12. Understand the company’s sales cycle, including seasonality.
13. Obtain a list of patents, trademarks and trade names. Ensure all filings are adequate.
14. Meet and talk with customers, if seller gives consent.

Due Diligence Checklist: Procurement

1. Understand the procurement function.
2. Evaluate policies & procedures applicable to the procurement function.
3. Understand the types of materials and inventories purchased, as well as their availability in the market.
4. List major vendors and volume of materials and inventories purchased each year.
5. Quantify outstanding purchase commitments and ensure they are reasonable for future anticipated volume.
6. Determine whether more than one vendor is available for critical items.

Due Diligence Checklist: Financial

1. Review books and records, financial statements, tax returns, and interim reports for the last five years, as well as current year-to-date.
   - Review monthly financial statements for the current year and possibly the previous year.
   - Evaluate sales and profitability by product line and location.
2. Review any changes in accounting methods during last several years.
   - With seller’s consent, meet with the company’s auditors and tax advisors and review their audit/tax work papers.
3. Determine financial ratings from D&B and other credit bureaus.
4. Understand accounting policies and practices for all areas, but especially inventory valuation method. Consider conducting a physical inventory.
5. Evaluate the company’s system of internal controls.
6. Review credit policies and collection procedures.
7. Evaluate the accounts receivable aging records. Ensure the allowance for doubtful accounts is adequate.
8. Identify real and personal property owned and leased. Consider an appraisal to evaluate its value and condition.

Due Diligence Checklist: Financial (Cont'd)

9. Identify all assets pledged under loan agreements, and consider any issues with their transfer to buyer.
10. Identify obsolete or slow moving inventory, and determine the need for any reserves.
11. Review detail of accounts payable and accrued liabilities. Ensure accruals are adequate. Ensure liabilities are reasonable as compared to historical levels.
12. Be alert for any contingent liabilities which could materialize from lawsuits, labor issues, environmental issues, etc.
13. Identify related party transactions and determine their impact on the company going forward.
14. Identify infrequent or non-recurring transactions and determine their impact on the company's financial position.
15. Review profitability by product line and location.

Due Diligence Checklist:
Human Resources

1. List current employees by department and compensation level.
2. Evaluate competence of management and key employees, and evaluate any needed changes in staffing.
3. Review the employee handbook.
4. Inquire as to compliance with DOL and other regulations.
5. Get a feel for employee morale.
6. Obtain benefit plans and determine their adequacy.
   - Ensure company is in compliance with the Affordable Care Act.
7. Understand incentive compensation plans and evaluate whether changes will be needed.
8. Review 401(k), pension and other retirement plans.

Due Diligence Checklist: Human Resources (Cont'd)

9. Identify employee vacancies in critical positions. Ensure the company has not been sacrificing staffing for window dressing.
10. Review turnover statistics.
11. Interview key employees, if seller consents.
12. Review union contracts and determine affected employees. Consider the impact of any upcoming union negotiations for renewed contracts.
13. Review any employment agreements or contracts.
14. Understand any labor disputes in the last few years.

Due Diligence Checklist: Legal Matters

1. Review the corporate and organization documents, especially in connection with a stock purchase.
2. Talk with inside and outside attorneys to identify and evaluate legal issues, ongoing litigation, etc.
3. Identify states in which the company is registered to conduct business and ensure filings are up-to-date.
4. Review patents, trademarks, and service marks to ensure they are adequately registered.
5. List representations and warranties to be requested of the seller.
6. Review a list of licenses, contracts, and leases to determine any impact on the acquisition and needs going forward.
7. For any loans which will be assumed, review applicable agreements.
8. Consider any impact of stock vs. asset purchase in order to structure the acquisition.

Due Diligence Checklist: Information Systems

1. Understand the various information systems and conclude as to their effectiveness.
2. Review the Company’s software licenses.
3. Understand the support structure for the IT systems.
4. Determine any future hardware and software requirements.
5. Understand the company’s disaster recovery plan and procedures.
6. Determine whether the company’s IT systems can interface with those of the buyer.

Due Diligence Checklist: Insurance

1. Review the company’s insurance coverage.
2. Determine the extent to which the company is self-insured, if applicable.
3. Obtain a history of losses and claims for the last several years.
4. Obtain information on any outstanding claims and evaluate the potential for loss.
5. Review the company’s workers compensation claims history and ratings.
6. Interview the company’s insurance brokers and consultants, if seller consents.
7. Evaluate the need for loss reserves and communicate this to those performing the financial due diligence.
8. Investigate need for any special coverages, such as environmental risks, cyber matters, earthquake or other potential catastrophic risks.

Due Diligence Checklist: Pro forma Financial

Develop prospective financial projections for the new company based on knowledge gained through due diligence, management's plans for the business and the anticipated capital and debt structure.

- Determine projected earnings for the new company.
- Determine projected cash available for anticipated debt service.
- Ensure projected financial results are adequate to support the purchase price.
  - These pro forma financial statements, prepared based on the results of due diligence, can help determine or validate the purchase price.

Issues requiring additional work

- Acquisition of only a division or separate line of business
- Acquisition of a business that is under common control with other businesses
- Significant issues or concerns identified during due diligence
- International business

International Issues

- Import/Export Duties, Tariffs and regulations
- Management attitudes
- Legal matters
- International Tax Issues
  - United States tax issues
  - Foreign country tax issues
- Cultural differences
- Language barriers

When might the seller conduct due diligence on the buyer?

- If seller will be financing the sale
- If seller will receive buyer’s stock instead of cash
- Personal desires for continuity of the business

Buyer Beware!

A savvy seller will likely have spent months or years preparing the company for sale.

The company and its financial reports will likely be at their best.

How can the Seller boost the value of the company?

The same way you would try to maximize the price of your house if you were to put it up for sale.

- Imagine what the buyers objections might be and address them ahead of time, or at least be ready for them.
  - Clean up ahead of time.
- Clean up related party transactions so they won't confuse the issues.
  - Get rid of the clutter.
- Cut unnecessary expenses.
  - A fresh paint job improves appearance.

Summary

- Due diligence is a process of investigation to gain information.
- Due diligence can be used in any type of transaction.
- Due diligence needs to be well planned.
- Due diligence activities should be practical for the acquisition.
  - Cost vs. benefit
- Due diligence benefits all parties involved in the transaction.
- Due diligence helps determine or support the price and other terms of the transaction.
- Due diligence helps ensure a successful acquisition and transition.
- Due diligence puts the buyer in a position to hit the ground running with the new company after acquisition.

Don’t be afraid to walk away

Sometimes the
best deals
are the ones
that don’t get done!

Contact Information

Jim Cochran, CEO

jim.cochran@valleyviewagri.com

Mike Craft, CFO

mike.craft@valleyviewagri.com

Valley View Agri, LLC

870-932-6440