When no one knows

Pre-announcement M&A activity and its effect on M&A outcomes

Cass Business School
CITY UNIVERSITY LONDON

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A study by the M&A Research Centre at Cass Business School and Intralinks | **November 2013**

Content

Executive summary

Longer due diligence results in a higher likelihood of deal success
The study found a strong positive statistical relationship between the length of the due diligence period and deal performance, as measured by acquirer total shareholder returns. This is an intuitive result but has not been shown before and affirms the very high importance of conducting rigorous due diligence.

Longer due diligence is to the advantage of the buyer (and to the disadvantage of the seller)
The research found a negative statistical relationship between the length of the due diligence period and the takeover premium, as measured by the offer price over the share price average for Day -50 to Day -40 prior to the announcement of the deal. This suggests that the results of increased due diligence provide the buyer with additional information that can be used during the negotiation to drive the sale price down.

Due diligence is done more quickly on public companies
The study found a negative statistical relationship between the length of the due diligence period and the listed status of the target, with deals involving listed targets having a shorter due diligence period. This can be attributed to the greater transparency of, and easier access to, information for listed targets.

Due diligence is done more quickly on larger targets
A negative statistical relationship was found between the length of the due diligence period and the size of the target. This can be partly attributed to the above finding, with listed targets also likely to be larger, but can also be attributed to the better resources and reputation of larger firms, which makes the due diligence process more straightforward.

Most M&A leaks are likely to be intentional
The study found that M&A leaks are very unlikely to take place before the opening of a VDR or shortly thereafter. Instead, any leaks are likely to take place further into the due diligence phase, and leaks do not appear to be related to the VDR's opening day *per se*, that is to say the VDR's opening does not cause the leak, but rather the day of the leak is more related to the day of the public announcement of the deal. This provides further evidence that on aggregate leaks are intentional and a result of either the seller or buyer attempting to push negotiations in their favour.

Methodology

M&A transactions that used the Intralinks virtual data room (VDR) platform between 2008 and 2012 were matched with publicly announced M&A transactions from the Thomson Reuters SDC Platinum™ database. After excluding deals for which a definite match could not be established, the process resulted in a data set of 519 M&A transactions.

This unique data set allowed metrics from the pre-announcement due diligence process to be compared with public data on variables including deal type, size, price and performance. A multivariate analysis on these parameters established where a statistically significant relationship existed, allowing inferences to be drawn on how the due diligence process is affected by the properties of the deal as well as the impact of due diligence on deal negotiations and deal success.

The relationship between VDR use and deal leaks was also investigated using event study analysis. Significant abnormal price movements were identified to establish how incidences of significant pre-announcement trading (SPAT) are related to VDR opening and deal announcement.

In conjunction with this research interviews were conducted with 30 M&A professionals (10 lawyers, 10 accountants and 10 corporate executives) to get a clearer picture on how due diligence impacts the dealmaking process, the tactics used by participants to push the process in their favour and the relationship with leaking.

The due diligence battle

Although it is logical that increased due diligence would typically increase a deal's likelihood of success, this has never been conclusively proven. This study provides firm evidence for this hypothesis, with a strong correlation between the length of time taken for due diligence and the deal performance, as measured by the acquirer's total shareholder return versus a market return index from month -3 to month +12 around the announcement of the deal.

"Often the time allowed for due diligence is not enough which affects the deal and has been a reason for many failures"

There are plenty of reasons why this is likely to be the case. Longer due diligence allows an acquirer to fully flesh out whether the business case stacks up and ensure that the valuation is realistic. A more rigorous examination also allows the buyer to uncover any problems that the seller had hoped to keep hidden and which may have gone unnoticed if due diligence was conducted more quickly.

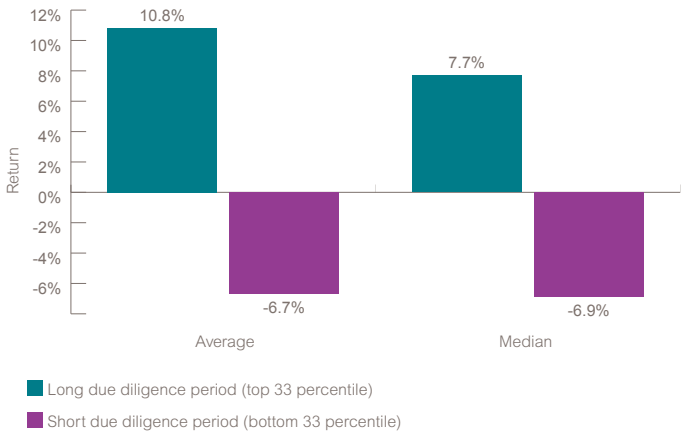
Length of due diligence period

Deal performance

This view is supported by the director of M&A at a US corporate who suggests that, "due diligence should be free from a time limit as there are many areas that need investigation and multiple reviews that are time-consuming. However, often the time allowed for due diligence is not enough, which has been a reason for many failures". A partner at a French accountancy firm agrees: "The time allowed for due diligence affects its effectiveness. If sufficient time is not allowed, there is increased risk of a deal failing."

"The deeper you dig for information the more arguments come up in regards to pricing"

Acquirer shareholder return versus local index return



However, a partner at a French law firm also believes the needs of the seller should be considered: "There should be a balance on the time allowed which is mutually agreeable to both seller and buyer. Too much due diligence can offend a target to the point where they walk away from a deal, so buyers need to plan their due diligence so that it can be completed within the agreed timeframe."

"Too much due diligence can offend a target to the point where they walk away from a deal"

Longer due diligence is to the advantage of the buyer

The relationship between deal performance and the length of the due diligence period can be attributed to buyers both avoiding bad deals and coming up with a better valuation for the deals that they follow through with. While our study cannot show how often additional due diligence leads to a buyer walking away from a deal, it does provide strong evidence for buyers arriving at different valuations thanks to a negative correlation between the length of time taken for due diligence and the takeover premium, as measured by the offer price over the share price average for Day -50 to Day -40 prior to the announcement of the deal.

This would suggest that extensive due diligence is an important tool to discover problems with the target, which in turn can be used to push down the valuation. This implies that longer due diligence is very much to the advantage of the buyer, but may often be to the disadvantage of the seller.

Length of due diligence period

Takeover premium

This is a view supported by respondents, who suggest that sellers will often try to limit the amount of time allowed for due diligence for this very reason: "If the asset is really attractive, the seller will be comfortable with a longer due diligence period, but if the asset is not that attractive and there is something that could negatively affect the deal then the seller will try to limit the time for due diligence," suggests a partner at a US law firm.

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A partner at a UK law firm adds: "When buyers do extensive due diligence, negative things can pop up and then the buyer will either walk away or ask for compensation, so the seller will always try to limit the time frame for due diligence."

This perspective is also shared by a managing director at a UK accountancy firm, who suggests that the seller might try to limit the time allowed, even if they do not have anything to hide: "It is always the case that the deeper you dig for information the more arguments come up in regards to pricing, so the seller will always try to limit the time allowed to perform due diligence".

A partner at a German law firm echoes this sentiment and reveals how the length of the due diligence can shape the negotiating process: "Whatever the position of the seller, whether strong or distressed, the seller will always limit the time for due diligence as extra time is used by the buyer to not only investigate the target but also to make the seller nervous so that they agree to the buyer's terms out of fear that any unappealing facts will be exposed."

What can a seller do to counter the buyer's advantage from a longer due diligence period?

So with it being clear that longer due diligence is good for the buyer but often not so good for the seller, how can a seller counter the buyer's advantage from a longer due diligence period?

Respondents suggest that one of the best, and most straightforward methods, is to orchestrate a competitive bidding process. This will put timing pressure onto the buyer, as they will fear that they could lose out to a rival who is willing to move faster and be less demanding during the due diligence phase. "Normally in a competitive bid process a buyer cannot say that they need more time, because the seller could agree to a bid from another buyer who is not as bothered about the due diligence," reveals a partner at a French accountancy firm.

"In a competitive bid process a buyer cannot say that they need more time, because the seller could agree to a bid from another buyer"

This view is supported by a partner at an Italian law firm: "When there is competition the buyers come under pressure and worry that other bidders will bid high to snatch the deal, so buyers tend to rush the due diligence and ignore the small, although sometimes important, aspects."

A partner at a German law firm agrees: "When there are several bidders, the seller has the upper hand. This puts pressure on the buyers who may be willing to end the due diligence process without completing it to seal the deal. This is true for most deals where there is competitive bidding. There are not many buyers that would withdraw from a deal simply because their due diligence requirements have not been met."

However, a managing director at a UK accountancy firm suggests that this is more likely to be the case for strategic buyers: "When the bidder is buying for financial reasons, due diligence is unlikely to be rushed. But when the buyer is buying for strategic gains, the buyer may rush the due diligence process and might not worry about investigating some areas."

But what if there is not a competitive bidding process?
When a deal is carried out with a competitive bidding process, the balance of power is likely to shift to the seller, who can use this fact to their advantage and limit the time allowed for due diligence. But what can a seller do if there is only one bidder.

Tne possible solution is to try and orchestrate a competitive bid process with a leak. In our study, *M&A Confidential: What Happens When Deals Leak*, one of the key findings was that leaking was likely to be used as a tool by sellers to encourage other buyers to enter the process – as described by a managing director at a German investment bank: "Leaking a deal will attract additional buyers, thereby increasing competition and making the initial buyer insecure so that they raise their bid."

Even the threat of another bidder is likely to help curtail the due diligence process and a leak can be used to push the buyer to wrap up the process before any nasty surprises have been uncovered. This process is described by the head of finance at a Spanish corporate: "Leaking a deal is one of the tactics used by sellers to make buyers speed up the due diligence process. Once deals are announced prematurely, buyers come under pressure to complete the deal quickly and decide whether the deal is still good for them."

"If a deal is prematurely announced, the pressure is applied to the team performing the due diligence. The announcement means that certain factors are ignored and processes not carefully implemented to meet the timelines and overcome the problems created by the leak," suggests a partner at a US law firm.

"Leaking a deal is one of the tactics used by the seller to make the buyer speed up the due diligence process"

"A premature announcement means the dealmakers are in a hurry to complete the deal, and the time allowed for due diligence will be less," adds a partner at an Italian law firm.

A partner at a UK accountancy firm agrees with this assessment but also thinks this tactic can backfire: "When a deal is leaked and an announcement is made prematurely the buyer may rush through the due diligence so that the deal can be completed without attracting unwanted competitors. Alternatively, the buyer will get more cautious and will intensify the due diligence to find out more information including what led to the leak."

The difference between public and private targets
Another notable finding from the current study was a correlation between the listed status of the target and the length of the due diligence period, with buyers generally taking less time to conduct due diligence on publicly listed firms.

"A premature announcement means the dealmakers are in a hurry to complete the deal, and the time allowed for due diligence will be less"

This is again an intuitive result, as listed companies are likely to be held to a higher degree of transparency, with their financial statements regularly audited, and therefore less likely to contain misleading or difficult to interpret information.

Target is publicly listed

Length of due diligence period

This suggestion is supported by a partner at an Italian law firm: "An accurate valuation of privately owned companies depends on the availability and reliability of the private company's historic financial information. For a public company, the financial statements are officially audited, documented and overseen by a government regulator, so it is easy to find the information and do due diligence."

A CFO at a US corporate elaborates: "For public companies, more time is spent on modelling hypothetical deals and a rigorous valuation for the fairness opinion. For private company targets more time is spent on nitty-gritty tasks such as adjusting the financial statements and digging up information, and this takes a lot of time, consultants and resources."

"For US private companies it is tough as there are no standards for their reporting and the chances of manipulation are very high"

A partner at a French law firm reveals how a target's listed status is likely to be to the buyer's advantage: "Buyers walk into the deal with significant prior analysis, instead of spending much time on due diligence during the course of the deal and this preparation gives them the upper hand in the deal."

Meanwhile, a partner at a US accountancy firm feels that private companies come with an increased level of risk: "For public company targets, all the critical information is available and needs little attention. But for US private companies it is tough as there are no standards for reporting and the chances of manipulation are very high – identifying any manipulation needs deep and extensive investigation."

The impact of deal size

A related result from the current study is that the target's size is negatively correlated with the length of the due diligence period, with acquirers generally taking less time to perform due diligence on larger companies. This is likely to be partly a result of the previous finding, as larger companies are more likely to be publicly listed.

Size of target

Length of due diligence period

However, there may be other factors at play, including the stronger reputation of larger targets, and the better resources larger companies have access to when being offered for sale.

The director of finance at a German corporate picks up on the problem of a lack of resources at smaller firms: "Small deals mostly involve small sellers. Small sellers do not have all the due diligence materials prepared. There is thus often delay in providing all the necessary information to buyers."

This view is supported by the director of finance at a Spanish corporate: "Small companies often lack the necessary experience and knowledge of due diligence and also refrain from using outside advisors as they are not ready to pay the costs."

Less obviously, it appears that larger companies are also more likely to have existing relationships with acquirers, which helps to cut the amount of due diligence required. A managing director at a British accountancy firm explains: "Larger deals often involve prior relationships where the seller and buyer know each other and are comfortable. This allows the information exchange to happen without any hassles and complete transparency is maintained. Due diligence is then more focused on the technical and regulatory aspects, that do not require as much time."

"Small companies often lack the necessary experience and knowledge of due diligence"

The director of finance at a US corporate agrees: "Large deals often happen between companies that are known to each other and the seller is already aware of the facts and figures. Also in large deals many resources and advisors are used, which helps in completing due diligence in less time."

Most M&A leaks are intentional

In our previous report, *M&A Confidential: What Happens When Deals Leak*, we tracked incidences of leaking during M&A transactions. Through interviews with dealmakers we established reasons – both intentional and accidental – why a deal might leak. The consensus was that most leaking happens for a reason and is intentional. Our current study allows us to investigate this hypothesis further by examining the relationship between leaking and a deal entering the due diligence phase – the point when a virtual data room is opened to external users.

For those deals that had a publically listed target (a sub-sample of 142 transactions) we found no evidence of leaking before a VDR is opened to external users, that is to say before due diligence begins.

At this stage, there are likely to be discussions taking place between the seller and potential buyers, so there is therefore plenty of potential for an accidental leak resulting from (for example) a misplaced document or incorrectly addressed email. The absence of any leaks at this point, when neither the buyer nor the seller has anything to gain from the deal becoming public knowledge, supports the assertion that most leaks happen intentionally.

There is also only limited evidence of leaks shortly after the VDR is opened to external users – which represents the day that due diligence begins. This provides evidence that few leaks happen simply because transactions have reached this advanced stage.

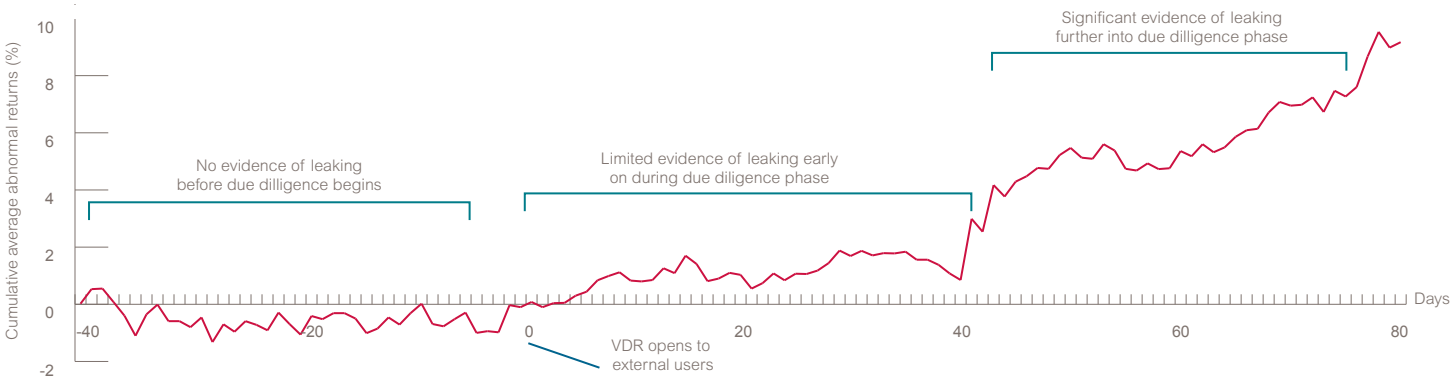
Instead, leaking tends to take place much further into the due diligence phase, when negotiations are likely to be reaching an advanced stage and either the buyer or seller may have something to gain from a leak. In addition, the data shows that leaks do not appear to be related to the VDR's opening day *per se*, that is to say the VDR's opening does not cause the leak, but rather the day of the leak is more related to the day of the public announcement of the deal. This provides further evidence that on aggregate leaks are intentional and a result of either the seller or buyer attempting to push negotiations in their favour.

With leaks only occurring when those involved have something to gain, these results taken together provide support for the theory that leaks are usually intentional. Indeed, leaks look increasingly likely to be motivated by one party being unhappy with how negotiations are progressing and therefore choosing to leak information to push the deal in a direction they prefer. There is little evidence that leaks happen accidently when a deal has been discussed or because there is information flowing between buyers and sellers.

This view is supported by nearly all respondents in our latest interviews, with the consensus being that intentional leaking happens much more often than accidental leaking. This assertion is summarised by a partner at a UK law firm, who states that "Leaks are intentional most of the time – now we have brilliant technology in place which ensures accidental leaks are prevented almost completely." This view is further supported by a partner at a UK accountancy firm, who comments, "Now the information exchange happens in a secured manner which is unlikely to be breached unless intentionally done."

Only one respondent out of 30 reported having direct experience of an accidental leak, with the experiences of a partner at a French law firm highlighting the possibility of severe consequences if a deal is leaked without authorisation: "We were the legal advisor on the deal. Due to some technical glitches some confidential documents were sent to the wrong party and the deal was leaked. The mistake was made by a third party and they were instantly blacklisted by the buyer."

VDR opening and transaction leakage



Statistics on the due diligence process

A review of the descriptive statistics for this novel database reveals some interesting (and previously unknown) facts about deal preparation.

This data reveals that the average due diligence period, defined as the length of time between the day on which the VDR was opened to external users and the public announcement of the transaction, is 124 days while the median is 101 days.

Data from the study also provides details about the the number of pages of information uploaded to the VDR by sellers during the M&A process, with an average of 34,426 pages and a median of 16,710. Finally the data also reveals the number of people using this information, with an average of 152 unique users during the due diligence period and a median of 106. These figures point to the large number of individuals involved in the average transaction, and the difficulty that this could pose in tracking down the source of any intentional leak.

	Average	Median
Length of due diligence period in days	124	101
Pages uploaded to VDR	34,426	16,710
Users logging into VDR during due diligence	152	106

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Notes:

Intralinks Contacts

New York –
Corporate Headquarters
150 East 42nd Street
8th Floor
New York, NY 10017
Tel: 212 543 7700
Fax: 212 543 7978
Email: info@intralinks.com

London
44 Featherstone Street
London, EC1Y 8RN
United Kingdom

Tel: +44 (0) 20 7549 5200
Fax: +44 (0) 20 7549 5201
Email: emea@intralinks.co

Singapore
Level 42
6 Battery Road
Singapore 049909

Tel: +65 6232 2040
Email: asiapacific@intralinks.com

São Paul
Rua Tenerife, 31, Bloco A,
cj. 121
Vila Olímpia São Paulo,
CEP 04548-040, Brasil

Tel: +55 11 4949 7700
Email: amLat@intralinks.com