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In the Nick of Time — Fast-Tracking the Due Diligence Process

BY CHRIS JEFFORDS AND ALEX SUTTON

Missing deadlines, poor data and information flow, and reworking previously completed borrowing bases and valuations engender costs that fall heavily on service providers, but also impact the resources of a lender. Deals subject to extensive delays form a poor foundation for future cooperation between the lender and the company. The following article offers five points to consider in order to avoid a drain on resources — financial or otherwise.

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As we write this article, we recall the number of times we both have answered the phone at 4:00 p.m. on Friday afternoon to handle a rush appraisal request, and how that has transpired and run its course. We think of the company contacts we end up calling at 5:00 p.m. on that Friday to schedule meetings with for first thing Monday who have never heard our names, cannot see us until Wednesday, or say "you can come, but the bank's team is going to be here as well, so…"

We think of the frantic calls we get after sending over a due diligence request list to the same contact that just received equally lengthy requests from the bank, the field auditors, private equity (PE) firms, other appraisers, environmental consultants, insurance companies and the like. Much of this chaos is perhaps unavoidable in the frenzy of the last minute deal, but there are best practices that the best deal teams follow, which mitigate the chaos, streamline the process and at least take a few "plates off the table." Some of these practices are more applicable to the last minute deal process, but they apply equally well to any regularly scheduled due diligence process.

Key source documents should be clearly identified so that all due diligence teams use the same data and can readily find relevant documents. If data is updated or replaced in the data room, all potential users of that data on all teams should be notified.

Add Specific Cooperation Expectations to Loan Covenants

Many lenders require appraisers to commit to a timing requirement in the appraisal engagement letter. Within this commitment is some kind of exigency clause whereby the appraiser is released from the timing requirements if the company being appraised doesn't fulfill information requests in a timely manner. All appraisers, whether they are an inventory appraiser with a three-page information request or a machinery and equipment appraiser trying to just get holding cost information from a reluctant borrower, are at the mercy of the company. An appraiser's willingness to hop on a plane the next day or that night or that hour will be meaningless if the company is not ready or able to convey the information needed within the required timeline.

For this reason, the lender's proposal should spell out specifically the cooperation expectation of companies, with maximum response times to fulfill standard data requests and other performance metrics. Standard information requests for each type of due diligence provider being contemplated could be provided as attachments to the proposal letter to give them advance notice of what they will be required to provide. Specific performance-related penalties could be levied for all requests not fulfilled within a certain period, which would be collected from the due diligence deposit. These cooperation covenants could also be spelled out in loan documents governing updates of field audits and appraisals.

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Consolidate Due Diligence Teams' Information Requests

Another source of frustration that can be alleviated is the multiple and duplicative information requests that mark the typical ABL transaction. Working with clients and audit teams to streamline requests — by either consolidating them with the field auditor and bank team requests or by customizing standard requests to the specific type of company being appraised — are viable ways to mitigate duplicative requests. Centralized reporting of information in a data room may alleviate these issues, but then access to the data room must be provided early in the process, and the structure of the data room must allow for quick searching and ready copying and downloading of all data in all formats.

Data rooms that inhibit access to information by restricting downloading and forced viewing of documents in the data room as opposed to allowing downloading of the data should also be avoided. Key source documents should be clearly identified so that all due diligence teams use the same data and can readily find relevant documents. If data is updated or replaced in the data room, all potential users of that data on all teams should be notified.

Confirm Availability of Key Company Contacts

In the typical initial large transaction due diligence rush, companies are often overloaded with multiple service providers accessing the same company contacts for information. Although at times unavoidable, the deal team leaders may be able to schedule around this a bit by staggering due diligence teams visits, or by making sure that an adequate number of contacts are available to answer questions and provide data. If the scheduling crunch cannot be avoided, certain providers may be able to be briefed together by the same company contact on common subjects.

At the same time, it is unrealistic to put all service providers in one big conference room and drag them all through the same presentations, which may be focused on only one discipline. If a lender requires a periodic update of the appraisal and field audit, staggering this due diligence in consecutive months rather than having both teams on site at the same time is a feasible option.

Satisfy Confidentiality and Permission Requests Up Front

Ensure the needs of the company are known ahead of time and iron out confidentiality and process issues in advance before these issues hold up a due diligence team on site. If a company is going to require separate confidentiality agreements for each service provider this should be taken care of immediately so that it does not delay the process later. Most appraisers want to document assets with photographs, so permissions required for photography should be acquired early in the process, and restrictions or requirements related to this issue should be addressed by the deal team ahead of time.

Determine and Clearly Communicate Ineligibles Early

The early determination of ineligibles and a centralized and clear approach to how they should be handled by each deal team mitigates delays and minimizes data requirements and/or speed of delivery of appraised value conclusions. If ineligibles are known, these should be centrally and clearly communicated to each related due diligence team, regardless of whether it is an inventory related ineligible, a leased piece of equipment or a parcel of real estate held for sale and not part of the ongoing operations of the company.

Due diligence teams should be proactively put in contact with each other to enable them to reconcile the assets to the agreed upon eligible borrowing base. The borrowing base numbers and any updates should be provided in a timely fashion to each due diligence team to allow reconciliation and updating of shifts in eligibility.

Fast tracking the due diligence process will be a win for all parties. The costs of delay are real and tangible to a lender. These costs include:

- Delaying the delivery of the conclusions of value from the appraisers; consummating the deal may not be possible and the earlier this is known, the better position the lender is in to mitigate its internal and external costs related to the deal;
- Delaying delivery of the lender's term sheet, perhaps allowing a competing syndicating team an exclusive window of opportunity;

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- Frustration of the bank's client; delaying the deal will typically cost the company being appraised money, and that will weaken its finances and collateral and sap its good will related to the transaction;
- Delays may increase the cost of due diligence whether it be from an internal or external audit team or a frustrated appraisal firm that spent five weeks completing what could have been completed in three.

Missing deadlines, poor data and information flow, and reworking previously completed borrowing bases and appraisal valuations engender costs that fall heavily on service providers, but also impact the resources of a lender, and ultimately the company as well. Deals subject to extensive delays form a poor foundation for future cooperation between the lender and the company. abfj

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