

Due Diligence – Brief overview and challenges



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In any public offering, due diligence is a very critical and time consuming part in the entire process. Under the SEBI regulations, the merchant banker is entrusted with the responsibility of conducting the due diligence in order to assist the investors in making an informed investment decision. The due diligence process plays a critical role in ensuring that the offer document is of high quality, contains adequate disclosures regarding the issuer company and achieves the right balance between company's business and liability. Typically, due diligence is divided into the following three aspects: business, legal and finance and accounting. However, given the significance of the due diligence process, it entails a comprehensive investigation of all material aspects regarding the company and requires gathering and verifying all of the material information included or incorporated by reference in the offer document.

Due Diligence – Potential Liability

The SEBI regulations, Companies Act and other relevant regulations impose potential liability on the issuer company, its directors and officers, the merchant bankers / underwriters, and the auditors or other experts, for material misstatements or omissions in connection with the public offering. Although the regulatory framework does not prescribe a specific definition for "due diligence", in practice, the objective of due diligence is to collect all the information about the Issuer company that is necessary for investors to take an informed investment decision. It should be noted that although the merchant banker is held responsible for overall due diligence by SEBI, expert assistance is always necessary, because the merchant banker may not possess the expertise in certain areas like legal, secretarial and accounting matters.

SEBI requires the merchant bankers to submit due diligence certificates in their prescribed formats at different stages of a transaction. Analyzing such due diligence certificates, we can outline the scope of the due diligence process and expectations from merchant bankers as follows:

- i) **Issuer's Absolute Responsibility:** Although merchant bankers are responsible for the quality and totality of the due diligence, the ultimate onus regarding the accuracy and completeness of the information provided lies with the issuer company. Essentially, the due diligence should progress with continued discussions and support from the issuer company in addition to reviewing the documents provided.
- ii) **Representation of facts in the offer document with due evaluation of documents:** A merchant banker is required to evaluate the documents provided by the issuer company to understand the factual status of the business, which needs to be presented to the investors at large. A thorough review of the due diligence documents provided by the issuer company, continuous follow up with queries and requests for additional documents as and when required and consequently disclosing the information in the offer document can be considered as adequate diligence exercise.
- iii) **Independent evaluation:** SEBI expects the merchant bankers to independently review and evaluate all documents and information provided by the Issuer. Therefore it is important that while conducting due diligence exercise, to the extent possible, merchant bankers should carry out or engage independent advisers / experts to carry out verifications on information provided by the issuer company. In order to ensure that the contents of the offer document are reviewed and verified by experts, the Issuer, in consultation with the merchant banker appoints advisors like domestic legal counsels, international legal counsel, accounting firms, tax experts, professional architects, etc. Merchant bankers and the legal advisors often engage into discussions with key management personnel of the issuer company, conduct site visits and independent background checks on the issuer company, promoters, group companies, directors and management. Websites such as www.watchoutinvestor.com, www.cibil.com, www.rbi.org.in are often useful for background check.

Categories of Due Diligence and Responsibilities

The goal of the due diligence review is to independently investigate and verify information about the company and its business to ensure the information contained in the offer document is accurate and that the offer document includes all information about the company's business, operations and financial condition and prospects that would be material to investors.

Accordingly, the due diligence investigation will include requesting and reviewing documents and records regarding the company and its operations, asking questions of management, key employees and the accountants, and reviewing public records and other outside sources.

The categories typically covered by the due diligence review include business, legal, finance and accounting information about the company. The merchant banker and legal counsel prepare a comprehensive due diligence checklist covering all categories of the due diligence review. The documents required under the checklist is required to be provided on a consolidated basis. Typically the checklist is prepared by the domestic legal counsel to the underwriters and is reviewed by the domestic legal counsel of the issuer company and the international legal counsel. In preparing the list, legal counsel typically begins with a list from prior deals and modifies it to reflect the particular circumstances of the company's business and industry.

The initial checklist gets supplemented in due course of the due diligence process, based on the review of documents and information provided.

Legal Due Diligence

Legal diligence generally includes a review of corporate documents, minutes of the board and shareholders meetings, secretarial documents, filings with registrar of companies, shareholder information, details of group companies and subsidiaries, details of promoters, contracts, government approvals, legal proceedings, intellectual property, tax matters, employment and labor matters, compensation and benefit plans and arrangements, real estate, environmental matters, regulatory clearances and licenses, etc.

The key purpose for legal counsel in reviewing documents is to identify any issues that would be material to investors so that required disclosures can be made in the offer documents. In addition, the due diligence review should identify issues that may adversely impact the company and the success of the offering, such as material litigation or the pending expiration of a material contract.

Underwriters' counsel and the company counsel works with the issuer company in gathering the relevant information to conduct legal due diligence. Pursuant to the legal due diligence, the underwriters' counsel and company counsel are required to provide legal opinions to the underwriters at closing.

Business Due Diligence

Business and financial diligence will include management presentations and discussions, question and answer sessions with management and key employees, review of historical and projected financial information, review of budgets and business plans, evaluate the key business strengths and strategies, visits to company facilities, calls with customers and

suppliers, and discussions with the company's accountants.

The lead merchant banker and the international legal counsel typically lead the business due diligence review. The offer document includes following sections which are particularly influenced by the business due diligence – business section, risk factors and management discussion and analysis. These three sections are generally drafted by the international legal counsel and reviewed by the domestic legal counsels. Although domestic legal counsels usually are not directly responsible for the business diligence review, it helps coordinate the review and needs to discuss and understand the results of the review in order to identify and understand issues that may impact the offer documents and the offering process.

Finance and Accounting Due Diligence

As per SEBI regulations, the issuer company needs to provide the restated audited financial statements for the previous five financial years along with any stub period such that the latest audited financials are not older than six months. The statutory auditor of the issuer company needs to provide the restated financials to the issuer company and the merchant bankers.

Additionally, the accountants need to respond to questions from the underwriters and their counsel about the company's financial information and accounting matters and also negotiate and deliver comfort letters to the underwriters at each of the following stages: (i) prior to filing the draft offer document (DRHP) with SEBI; (ii) prior to filing the ref herring prospectus (RHP) with registrar of companies; (iii) on pricing and filing of final offer document with registrar of companies; and (iv) on allotment of shares. These responsibilities entail a comprehensive review and investigation of the company's financial and accounting affairs by the accountants. The auditors are also required to provide the merchant banker additional certificates like certificate of tax benefits, certificate on objects of the issue, consent for inclusion of name in the offer document as statutory auditors and as experts.

Timing and Process

The underwriters' counsel and company counsel typically commence the due diligence process by delivering a due diligence request list to the company and its counsel. The company will gather and organize the requested information and respond to questions and additional requests from the underwriters' counsel and company counsel, based on their review of the information and documents provided.

Typically, the company will set up a website with restricted access, referred to as a virtual data room, and load the requested documents onto the website for members of the working group to access. Additionally, underwriters' counsel or company counsel will prepare a questionnaire for the company's directors and officers that are designed to obtain required disclosures for the

offer document, the standard certificates and undertakings and any other filings with SEBI and stock exchanges.

Business discussions are held with the issuer company in the form of meetings or conference calls wherein management and key employees of the company make presentations about the company's business, operations and prospects and respond to questions from the underwriters and their counsel. During this time, the underwriters may also conduct site visits to company facilities.

The merchant bankers and the issuer company conduct drafting sessions wherein the disclosures in the offer document are reviewed in detail and comments are taken from all parties. Separate drafting sessions may also be conducted for business and non-business related contents.

The underwriters and their counsel also arrange "bring-down" due diligence calls with the issuer company and the statutory auditor at various stages, including (i) prior to filing the draft offer document (DRHP) with SEBI; (ii) prior to filing the ref herring prospectus (RHP) with registrar of companies; (iii) on pricing and filing of final offer document with registrar of companies; and (iv) on allotment of shares.

These bring-down due diligence calls consist of asking the issuer company and the auditors questions to confirm the results of the original due diligence investigations and that there have been no material events or changes affecting the company or its business, operations or financial position since completion of the initial due diligence investigation. Representatives of the company, the underwriting syndicate, company and underwriters' counsel and the auditors typically participate in the bring-down diligence calls.

Precursors for a successful due diligence

The success of due diligence exercise depends mainly on the availability of documents and information with the issuer. It is the responsibility of the merchant bankers to educate the management of the issuer company about the requirement for complete and accurate disclosures in the offer document as well as the risk and liability associated with incorrect or inadequate disclosures. The following steps may be taken to make the due diligence process more effective.

A. Setting up a due diligence team at the issuer company

- i) Discuss the due diligence process with the key persons from issuer company
- ii) Assist the issuer company in setting up a due diligence team as the main point of contact
- iii) Involve the key management personnel like the CFO, Company Secretary, Business Heads in the due diligence team in an active role
- iv) Provide a due diligence checklist to due diligence team to start with, to be supplemented later based on the outcomes

B. Reviewing the progress and timelines on a continuous basis

The timelines of a due diligence exercise may vary significantly depending on the issues raised while reviewing the documents. It is therefore pertinent to keep an eye on the overall timelines set and review the same periodically viz-a-viz the actual progress.

C. Raising legal or business issues well in advance

Any material issues faced in the legal aspects or business should be raised with the issuer company as and when such issues surface. Issuer companies often manage their databases in a decentralized manner, which may further increase the response time for issues and queries raised by merchant bankers or legal counsels.

D. Keeping the team informed about major timelines

The due diligence process should largely be completed prior to the filing of the draft offer document with SEBI. However, due to the continuously changing business environment and market conditions, the due diligence process continues even after the filing of draft offer document, until the completion of listing of the shares. In order to ensure timely completion of the incremental diligence activities, it is a prerequisite to keep the team aware of the critical dates or milestones in the due diligence process.

Key challenges in due diligence process

A. Inadequate disclosures by issuer company

Any incomplete disclosures of the documents by the issuer company to the legal counsels may result in less or incorrect disclosures in the offer document. As the documents and information is best known and available only with the issuer company, the merchant banker and the legal counsels may not be in a position to identify such inadequacies in disclosures.

B. Overseas liabilities faced by issuer company

Issuer companies that have overseas business or contracts may be subject to legal proceedings in countries other than India. Although the international legal counsels are entrusted with the business diligence from an overseas perspective, certain liabilities may not surface while preparation of offer document due to limitation of expertise of the international legal counsels.

C. Managing timelines of due diligence

Due diligence is an extensive and time consuming process. However, the success of a public issue is also highly dependent on the applicable market conditions. A critical challenge here can be seen as completion of the due diligence process and launch

the issue in a conducive market window, because any delay in launch may result in drastic changes in market conditions, eventually risking the issue itself.

D. Magnitude of data management

In case the issuer company belongs to a large conglomerate group, gathering the information and

documents itself may pose a challenge in terms of data management. Also, certain sectors like infrastructure or power are inherently complex in terms of documentation and data management due to the extensive regulatory approvals required by them. Due diligence of such issuer companies essentially puts a challenge of effective data mining and assimilation for the legal counsels and lead managers.

Key Reference: Due Diligence Manual, Association of Investment Bankers of India (AIBI)
