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Legal Due Diligences for private equity transactions: a powerful tool if used correctly

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Local and cross-border private equity investors continue to support the growth and development of companies in South Africa, as well as the economy as a whole.

With an increase in the establishment of private equity funds both globally and in South Africa, as well as their appetite for investing in emerging markets, keeping track of the approach of private equity funds and M&A lawyers to legal aspects surrounding private equity deal-making is becoming increasingly important.

One of these aspects that require careful consideration is the need to conduct a thorough legal due diligence to identify and understand material legal risks associated with the business and affairs of the target company or group.

Whilst investors or the counter parties to a potential transaction will typically have a pre-determined view on the time frame for the conducting of a legal due diligence and thereafter for the negotiation and closing of the transaction, experience has shown that the amount of time required to conduct a thorough due diligence into the business and affairs of the target is sometimes underestimated by the parties.

In this article, we discuss some of the key considerations which private equity investors should bear in mind in the context of how they approach legal due diligence investigations.

A realistic timeline for the transaction process and recognising the value of conducting a due diligence

Whereas a projected timeline to conduct a due diligence and close a transaction is important and necessary, it is sometimes the case that sufficient time is allocated for contract negotiations and the preparation of the transaction documents, but that too little time is allowed for conducting a proper legal due diligence investigation.

The reason for this, in some cases, is that a legal due diligence is viewed as a "formality" which could be completed in a short space of time (or which could be completed concurrently with drafting and negotiating the transaction agreements).

Some view it as an expensive exercise and misguidedly believe that they can instead "negotiate warranties, indemnities and ask for security" to cover themselves for any risks which would have been identified by the legal due diligence.

This is an over-simplification of the issue because it begs the question: how can one negotiate and draft for the appropriate protections in a contract if one does not have a clear understanding and appreciation for what risks and issues they are trying to protect themselves against?

Bearing in mind that a legal due diligence is aimed at identifying risks associated with the target, the outcome thereof will often lead to an adjustment of the timeline for the negotiation of the transaction agreements that could not have been foreseen at the onset.

For example, where a material risk is identified which could result in a substantial liability for the target (and by implication for the investor), investors may seek to negotiate contractual protection in order to be adequately indemnified against such risk (over and above "usual" warranties and indemnities included in a sale or subscription agreement).

This could include an escrow arrangement or the need for warranty and indemnity insurance or the provision of a guarantee by bank or affiliate of the target or seller, all of which the parties would not have been expressly contemplated at the time of the term sheet negotiations and which necessarily have an impact on the timeline for the transaction process.

It should also be borne in mind, when determining a deal-making timeline, that a legal due diligence can only effectively commence once the target is in a position to collate all information and documents relevant to the due diligence and to populate such information and documents in a virtual data room to enable the investor's attorneys to review same.

For the above reasons, it is advisable for a private equity investors to engage with its legal advisors at an early stage (preferably at the term sheet stage) in order for them to assist in the determination of a realistic timeline for the due diligence.

This can help to ensure that the appropriate time and resources are allocated to the conducting of the due diligence which in turn will result in better quality information and valuable insights on the target being provided to the investor which will place it in a stronger position for the negotiation of the transaction documents.

The old adage "knowledge is power" remains applicable in private equity transactions just as it does in other spheres.

The source of the knowledge held by an investor in respect of a target is primarily the legal due diligence conducted and the quality of such knowledge will depend on how it is conducted and whether sufficient time and resources are allocated to the conducting of it.

Transaction structure

Whereas parties often contemplate a specific transaction structure during term sheet negotiations or the submission of an expression of interest letter ("**EOI**"), the outcome of a legal due diligence investigation will often dictate changes to the initially conceived structure for the transaction.

By way of example, the parties may have intended to conclude a sale of shares agreement, however issues identified during the legal due diligence may cause an investor to conclude that there are good commercial reasons to structure the transaction differently (i.e. as a sale of business).

Alternatively, following the outcome of the due diligence, investors may seek to restructure the target group prior to becoming a shareholder in the holding company of the target group (as there may be good commercial, strategic or tax reasons to do so).

Such a determination will then lead to an investor requiring that additional suspensive conditions (which would not have been contemplated in the term sheet or EOI) be negotiated and included in the transaction agreement, in order to achieve such a restructuring prior to the implementation of the investor's investment in the target group.

Price adjustments

Having regard to the material risks or issues identified in the legal due diligence and the extent to which such risks or issues are able to be resolved or mitigated against by contractual or other measures, certain of such material risks or issues may justify the investor in negotiating a downward price adjustment to take account of the commercial/finance impact of such risks/issues on the valuation of the target.

Therefore, when negotiating a term sheet or concluding an EOI, sufficient flexibility should be included to allow for subsequent price adjustment of the proposed purchase/subscription consideration offered based on the outcome of the legal due diligence.

The valuation methodology used to determine the purchase price may also inform the nature of the legal due diligence to be conducted.

For example, if a net asset value pricing methodology is used, then the nature, title and encumbrance of the assets and the finance and debt agreements will be of particular relevance, whereas if an earnings multiple pricing methodology is used, such as using EBITDA, then the material customer and supplier agreements of the target will be of particular relevance.

These considerations can impact on how much time and resources are allocated by the investor and their legal advisors in focusing on particular areas and documentation of the target.

Conclusion

Where parties only have a short window to implement a transaction, the need to conduct a thorough legal due diligence should still be prioritised.

The outcome of the legal due diligence will often impact on the projected timeline as the findings thereof may give rise to further negotiations between parties on risks and issues identified, and can result in changes to the transaction structure and the negotiation of additional suspensive conditions.

By giving adequate time and attention to the conducting of a legal due diligence, a private equity fund is able to place themselves in the best possible position when negotiating the purchase price as well as other salient terms to be included in the transaction agreement, which could include escrow arrangements and other forms of security, warranties and indemnities and even price adjustment mechanisms that take into account risks and issues identified through the due diligence).



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