Stockholm School of Economics
Department of Accounting
Master Thesis in Accounting and Financial Management
Spring 2012
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The Art of Due Diligence

A study on private equity firms acting in the Swedish market

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Abstract

This paper describes the due diligence process as it is used by private equity firms acting in the Swedish market. The aim of the study is to investigate the value enhancement that the advisers provide in a due diligence, both from the perspective of the adviser and of the private equity firm. We do this by identifying what constitutes good due diligence, if the due diligence affects an investment decision and whether or not the private equity managers and advisers perceive the due diligence in the same way.

The study was conducted by including representatives from 11 private equity firms, 4 consultancy firms, 2 law firms and 4 credit institutions which resulted in a total of 18 interviews and 4 survey answers.

We find that due diligence has implications on the valuation and structure of the deal and mainly provides comfort in the investment decision. However, it has limited impact on the investment decision as it very seldom causes the deal not to go through. Finally, we conclude that the due diligence process is becoming institutionalized and that the private equity firms can gain legitimacy for their investments from stakeholders, such as the investors and the banks, by doing a due diligence and as an effect receive financing for the deal.

Keywords: due diligence, private equity, buyout, investment decision, consultants

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Acknowledgements

We would like to thank the respondents who made this study possible to perform. We are especially thankful to the private equity managers, consultants, lawyers and bank representatives who gave us valuable information and insight in the due diligence process. Furthermore, we are grateful for the important assistance provided by our tutor Henrik Andersson throughout our work and Per Strömberg for helpful advice regarding the private equity industry. Lastly, we would like to thank our fellow students for inspiration and thoughtful comments along the way which has resulted in this master thesis.

May 14th, 2012

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1. Introduction

1.1. Research Background

Businesses are complex institutions consisting of many interrelated functions and activities. Potential acquirers or investors must be able to identify, understand and evaluate the pros and cons of each aspect of their investment as efficiently as possible. Due diligence is the process in which an individual or an organization seeks sufficient information about a business entity in order to be able to take an informed and rational decision for a specific purpose. (Spedding, 2009)

The term due diligence comes from Anglo-American law (Pack, 2002) and the process has evolved over decades by tradition in the USA. (Spedding, 2009) It is originally aimed at protecting the interest of investors by reasonable investigation where the standard of reasonableness has been described as that required of a prudent man in the management of his own property. The concept has been transformed into a preventive exercise aimed at identification, disclosure and limitation of risks. (Pack, 2002)

Prediction for how due diligence will look like in 2020 have been made by Lajoux (2011). She claims that the due diligence investigation will be linked to the whole acquisition process, from pre-deal strategy to post-deal integration and that high-tech tools such as decision-making instruments and electronic data rooms will become routine and enable a more efficient process. (Lajoux, 2011) Our perception is that due diligence is continuously increasing in its use. Furthermore, it seems like due diligence is taken for granted in an acquisition process, but there is however no clear picture of how the investigation actually affects the decision-making. The ambition of this study is therefore to investigate the due diligence process as it is performed and used at present time in order to understand what are important aspects of the process and being able to draw conclusions about its impact on the decision-making in an acquisition.

Today, due diligence is performed in a wide variety of situations and can deal with financial and non-financial concerns in order to investigate and evaluate a business opportunity and determine the potential future of the business. The main due diligence topics are financial, legal and commercial due diligence respectively which will also be subject to investigation in this research. The need of a due diligence process is of importance in the context of an acquisition where one is dealing with the complexity of an individual organization operating separately from that of the acquiring entity. (Howson, 2003) Furthermore, the lack of adequate due diligence has been described as most evident in the area of acquisitions which is shown in the poor performance experienced by many corporations. Due diligence is often blamed as being the reason for these transactions not living up to their expectations or failing completely. (Crilly, 1998; Howson, 2003; Bing, 2008) This paper will focus on the processes, context and typical aspects of due diligence preceding the activity of an acquisition. Furthermore it will focus on the acquirer's perspective and the use of external providers of due diligence in order to investigate what has been said about how an acquirer succeeds with an acquisition on the way to a takeover and what are potential learning points from good and bad due diligence respectively.

Due diligence is often used for the review process applied to an investment by private equity firms. Those firms have had extremely high levels of activity regarding acquisitions, such as buyouts, in recent years and consist of workforces of investment professionals, specialized in company acquisitions and development. (Lerner, Hardymon, & Leamon, 2008) As the private equity firms make a substantial amount of acquisitions they are used to buying external advice for performing the due diligence. We thus consider them as a central force in the development of the due diligence. Therefore, we focus on private equity firms with regards to the acquirer in the due diligence process.

1.2. Purpose and Research Questions

Due diligence has been said to make the difference between a good and a bad acquisition. (Spedding, 2009) The focus of recent literature has however tended to describe the process, from the provider's perspective, and how it should be performed step by step. Our paper is an attempt to investigate the value enhancement that the advisers provide in doing a due diligence investigation, not only from the perspective of the provider himself, but also the acquirer of the service, that is, the private equity firm. We do this to find out if the parties think that they have gotten out the most of the process, what are critical steps in practice and lessons to be learnt from previous experience.

Four main questions are addressed:

1. ***What is due diligence?***

This question is aimed at providing a general understanding of the due diligence process and how it is performed.

2. ***When has the due diligence worked well and bad respectively?***

The purpose of the second research question is to explore good and bad experiences of due diligence. We want to investigate how the ideal due diligence process looks like in order to find some kind of best practice with regards to optimizing the investigation. Furthermore we notice that previous literature tend to focus on *what* went wrong in a due diligence process. We want to take one step further and elaborate upon *why* it was not possible to capture what went wrong in a deal and how it could possibly have been prevented.

3. ***Do the involved parties, that is, the private equity firms and the consultants, perceive the due diligence process in the same way or differently?***

Regarding the third question it lies in our interest to learn more about the involved parties' perceptions about themselves, each other as well as other things relating to the due diligence process in order to understand if they have gotten out the most out of the investigation. If the parties for example do not have the same perception of what is happening throughout the process, then it might be that it has not been done efficiently. That is, there may be room for improvement.

4. ***How does the due diligence affect the decision-making with regards to an investment?***

The fourth question is interesting as it challenges what the literature says about the importance of due diligence. Due diligence has been said to be the norm in decision-making and vital in every acquisition. We intend to investigate if due diligence is as essential as it is described to be by finding out what difference it does in decision-making. Does the due diligence affect the decision about going through with a deal or not, or has the private equity firm already made up its mind with regards to the transaction?

1.3. Scope of the Investigation

In order to fully understand the due diligence process we have chosen to include the buyer, the provider of the service and the debt provider in our study. The ones performing the due diligence are often consultancy firms and lawyers which are approached respectively. Regarding the buyer, as pointed out earlier, we will take the perspective of the private equity firm. As they frequently do many deals we conclude that they have the appropriate experience in buying the due diligence service from outside professionals to learn from them and add value to our study. Furthermore, as Sweden is one the most prominent countries in the European private equity market (SVCA, 2012) we consider this market to be an appropriate choice for conducting our research. Within this market we get access to a variety of private equity firms with regards to the size of the firm, type of investments conducted and number of years of experience within the industry.

Due to the nature of the private equity firms, they are dependent on successful investments. The first part in the investment process is to find and assess a possible target company. Therefore, the due diligence process becomes very important. This is the process that we attempt to investigate, that is, the process of determining whether or not the company that the private equity firm intends to invest in has the potential of future success or not. We hope to learn from the private equity firms how this is done in practice and what actual effect this process has on their final investment decision.

Since we aim to study the whole due diligence process that is performed in an acquisition we have chosen to focus specifically on the buyouts made by private equity firms. Buyouts by definition constitute the acquisition of an entire company which results in a comprehensive due diligence. Furthermore the buyout targets are mature companies allowing for the investigation of past performance and the connection to future development.

Within the due diligence, we have chosen to focus on its three main topics; financial, legal and commercial due diligence respectively. Those cover the greater part of the due diligence process and are frequently used by most buyers of the service. Thus, it seems reasonable to include them in our study in order to get a good understanding of the process.

1.3.1. Key Concepts

As an acquisition can refer to various integration options we want to clarify our intention throughout this report in that we focus on the type on integration present within a buyout, that is, a holding. A holding indicates that the acquired company is held to be developed and sold at a later stage. (Spedding, 2009) Therefore, when we refer to acquisitions or deals, we allude to a buyout.

Furthermore, with regards to the external provider of the due diligence investigation we will refer to them as the adviser or the consultant. When a certain adviser, such as an accountant or a lawyer, is referred that will be explicit.

2. Method

2.1. Qualitative Study

In order for the study to fulfill its purpose we have chosen to make a qualitative research. It allows for interpretation of observations and to find characteristic features of the due diligence process. Our goal of making a qualitative research is to study due diligence from the perspective of the involved parties and to get a comprehensive understanding about the process and its role in decision-making. By meeting with an extensive number of interview objects, learn from previous literature and take into consideration what has been said in previous research papers, we enable for the incorporation of a broad combination of observations which allow for the triangulation of data. We think that this will increase the credibility and validity of the results. Furthermore, we are positive that including a broad span of respondents and comparing and contrasting different opinions will be beneficial for the generalizability of our findings.

In order to improve our knowledge about due diligence and get the most out of the research questions we started off by going through various sources of information about the due diligence process and documenting what it includes and how it is structured. Then we continued with the essential part of getting to know what has gone well and bad in the due diligence process. This is where the knowledge of the private equity firms and the experience of the consultants are critical ingredients. Thus, the interviews laid ground for an interesting discussion that complements what has been said about due diligence to this day. Our last step was to get a feel for what role the due diligence plays in the outcome of the final decision. By approaching the private equity companies and ask for their opinions with regards to what difference a due diligence makes, we learnt more about the importance of the investigation.

2.2. Sources of Information

2.2.1. Respondents

As we feel that personal meetings generate the most valuable information when it comes to the extent to which explaining and further reasoning can be made and follow-up questions can be asked, we have aimed for conducting personal interviews first and foremost. We have made one questionnaire for the consultants, private equity firms and banks respectively that make up the basis for the interviews. A great deal of planning was made in advance of the interviews in order to be properly prepared and to get the most out of the valuable time that the knowledgeable and experienced parties provided us with. The interviews lasted for 30 to 80 minutes.

2.2.1.1. Private Equity Firms

Regarding the private equity firms we intended to meet with as many companies as possible whose business were in line with the scope of our investigation. We therefore scanned the market by writing down all the private equity firms that were members of SVCA operating as well as having an office in Sweden and being engaged in the later stage of the investment cycle, i.e. performing buyouts. Another criterion was that the private equity firms needed to be doing investments in several industries in order to avoid industry-specific answers in our interviews. In total we contacted 15 firms out of which 11 responded and joined our research. Those firms had a spread on the size of their recent investments ranging from SEK 100 million to more than SEK 5 billion. We consider this to be a satisfying sample of respondents more than well providing a fair view of the overall perception of due diligence within the private equity firms operating in the Swedish market.

Further, the one most important criterion in approaching interview objects within the private equity firms was that the person in question should have experience from buying external advice when it comes to the due diligence investigation done in a private equity investment. People from various backgrounds, different number of years of experience within the private equity industry and diverse authority within the organization were interviewed to get a varied and balanced response. In order to highlight the valuable experience of the interview objects we hereby provide information on their positions within the companies respectively. Four were partners and investment managers, two were senior investment managers, one was a member of the investment committee and four were representatives of the junior investment analysts. Therefore we have met with people who are specialists within our area of study. Some of the private equity managers that we spoke to even had a background within the consultancy industry and thus had previously provided due diligence service to private equity firms themselves. It total, we held six interviews with the private equity firms face-to-face, two of the interviews were conducted over the phone and the last three interview objects responded via the questionnaire survey provided online.

2.2.1.2. Consultants

With the intention to get a weighted picture of the different types of due diligence, that is, financial, legal and commercial respectively, we interviewed two to three consultants from every category of investigation. This resulted in seven interviews conducted in person with both authors present. In order to enable for a flowing discussion and continuous attention in the conversation one of the authors asked the questions during the interviews and the other took notes. Interview objects were chosen based on their experience and knowledge within the field of performing due diligence in private equity deals. This means that people from various levels within the organizations and with different exposure and role in the due diligence process have been interviewed which has generated a satisfying spread in the variety of views sought in this research.

To begin with we met with five representatives from three well renowned accounting firms respectively. The firms were able to handle the biggest deals completed in the Swedish market, but performed due diligence on smaller deals as well. The representatives had experience reaching from three up to 25 years providing us with a satisfying variety in the response. Further, we conducted interviews with two lawyers from two of the most prominent law firms in Sweden. The respondents both held high-level positions within the firms with a long experience within the field. Lastly, two interviews were held with commercial due diligence providers at two highly successful firms in the market. Those firms have different ways of conducting their business and their representatives came from diverse backgrounds performing separate parts of the due diligence investigation which we think resulted in a proper view of the investigation.

2.2.1.3. Credit Institutions

We have also included representation from four of the major Nordic credit institutions in our study. Three structured interviews were held and one response was received via a questionnaire document. In total we got answers from six representatives who gave the banks' view on the due diligence process and important aspects therein. Four of the interview objects were people from the acquisition finance department and two were representatives from the mergers and acquisitions department. It is important to emphasize though, that the two persons from the mergers and acquisitions department had long experience from various firms in the kind of deals that we were referring to in our study. Therefore, they could provide us with an extensive picture of how the due diligence process is initiated, carried out and their perception of the implications it has on the final decision.

2.2.2. Literature

Previous literature and research papers on acquisitions, due diligence and private equity respectively have provided guidance in assemble, interpret and being able to draw conclusions regarding the findings from our empirical study. Furthermore, recent literature has also been a valuable source of information when it comes to developing our original understanding about the due diligence process and finding interesting aspects of the investigation.

2.3. Method Discussion

In order for the reader to be able to know something about the applicability of the results from our study we hereby discuss relevant aspects of our research.

2.3.1. Validity and Reliability

To fulfill reliability regarding our course of action in the study we have attached the interview documents that have laid ground for the research in the end of this report. Regarding the interview objects, our intention has been to get a view of the due diligence as varied as possible. This is shown in our extensive list of the number of interviews performed. Therefore, we can with certainty claim that our study is not affected by chance or contingent circumstances and if it was to be replicated today there is a good possibility of getting the same kind of answers. However, as the private equity firms operate in an uncertain, fast-moving environment, performing similar research in a different period in time might give another view of the perception of the due diligence process. But, as we have taken both a general approach as well as asked for specific cases during the interview sessions and compared various opinions referring to different cases we consider to have come up with robust results, at least up to this date.

It should be noticed though that we have adapted the questions to the situation, that is, not all questions have been asked during every interview session, and some questions have under some circumstances been added in order to get the best picture possible in every case. We aimed at creating an atmosphere of mutual trust to get the most out of the discussions and how we asked the questions surely had implications for the answers we received. As the purpose of the study is to describe the phenomenon of due diligence according to our understanding about how the involved parties perceive the process, we think that this procedure has added the most value to our research. However, as a consequence of the semi-structured interviews and subjectivity that permeates our results, replicating our research may not lead to identical conclusions. Those are our own.

This being said, some comments about the validity of the research follow naturally. The degree to which the research results are interpreted correctly and depict reality may be deteriorated by the subjectivity in our interpretations and analysis of the empirical findings. Personal identifications and understanding is unavoidable in a qualitative study of this kind as it is part of its purpose. The validity of our study has however been increased by both authors summarizing our own perceptions of the findings separately and then discussions were held to go through and agree upon the results. If there were any uncertainties regarding issues identified during interviews, the interview object was contacted for clarification.

Furthermore, interviews were mainly held individually but also in pairs to allow for personal opinions as well as for the persons to complement each other's answers. Thus we approached several people within the same organization with the same questions. Interviewing people from various business units and levels have the advantage of increasing the possibility of receiving company-specific rather than project-specific answers.

2.3.2. Generalizability of Results

Regarding whether the results of our study are generalizable we think that the broad span of respondents, both from the provider and buyer of the due diligence, have generated a wide variety of perceptions. This research is based on many different cases and thus it represents an aggregate perception within the industry of study and can be applicable therein. As we have a clearly defined scope in which our research is conducted, it may be plausible to generalize our findings within a similar context, that is, in the environment in which due diligence is described in our particular case, that of the private equity firm.

2.3.3. Focus of Previous Literature

Previous literature on due diligence tend to focus on a merger and acquisition situation where an industrial player is the buyer. As a consequence the literature is intensive in terms of integrating two companies and questioning the ability of realizing synergies. Therefore, previous literature has been of limited use in this research report and our own empirical findings, with regards to important aspects of due diligence, thus come into greater light.

2.4. Structure of the Report

Due to the objective of our study we believe that the research is best presented in an integrated solution. We will alternate previous research with our own empirical findings as we think that this will increase the readability of the report and thus facilitate for the reader to follow our reasoning.

Understanding due diligence in an acquisition made by private equity firms requires a sense of the whole as well as of all the key parts. (Lajoux, 2011) Therefore, we start by providing a description of the private equity firms and their strategy in order to understand how they use the due diligence in conducting their business. Then we give a brief explanation of how their typical investment process is carried out and the importance of due diligence in this type of transaction. The focus of the rest of the report is on the due diligence process; what it is, the purpose of the investigation and who conducts it and how it is done. Then we go into greater depth on how due diligence is conducted in various areas; financial, legal and commercial respectively. Furthermore, certain trends as well as limitations of due diligence, both as portrayed by the literature and captured in our empirical study, are described.

3. Private Equity

3.1. Private Equity Firms

Private equity as compared to public equity is non-traded equity that can be financed in a number of ways. Examples of investors are business angels, venture capital firms and buyout firms. They are all active in different stages of a firm's business cycle performing everything from seed investments to buyouts. While seed investments are made in business ideas in order to give raise to running companies and venture capital investment are made within the expansion phase, buyouts are rather the investments in mature companies. Active owners with financial capabilities can potentially facilitate further growth. In terms of total private equity investments, buyouts are the most common type of investment. (SVCA, 2012)

According to Lerner, Hardymon, & Leamon (2008) private equity firms fill a financing gap of projects left by the banks which are categorized with high risk and the potential of providing high reward. Such projects could for example be troubled companies with a need for restructuring. Unlike banks, private equity firms can invest in equity and thus take advantage of potential upside.

The funding for the investments made by the private equity firms come from investors like pension funds, insurance companies and endowments who look for illiquid investments with a long investment horizon. Private equity funds, which are managed by the private equity firm, can offer such investment opportunity and also have the knowledge to make investments in high-risk projects. (Lerner, Hardymon, & Leamon, 2008)

The private equity firms' organizations are often small with a limited number of employees. The investment managers are the ones who assess new investments and keep track of portfolio companies. Private equity firms typically also consist of an investment committee which evaluates the deals and takes the final investment decision. (Nyman, 2002) From the conducted interviews in our study it has been explained that due diligence is directed by the managers within the private equity firms and ultimately the result of the investigation has to be presented to the investment committee.

It has also come to our knowledge that the employees in the private equity firms have generally invested in the private equity fund. Those employees are thus called partners. Some of the interview objects have expressed a higher personal involvement in new investments as a consequence of the correlation between fund performance and private wealth.

The size of the private equity firms' investments differ although most firms have an upper and lower limit for the investments undertaken. Those limits often refer to major investments whereas add-on investments can be substantially smaller. (Nyman, 2002) The private equity firms have well-defined strategies for the investments that they undertake. The size of the investment is one important parameter of the strategy and the private equity firms in our study undertake investments within a span of SEK 100 million to approximately SEK 20 billion in terms of enterprise value.

3.2. Historical Development of Swedish Private Equity

The private equity industry in Sweden was developed in the late 1980's and was one of the first to flourish in Europe. The industry grew strong in the late 1990's and started to generate higher returns than the rest of Europe. Only in 2011 the private equity firms invested SEK 31 billion in buyouts. (SVCA, 2012) Lerner, Hardymon, & Leamon (2008) argue that the tax regime in Sweden together with high returns and the educated and international-oriented population have contributed to the favorable development of private equity.

Today, the private equity market is becoming more competitive and the increasing number of structured auction processes is making it harder to generate returns by acquiring underpriced companies. As a consequence, private equity firms cannot rely on financial engineering and they therefore have to generate operational improvements to a greater extent. (Lerner, Hardymon, & Leamon, 2008) This has been expressed by the private equity firms in that they highly value external advice on potential improvements of the business in which they intend to invest. Further, it has been acknowledged that the development during the last decade regarding due diligence has gone from focusing on past performance and avoiding risks to, in addition, plan for future performance.

Another issue facing the private equity market is the growing public skepticism and union activism against private equity investments. (Lerner, Hardymon, & Leamon, 2008) The private equity firms agree on the increasing importance in investigating management in the target firm and the potential investors. It is vital for the firms' long-term reputation to not let the "wrong" people invest in a deal, that is, the due diligence has to investigate, not only the business as such but also the people behind it as well as those investing in it. This is done in order to avoid involvement with crime, pollution, socially unacceptable behavior, and such.

3.3. Value Creation by Private Equity Firms

Kaplan & Strömberg (2009) argue that there are three types of engineering in which private equity firms generate value; financial, governance and operational engineering respectively. In the late 1980's there were theories that emphasized the positive effect of financial and governance engineering. Financial engineering refers to the benefit of leverage. Jensen (1986) described the disciplinary effect of debt where regular interest payments reduce cash that could be invested in negative NPV projects in favor of the management. Another effect is the tax shield generated by the debt. Governance engineering on the other hand means that private equity firms control the board of their companies and thus take an active part of the governance as compared to the owners of a public company. Previous literature has observed increasing management holding in the target companies. It is argued that this increase would result in aligned incentives between management of the firm and those of the investors generating higher returns. (Kaplan, 1989; Kaplan & Strömberg, 2009) Furthermore, Bruton, Keels & Scifres (2002) find support for agency theory in looking at companies going through a buyout and then return to public ownership, that is, the companies managed to generate higher returns under private ownership as a consequence of decreased agency problems. The perception of the empirical findings is that agency theory is important and a big part to take into consideration in a buyout as the future performance of a company is highly dependent on the performance of management. Thus, the alignment of interests starts already in the due diligence process.

Furthermore, operational engineering refers to the focus on finding possible operational improvements in the buyouts. Cumming, Siegel, & Wright (2007) distinguish between financial and real return activities respectively, where the real return activities are referring to operational improvements. From our empirical study we understand that the due diligence process fills an important function in finding and/or evaluating such potential operational improvements.

3.4. Leveraged Buyouts

The financing of a buyout is a combination of equity and debt where the debt typically makes up 60 to 90 percent of the total investment. (Kaplan & Strömberg, 2009) The term leveraged buyout is a common expression for many types of buyouts, for example a management buyout, and there is no absolute definition of the term as such. One thing is certain though, debt in an important financing component. (Nyman, 2002)

A buyout has three major phases; the entry, enhancement and exit respectively. It is in the entry phase that the target is investigated through a due diligence. Berg & Gottschalg (2004) argue that the most important step in this phase is to set the valuation of the company and through negotiations between buyer and seller reach an agreed price level. The price sets the hurdle of the future return for the investors.

As a general rule private equity firms plan to hold their investments for three to five years. However, the holding period could vary both with regards to performance of the company and the market timing for an exit. It is important for the private equity firm to plan for the exit already at the time of the investment and this is therefore a part of the due diligence investigation that is highly valued by the private equity managers. There are two main types of exits. First there is the divestment to either an industrial company or another private equity firm and secondly there is a public placement of the company. (Nyman, 2002) This is something that the private equity firms request advice on from the external consultants. It lies in their interest to have an explicit plan about the whole investment process from investing to exiting before going through with the deal.

3.4.1. The Financing

There are a number of financing alternatives for a leveraged buyout. Kaplan & Stein (1993) showed that during the 1980's banks provided the majority of debt used for financing buyouts. The loans were often short-term and there was a high degree of covenants. The reason for the popularity of bank debt was that bigger debt stakes were easier to renegotiate than diversified public debt and this is something that is valid even today. As an effect of the bigger debt stakes the banks can be more restrictive in setting the covenants and thus lower the cost of bankruptcy. Therefore, moral hazard problems can be narrowed as a consequence of stricter covenants. In addition, the banks have a greater ability to monitor the levered company compared to diversified debt holders. The incentive effect mentioned above is also increasing the attractiveness of senior debt with recurring payments. (Jensen, 1986)

Demiroglu & James (2010) find that the reputation of a private equity firm has implications for the debt in a leveraged buyout. More reputable private equity firms tend to pay a narrower loan spread and have longer maturity. There is also a correlation between the level of leverage in a leveraged buyout and the reputation of the private equity firm suggesting that reputation reduces the agency costs between the bank and the private equity firm. Our findings suggest that there is a preference for high levels of leverage, that is, the private equity firms tend to take on as much debt as possible in every specific deal. One of the bank representatives mentions though that they generally decline loans to private equity firms in nine cases out of ten. We do not find confirmation however, that a higher degree of reputation in the market and a more stable relationship with the bank would imply an increased probability of receiving financing from the bank. On the other hand there seems to be a difference in the treatment of an industrial player and a private equity firm respectively as a bank manager argues;

"Financial buyers are more accurate, while industrial buyers think they have the knowledge in-house and thus it is harder to make them purchase all relevant due diligence service."

Therefore, it seems like the due diligence investigation is more extensive in the case of an investment made by a private equity firm as compared to that of an industrial player, which seems to be something that the banks prefer. Given the private equity firms' dependence on bank financing and the fact that they know how easily the banks can reject a loan request for a leveraged buyout it might simply be that they are reluctant to disapprove the requests of the bank and are therefore very thorough in making proper due diligence.

3.5. The Investment Process

To understand how due diligence fits into an acquisition we assume that the process consists of four stages as illustrated below.

Stage 1	Stage 2	Stage 3	Stage 4
• Strategic review • Systematic search • Approach	• Heads of terms • Due Diligence	• Sale and purchase negotiation	• Post-completion

Source: Howson (2003)

Stage one is about identifying an acquisition target and making an approach which is done following a strategic review. If the approach results in an agreement to go further, the deal enters the second stage where the two parties set the broad terms of the deal in a letter of intent and the buyer begins due diligence. By identifying risks against which the buyer should negotiate some sort of protection, e.g. a price reduction or a guarantee by the seller, due diligence results in negotiations. If all goes well the sale document is signed and the deal is completed. Furthermore, due diligence should also play a major role in shaping the post-completion plan as stage four is about making the return from the new acquisition justify the price paid which in many ways is central in the work of the private equity firms. (Howson, 2003) The consultants and private equity managers describe that an important factor in the acquisition process is to as early as possible look for and potentially find so called *red flags*. Red flags highlight the most fundamental issues and risks in the target company and are summarized in a red flag report. This report is essential for private equity firms as it gives them the opportunity to kill the deal and avoid unnecessary expensive and time consuming due diligence investigation if issues that cannot be managed or accepted are revealed.

3.5.1. The Auction Process

As mentioned above structured processes, that is, auction processes, are becoming more usual as a form of an acquisition. We understand from our empirical findings that auction processes are common in private equity deals. Auction processes are initiated and managed by the seller or an investment bank. (Gole & Hilger, 2009; Spedding, 2009) Before an auction process the buyer has to justify the potential acquisition regarding its strategic fit as well as its potential to create future value, in order not to invest only because of the availability of the deal. (Gole & Hilger, 2009) Naturally then, due diligence is performed between preliminary agreement and final signing as illustrated below. (Bing, 2008)

Presentation	**Teaser**	**Information memorandum (IM)**	**Preliminary due diligence**	**Confirmatory due diligence**	**Final contract**
Information	Basic description of business with abbreviated financials	Expansive description of business and market with detailed financials	Presentation by management and access to data room	Access to detailed, proprietary information	Information supported by representations and warranties
Audience	Distributed to broad market of potential buyers	Distributed to many qualified bidders	Presentation and access limited to small number of bidders	Limited to final bidder(s)	Acquirer only

Source: Gole & Hilger (2009)

We learn from our investigation that throughout the process more information will be distributed as the number of participants decrease. The point made in interviews is that the seller does not unnecessarily want to reveal sensitive company-specific information. Therefore the seller wants as many *genuinely* interested bidders as possible. The struggle however with the buyer then is that the buyer wishes to see a satisfying probability of winning the auction already when a potential target is approached and rather wants exclusivity in the process which is expressed by many of the private equity firms. One private equity manager further explains that there is no confirmatory value in that there are many other interested bidders as that decreases the probability of getting the deal and thus makes it less attractive.

One of the consultants mentions that the auction process creates time pressure which have certain implication for the due diligence process. The manager stresses that the nature of the auction process decreases the time for questioning the information that is being provided to a great extent. Another aspect, expressed by a private equity manager, is that the current market situation, including the prevalent debt market, are causes for the varying time spans that the auction process and the corresponding due diligence investigation may take. In good times it is the seller’s market and the seller thus has the power to speed up the auction process, whereas in bad times, in which financing is restraint, the auction process most likely is prolonged.

3.5.1.1. The Due Diligence in an Auction Process

The information memorandum is a selling document prepared by the seller to present the company and estimations of its future development. A lot of the due diligence investigation is based on the information memorandum together with the data room where information about the target is provided to the buyers. Regarding preliminary and confirmatory due diligence as seen in the table above, Gole & Hilger (2009) claim that the buyer starts by doing a brief due diligence based on enough information for submitting indicative bids. After a selection of indicative bids have been accepted the buyers who are still in the process will have access to more confidential information and thus being able to conduct a more thorough due diligence. It is important to notice however, that the view we have gotten from our empirical findings is that the private equity firms can put indicative bids without having engaged all the types of consultants in the process. The literature on this aspect refers to due diligence as the phase in which the buyer investigates whether it is in their interest to invest in the target company. We want to point out that this type of due diligence investigation, i.e. finding target companies that fit in strategically is something that the private equity firms are good at doing in-house.

4. Due Diligence

4.1. Definition of Due Diligence

Due diligence is an investigation made by a prospective purchaser to confirm that it is buying what it thinks it is buying. It is about understanding more about the business being bought, examine all the facts impacting value and reducing risk. The better the due diligence, the more buyers know about a target and therefore the more they know about the risks they are taking on which will be subject to negotiation. These considerations will form the basis of reports on which ultimate investing and credit decisions are taken. Due diligence is undertaken so that the correct decisions can be made. (Howson, 2003; Spedding, 2009) The most instant and frequent answer to the question of *what is the definition of due diligence* that we have received in our interviews is risk minimization which confirms that the main objective is to protect from downside risk. However, potential upside is of high importance and has become more frequently asked for in recent years. As one private equity manager expresses;

> *"It is important to understand the possibility of improvements and how to get there. We want recommendations on the entire holding period from investment to exit."*

4.2. The Scope of Due Diligence

Due diligence assesses the deal from a commercial, financial and legal point of view. Those are the main due diligence topics that acquirers generally investigate by creating a checklist of needed information and then obtaining that information by examining financial statements, evaluating management and operations and reviewing legal liability. (Lajoux, 2011; Spedding, 2009) The assessment of these factors is undertaken by a team of professionals of varying specialties to investigate different aspects of the business. (Spedding, 2009) Financial due diligence focuses on the validation of historical information and the review of management and systems in order to confirm underlying profit and provide basis for valuation. Legal due diligence focuses on contractual agreements and problem-spotting with the aim of finding points of warranties and indemnities, validate all existing contracts as well as sale and purchase agreements. The commercial due diligence on the other hand, is about studying market dynamics, the target's competitive position and commercial prospects. The intention is to predict sustainability of future profits, formulate a strategy for the business and gather input to valuation. (Howson, 2003)

Our study shows that the scope of the due diligence is of major importance for the outcome of the investigation, that is, to find an accurate scope will determine the quality of the due diligence. Given the scope of due diligence the private equity firms seem content with the performance of the due diligence provider. As long as the scope is accurately set the external advisers have been described as excellent in fulfilling the purpose of the investigation. However, we identify discrepancies when it comes to the design of the scope throughout the due diligence process. The private equity firms prefer the scope to be narrowed as the due diligence investigation evolves and new findings are highlighted and further stress that emphasis should be put on the most important factors affecting the deal. The providers of due diligence rather have a broader scope in order to cover as many aspects of the business as possible and are thus reluctant to decrease the amount of investigation. One consultant explains:

> *"We would never advice the private equity manager to narrow the scope."*

4.2.1. Determining the Extent of the Due Diligence

Structuring the due diligence investigation is about balancing cost and perceived risk and the extent of the investigation that is required is a judgment call. (Crilly, 1998) It is up to the investor to decide what information is essential. (Bing, 2008) Two things have to be determined: which areas to cover and how much investigation to do. Those will differ from case to case as it in practice is time, money and the seller that will determine how much investigation a buyer can do. (Howson, 2003) Time and money have been shown in our empirical study to be two important determinants of the amount of investigation to be done. On the other hand, the statement that the seller sets the frame for the process is questionable as the lack of information is often due to the fact that the information as such does not even exist. We have identified a discrepancy between the literature and practice on the Swedish market. The literature is a reflection of the circumstances on the American market while our interview objects, in contrast, stress that the Swedish mergers and acquisitions market rather has typical characteristics of a small business environment. In this type of environment almost all actors within the market knows each other and therefore important aspects to consider regarding access to information are for example relationship building and trust. Therefore, our perception is that even though the seller sits on all the information and thus has the ability to control the information flow, this is not an issue in practice.

One issue mentioned though is the time it takes to deliver information about the target firm. An important factor to bear in mind is that the target company has to run its business as usual at the same time as gathering and distributing information required by the buyer. The buyer does the investigation with full resources which is hard for the selling company to match. The implications are thus that the private equity firms are of the opinion that the due diligence process takes an unnecessary amount of time and thus cost too much.

The key with regards to the extent of investigation to be made is to be thorough but reasonable. (Howson, 2003) An acquirer cannot, and should not be expected to, discover every possible risk. (Lajoux, 2011) Deciding what to cover in due diligence is a function of how much the buying company thinks it knows about a business and how much risk it attaches to areas where its knowledge is limited. (Howson, 2003) From our empirical findings we see that it might well be that those are the two most important factors for determining what to include in the due diligence. However, it is not always apparent how much you actually do know before the due diligence starts. One private equity manager describes that big mistakes can be made by assuming that you know more than what is the actual case and as a consequence appropriate due diligence may not be undertaken. The manager referred to an add-on investment where they thought they had relevant knowledge due to a previous investment. The due diligence was set up only in order to obey the demands of the bank and thus the investigation was intensive in terms of risk minimization and studying historical performance at the cost of not questioning the prospects of future growth. The consequence was that the sales estimates failed and thus the price paid was too high. This type of problem is also mentioned by one of the representatives from a bank. He argues that;

"Bad due diligence is often due to an over-belief in oneself."

Furthermore, discovery of new risks should be communicated instantly to the buyer and can result in expanding the scope and the depth of the review. (Gole & Hilger, 2009) One investment manager expressed how surprisingly fast the consultants can understand the business. Given that a specific topic is investigated they can rapidly gain knowledge beyond that of the private equity firm itself. This is something that the consultants do not always seem to be aware of and they thus seem to not fully understand their ability to guide the private equity firms with regards to such topics. This is further acknowledged in that the private equity managers express that they want more advice on setting the scope.

4.3. Purposes and Objectives of Due Diligence

Due diligence should always be used in an acquisition process as it reduces the risk of failure which means it can be the difference between succeeding and failing (Pack, 2002; Spedding, 2009). However, the empirical findings suggest that since due diligence is such an integrated part of the acquisition process it is hard to distinguish it as the determining factor of the outcome of the deal. Yet, the private equity managers and the consultants do agree on the fact that not performing due diligence at all is too risky.

Due diligence is successful when defects and problems are discovered early enough for the deal to be renegotiated or avoided entirely. Another form of success is that the business is represented in a way so that there are no surprises after deal closure. (Bing, 2008) According to the private equity managers successful due diligence is when the process provides comfort in the investment decision. This comfort is provided by the consultants coming up with as many negative aspects as possible regarding the potential deal, but those findings do not result in an abandoned deal. In that case, the private equity managers feel certain that their business case is solid enough for comfortably going through with the investment. One private equity manager explains;

"By confirming our understanding of the business, validating key assumptions and identifying previously undisclosed risks, the aim of the due diligence is to inform the decision that we are about to make."

This reflects the overall perception that we have gotten from our investigation, that is, it seems like due diligence has more of an informatory and validating role in that it provides comfort in the decision rather than changing the decision to invest.

4.3.1. Balancing Risk and Reward

Due diligence should be approached with a clear purpose. The purpose will depend on the strategy of the investor and balancing risk and reward should be central in the process. (Spedding, 2009) We see that the private equity firms have a multi-purpose of the due diligence investigation. If they would have performed the due diligence only for their own sake, the investigation would be more centered towards potential upside and future performance. However, the financing of the deals is dependent on the acceptance from the bank, that is, ultimately the requirements from the bank regarding the due diligence have to be satisfied in order to receive financing. The balancing between risk and reward thus tends to favor the search for risks and the establishment of an acceptable worst-case scenario at the expense of finding and analyzing potential for improvements.

4.3.2. Deal Killers

The objectives should be value driven and the findings should facilitate the negotiation process and help creating post-acquisition action plans. (Gole and Hilger, 2009) Lajoux (2011) argues that warning signs that need to be investigated further are called *red flags* and that those can be limited in a number of ways. However, as one private equity manager explains, the private equity firms sometimes use so called red flag reports, that are conducted by consultants at an early stage of the investigation, which are of binary nature meaning that they should emphasize the biggest risks and risks that might even be unacceptable. This is done in order for the private equity firms to make a decision regarding conducting further investigation or not. Further, after the red flag report has been presented, there is also a general preference for the consultants to raise red flags throughout the due diligence process, preferably as soon as possible.

There are three different outcomes of the pre-close findings and recommendations; conditions to close may be established, the valuation revised or a decision has to be made regarding go or no-go. The no-go decision would be a consequence of deal-breaking issues. Examples would be that the strategic assumptions for the acquisition prove to be wrong, value cannot be generated, rather destroyed and irresoluble management issues. (Gole & Hilger, 2009) In practice, the respondents mean that deal killers are rare. Rather, the due diligence can end up in changed deal structure or adjusted price that the private equity firm is willing to pay. As a consequence of lowered prices, it is more likely that the deal is defaulted at the initiative of the seller who is not willing to accept such price level. Another reason mentioned for potentially leaving the deal is changed market dynamics and therefore the decision is not a consequence of the due diligence per se.

4.3.3. Value Adding Factors

The value due diligence can add is finding problems no one knew existed and facing worst-case scenarios. (Lajoux, 2011) Another value is its comfort factor. Most buyers are more comfortable knowing about problems beforehand rather than being left with the possibility of making warranty or indemnity claims or having to sue the seller after completion. External advisers are expensive, but not compared with going to law. The private equity managers agree on that in order to know something about a potential bad case, worst-case scenarios are required. Those provide comfort in decisions, but can unfortunately be hard to get from the consultants as they tend to focus on reasonable estimates and not so much on coming to terms with what is the worst development possible. Lastly, due diligence provides the buyer with knowledge and knowledge is power. The more that is known about a target's business the better prepared is the buyer for the negotiations. Thus, due diligence can be a worthwhile investment. (Howson, 2003) Our impression is that the private equity managers feel comfort in their knowledge level which, in their perception, often exceeds the knowledge of the target firm's own awareness about themselves with regards to the context of the target firm and its potential development. That is, through the due diligence investigation the private equity managers get sufficient information to feel comfortable about the price they pay which is linked to the return they aim to generate.

Another value adding factor of due diligence is expressed by various consultants. They have explained that finding upside potential in an acquisition might increase the likelihood that the private equity firm wins an auction process and thus gets the deal as it allows for paying a higher price.

4.3.4. Failed Investments

The due diligence literature suggests that many acquisitions fail due to making the same mistakes over and over again and not focusing on the right aspects in performing due diligence. The argument is that the due diligence investigation tends to focus too much on verifying the company and its historical numbers at the expense of questioning the strategic fit and underlying logic of the deal. (Howson, 2003; Bing, 2008; Lajoux, 2011; Cullinan, Le Roux and Weddigen, 2004) The problem then is that based on an initial belief that the deal has sufficient upside, acquirers tend to overpay in completing the deal, especially in an auction situation where focus is put on winning the deal.

Our respondents claim that first of all very few bad acquisitions are made. But in the case of a bad acquisition there is support for the literature in that it is the price paid that is the main issue. It is however very seldom that the big risks actually occur and in that sense the private equity firms, with support from the consultants, manage to reveal such risks in an appropriate way. Rather, private equity managers tend to blame macroeconomic factors, such as an unexpected declining market situation, to be the reason for less successful deals. The private equity managers are unwilling to accredit the poor predictions to the due diligence and especially to the consultant performing it. This difference in comparing with what the literature has said about underlying reasons for "bad" acquisitions may be due to the literature mainly focusing on merger and acquisitions performed by industrial buyers whilst we study private equity firm buyouts in particular. We have found that private equity firms in general are good at assessing potential deals in a rational, non-emotional way without overconfidence. Thus, the price they are willing to pay seems to reflect the rational development of the target company which is an effect of a combination of well performed due diligence by the consultants and a great deal of good sense by the private equity managers themselves.

4.4. The Advisers' Role in the Due Diligence Process

Theory suggests that the speed of the deal and the diverse range of required expertise mean that advisers are usually performing the due diligence. (Howson, 2003) As due diligence should not be performed in a mechanical manner, it requires a certain mind-set that combines a risk-assessment approach with a value-creation mentality of an investor. (Gole & Hilger, 2009) This is where the experience and capability of the due diligence team is essential. (Spedding, 2009) As outside professionals are expensive it is important to pick the right ones and to get the best out of them. The key is to plan and establish in a written terms of reference what needs to be done by when and by whom, coordinate the efforts of all involved and communicate throughout the whole process. (Howson, 2003)

4.4.1. Why Hire Advisers?

The question why external advisers are hired to perform due diligence is interesting with regards to the private equity firms as they often have the knowledge and expertise themselves due to the frequently occurring background within consultancy. Generally, we conclude that it is difficult to distinguish the single most important aspect of hiring external consultants for the private equity firms. However, since their organizations are small and an acquisition process is intensive in terms of human resources, outsourcing is frequently mentioned as being a central factor. One private equity manager expresses;

"Financial due diligence is a lot about outsourcing. Everyone has got the financial competence in-house although there are parts of the investigation that we have not got the time or number of people to solve."

Our empirical finding is that the private equity firms operating in the Swedish market see no economic value in performing such processes in-house. As there is not an even flow of potential acquisitions on the Swedish market, there would be an increased risk in hiring a workforce to provide such services.

There seems to be a difference between different types of due diligence, but an independent opinion of an external adviser is always appreciated by the private equity firms and is a requirement by the bank that has to be satisfied. The independence of external advisers is a vital aspect with regards to the objectivity sought after by the financial institutions. However, an important aspect of not having such ability in-house is that you have to fight against your competitors for that type of resource which is rather scarce on the market. When there is a deal lurking around the corner it is of high importance to instantly get in contact with and reserve your "favorite" consultants before someone else does. As an investment manager in a private equity firm explains;

"If we know that we will give an indicative bid we contact suppliers of all three major due diligences, before we even get the information memorandum."

Further, regarding legal due diligence, it stands out since knowledge and expertise seem to be rare within the private equity firms on this area.

The consultants' view however is that knowledge plays the most important role when using external advisers. They argue that their experience with regards to performing a due diligence investigation enables them to perform the process more efficiently. They admit however that resources are an important factor. One of the consultants identifies outsourcing as a factor when choosing adviser as he explains that;

"People in private equity firms are very competent. However, they have a lot to do."

According to the literature, the advisers should be free from any conflict of interest and independent in conducting the due diligence. (Lajoux, 2011; Gole & Hilger, 2009) The consultants are aware of their role as an independent adviser and always strive for giving an objective opinion. As a part of being external one consultant argues that private equity firms wish to gain and/or maintain a good relationship with the target company and thus let the consultant ask sensible questions that the target may interpret as offensive. This view is in accordance with that provided by the literature as Lajoux (2011) explains that thorough due diligence might decrease the feeling of mutual trust between the buyer and the seller. The risk of harming this relationship is thus decreased by the use of external advisers.

4.4.2. Important Aspects When Choosing Firm and Team

We have acknowledged discrepancies between the private equity managers and the consultants regarding what they consider to be important aspects when choosing external advisers. Consultants tend to focus to a great extent on knowledge as being crucial and stress experience within the target's industry as becoming more important. Private equity managers, on the other hand, consider relationships built on previous experience and trust as the one most important factor in choosing who to work with. Therefore, private equity firms typically use sources of expertise from retained consultants, which is also suggested by the literature. (Howson, 2003; Lajoux, 2011) One private equity manager explains that;

"It is an advantage to have previous industry experience, but in the end trust is what matters".

Another private equity manager claims that;

"People are more important than the firm as such. The project leader is essential. There is more difference within a company than between companies, but the name of the firm sets the price though."

Howson (2003) argues that the buyer should not allow due diligence to be pushed down to junior levels unless it is appropriate. This might not always be best for the client. Therefore, it is important to make sure that senior advisers have the kind of involvement that is requested. As the author explains; "*You do not want to be lumbered with the B team*". The general view provided by the consultants is that juniors are used for gathering and compiling vast amounts of information, mainly so that the more senior advisers can focus on the bigger commercial picture and providing the private equity firm with proper advice. They argue that the private equity firms do not affect the composition of team to a great extent and that advisers share experience within the firm, that is, they learn from their own mistakes and guide juniors in what to look for. In contrast, according to the private equity managers, while acknowledging that balanced staffing is important as seniors are needed for the overhead perspective and project leadership while juniors are an important factor when the investigation is data intensive, their general view is that in relation to their knowledge and experience, juniors cost way too much. The private equity managers do not seem to have much of an opinion regarding the composition of the team except for regarding the project leader and to some extent senior staffing. However, in our opinion, more involvement from the private equity firms when it comes to setting the team would not affect the perceived result of the investigation as the private equity managers think that the consultants do a satisfying job regarding fulfilling the scope of the investigation.

It seems like, in the perception of the private equity managers', the name of the consultancy firm is of greatest importance to the bank. This is something that is also confirmed by the bank representatives themselves as being their general view. One bank representative means that due diligence should be performed by a reputable firm and another says that the financial due diligence preferably should be performed by one of the "big four". One of the representatives argues that a misleading report from an external adviser puts the adviser's reputation at risk. Hence, reputable and well-established firms have more to lose than the smaller companies which make such reports more valid for the bank.

The different types of due diligence are performed by different teams of people. Typically, the financial due diligence investigator is a firm of accountants, legal due diligence is usually performed by lawyers that have expertise in business law and commercial due diligence on the other hand is carried out by a wide range of organizations. The choice of who to work with in performing commercial due diligence has been described as less obvious than for the other types, but according to the literature the choice will depend on the requirements of the buyer and to some extent industry experience may also be a consideration. (Lajoux, 2011)

According to our findings there is a slight difference in important aspects when choosing the team between the different types of due diligence. The consultants express that knowledge is most important in legal due diligence, while personal contacts and previous cooperation play a bigger role in financial due diligence in which the consultants want to provide high quality resulting in retained relationships. When it comes to commercial due diligence, this is the type where industry experience seems to play the greatest role according the consultants. This view is also shared by the private equity managers in that they argue that there are few providers of financial due diligence in the market which they think is boring since this inhibits a variety to choose from and thus they usually cooperate with the same advisers over time. Further, many private equity managers mention that there a more alternatives on commercial due diligence as there are small firms frequently appearing within the market. This diversity is something that they appreciate. Those firms are described as having good capacity of performing the investigation and experience, both in carrying out due diligence and in the target's industry, which are stressed as important aspects in the final choice. Thus, what matters the most regarding commercial due diligence is the skill of the team performing the investigation.

4.4.3. Interaction Within Due Diligence

4.4.3.1. Interaction Between Advisers

The literature suggests that different consultants should be aware of other consultants in the acquisition process and actively encourage communication and collaboration. (Howson, 2003; Gole & Hilger, 2009) We have found that consultants are well informed about other consultants and the private equity firm takes initiative for a startup meeting in a due diligence process. In this meeting where all consultants are present the aims and roles for the due diligence are discussed and aligned. The general view that we have gotten from the private equity firms is that the consultants do a satisfying job within their field of responsibly as well as identify and solve potential overlapping in the research. Our perception is that performers of financial and legal due diligence are working interactively to the greatest extent as a consequence of overlapping areas of investigation. Furthermore, it is common that the commercial due diligence is already finished when the financial and legal due diligence start. As one of the lawyers puts it;

"We seldom meet the management consultants, all we see is their reports."

The general view of the consultants' is that they understand the importance of being professional in the consultancy role and thus being able to collaborate with other advisers and firms. This is something that the private equity managers express an overall satisfaction with and thus we do not perceive the interaction between the different advisers as a problem.

Another important aspect of having different teams of advisers interacting is that different perspectives of certain aspects within the due diligence can give rise to discussions that may result in a better output. The fact that different perspectives exist is clearly shown in one of the financial adviser's opinion that;

"The lawyers tend to emphasize all problems which sometimes results in exaggerated complexity of problems."

Even though this creates a tension between different professionals our understanding is that the private equity managers perceive the interaction as mature and essential for the best result of the due diligence.

4.4.3.2. Interaction Between the Private Equity Firms and the Advisers

According to the literature, the buyer controls the due diligence process, that is, it is the buyer who must properly brief the adviser on key issues and areas of greatest worry as well as what constitutes acceptable risks and it is also the buyer's role to make decisions regarding the deal. Specifying what is wanted in terms of information needed and how it should be presented will keep the process focused and keep costs down. (Howson, 2003; Spedding, 2009)

Our empirical findings support the view that the private equity managers think that the consultants are good at fulfilling the scope, but recognize that if they are not properly briefed they tend to go out and collect everything and provide a report that covers every little detail. As one private equity manager puts it;

"If you let go of the consultants, they will run and deliver a lot of information without the correct focus."

A good due diligence investigation is dependent on setting an accurate scope. In the private equity managers' perception a good consultant can set an accurate scope and is proactive throughout the process and can separate important issues from less important factors. This is however, dependent on the project leader. Even though the private equity managers know that they are the ones deciding what to look at in the due diligence, it is important for them to work together with a project manager who has the right experience in order to provide correct guidance in setting the scope and decide what to look for in the investigation. Further, private equity managers consider the scope to be a starting point for the investigation that can and preferably should change during the process with reference to the findings. It has appeared that they request the consultants to think more like investors in order for them to add value in the process. Another important finding is that the private equity managers are of the opinion that the consultants do not always get to the conclusions nor provide recommendations to a satisfying extent. Instead they have been said to just report a lot of data which is an example of bad due diligence in the opinion of the private equity managers. One of the private equity managers claims that;

"It is up to the consultant to show possible improvements and how to get there."

The consultants on the other hand, emphasize the importance of having a broad scope and fulfill that particular scope in order not to miss out on any aspect. One consultant argues that;

"The private equity firms narrow down the scope in order to save money. We however take the risk and thus do not want anyone to tell us not to look under a particular rock. "

Even though important risks should be emphasized the consultant expresses a need for investigating all parts to be able to guarantee and be responsible for the findings and avoid lawsuit.

4.4.4. External Advisers and the Investment Decision

Regarding the impact on the final decision of the deal, due diligence is normally not seen as a success factor, neither by the consultants nor by the private equity managers. Due diligence involves identifying problems, but those can usually be settled prior to the acquisition. One consultant confirms this as he claims that;

"There is no correlation between a good due diligence and a good acquisition. However a good price could be reached with our help since that is what we are good at."

The general view of the private equity managers is that financial due diligence is a hygiene factor that rather play a confirmatory role than impacting on the decision as such. Legal due diligence has been described as important in order to see that the legal structure is correct, but is also about confirming rather than affecting decisions. Further, this is also a view applicable to commercial due diligence as one private equity manager explains that;

"Sometimes it could be equally good to talk to a wise man as receiving a report from a prestigious management consultant. However, the bank and the investment committee require the report. "

There are however cases in which all three types of due diligence have been said to be vital for the outcome of the deal. In one case, the legal due diligence was said to be very important for the decision since there were few customers and a high customer dependence. This meant that this was important for the contract and the legal due diligence could support that the contracts were valid which gave comfort in the investment decision. However, once again, to us this rather seems to be about providing comfort in the decision than changing the decision as such.

One central aspect though that we have identified, and that is also reflected in the citation above, is that the private equity managers acknowledge that they would probably not have received bank financing or approval in their investment committee without a due diligence that supports the decision. In that sense, due diligence is essential for being able to do the deal at all. As a result, we conclude that even though due diligence to a great extent only confirms hypothesis and does not change decisions per se, it is a necessity in order to seal the deal.

4.4.5. Advisory Fees

The literature suggests that you get what you pay for with regards to the cost of due diligence. You can either have a cheap or a good report, but not both. It has been said that to some extent, the choice of consultant should not be too cost-driven as their reputation and experience are more important than fee considerations. But Howson (2003) notices that an advisory firm will always charge what it thinks it can get away with. He therefore argues that it is worth finding out what other firms have recently paid for similar services and whether they thought it was reasonable.

The general estimation given by the private equity firms of the total price that they pay for a due diligence investigation is approximately 0.2-0.5 percent of the enterprise value of a deal. We see that the cost is never higher than 5 percent of the enterprise value and that it is normally somewhat lower in relation to the enterprise value in larger deals than what it is in smaller deals. For example, one of the big private equity firms mentioned that on a deal with an enterprise value of SEK 5 billion the cost of due diligence ends up at about SEK 5 to 10 million. Furthermore, the overall view of the private equity managers is that the price of a due diligence investigation lies somewhere between SEK 500 thousand and SEK 1 million and the total cost usually ends up somewhere between SEK 2 to 6 million for the entire process. Financial and legal due diligence are somewhat more expensive. The general comment regarding the price is that it is way too expensive. However, the private equity managers further express an understanding of the fact that the due diligence has to be done and they argue that price is not a determining factor, first for whether or not the due diligence is done and secondly for whom you choose to work with since the "right" person is more important than the price you pay. As one private equity manager puts it;

"The reason for why we do due diligence is that it signalizes quality which is an important factor for the credit institution and this is what we sometimes pay extra for."

It is acknowledged by one private equity manager that if the purpose of due diligence is to find flaws in the target company the investigation might seem rather unnecessary as there is limited discrepancy in the Nordic market between the general perception of companies and what the companies actually prove to be. An example of this has been said to be the lack of lawsuits. However, the manager perceives the due diligence as a necessity and the investigation could not have been done by the private equity firm alone.

The consultants observe that there are some private equity firms, which they refer to as shop-arounds, who continuously go out in the market and search for the cheapest due diligence possible. However, this is not the picture that we get from the private equity managers as they explain that relations and previous cooperation are the most important factors and in the cases where they choose to work with new external providers it is in order to broaden their own network and thus give raise to some competition.

The consultants estimate the price of due diligence to lie in the span of approximately 0.1 to 1 percentage. This is however referring to one part of the total due diligence investigation. This means that the estimated cost for all different types of due diligence would end up in alignment with the view of the private equity firms. It has been expressed however, by the providers of financial due diligence, that they are of the opinion that the lawyers, together with the banks, constitute the expensive part of the due diligence. They argue that it is hard to charge SEK 1 million when the enterprise value of the deal is SEK 100 million, that is, they do not always receive a total of 1 percentage of the enterprise value. One private equity manager claims on the other hand that it is not appreciated when the consultants want to charge more in actual terms in a large deal. This is seen in the following comment:

"The consultants have to be reasonable. In a large deal they think it is okay to charge for example SEK 10 million, but they should be happy with receiving SEK 5 million."

Regarding the general perception of the price, the consultants, as compared to the private equity firms, are of a different opinion. They all agree that the price level of due diligence is motivated as an effect of the work that is put in the process.

The payment structure for a due diligence investigation is generally based on the number of hours put into the process referring to financial due diligence providers and lawyers and on a weekly or project basis with regards to commercial due diligence. The view is that this is the ideal payment structure, as compared to for example contingent fees, in order to prohibit bad incentives and overly positive reports provided by the consultants. Howson (2003) claims that the providers of the commercial due diligence do not want to present only negative result as that may lead to their work being ended with undesirable consequences for the fee. We have however in our research not identified this type of mentality. We find that it is highly important for the consultants to remain their objectivity and they thus prefer a project-based fee which is not dependent on the outcome of the deal.

The private equity managers prefer to get an estimation of how much the investigation will cost in terms of the number of hours that the scope will require. The consultants express that it is difficult to assess the cost beforehand and that there is always a discussion regarding price when big spreads between the estimation and actual outcome occur. The private equity managers mention that they are reluctant to changing the price throughout the process as long as it does not change as a pure consequence of an expanded scope. They further argue that the consultants are smart in that they are prepared to provide a discount when they know that they have not done a satisfying job, that is, not added value in the process, in order to overprice their service in good times, i.e. when the deal goes through.

Another pricing technique that has been discovered is that consultants can give discount on their due diligence process in order to receive follow-up projects in the case of a deal. Furthermore, the structure of the information provided from the target company is a determining factor for the time spent on the investigation and thus for the price charged. If the provided data room is messy and contains irrelevant or even faulty documents, the entire process will be less efficient and consequently more expensive.

4.4.6. The Due Diligence Report

Regarding how the information found in the due diligence investigation is presented to the private equity firm, Spedding (2009) mentions that it might be satisfying with accurate and timely information, but the private equity managers in our investigation are generally more concerned with the overview or bottom line. This is evident in our research as the private equity firms have a preference for brief reports. Even though the consultants clean up the collected information to make it more readable for the private equity firms, more to the point information is still asked for by the managers. The perception of the private equity managers, with regards to the amount of information provided by the consultants, is that they think that consultants intend to signal thorough investigation by providing long due diligence reports. The general view of the bank representatives is in line with this reasoning. One of the bank representatives says that;

> *"Long and unstructured reports are bad. We do not want too much information. Of course it is signaling from the consultants that have gone through everything but our wish is that they emphasize and flag important issues."*

Furthermore, even though the report is long private equity managers require the important aspects to be highlighted so that the entire report does not have to be read from the beginning to the end by everyone in order to capture the essence. This is also one of the main findings in the literature as it mentions the executive summary as being the most essential chapter of the report since this is often the only part that will actually be read. General conclusions about each area of investigation and its impact are expressed. (Howson, 2003; Gole & Hilger, 2009) Some consultants argue however that the report should not be read from the beginning to the end but rather there are different parts for different readers.

Furthermore, the private equity managers have expressed a common request for the advisers to be bolder when it comes to providing opinions and recommendations. As one private equity manager explains;

> *"They do all the analysis but they also have to draw conclusions about what it actually means and what they think. The consultants are struggling with this today, but it is our job to point them in the right direction in developing this mindset."*

The private equity managers argue that even though accountants aim to communicate the reasons why the future will look in a certain way, they rarely go further than giving comfort that the forecasts have been prepared with care. A common theme in the literature is that providing prospects is a topic that makes accountants very nervous. They are reluctant to make predictions that go further than twelve months into the future. (Howson, 2003; Pack, 2002) Howson (2003) provides a solution in order to come up with longer forecasts. He suggests that the financial and commercial due diligence teams should work together. As the financial team knows a lot about the business operations while the commercial team understands the market prospects well the teams should review the projections together. One bank representative confirms the idea that it could be an advantage to connect financial and commercial due diligence. The bank representative argues that in connecting past figures with drivers and estimates it could be easier to quantify the commercial assumptions. Therefore, there is room for more interaction between the financial and commercial due diligence teams. This reasoning seems to be in line with the private equity managers' perception that the commercial due diligence team is the one that interacts the least with the other due diligence teams. It may perhaps be a good idea to encourage further cooperation in order to come to terms with getting more explicit recommendations and predictions about the future.

4.5. Financial Due Diligence

4.5.1. Purpose

Besides examining accounting policies and information systems, financial due diligence aims to give a view of underlying profit to tell something about the future. Financial due diligence focuses on key drivers of the business and says what the numbers are and why they are what they are. As this is the purpose of financial due diligence the investigator should be more concerned with finding and understanding anything that looks suspicious rather than working on the numbers given by the target. (Howson, 2003; Lajoux, 2011)

We find from our study that the banks consider the financial due diligence as being factual and confirmatory. Further, the general view of the consultants is that the most important aims of financial due diligence are to create comparability, provide understanding for what are value drivers in the business, avoid big risks and serve as input for valuation and thus in the end affect the decision. As one consultant puts it;

"Our job is to clean up the financial information and make it readable for the private equity firm."

The view of the private equity firms is much in line with this reasoning. The private equity managers express the usefulness of financial due diligence as creating comparability in that it adjusts for non-recurring items in the financials. They further argue that other important objectives are to connect past performance with the future, provide comfort in decisions in creating worst-case scenarios and express a general need for external advisers to perform this investigation as the private equity firms do not possess in-house expertise within this area of study. Furthermore, the financial due diligence is something that the private equity firms always use since they think that there is too much risk in not doing it. The private equity managers thus agree that financial due diligence protects from downside risk. That being said, financial due diligence is about verifying the company, confirm or reject hypothesis regarding the business and provide downside protection.

According to the literature, its real aim is to look beyond the collected information and assist the acquirer in forming a view on underlying profitability in order to provide the basis for forecasting future performance. (Howson, 2003; Spedding, 2009; Pack, 2002) Therefore, when reviewing financial statements, the buyer must look for both positive aspects and negative issues. (Lajoux, 2011) The focus on risk however has in our investigation been said to be a consequence of the fact that the information provided by the seller will have presented the target firm in its best light and thus opportunities have already been well-defined. Estimates are thus assumed to be in favor of the seller at the cost of the buyer.

Furthermore, we identify a difference in how the private equity managers perceive the financial due diligence's effect on the investment decision in that their general view is that the consultants do not come up with something completely different and that the investigation seldom has any effect except for confirming or rejecting an already developed business case. However, as the consultants explain, the private equity firms still use the findings from the due diligence in their own valuation models which thus affect the price that they are willing to pay.

4.5.2. The Process

Financial due diligence is usually performed with the aid of structured checklists. (Pack, 2002) The process will usually start with an information request where the buyer informs the target on what information requirements they have and which people they wish to see. (Howson, 2003) The consultants in our study express that it is important to classify what is *nice* to know and what is *need* to know respectively in order to focus on the right things. Further, one consultant admits that in the past financial due diligence was all about controlling all items on the balance sheet, but now the focus is rather on looking at particular items that have an effect on valuation. The consultants aim to work more interactively with the private equity firms throughout the due diligence process as they think that they thereby can deliver more value and perceive that the private equity managers are more content with a more integrated relationship. The private equity managers on the other hand acknowledge that the financial due diligence investigation is okay, but that it needs much more guidance and supervision from the private equity managers themselves. The general argument is that they need to tell the consultants to a larger extent, as compared to for example legal due diligence, what to do. The private equity managers further explain that the financial due diligence providers need to process large amounts of data and do not always have the time, and sometimes not even the knowledge, to analyze it properly. That is, the consultants do not always provide conclusions and recommendation to a satisfying extent. Instead, they just report the data. Therefore, the private equity managers wish that more financial due diligence providers would think to a greater extent like an investor.

4.6. Legal Due Diligence

4.6.1. Purpose

The primary purpose of the legal due diligence is to verify the legal affairs and good standing of the target which impact the price being offered. (Spedding, 2009; Pack, 2002) The objectives of the legal due diligence are threefold; first to uncover potential liabilities, second to find any legal or contractual obstacles and third to form the basis of the final sale and purchase agreement which binds both parties to completing the transaction, and states what happens if problems occur. (Howson, 2003; Lajoux, 2011)

The consultants in our investigation claim that they look for ways to structure the deal and emphasize their role as looking for problems and making sure to come up with and provide solutions to them. Their view of themselves and their role in the due diligence process is very much in line with that of the literature. Their main focus is to structure the deal, provide clauses for potential problems and reveal big structural risks. Thus, their work is very much solution-oriented. As one lawyer comments on the firm's role within due diligence;

"Since we enter rather late in the process, we have more of a confirmatory role rather than affecting the investment decision and our job tends to be of a more executive characteristic than that of other types of due diligence."

This view is supported by the private equity managers who stress the fact that the lawyers seldom affect the investment decision. Rather they consider legal due diligence as being more focused on providing downside protection as it reviews as well as establishes the most important contracts in the deal. Furthermore, they consider legal due diligence as essential as the lawyers have knowledge and thus understand things that the private equity managers do not.

4.6.2. The Process

There is a strong relationship between the quality of the due diligence and the buyer's management of the process. It is important to brief the lawyers regarding what there is to know about the deal. The process usually starts with the buyer setting up some searches and sending a request for information to the target's lawyers. Most of the information comes from the seller and the acquirer's legal advisers review the documents in a fairly mechanical way which has the advantage of being cost-effective while leaving the more experienced advisers more time for supervision and to investigate the most important items. Other advisers usually complete their due diligence before legal due diligence is finished. (Howson, 2003)

The private equity managers explain that they always use legal due diligence and 100 percent of the investigation is done externally. The general view of the private equity managers is that the legal due diligence providers are usually better in delivering their scope and determining the key issues in the investigation as compared to other consultants. This might be an effect of the lawyers entering the process relatively late and thus what is left to be done is quite clear-cut. The lawyers look further into certain concerns that have already been highlighted by others and wrap-up the investigation rather than rejecting what has been done in the process along the way.

4.7. Commercial Due Diligence

4.7.1 Purpose

A company is not acquired for its past performance but for its ability to generate profits in the future. Commercial due diligence is about estimating future performance. It is the investigation of a company's market, competitive position and future prospects. The three aims are to reduce risk, to help with valuation and to help plan integration respectively. It should give comfort that the deal will actually work. Buying now with a view of exiting requires a strategic understanding of the target and its market in order to understand the prospects of selling the business. (Howson, 2003; Spedding, 2009; Pack, 2002) This is also what the consultants stress about commercial due diligence. They explain that this type of due diligence is the first thing you do in an investigation as it is important to establish a solid case in order for the process to be worth continuing. In their view, the private equity firms brief a business case from which they gather information and verify existing information in order to support that particular case.

In the opinion of the private equity managers, the commercial due diligence is the one most important type of due diligence in that it looks for upside potential and provides input for the business model. They argue that even bad companies can be really good investments and it is thus essential to properly understand the market and the company's position and development within it. It therefore seems natural that they consider previous industry experience as being one of the most important factors in choosing the team.

One of the bank representatives further argues that commercial due diligence is the most qualitative of the three types of due diligence which implies that there is a greater need to analyze and question the findings. This strengthens the view that knowledge is crucial in assessing for instance the target's market position and growth potential.

We also notice that when the private equity managers are asked about both successful and less successful deals, the commercial due diligence frequently comes up as an underlying factor affecting the outcome of the deal. Commercial due diligence thus seems to be the only type of due diligence that stands out regarding providing new information and prediction about market conditions that actually do have an impact on the decision per se. However, the abstractness of this type of due diligence in that it aims at predicting the future, not only for the target company but also for the entire market, makes it the most difficult kind to fulfill. This has also been identified by the private equity managers as they observe that it is hard to access correct and valid information within commercial due diligence and require better commercial due diligence overall in that they want the providers to penetrate central questions to a greater extent.

4.7.2. The Process

Commercial due diligence looks outside the target firm for information, for example by studying published sources and talking to knowledgeable people in the same market as the target. (Howson, 2003; Lajoux, 2011) Commercial due diligence does not have to be carried out after the letter of intent has been negotiated. Reasons for carrying out commercial due diligence early on include that it can confirm or reject the buyer's acquisition strategy, it is the least expensive type of investigation to buy from external advisers and can provide a pre-acquisition go- or no-go decision before more expensive investigations are started, and as it can be conducted without the knowledge of the target it can avoid raising the seller's expectations, avoid any embarrassment if the acquisition is not progressed and allows investigation to be made before any restraints are imposed by confidentiality agreements. (Howson, 2003)

The private equity managers explain that industry experts within their network are of great importance and are often consulted early in the process. They argue that some work in the commercial due diligence can be done before access to the data room is given as it is looking at external information, that is, having an outside-in perspective. As the financial due diligence tends to be internally focused while commercial due diligence attempts to understand the future by getting information mainly from sources outside the target (Howson, 2003; Spedding, 2009; Pack, 2002) the private equity firms get various views on the business which they appreciate.

Furthermore, the private equity managers argue that there is more discussion regarding the scope in commercial due diligence than in other types. Also, the scope changes more along the way than it does in financial and legal due diligence respectively. This seems reasonable as commercial due diligence starts in such an early phase of the acquisition process and thus the aim and expectations of the investigation might not yet have been established and there is room for development.

An important aspect that we have identified in our study is that the private equity managers express that it could have been better for them to put more focus on commercial due diligence overall. The reason they mention however for not emphasizing commercial due diligence to a greater extent is that the banks demand heavy due diligence in all areas. According to one bank representative the commercial due diligence is not as essential as the financial and legal investigations respectively. This is because the banks are mostly interested in the target's performance within the nearest future in order to make sure that debt covenants can be held and the debt level paid down. In their assessment the financial and legal due diligence add most comfort with regards to those aspects.

4.8. Other Due Diligence

Other important due diligence parts that have been mentioned in our interviews, besides the three main due diligence areas discussed above, are management, environmental, technical, IT, tax, insurance and pension due diligence respectively. Tax and pension due diligence aim at discovering potential future liabilities arising as a consequence of actions in the past. Those have been mentioned to be linked both to financial and legal due diligence. It is therefore of importance to clarify for the accountants and lawyers respectively from the beginning their area of investigation and responsibility as well as making sure that those two teams work interactively.

Other types of due diligence performed are closely connected to the nature of the target company. This could for example mean that a technical due diligence is necessary in order to understand the fundamental of a technical business or that an environmental due diligence is performed on a company with production facilities that could possibly result in extensive future liabilities as a consequence of pollution. This highlights the importance of adapting due diligence for every specific deal and the significance in the private equity firms being clear in their expectations of the investigation from the beginning as well as understanding where external advice is needed.

Some of the private equity managers in our study argue that management due diligence has become more important over the last decade. Management due diligence seeks to investigate the individuals of the management in the target firm regarding their competence, ambitions and background. The aim is to determine an appropriate composition of the management after a potential acquisition. One private equity manager said that the management due diligence in some cases has been conducted after the completion of the acquisitions. He explained that this was reasonable since replacing parts of the management team was not a big issue relative to the importance of investing in an appropriate business.

4.9. Integrated Due Diligence

Some of the consultants mention that an integrated due diligence, that is, that several types of due diligence are performed by one team of consultants from the same firm could be valuable for the private equity firms doing small deals. This would provide the private equity firms with one single coherent report of information and recommendation regarding the target company. This integrated type of work was said by a private equity manager to be useful for the smaller private equity firms and he argued that the service could be more cost efficient. The opinion that we have gotten from the larger private equity firms however is that an integrated due diligence is a good idea in theory but that it does not work in practice. For them, the general picture was that getting different opinions is not a problem and as long as the different consultants communicate with each other the recommendations received are relatively consistent. We have understood that there are concerns that the level of quality would not be the same when using an integrated service provider as compared to using separate specialists. The literature coincides with this reasoning in saying that buying the 'best in class', usually means engaging a number of teams. (Howson, 2003)

5. Analysis

5.1. Information Asymmetry

A common view from our study is that due diligence aims at verifying that the target company is what it looks like and understand the context of its business. The seller obviously has access to more information about the target company than what the buyer has. This can be referred to as a problem of information asymmetry and has been described by (Akerlof, 1970) in the example of a "lemon market". The essence is that information asymmetry makes it hard for the buyer to separate good companies from bad companies which could lead to bad investment decisions. Regarding the setting of the private equity firm in which an external adviser provides due diligence in a potential buyout, the main objective of making the investigation is to decrease the level of information asymmetries in order to make an informed and rational decision based on knowledge rather than on hypothesis. We see from our study that the due diligence fulfills its purpose in that it provides comfort in the private equity firms' investment decision. The due diligence confirms many of the beliefs that the buyer has regarding the target firm. Therefore, the investigation clarifies ambiguities and makes the private equity managers more confident in pursuing the investment.

The information asymmetries hold for the banks and the investors as well. However, our study shows that the different stakeholders tend to have different objectives and thus try to direct the due diligence in order to address their specific interests. This seems to have implications for the private equity firms in that the due diligence investigation according to them focuses too much on the historical financials aspects when they on the other hand wish that more effort was put on making predictions about the future, giving more commercial comfort in the investment decision.

5.2. Signaling

Our research shows that the private equity firms set the scope, that is, they decide what will be investigated in the due diligence process. Therefore, reflecting upon why they choose to focus the due diligence towards verifying historical performance rather than putting more emphasis on predicting the future and find potential improvement in the target company is an interesting aspect.

An important factor of the due diligence has proven to be the receiver of the results. In a leveraged buyout the financing naturally plays an important role and thus the bank is a central receiver of the due diligence which is confirmed both by the private equity firm as well as the banks themselves. It seems like the reason for why the private equity firms focus the due diligence on aspects that do not have an essential effect on the investment decision is that they intend to signal to the bank that a certain buyout is a good investment for the bank. That is, in order for the bank to provide financing a proper due diligence has to be conducted; proper in the sense that it focuses on aspects that are central to the bank.

The bank representatives seem to think that protection from downside risk is the most important part of the due diligence. We interpret that the underlying reason for this is that the banks do normally not take part of potential gains from an investment. As a consequence they are reluctant to take on any unnecessary risk. Instead the banks want to make sure that the target company has the ability to manage a substantially higher level of leverage and reduce it to a reasonable level in an acceptable period of time. We have understood that the banks have a shorter time perspective than the private equity firms and this is obviously something that the private equity firms have to take into consideration in planning the due diligence.

5.2.1. External Consultants

The bank representatives are of the opinion that due diligence should be performed by reputable firms. Those firms have much to lose in the case of making a bad recommendation. It has been argued by Armbrüster (2006) that large and renowned consultancies are carriers of knowledge, but also tend to bring legitimacy and thus their analyses and reputation can validate decisions. For the private equity firms, external consultants are useful in that their independent opinion both legitimize the decisions taken as well as signaling to other stakeholders that the investment is of good quality.

5.2.2. Cost as a Signaling Factor

The general perception of the private equity managers is that due diligence is way too expensive. However, the cost of the due diligence is an important signaling factor. Consultants sell an intangible good and one way of signaling high quality of the provided service is by letting the buyer know that the cost of the signaling has been high. (Spence, 1973) Well-renowned consultancies ensure high quality by recruiting the best candidates. This quality is then shown to others in that the cost for recruiting those people is high and that high salaries are paid. Furthermore, if the signaling is successful those consultancy firms can charge the buyer with a higher price. In using those external providers of due diligence, the private equity firms can in turn assure the bank of the quality of their decisions.

5.3. Institutionalization

It is our perception that due diligence has developed to become more comprehensive over time. One private equity manager expressed the pressure to include in the due diligence what everyone else does. Therefore, it is more important to have done everything rather than focusing on the most essential aspects and the due diligence process has thus become more standardized.

Meyer & Rowan (1977) argue that organizations act upon rationalized institutional rules. Such rules are created as an effect of a common belief of how things work. Organizations thus tend to follow such socially accepted ways of conducting business as there is a general perception that it results in operational efficiency. Acting upon the rules will create organizational myths that are incorporated by the organizations who, as an effect, gain legitimacy, stability and resources. Since the private equity firms cannot know the ultimate way of acquiring a company the development of due diligence is based on the beliefs of what is the ultimate way of conduction such investigation. As due diligence has become more comprehensive other actors within the acquisition context such as the banks, the investors and the consultants have incorporated the beliefs that this is the "right" way of doing it. This being said we do not claim that the due diligence as such, or the way of performing it, is wrong but we argue that the due diligence concept is becoming institutionalized in that it is performed based on both one's own expectations and the expectations of others and thereby gain legitimacy.

Berger & Luckman (1967) mean that institutionalization implies that actors and their corresponding acts are categorized. Institutionalization is not created overnight and is not only giving a picture of an organization but also gives a definition of how an organization is supposed to be. Although the institutionalization is not a rule, stepping outside of the definition of a role will make the actor assume that the action will be questioned and eventually that the role of the actor will be questioned by the context in which the actor is positioned. The implication is that the private equity firms will continue to increase the range of due diligence and continue to obey the expectations of the banks in order to maintain the legitimacy and thereby gain financing. By their own actions they will affect the institutional rules and thus the actions of others.

5.4. The Impact on the Investment Decision

The private equity managers, consultants and the bank representatives are of the opinion that the due diligence is of importance in the investment process. The due diligence has been said to have impact on the perception of the price and the structure of the deal as it discovers risks and thus lay ground for negotiation. However, the due diligence process seems to have a limited effect on the decision whether to invest or not. Our study shows that "deal killers" seldom occur. The fact that the private equity firms enter the due diligence process with the ambition to seal the deal the due diligence is about verifying established hypothesis rather than affecting the decision of whether or not to invest. This is shown in that the private equity managers want to consider all risks attached to the deal. But the general view is that almost always those risks are manageable as they result in either changes in the valuation or the structure of the deal. To us is seems like this behavior is reasonable within the context of the private equity firms since it lies in their nature to take on an acceptable amount of risk. One private equity manager even said that although the consultants provided the recommendation of not doing the deal they chose to invest anyways. This shows that private equity managers are well aware of the fact that the consultants give advice but that in the end it is their own decision to make, whether or not to invest. Sometimes parts of the due diligence are even done after the acquisition has been made. However such parts seem to mainly be in the interest of the private equity firm. Other parts that are crucial to other stakeholders, most importantly the bank, cannot be accepted to be performed after the completion of the deal.

With guidance from the literature we see that a proper due diligence process can enable for taking a decision that is sought from the beginning. Jansson (1992) has shown that organizations and their institutionalized behavior not only limit the freedom to act, as has been suggested by DiMaggio (1988) amongst others, but it also enables for taking *further* actions. In his study investment decisions that had already been taken were enabled by financial calculations that were a part of the institutionalized behavior. The calculations thus motivated and legitimized the investment decisions. We think that the performance of due diligence enables the private equity firms to make investment decisions since due diligence has become an institutionalized behavior which legitimize their decision although it might not have an effect on the decision as such. Nevertheless, the initial investment decision is based on the assumption that a due diligence will be performed and consequently it becomes a hygiene factor.

Furthermore, as mentioned above private equity managers seek to identify all possible risks but do not necessarily have to extinguish all risk as they feel that as long as they are aware of all risks and thus have a certain amount of control they can feel comfort in their investment decision. This is one of our main findings; that due diligence provides comfort in the investment decisions and that it is too much risk in not doing the investigation at all. Due diligence thus limits perceived risk. Olsen (1997) explains that the most efficient way of decreasing the experienced risk is to increase the feeling of control. Thus, in the case of the private equity firms due diligence limits the perceived risk which allows for comfort in the investment decision.

5.5. Limitations of Due Diligence

We have acknowledged that in the due diligence there are issues that cannot be solved and thus are more or less unavoidable. Such issues include that of getting access to full information and making accurate predictions about the future. The key to a successful due diligence is the data. The problem though is that all information might not even exist, which implies that the due diligence can only identify the absence of the information. Our experience is that the consultants are good at handling this type of problem in that they write satisfying warranties and clauses protecting from future negative findings. Another evidence of this is that the private equity mangers do not refer to bad due diligence as the reason for a failed deal. Rather they blame macroeconomic factors and we thus conclude that making predictions about macroeconomic development and the future of the target is the inherent problem in due diligence.

Even though our study shows that a declining market is the reason for why buyouts turn out less successful there is a common wish among the private equity managers for the consultants to provide more recommendations on the future development of the target's business. The private equity managers are aware that no forecast is ever right and that due diligence is more about understanding a range of possible outcomes and risk inherent in the business. We therefore think that it is important for the consultants to feel comfort in that the private equity managers know that it is their own decision in the end and that they would not blame the consultants for the outcome of the deal. What they request are estimates and predictions that are roughly right based on present information.

Our study shows that the consultants on the other hand have their own agenda in providing their recommendations. In order to avoid the risk of being held responsible for faulty recommendations they will do everything they can to protect themselves. It thus seems like they are reluctant to provide such recommendation as a consequence of wanting to maintain their reputation and their independency.

5.6. Maturing Industry

The private equity managers have expressed a common perception that the private equity industry has changed over time. They acknowledge that returns can no longer be generated merely based on financial and governmental engineering. There is an increasing demand for operational improvement in the target firms in order to generate sufficient returns. This increased competition and hence decreased margins in the private equity industry may indicate a maturing industry. (Klepper, 1997) This is further reflected in the private firms' purpose and design of the due diligence. The private equity managers stress that operational improvements and business development should characterize the due diligence process. We see that the due diligence process has gone from revealing risks by ticking boxes to becoming a far more comprehensive exercise. The perception of the private equity managers is that due diligence has gone through extensive competence improvements and is generally of better quality. What they require though is that more emphasis is put on finding potential upside in an investment and thus is seems like their requirements lie ahead of what the consultants have been able to implement up until this day.

As we have noticed the banks are not mainly interested in the search for potential upside in the performance of due diligence. Therefore, we think that as long as the banks, who are the main providers of debt in leveraged buyouts, are emphasizing the importance of risk minimization and verification of the past they make an obstacle for the development of due diligence in this direction.

6. Concluding Remarks

Our study shows that the purpose of due diligence is to minimize risks in an investment situation. The respondents provide a consistent view in that the due diligence aims to verify that the target business is what it seems to be by confirming historical performance and investigating the validity of hypothesis. However, we conclude that the entire procedure of performing due diligence is becoming institutionalized. Hence, the due diligence aims to create legitimacy in the investment decision which allows for acceptance from the stakeholders such as the banks and the investors.

Regarding good and bad due diligence we find that the link between the due diligence and the outcome of a deal is weak. Our respondents even go as far as claiming that there is no such link. Rather the reasons for a bad acquisition are unpredictable macroeconomic factors and an over-belief in ones knowledge about the target company as well as one's ability to develop the business. Our conclusion is that the difference between good and bad due diligence is that a well-performed due diligence provides comfort in the investment decision.

It is our conclusion that the due diligence has limited impact on the investment decision. We find that even though due diligence has an impact on what the private equity firm is willing to pay and the structure of the deal, the due diligence rarely changes the decision of investing. We want to stress however that the investment decision could not be *taken* without the due diligence as our respondents have emphasized the risk of not doing due diligence at all is too big. Therefore, we argue that due diligence has become a hygiene factor both with regards to the private equity firm itself and for other parties involved in the process.

In assessing what the ideal due diligence looks like we have received various opinions of improvements. We find that those suggestions are based on one's own interest and therefore the ultimate due diligence process is different for different parties in the due diligence process, that is, the private equity firms, the consultants and the banks respectively. Our study shows that the private equity managers request more commercial focus in the due diligence as they would like more emphasis to be put on making predictions about the potential of the target firm. However, we conclude that the setting and development of due diligence is based on balancing various needs of different parties. Therefore, the commercial focus will be held back mainly from the banks but also from the consultants who are responsible for verifying that the information regarding the company is correct up until this point in time.

One of our main conclusions is the balancing act between the different actors in the due diligence process in that of the design of the scope. While the private equity managers express a preference for a narrow scope connected to a cost and time efficient due diligence the consultants are reluctant to decrease the amount of investigation. We find from our study that it is important that the consultants realize and take advantage of their fast learning curve and thus their ability to guide the private equity managers in adapting the scope throughout the process.

Another aspect with regards to the discrepancies in the perception of due diligence is that of choosing the team. The consultants are of the opinion that knowledge is the most important factor when choosing team. We conclude however that due diligence is a relation-driven process in which there are established routines for whom you choose to work with. It is claimed that knowledge is important but the name of the company performing the due diligence is what signals that the knowledge actually exists. Therefore the decision is based on already established relationships. This could further be connected to the institutionalization of the entire process.

7. References

7.1. Interviews

1.	2012-02-16	Commercial due diligence provider 1
2.	2012-03-14	Commercial due diligence provider 2
3.	2012-03-19	Financial due diligence provider 1
4.	2012-03-23	Legal due diligence provider 1
5.	2012-03-29	Financial due diligence provider 2
6.	2012-03-29	Legal due diligence provider 2
7.	2012-04-02	Private equity firm 1
8.	2012-04-02	Private equity firm 2 – Phone interview
9.	2012-04-04	Financial due diligence provider 3
10.	2012-04-09	Private equity firm 3 – Phone interview
11.	2012-04-10	Private equity firm 4
12.	2012-04-13	Private equity firm 5
13.	2012-04-13	Bank 1
14.	2012-04-13	Private equity firm 6
15.	2012-04-17	Private equity firm 7
16.	2012-04-17	Bank 2
17.	2012-04-18	Private equity firm 8
18.	2012-04-27	Bank 3

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Appendix A – Interview Questions for Private Equity Firms

Q1 For how many years have your firm been operating in the Swedish market

Q2 Are you a private or a publicly listed company?

❍ Private (1)
❍ Public (2)

Q3 From an enterprise value (EV) perspective, within what range are the companies that you assess and acquire? Several choices possible.

❑ Less than SEK 0.1 billion (1)
❑ Between SEK 0.1 - 0.5 billion (2)
❑ Between SEK 0.5 - 2 billion (3)
❑ More than SEK 2 billion (4)

Q4 What are your core industries for investment?

❑ Technology, media, telecommunication (1)
❑ Consumer (2)
❑ Industrials and chemicals (3)
❑ Pharma, medical & biotech (4)
❑ Business services (5)
❑ Real estate (6)
❑ Financial services (7)
❑ Transportation (8)
❑ Construction (9)
❑ Leisure (10)
❑ Energy, mining & utilities (11)
❑ Other (12) ____________________

Q5 What are your purposes and objectives of the different due diligence types performed by an external adviser? Please rank the following options (1-3 for each type of due diligence; financial, legal and commercial respectively, number one being the most important).

	Financial (1)	Legal (2)	Commercial (3)
Collecting information about the target company and its environment			

(1) Verification that the business is what it seems to be (2) Creating a business case (3) Other (4)			

Q6 How often do you use external advisers performing the different due diligence processes? Please answer between 1-100 where 1 is never and 100 always.

_______ Financial (1)
_______ Legal (2)
_______ Commercial (3)

Q7 What do you expect to be the effect of the result from the due diligence performed by an external adviser?

	Financial (1)	Legal (2)	Commercial (3)
Adjusting the price you are willing to pay (1)	❑	❑	❑
To continue or to leave the acquisition process (2)	❑	❑	❑
Other (3)	❑	❑	❑

Q8 Regarding financial due diligence, when do external advisers enter the due diligence process? How much is done internally and externally respectively?

Q9 Regarding legal due diligence, when do external advisers enter the due diligence process? How much is done internally and externally respectively?

Q10 Regarding commercial due diligence, when do external advisers enter the due diligence process? How much is done internally and externally respectively?

Q11 To what extent is the business case developed within the due diligence, i.e. how much do you and the external adviser contribute to develop the business case respectively?

Q12 How often do you abandon an acquisition process as a consequence of the due diligence? What is the most common reason? Please answer in approximate percentage.

Q13 What can an external adviser provide? Please rank the following 5 options (1-5 for each type of due diligence; financial, legal and commercial respectively, number one being the most important and other is optional).

	Financial (1)	Legal (2)	Commercial (3)
Knowledge that you do not possess in-house (1)			
Outsourcing (2)			
Independent opinion (3)			
Access to key persons (4)			
Access to target company (5)			
Other (6)			

Q14 What are the most important aspects when choosing an external adviser performing the due diligence? Please rank the following 6 options (1-6 for each type of due diligence; financial, legal and commercial respectively, number one being the most important and other is optional).

	Financial (1)	Legal (2)	Commercial (3)
Previous cooperation (1)			
Reputation (2)			
Personal contacts (3)			
The adviser's experience in the target's industry (4)			
The adviser's experience of the target company (5)			
Price (6)			
Other (7)			

Q15 What is most important regarding the composition of the team performing the due diligence (for example number of consultants, seniority or previous experience)?

Q16 What potential problems do you see with having several advisers performing different types of due diligence resulting in various opinions?

Q17 To what extent do you affect the due diligence process once the scope is set (please choose an option for each type of due diligence)?

	Actively changing the scope throughout the process (1)	Regular discussions (2)	Passive throughout the process, letting the advisers do the investigation independently (3)
Financial (1)	❍	❍	❍
Legal (2)	❍	❍	❍
Commercial (3)	❍	❍	❍

Q18 How well do you think that external advisers meet your expectations of the due diligence and manage to fulfill the scope of the investigation?

	Very well (1)	Good (2)	Not so good (3)	Badly (4)
Financial (1)	❍	❍	❍	❍
Legal (2)	❍	❍	❍	❍
Commercial (3)	❍	❍	❍	❍

Q19 What kind of discrepancies do you generally see between the expectations and the result of the due diligence?

Q20 What is the total price, on average, for a due diligence investigation relative to the transaction value?

Q21 Do you prefer a certain payment structure (eg. fixed, variable or success fee)?

Q22 Generally, regarding the costs and benefits; do you perceive that the benefits received from the due diligence investigation correspond to the price you actually pay?

	No, the due diligence is often a necessity but overpriced (1)	No, the due diligence is often a necessity but the consultants tend to sell more than actually needed (2)	Yes, the benefits outweigh the costs (3)	Yes, price is never an issue (4)
Financial (1)	❍	❍	❍	❍
Legal (2)	❍	❍	❍	❍
Commercial (3)	❍	❍	❍	❍

Case 1 For the following section, please think of a successful acquisition in which external advisers were involved in the due diligence process.

Q23 In what year did the transaction take place?

Q24 In percentage, what was the stake acquired in the target company?

Q25 Within what span was the acquisition price?

Q26 Within what industry was the target company acquired?

Q27 What was your knowledge within the target company´s industry before the acquisition?

❍ Poor (1)
❍ Good (2)
❍ Excellent (3)

Q28 What kind of external due diligence was performed on the target company?

❑ Financial (1)
❑ Commercial (2)
❑ Legal (3)
❑ Other (4) ____________________

Q29 How important was the due diligence for the final decision regarding the acquisition?

	Not important at all (1)	Not so important (2)	Important (3)	Very important (4)	Essential (5)
Financial (1)	❍	❍	❍	❍	❍
Legal (2)	❍	❍	❍	❍	❍
Commercial (3)	❍	❍	❍	❍	❍

Q30 Did the due diligence change OR confirm your initial opinion about the acquisition decision? Please answer between 1 and 100 where 1 is Confirmed opinion and 100 is Changed opinion.

______ Financial (1)
______ Legal (2)
______ Commercial (3)

Q31 Was there anything that came out from the due diligence that made any major impact on your investment decision? Please exemplify.

Q32 What part of the due diligence investigation generated the most value overall?

Q33 Was there anything missing in the due diligence process, i.e. was there something that could have been done differently?

Q34 What about the breadth and depth of the information provided, has it been satisfactory with reference to the objectives of the due diligence investigation (i.e. is it too much or too little information)?

Q35 Do you think that the due diligence investigation was a reason for the successful outcome of the transaction? Why/why not?

Case 2 For the following section, please think of a less successful acquisition in which external advisers were involved in the due diligence process.

Q36 In what year did the transaction take place?

Q37 In percentage, what was the stake acquired in the company?

Q38 Within what span was the acquisition price?

Q39 Within what industry was the company acquired?

Q40 What was your knowledge within the target company´s industry before the acquisition?

- ❍ Poor (1)
- ❍ Good (2)
- ❍ Excellent (3)

Q41 What kind of external due diligence did you examine on the target company?

- ❍ Financial (1)
- ❍ Commercial (2)
- ❍ Legal (3)
- ❍ Other (4) ____________________

Q42 How important was the due diligence for the final decision regarding the acquisition?

	Not important at all (1)	Not so important (2)	Important (3)	Very important (4)	Essential (5)
Financial (1)	❍	❍	❍	❍	❍
Legal (2)	❍	❍	❍	❍	❍
Commercial (3)	❍	❍	❍	❍	❍

Q43 Did the due diligence change OR confirm your initial opinion about the acquisition decision? Please answer between 1 and 100 where 1 is Confirmed opinion and 100 is Changed opinion.

_______ Financial (1)
_______ Legal (2)
_______ Commercial (3)

Q44 Why was this a less successful acquisition?

Q45 How could it potentially have been prevented from being a bad acquisition?

Q46 Was something missing in the due diligence that could have changed the outcome of the deal?

- ❍ Yes (1)
- ❍ No (2)

Q46b What was missing and what were potential reasons for this (eg. too narrow scope, poor performed due diligence with regards to the scope, lack of time, poor integration of different opinions)?

Q47 What about the breadth and depth of the information provided, has it been satisfactory with reference to the objectives of the due diligence investigation (i.e. is it too much or too little information)?

Q48 Will you hire the external adviser for similar tasks in the future? Why/why not?

- ❍ Yes (1) ____________________
- ❍ No (2) ____________________

Q49 Do you think that the due diligence investigation was a reason for the less successful outcome of the transaction? Why/why not?

Appendix B – Interview Questions for Consultants

Q1 What is the name of your company?

Q2 From an enterprise value (EV) perspective, within what range are the companies that you perform due diligence on?

❍ Less than SEK 0.1 billion (1)
❍ Between SEK 0.1 - 0.5 billion (2)
❍ Between SEK 0.5 - 2 billion (3)
❍ More than SEK 2 billion (4)

Q3 What kind of due diligence do you perform?

❑ Financial (1)
❑ Legal (2)
❑ Commercial (3)

Q4 Within what industries do you mainly perform due diligence?

❑ Technology, media, telecommunication (1)
❑ Consumer (2)
❑ Industrials and chemicals (3)
❑ Pharma, medical & biotech (4)
❑ Business services (5)
❑ Real estate (6)
❑ Financial services (7)
❑ Transportation (8)
❑ Construction (9)
❑ Leisure (10)
❑ Energy, mining & utilities (11)
❑ All of the above (12)
❑ Other (13) ____________________

Q5 What are your purposes and objectives of the different due diligence types performed? Please rank the following options (number one being the most important).

	Financial (1)	Legal (2)	Commercial (3)
Collecting information about the business and its environment (1)			
Verification that the business is what it seems to be (2)			
Creating a business case (3)			
Other (4)			

Q6 What do you expect to be the effect of the result from the due diligence?

	Financial (1)	Legal (2)	Commercial (3)
Adjusting the price on the target (1)	❑	❑	❑
To continue or to leave the acquisition process (2)	❑	❑	❑
Other (3)	❑	❑	❑

Q7 How is a due diligence investigation initiated and who is in contact with whom?

Q8 Regarding financial due diligence, when do external advisers enter the due diligence process? How much is done within the PE firm and by an external adviser respectively? For how long are the external advisers involved?

Q9 Regarding legal due diligence, when do external advisers enter the due diligence process? How much is done within the PE firm and by an external adviser respectively? For how long are the external advisers involved?

Q10 Regarding commercial due diligence, when do external advisers enter the due diligence process? How much is done within the PE firm and by an external adviser respectively? For how long are the external advisers involved?

Q11 How often is the acquisition process abandoned as a consequence of the due diligence? What is the most common reason? Please answer in approximate percentage.

Q12 What can an external adviser provide? Please rank the following 5 options (number one being the most important and other is optional).

	Financial (1)	Legal (2)	Commercial (3)
Knowledge that the PE firm does not possess in-house (1)			
Outsourcing (2)			
Independent opinion (3)			
Access to target company (4)			
Other (5)			

Q13 What do you think are the most important aspects when choosing an external adviser performing the due diligence? Please rank the following 7 options (number one being the most important and other is optional).

	Financial (1)	Legal (2)	Commercial (3)
Previous cooperation (1)			
Reputation (2)			
Personal contacts (3)			
The adviser's experience in the target's industry (4)			
The adviser's experience of the target company (5)			
Price (6)			
Other (7)			

Q14 How do you set up the team for a due diligence?

Q15 What do you think is most important regarding the composition of the team performing the due diligence (for example number of consultants, seniority and previous experience)?

Q16 Are you noticed if other consultants are performing both different and the same kind of due diligence at the same time as you? In that case, are you interacting and how is this affecting your final opinion delivered to the PE firm? How are PE firms dealing with different opinions?

Q17 To what extent do the PE firms affect the due diligence process once the scope is set?

	Actively changing the scope throughout the process (1)	Regular discussions (2)	Passive throughout the process, letting the advisers do the investigation independently (3)
Financial (1)	❍	❍	❍
Legal (2)	❍	❍	❍
Commercial (3)	❍	❍	❍

Q18 How well do you think that you meet the PE firms' expectations of the due diligence and manage to fulfill the scope of the investigation?

	Very well (1)	Good (2)	Not so good (3)	Badly (4)
Financial (1)	❍	❍	❍	❍
Legal (2)	❍	❍	❍	❍
Commercial (3)	❍	❍	❍	❍

Q19 What kind of discrepancies do you generally see between the expectations and the result of the due diligence?

Q20 How do you follow up your due diligence?

Q21 Do you see any potential problems with a thorough due diligence?

Q22 Do you see any recent trends in due diligence?

Q23 What is the total price, on average, for a due diligence investigation relative to the transaction value?

Q24 How is the payment structured (fixed fee, variable fee, success fee etc.)? Do you prefer one or the other?

Q25 Generally, regarding the costs and benefits; do you perceive that the benefits generated from the due diligence investigation correspond to the price that you charge for the service?

	Yes, benefits always outweigh the cost (1)	Yes, we offer expertise and price is set accordingly (2)	No, the due diligence is most often a necessity but what generates the costs is the PE firms constantly expanding the scope (3)	No, the PE firms expects the risks to be higher than what they actually are (4)
Financial (1)	❍	❍	❍	❍
Legal (2)	❍	❍	❍	❍
Commercial (3)	❍	❍	❍	❍

Q26 How do you perceive the market for due diligence services? Is it competitive and are prices reasonable?

Case 1 For the following section, please think of a successful acquisition in which you were involved as an external adviser in the due diligence process.

Q27 In what year did the transaction take place?

Q28 In percentage, what was the stake acquired in the target company?

Q29 Within what span was the acquisition price?

- ❍ Less than SEK 0.1 billion (1)
- ❍ Between SEK 0.1 - 0.5 billion (2)
- ❍ Between SEK 0.5 - 2 billion (3)
- ❍ More than SEK 2 billion (4)

Q30 Within what industry was the target company?

- ❑ Technology, media, telecommunication (1)
- ❑ Consumer (2)
- ❑ Industrials and chemicals (3)
- ❑ Pharma, medical & biotech (4)
- ❑ Business services (5)
- ❑ Real estate (6)
- ❑ Financial services (7)
- ❑ Transportation (8)
- ❑ Construction (9)
- ❑ Leisure (10)
- ❑ Energy, mining & utilities (11)
- ❑ Other (12) ____________________

Q31 What was your knowledge within the target company´s industry before the due diligence started?

❍ Poor (1)
❍ Good (2)
❍ Excellent (3)

Q32 How important do you think that the due diligence was for the final decision regarding the acquisition?

	Not important at all (1)	Not so important (2)	Important (3)	Very important (4)	Essential (5)
Financial (1)	❍	❍	❍	❍	❍
Legal (2)	❍	❍	❍	❍	❍
Commercial (3)	❍	❍	❍	❍	❍

Q33 Did the due diligence change OR confirm the PE firm's opinion about the acquisition decision?

_______ Financial (1)
_______ Legal (2)
_______ Commercial (3)

Q34 Was there anything unexpected that came out from the due diligence that made any major impact on the PE firm's investment decision? Please exemplify.

Q35 What part of the due diligence investigation generated the most value overall?

Q36 Was there anything missing in the due diligence process, i.e. was there something that could have been done differently?

Q37 What about the breadth and depth of the information provided, has it been satisfactory with reference to the objectives of the due diligence investigation (i.e. is it too much or too little information)?

Q38 Do you think that the due diligence investigation was a reason for the successful outcome of the transaction? Why/why not?

Case 2 For the following section, please think of a less successful acquisition in which you were involved as an external adviser in the due diligence process.

Q39 In what year did the transaction take place?

Q40 In percentage, what was the stake acquired in the company?

Q41 Within what span was the acquisition price?

- ❍ Less than SEK 0.1 billion (1)
- ❍ Between SEK 0.1 - 0.5 billion (2)
- ❍ Between SEK 0.5 - 2 billion (3)
- ❍ More than SEK 2 billion (4)

Q42 Within what industry was the target company?

- ❑ Technology, media, telecommunication (1)
- ❑ Consumer (2)
- ❑ Industrials and chemicals (3)
- ❑ Pharma, medical & biotech (4)
- ❑ Business services (5)
- ❑ Real estate (6)
- ❑ Financial services (7)
- ❑ Transportation (8)
- ❑ Construction (9)
- ❑ Leisure (10)
- ❑ Energy, mining & utilities (11)
- ❑ Other (12) ____________________

Q43 What was your knowledge within the target company´s industry before the due diligence started?

- ❍ Poor (1)
- ❍ Good (2)
- ❍ Excellent (3)

Q44 How important was the due diligence for the final decision regarding the acquisition?

	Not important at all (1)	Not so important (2)	Important (3)	Very important (4)	Essential (5)
Financial (1)	❍	❍	❍	❍	❍
Legal (2)	❍	❍	❍	❍	❍
Commercial (3)	❍	❍	❍	❍	❍

Q45 Did the due diligence change OR confirm the PE firm's initial opinion about the acquisition decision?

_______ Financial (1)
_______ Legal (2)
_______ Commercial (3)

Q46 Why was this a less successful acquisition?

Q47 How could it potentially have been prevented from being a bad acquisition?

Q48 Was something missing in the due diligence that could have changed the outcome of the deal?

- ❍ Yes (1)
- ❍ No (2)

Q48b What was missing and what were potential reasons for this? (e.g. too narrow scope, poor performed due diligence with regards to the scope, lack of time, poor integration of different opinions)

Q49 What about the breadth and depth of the information provided, has it been satisfactory with reference to the objectives of the due diligence investigation (i.e. is it too much or too little information)?

Q50 Do you think that the PE firm will work with you for similar tasks in the future? Why/why not?

- ❍ Yes (1) ____________________
- ❍ No (2) ____________________

Q51 Do you think that the due diligence investigation was a reason for the less successful outcome of the transaction? Why/why not?

Appendix C – Interview Questions for Credit Institutions

1. What type of due diligence (financial, legal, commercial) is of importance in your opinion? Why?

2. What is your purpose/objective of a due diligence investigation? What do you look for?

3. What requirements/demands do you have on a due diligence process (before the buyout has taken place)?

4. Generally, what are the most important aspects of a due diligence process? What do you perceive as good and bad due diligence respectively?

5. What role, as a lender, do you play in a due diligence process? Are you involved in the due diligence investigation as such? How?

6. Do you propose any specific risk factors that you think should be assessed?

7. How do you evaluate and use the result of a due diligence?

8. Does your evaluation of the due diligence differ when working with private equity firms and industrial firms respectively? How? Why/why not?

9. How important is the external adviser's independency? How independent do you think that the external advisers actually are when performing the due diligence? What are potential aspects that affect their independency?

10. Do you charge any fees in the assessment of a private equity buyout (i.e. in the due diligence process)? How is the payment structured?