Mergermarket

SRS ACQUIOM

Best Practices in M&A Due Diligence

From Tech to ESG, Dealmakers Must Prepare Themselves for Broader and Deeper Scrutiny

Contents

Methodology	2
Foreword & Key Findings	3
Part 1: Due Diligence Burden Growing	4
Part 2: Investment Banks See Many Companies Unprepared for Rising Scrutiny	8
Part 3: Technology Key to Frictionless Due Diligence	12
Outlook: Expect the Unexpected	15

Methodology

In Q4 2023, SRS Acquiom, in partnership with Mergermarket, surveyed 150 senior executives at investment banks (IBs) headquartered in the United States. Of that pool of survey participants, 50 represented boutique IBs with assets under management (AUM) of up to US$500m; 50 represented medium-sized IBs with AUM between US$500m-US$1bn; and 50 represented large IBs with AUM exceeding US$1bn. Each of these subsets of 50 respondents was divided equally between IBs that worked primarily on the buy-side (25) and sell-side (25) in the private-target transactions in which they participated in the past 12 months.

Foreword: Digging Deeper

Though inflation waned over 2023 and growth ticked up in key economies, investors' prevailing risk aversion meant M&A activity was muted. Private equity funds, wary of higher leverage costs, focused on portfolio optimization, add-ons, and public-to-private deals. Corporates, meanwhile, capitalized on reduced competition to pursue acquisitions with good value-creation potential, shifting the balance in global M&A toward strategics.

Due diligence evolved in turn, with dealmakers spotlighting not only core financial, legal, and operational aspects, but also target companies' potential for strategic transformation. This all-encompassing approach, facilitated by new technologies and high-quality data, requires investors to peel back further layers to understand a target's true value. And while more thorough reviews have lengthened the due diligence process, more precise evaluations of companies are the welcome result.

This research explores how investment banks (IBs) are adapting to these developments within the context of modern due diligence.

Key Findings

Due diligence is taking longer: Almost two-thirds of respondents (64%) report that, compared to their pre-pandemic experience, it takes more time now to complete due diligence in a typical M&A transaction, with over half of those respondents (58%) saying it takes on average another 1-3 months to complete due diligence. Almost half of respondents (44%) indicate that a typical M&A deal now takes between 5-6 months from initial information sharing to closing.

Vetting information presents greatest hurdle: The greatest challenge faced by our respondents in the latest buy-side deal in which they participated was vetting the information received, with 31% of top-two votes, weighted largely toward the largest IBs surveyed (48%). Another key challenge raised consistently across IBs of all sizes is unreliable/unclear data, cited by 25% overall.

Regulatory scrutiny will weigh on M&A: Almost half of respondents expect rising regulatory scrutiny in relation to U.S. antitrust rules and foreign direct investment (FDI) (46% and 45%, respectively) to significantly complicate due diligence over the next 12-24 months.

Technology is the pillar of dealmaking today: The most notable way in which respondent organizations' M&A due diligence processes have developed over the last 12-24 months is the incorporation of more technology tools, cited by 80%, by far the largest share.

VDRs are the lifeblood of due diligence: The two technologies that the largest shares of respondents identify as being the most beneficial in streamlining due diligence are virtual data rooms (51% of top-two votes) and project management software (50%).

Part 1: Due Diligence Burden Growing

Timelines Protracted Post-Pandemic

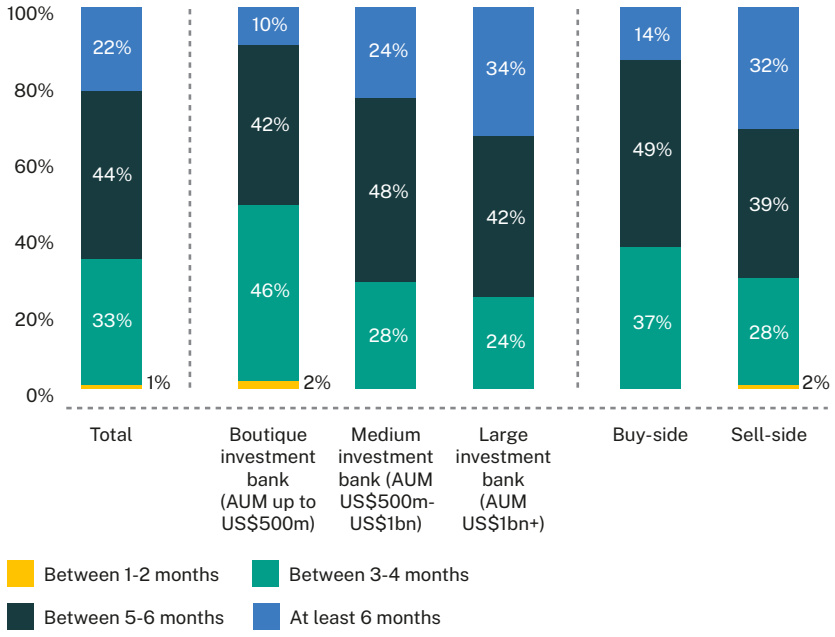
Around half of survey respondents (44%) say a typical deal takes between 5-6 months to complete, though this varies considerably depending on transaction size. Boutique IBs tend to complete transactions more quickly, with 46% finishing deals in 3-4 months. Medium-sized and large IBs typically experience longer timelines, with 34% of the biggest IBs taking at least 6 months, reflecting the complexity of deals they handle.

A managing director of a medium-sized IB highlighted the growing number of risk angles that need to be accounted for, saying: "Technology risks and cyber threats are reviewed comprehensively by most teams. Discussions regarding the cost of rectifying any threats also go on for a longer period."

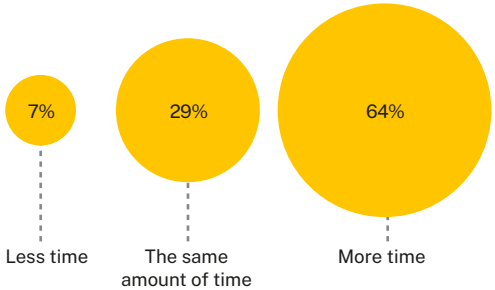
Moreover, almost two-thirds (64%) of IBs report that diligence now takes longer than in pre-pandemic times. This can lead to higher legal, consulting, and VDR fees when not using a vendor with flat-rate pricing as the due diligence process becomes more protracted.

The extent of this change is significant, with 58% indicating an extension of 1-3 months on average. This trend is particularly pronounced in medium-sized and large IBs, where 25% and 27%, respectively, report a 3-6-month extension. Boutique IBs, however, have seen a more modest increase, with 35% noting just a few additional weeks.

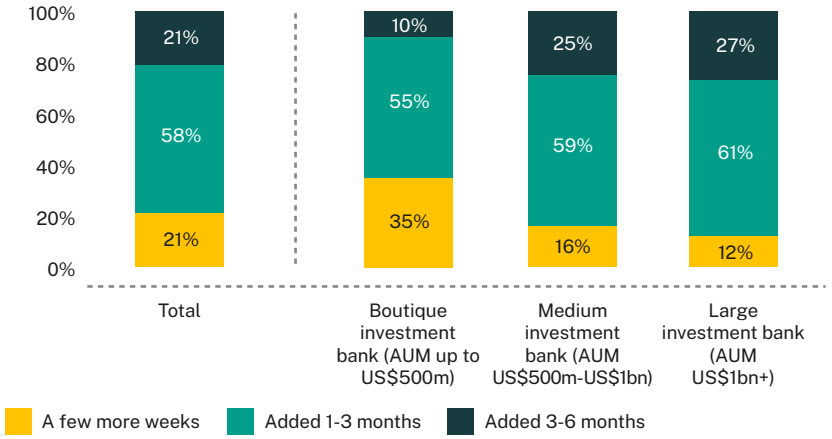
Looking at your firm's transactions over the past year, how long does it take to complete a typical M&A transaction from the initial information sharing to closing? (Select one)



Compared to your pre-pandemic experience, does it take more, less, or the same amount of time to complete due diligence in a typical M&A transaction in which you participate? (Select one)



If respondent answered 'More time' (opposite), how much longer does it take on average to complete due diligence in a typical M&A transaction now? (Select one)

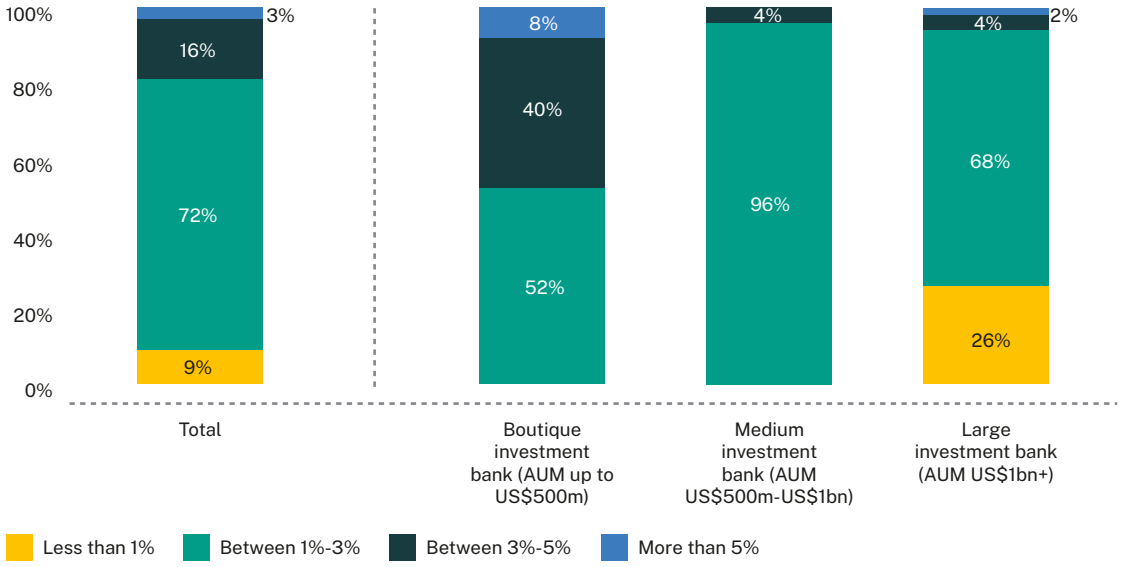


Average Expenses Higher for Smaller IBs

The depth and scope — and ultimately the cost — of due diligence required, and whether additional third-party specialists are needed, hinges on the perceived risks and strategic importance of the acquisition.

Most respondents (72%) indicate that costs fall between 1%-3% of total deal fees, though there is considerable divergence here. Over a quarter (26%) of large IBs report due diligence expenses at under 1% of total costs, by virtue of the size of the deals they advise on. Contrastingly, almost all medium-sized IBs (96%) align with the majority, while boutique IBs often see higher relative expenses, with 40% reporting costs between 3%-5%, and a notable 8% exceeding 5%.

As a percentage of the total deal fees and expenses, how much does due diligence (excluding legal fees) cost in a typical M&A transaction in which you participate? (Select one)



The depth and scope — and ultimately the cost — of due diligence required, and whether additional third-party specialists are needed, hinges on the perceived risks and strategic importance of the acquisition.

Agile IBs Capitalize on Tech Adoption

Over the past two years, new technologies have had the biggest hand in shaping due diligence processes for IBs of all sizes — 80% of respondents report that their adoption of these tools in the last 12-24 months has been the most pronounced development in their workflows.

"Incorporating more technologies has been one of the major changes for us recently. We wanted to create a strong ecosystem and compete with larger firms more effectively," says the managing director of a boutique IB. "The gradual enhancements of technology are helping with that." Boutique IBs lead in this recent technology adoption at 94%, compared to 76% for medium-sized and 70% for large IBs.

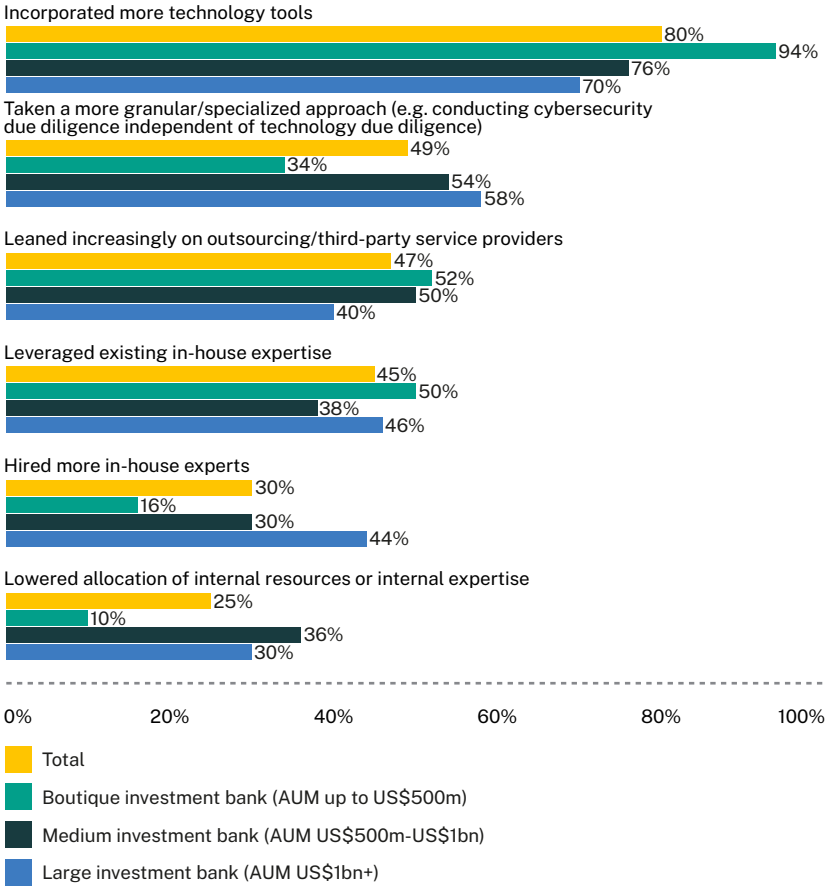
Third Parties Engaged to Address More Granular Reviews

In the past two years, 49% of respondents adopted a more detailed approach to due diligence, such as separating out cybersecurity and IT into separate reviews. Additionally, 47% now rely more heavily on third-party service providers, and 45% more extensively leverage in-house expertise.

Large IBs are more inclined to hire in-house experts (44%), compared to medium-sized (30%) and boutique IBs (16%). This tracks with outsourcing trends; 40% of large banks report increasing their third-party arrangements, versus 50% and 52% of medium-sized and boutique banks, respectively.

"We felt it was necessary to hire third-party providers for some of the assessments. Intricate details are considered important to the valuation, particularly when it's related to sustainability. We also used outside services to complete work on time," says the managing director, of a medium-sized IB.

In what ways, if any, have your M&A due diligence processes developed over the last 12-24 months? (Select all that apply)



> Incorporating more technologies has been one of the major changes for us recently. We wanted to create a strong ecosystem and compete with larger firms more effectively.
>
> **Managing director, boutique IB**

Vetting Information and ESG Present Greatest Hurdles

Around a third of respondents (31%) highlight vetting information as one of their top-two buy-side challenges. An equal share cites insufficient in-house ESG expertise as a key setback.

Large IBs feel the challenge of vetting information more acutely; 48% of these respondents identify this as a top-two challenge, versus 18% and 28% of medium-sized and boutique IBs, respectively. The biggest respondents were also somewhat more likely to cite a lack of in-house ESG expertise (38%, versus 30% and 24% of medium-sized and boutique IBs, respectively), though this is clearly a hurdle for all respondents.

This lack of internal resources is relative — larger banks handling bigger deals adhering to higher standards face greater demands. "Especially after the pandemic, the emphasis given to ESG due diligence has increased considerably. Companies are also spending more money on ESG reviews. They prioritize ESG because it promises long-term sustainable returns as well," adds the managing director of a large IB.

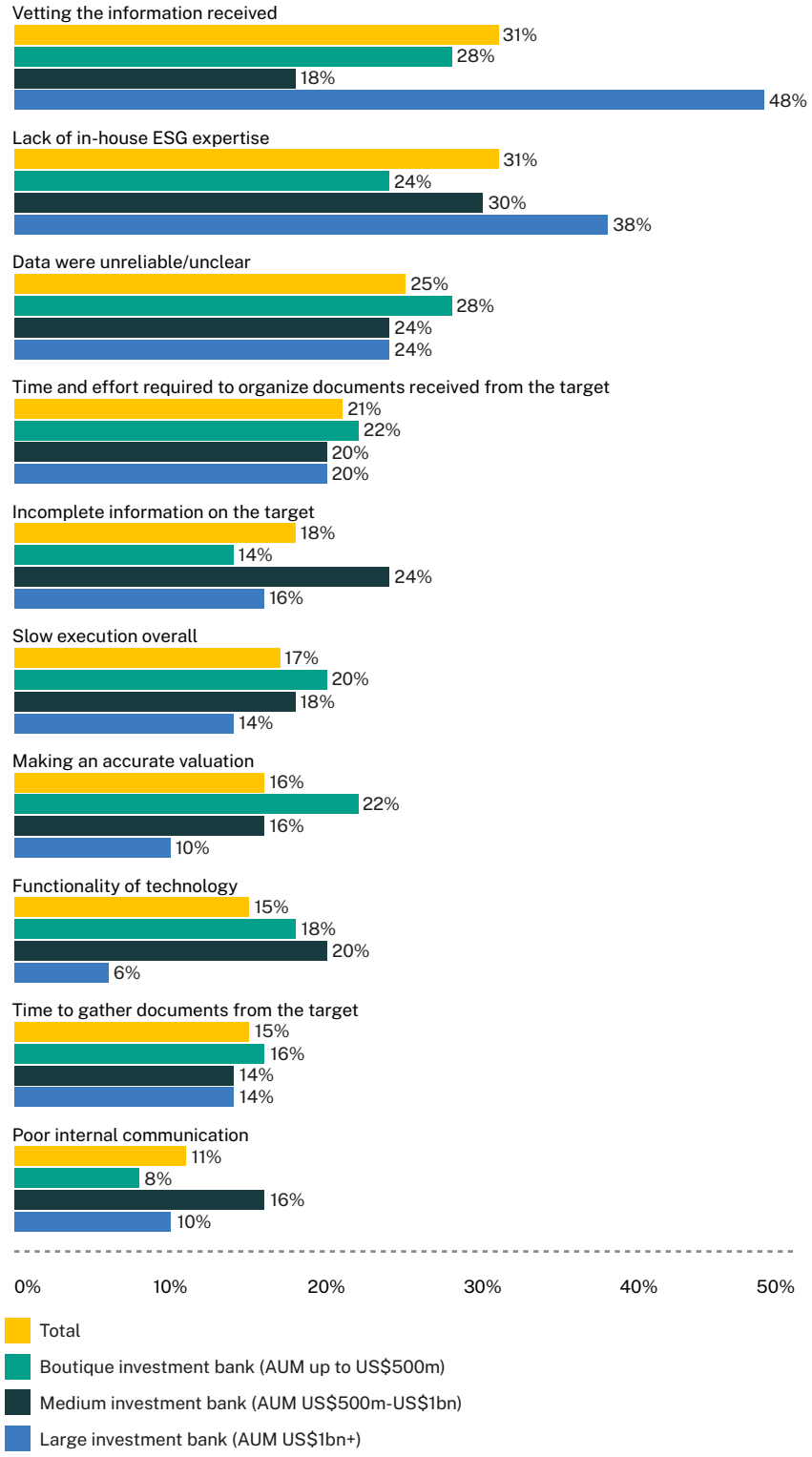
Unreliable Data Stymie Due Diligence

Rising ESG-related litigation makes it imperative for acquirers to thoroughly evaluate ESG risks during due diligence. This growing pressure is pushing advisors to expand their in-house teams, though the relative immaturity of ESG data tracking and reporting, especially among private businesses, impedes diligence exercises.

"The data on ESG and commercial activity has often been unreliable. We could not track the sustainability progress across the value chain effectively. I think that data unreliability challenges will continue for the foreseeable future," says the managing director of a boutique IB.

Data holes impact more than ESG metrics. A quarter of all respondents cite unreliable data as a top-two challenge, weighted slightly toward smaller IBs (28%) working on smaller deals involving targets in earlier governance maturity.

In the most recent buy-side M&A transaction in which you participated, what was the biggest challenge faced during the due diligence process? (Select top two)



Part 2: Investment Banks See Many Companies Unprepared for Rising Scrutiny

Pandemic Underscores Financial Diligence

Target reviews have expanded in scope and depth; however, verifying a company's financial statements remains the crux of due diligence. It follows that 42% of respondents say that financial appraisals were one of their top-two diligence priorities over the past 12 months in terms of time and resources.

The significance of drilling down into financials was magnified post-pandemic, marked by the uptake of the concept of EBITDAC (earnings before interest, tax, depreciation, amortization, and coronavirus).

The managing director of a large IB shared that many businesses are still grappling with these pressures: "Many companies are unable to manage the sudden impact of macro conditions, including currency fluctuations, global inflation, and economic distress. Reviewing these factors during due diligence has increased complexities."

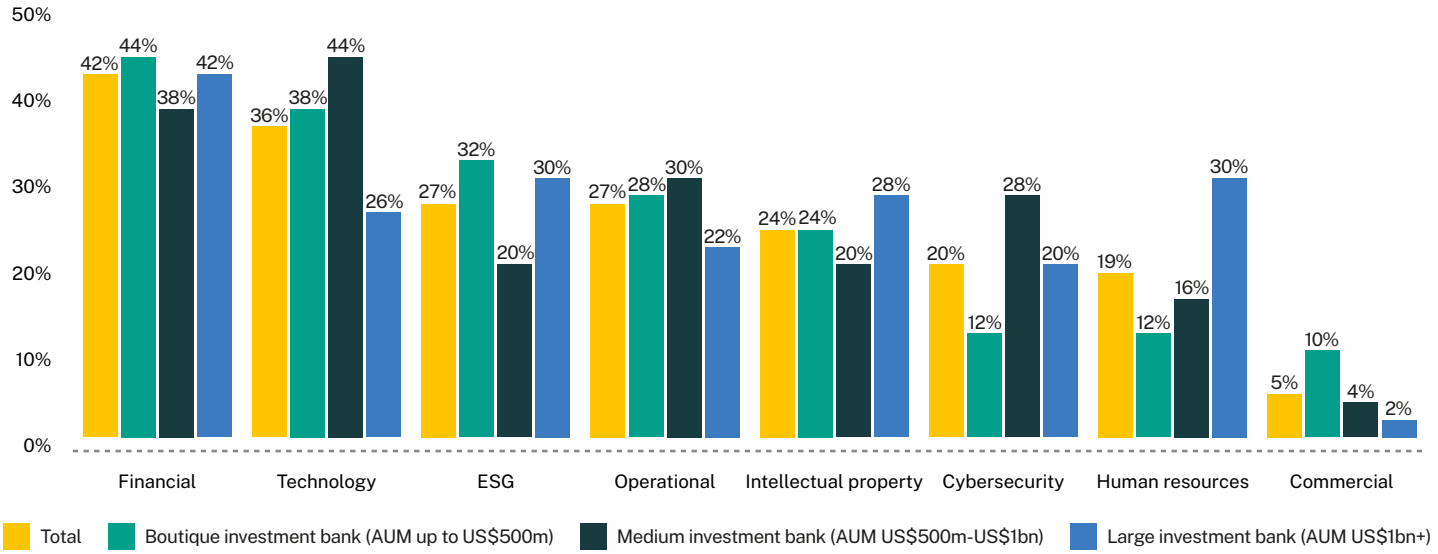
Large IBs Prioritize HR Appraisals

After financial appraisals, 36% of respondents emphasize technology diligence as one of their top-two areas of focus, covering evaluations of targets' technical assets, software, IP, and IT systems' scalability. This is key to identifying potential hurdles when integrating or upgrading technology systems post-acquisition.

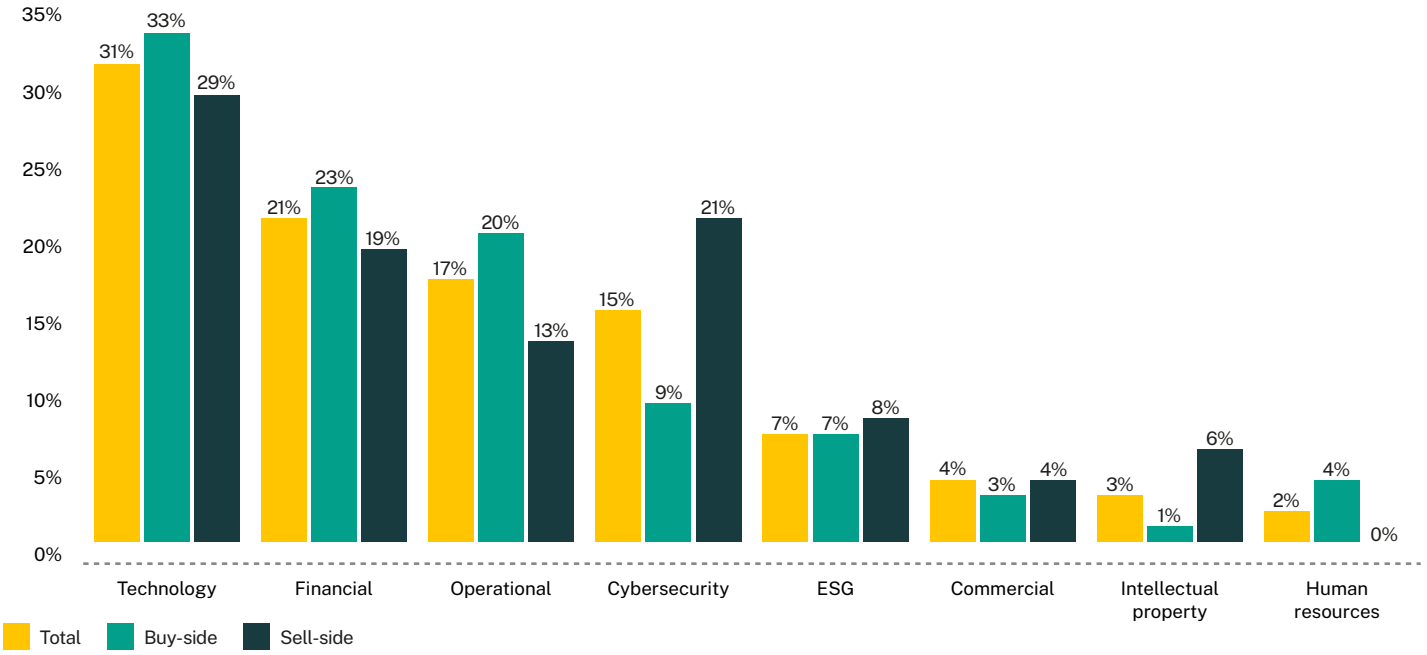
Notably, large IBs are less likely (26%) than their medium-sized (44%) and boutique (38%) peers to say that dealmakers have prioritized technology due diligence over the last 12 months. This perhaps reflects how technology reviews have long been a priority on large-cap deals and already grown into a fully integrated part of the diligence process.

Conversely, large IBs are more likely to cite human resources as an area of emphasis (30%, versus just 16% and 12% of medium-sized and boutique IBs, respectively).

A) In your experience, which of the following areas of due diligence have been prioritized by dealmakers over the last 12 months and have seen the most noticeable increase in terms of resources/time allocated? (Select top two)



B) Of the elements of due diligence listed in part A (page 8), which is the most costly/onerous to complete to a sufficiently high standard in a typical M&A transaction in which you participate? (Select one)



Tech Reviews Most Onerous Facet of Due Diligence

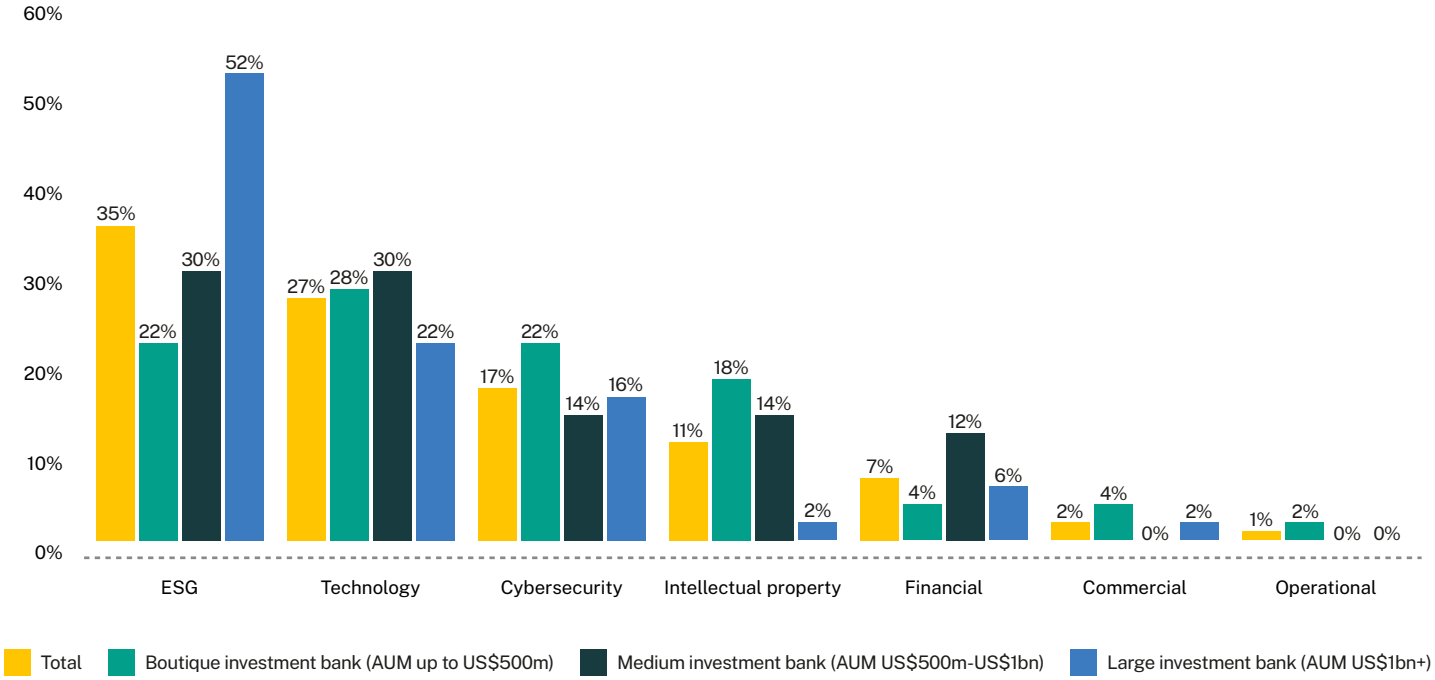
Of the various aspects of due diligence, 31% of respondents say technology appraisals are by far the most costly and onerous to complete to a sufficiently high standard in a typical M&A transaction, ahead of second-place financial due diligence (21%).

Respondents working primarily on the buy-side are more likely than their sell-side peers to cite operational due diligence as the most resource-intensive facet of due diligence (20% versus 13%, respectively). This stands to reason since, in the case of mergers, operational diligence is necessary to understand whether the target is a good fit.

On the sell-side, 21% say that cybersecurity due diligence is a challenge in terms of resources, while only 9% of buy-side respondents agree. This is indicative of vendors' need to present a company as a secure investment with robust controls in place to protect critical assets.



C) Of the elements listed in part A (page 8), for which are you most likely to hire third-party subject-matter experts to assist in due diligence? (Select one)



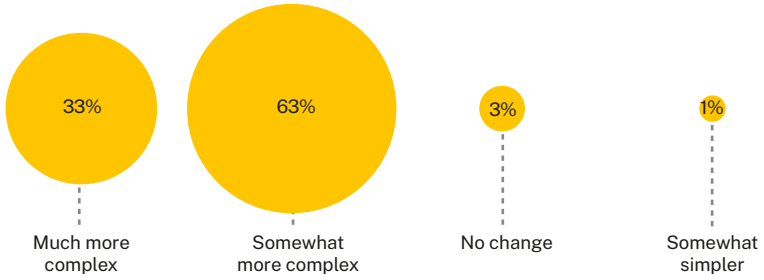
IBs Report Many Companies Ill-Equipped to Conduct ESG Diligence

Over a third of respondents (35%) say they are most likely to hire third-party advisors to assist on ESG due diligence, with technology (27%) and cybersecurity (17%) being the next most popular responses.

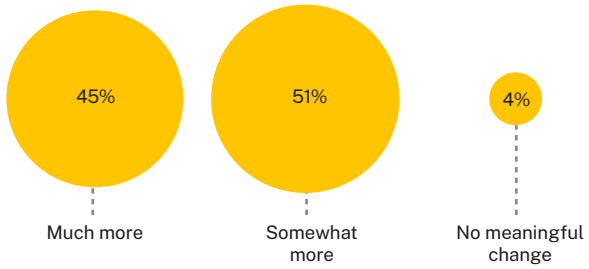
"Although ESG data management is considered a critical part of business activities, many companies do not have mature strategies to manage ESG information. Scattered information can lead to more complex due diligence processes," says the managing director of a medium-sized IB.

Large IBs are much more likely (52%) than their medium-sized (30%) and boutique (22%) peers to engage third parties for ESG due diligence, reflecting the higher governance standards that are expected of larger businesses.

How much more complex do you expect the overall M&A due diligence process in M&A to become over the next 12-24 months? (Select one)



How much more scrutiny do you expect due diligence relating to environmental, social & governance (ESG) issues to come under over the next 12-24 months? (Select one)



Due Diligence is Growing Ever More Complex

Most respondents (63%) anticipate due diligence becoming somewhat more complex in the next 12-24 months, with an additional 33% forecasting a substantial increase in complexity.

Almost all respondents (96%) expect ESG due diligence to come under more scrutiny. “A lot of this comes from greenwashing,” says the managing director of a medium-sized IB. “Some companies have set a very bad example when it comes to proclaiming green credentials, and this means there will be more scrutiny overall.”

The outlook is similar for cybersecurity due diligence; virtually all respondents (98%) anticipate stricter scrutiny over the next 12-24 months. Mounting cyber threats and the digitalization of business models underscore the necessity of closely evaluating a target’s security.

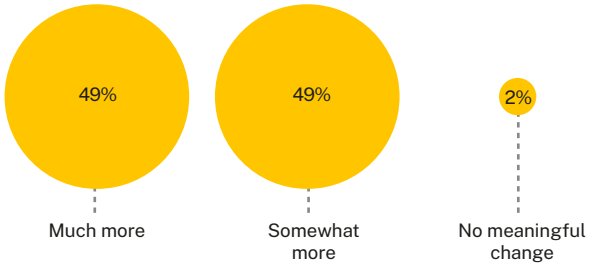
Government Interference Set to Intensify

Under the current U.S. administration, the Federal Trade Commission and Department of Justice have pursued far more rigorous antitrust oversight. Over the next 12-24 months, 46% of respondents expect rising scrutiny from U.S. competition regulators to make M&A due diligence processes significantly more complicated. A further 44% say this will complicate due diligence at least somewhat. Large IBs show the most concern, with 64% of this cohort forecasting significant complications, versus 42% and 32% of medium-sized and boutique IBs, respectively.

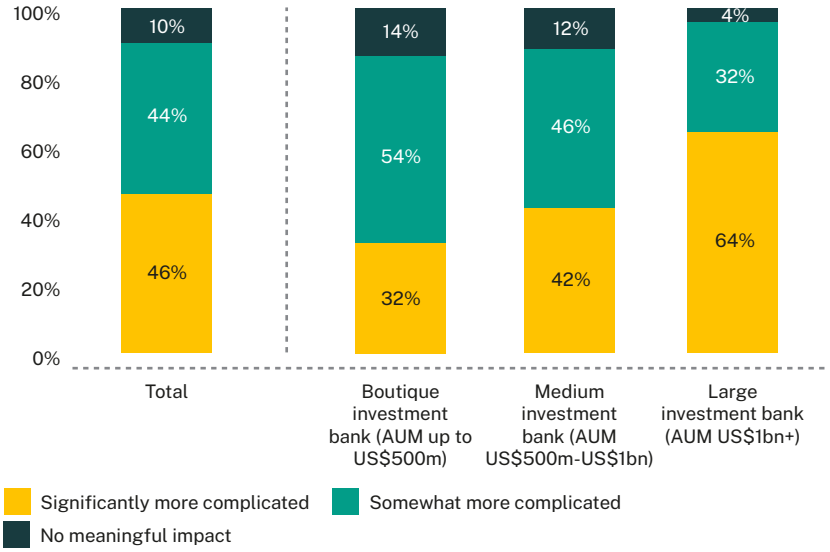
A major challenge is the unpredictable perspectives that agencies may have on specific transactions. “The U.S. antitrust norms can be somewhat ambiguous. The expectations relating to merger control and merger conduct are not very specific,” says the managing director of a large IB. “The extent of government interference in deals is troubling.”

These complexities extend beyond borders, with geopolitical competition constraining cross-border M&A. Nearly all respondents believe that rising regulatory scrutiny related to FDI measures will complicate M&A due diligence processes either significantly (45%) or somewhat (43%) over the next 12-24 months.

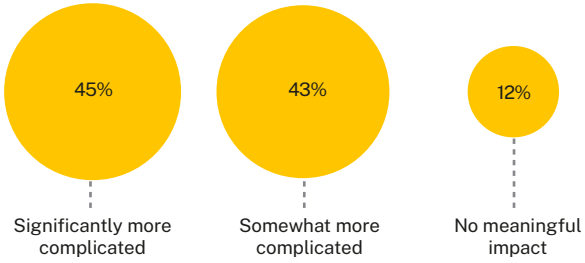
How much more scrutiny do you expect due diligence relating to cybersecurity to come under over the next 12-24 months? (Select one)



To what extent do you expect rising regulatory scrutiny in relation to U.S. antitrust rules to complicate M&A due diligence processes over the next 12-24 months? (Select one)



To what extent do you expect rising regulatory scrutiny in relation to foreign direct investment measures to complicate M&A due diligence processes over the next 12-24 months? (Select one)



Part 3: Technology Key to Frictionless Due Diligence

Pre-Empting Bottlenecks is Primary Maxim

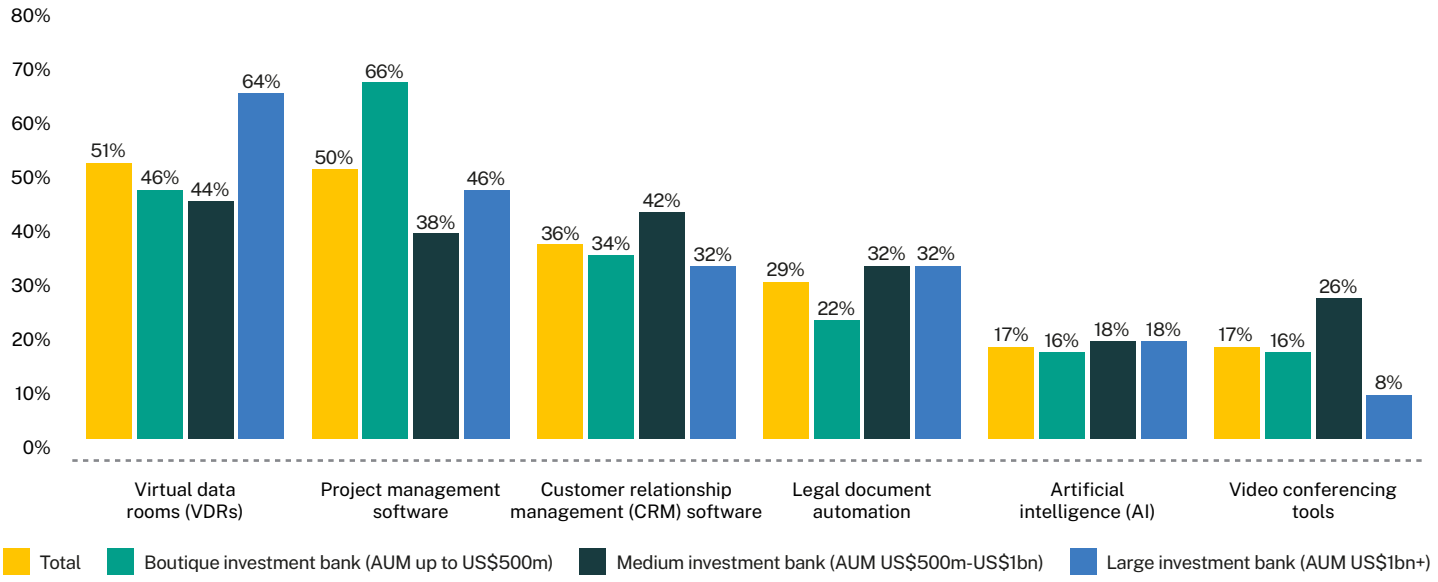
Dealmakers are constantly seeking ways to streamline due diligence and optimize their resources without compromising on thoroughness. Regarding specific measures to minimize friction, 42% of respondents cite conducting regular reviews to pinpoint bottleneck risks as one of their top-two strategies.

Identifying key areas for due diligence based on the target's risk profile is highlighted as a critical measure by 40% of respondents. Other beneficial strategies include setting predefined timeframes or "sprint" periods for specific tasks (35%) and employing standardized checklists (34% of votes).

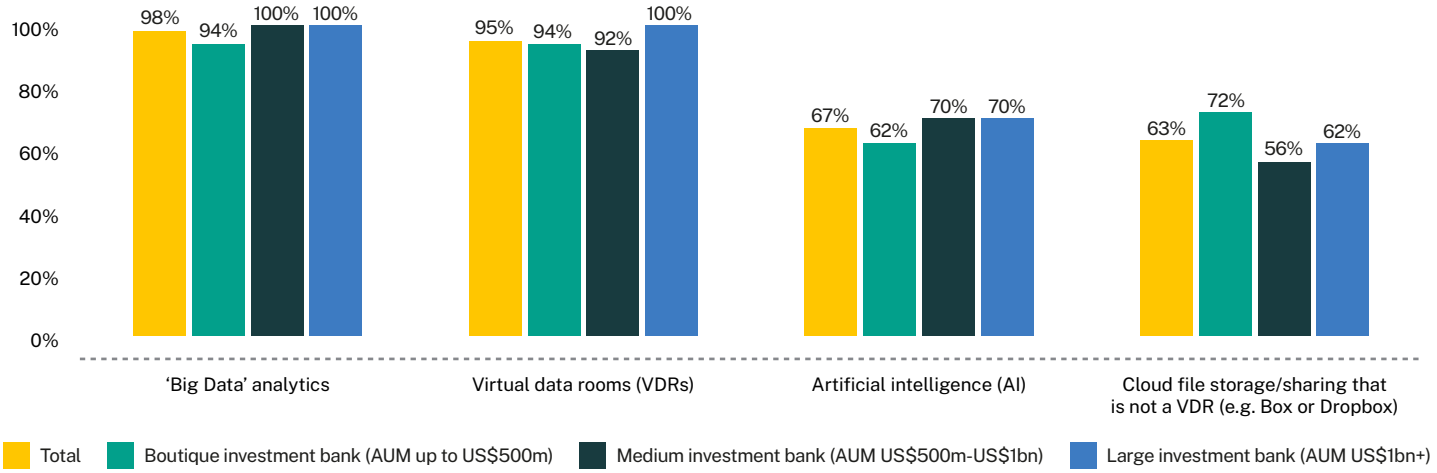
Which of the following processes are most beneficial in helping to streamline the overall due diligence in a typical M&A transaction in which you participate? (Select top two)



Which of the following technologies are most beneficial in helping to streamline the overall due diligence in a typical M&A transaction in which you participate? (Select top two)



Which of the following technologies do you habitually use during a typical due diligence process? (Select all that apply)

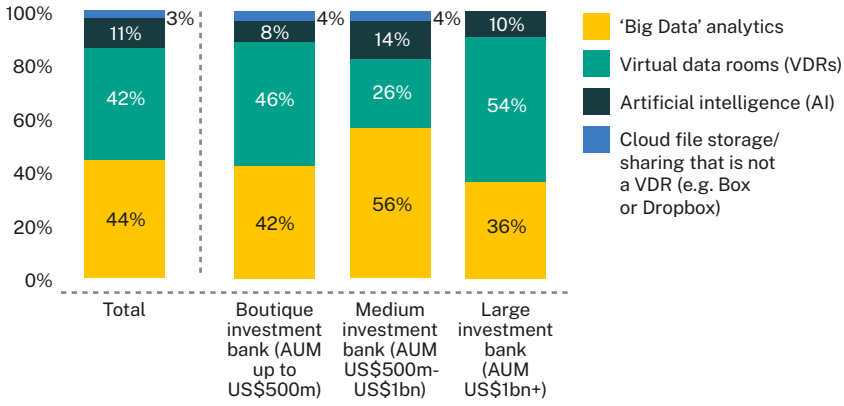


Data Analytics Most Valuable Tool

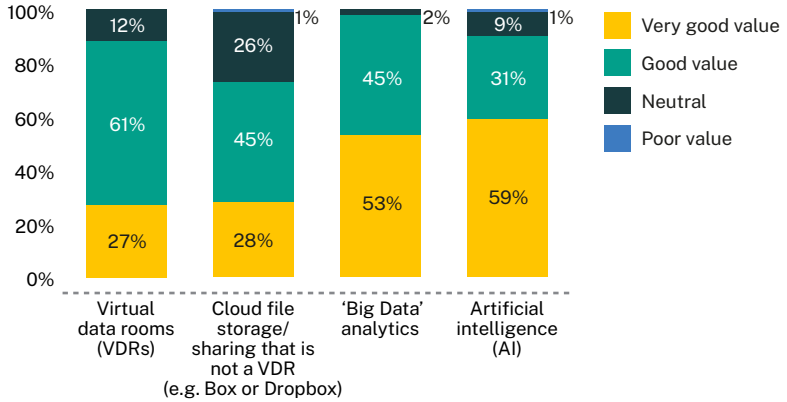
Among the technology tools IBs habitually employ during a typical due diligence process, Big Data analytics (44%) and VDRs (42%) are most frequently identified to be the most valuable. Moreover, almost all respondents (98%) believe Big Data analytics technology offers either good or very good value for the cost, and 88% say the same of VDRs.

Larger IBs have a stronger inclination toward VDRs; 54% consider them the single most valuable technology, versus 26% of medium-sized IBs. This could be attributed to the scale of deals to which larger banks are assigned, where the secure handling of vast sums of sensitive data is the top priority. Conversely, medium-sized banks lean more toward Big Data analytics (56%, compared to 36% of larger IBs). This perhaps speaks to the greater scope for experimentation in these organizations, whereas large banks may have more rigid workflows.

Which of the following technologies do you habitually use during a typical due diligence process? (Select the single most valuable currently)



For each of the technologies listed above, to what degree do these offer good value for the cost? (Select one)



VDR Costs Catch Sellers Off Guard

Concerning their use of VDRs and the pricing of these tools, just over a third of respondents (37%) say the final cost of the VDR is usually higher than was estimated, with this share of survey participants weighted more toward respondents who operate primarily on the sell-side (51%). Only a little more than half of respondents (56%) say the final cost usually matches the estimate provided in the initial bid. Buy-side respondents are more likely than sell-side respondents to state that the final cost aligns with the initial estimate.

The final cost of the VDR, including fees, for the deals on which respondents work varies considerably according to their size. Among boutique IBs, 72% say the cost is typically between US$15,000-US$30,000. For 68% of medium-sized IBs, it is between US$30,000-US$50,000, and for most large IBs (56%) between US$50,000-US$100,000.

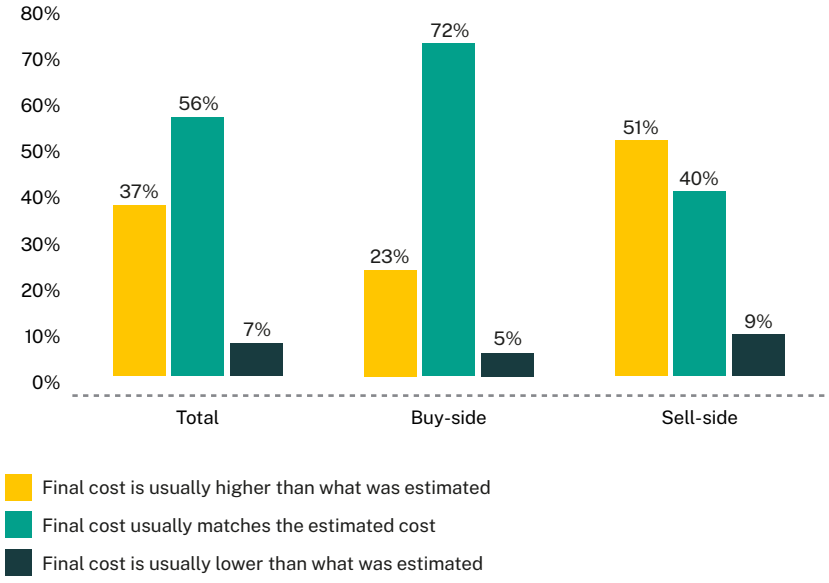
AI Tools in Their Infancy

Two-thirds of IBs report habitually using AI during a typical due diligence process, and just 11% say it is currently the most valuable technology at their disposal, while 17% cite it as a top-two tool for streamlining due diligence.

While still plainly in the early stages of maturation and adoption, 59% of respondents believe AI tools already offer very good value relative to their cost. However, some respondents caution against fixating on the cost efficiency of AI at this stage in its adoption cycle, advising that banks should first understand how it can be used to best effect.

The managing director of a large IB says: "We spend too much time analyzing the monetizing capacity of machine learning tools, and we tend to miss opportunities of using them to their full potential. We can enhance our approach to adopting this technology in the next 12 months."

How often does the final cost of the VDR match the estimated cost in the initial bid? (Select one)



We spend too much time analyzing the monetizing capacity of machine learning tools, and we tend to miss opportunities of using them to their full potential. We can enhance our approach to adopting this technology in the next 12 months.

Managing director, large IB



Outlook: Expect the Unexpected

Due diligence providers face increasing demands over the next 12 months, from the growing emphasis on technology adoption, to the need for more robust target company assessments and increased scrutiny.

Simultaneously, there will be an increasing emphasis on ESG reviews, reflecting mounting regulatory requirements. This hawkishness applies also to intensifying antitrust risk, which necessitates a more nuanced approach to navigate an often-ambiguous regulatory landscape.

The need for resilience and agility is a central through-line. Following recent major risk events, IBs must be ready to manage whatever shocks come their way. As the managing director of a large IB puts it: “The recent past has shown us we need to be more prepared for the unexpected.” Being able to pivot and adapt will be more critical than ever moving forward. As the past three years have shown, failure thrives in the absence of preparation.

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