Doing Effective Due Diligence

by Charles B. Wendel

This week and next we'll focus on issues related to due diligence. As M&A activities are likely to increase in 2023, excellence in due diligence is critical for sellers but in particular for acquirors. Yet, there are at least two current examples of due diligence disasters, both economic Titantics and PR embarrassments.

The financial press has recently featured headline stories about supposedly sophisticated and super-smart investors being scammed by "entrepreneurs" who tricked them despite their "independent" due diligence processes.

Most notoriously, the head of FTX seems to have run an old-fashioned Ponzi scheme, which some of the top Fintech investors lined up for, eager to buy a piece of the unlimited upside. Names like Sequoia Capital, SoftBank, Robert Kraft, and the Paul Tudor Jones family trusts face the zeroing out of their investments.

In a September 2022 profile now taken off Sequoia Capital's website (after a $200mm+ write-off), the fan-like adoration of the head of FTX seems cringe-worthy: "We were incredibly impressed," Michelle Bailhe, a partner at Sequoia who set up the meeting, recounted in the article. "It was one of those your-hair-is-blown-back type of meetings." The article goes on to quote her enthusiastic view of FTX and its founder:

"Of the exchanges that we had met and looked at, some of them had regulatory issues, some of them were already public," Bailhe says. "And then there was Sam." The exchange that SBF had started to build, FTX, was Goldilocks-perfect. There was no concerted effort to skirt the law, no Zuckerbergian diktat demanding that things be broken. And, yet FTX wasn't waiting to get permission to innovate." For sure.

And what how did the best-in-breed partners respond to the founder who played a video game during the meeting?

"Suddenly, the chat window on Sequoia's side of the Zoom lights up with partners freaking out.

'I LOVE THIS FOUNDER,' typed one partner.

'I am a 10 out of 10,' pinged another.

'YES!!!' exclaimed a third."

Goldilocks perfect, indeed.

Within banking, just last week Chase shut down a website, its college financial aid platform. Reports state that in 2021 the bank paid $175mm for Frank, a company that it said provided the "fastest-growing college financial planning platform" used by 5mm students to find various types of aid. Chase now claims that its actual users numbered 400,000 with the other 4mm created by a data scientist paid to invest more users prior to sale.

In 2020, Frank, the Chase calamity, had been warned by the FTC that it may be unlawfully misleading consumers" about student Covid relief. In 2018 Frank settled with the Department of Education on an issue related to misrepresenting itself. Other warning signs occurred prior to the Chase offer (including four Congresspersons asking for an investigation.

Somehow Chase, about as smart a bunch of bankers as exist today, failed to check the numbers provided by Frank despite its somewhat sketchy history.

In both instances as well as many others , the investors were sophisticated and well experienced in evaluating investments. But in both these cases the investors made basic mistakes, embarrassing themselves, losing millions, and setting themselves up for lawsuits attacking their actions and failure to protect their own investors.

How could this happen to these top tier teams?

Probably the most impactful work we have done has been in the area of due diligence, helping clients wring the most out of transaction and , at least as important, warning clients away from deals that presented ore pitfalls than likely profit.

Next week we'll discuss five areas that impact the effectiveness of due diligence, and we'll suggest some approaches for success:

1. Avoiding deal bias
2. Chasing the shiny penny
3. Relying on the other guy
4. Bowing to the Emperor
5. Assigning the wrong team/penny wise but pound foolish