EMPEA

How Pre-Deal Due Diligence Investigating Is Changing with the COVID-19 Pandemic

By Randal Phillips, Partner, Mintz Group

Among the many corporate functions upended by the coronavirus crisis is M&A due diligence. After all, deals used to start with a handshake, with assurance conveyed by a touch. But now handshakes, management meetings, dinners, and rounds of golf have been replaced by faces in Zoom boxes. And that's just the beginning of how due diligence is adapting, particularly for cross-border deals facing newly hostile borders.

To a greater degree now, taking advantage of cross-border deal opportunities means doing business with people you do not know, and will likely not even meet for a while. In risky times, being skillful at independent fact-gathering—diligence—is more important than ever.

We have noted on many occasions how investigation is the job of a private equity deal team. How successful investing depends on deep investigating—gathering independent facts that deal teams need to test the representations being made to them across the table.

Well, in the age of coronavirus, your investigations just got harder and more complex. We hope this article helps by highlighting some specific due-diligence considerations in these changing times. After all, it's not the first time that diligence has had to adapt to new risks (think 9/11 and terrorist financing).

"To a greater degree now, taking advantage of cross-border deal opportunities means doing business with people you do not know, and will likely not even meet for a while. In risky times, being skillful at independent fact-gathering—diligence—is more important than ever."

As due diligence professionals with experience helping private equity and other institutional investors, we want to offer four observations, a sort of report from the front on how an investigative due diligence firm and its clients are adapting to the coronavirus crisis, a few months in:

1. Check the Politics

Recent unprecedented events have shaken industries the world over, and deal diligence is racing to keep pace. For example, governments are speeding to erect barriers against foreign investment, out of concern about protecting increasingly vulnerable local industries. This protectionism is adding a layer of complexity to pre-transaction due diligence.

Some governments are taking "drastic" steps to repel foreign investors, according to Baker McKenzie's Samantha Mobley, in a recent *Legal Business* column. Spain, for example, is requiring non-EU players to get Madrid's approval to invest in strategic sectors such as technology, health care, and even media.

"These developments highlight the need for investors to carefully consider foreign investment review risks at this highly-sensitive and volatile time both for deals currently underway and transactions being contemplated," Ms. Mobley said. "Never has it been more relevant for [investment] companies to keep in mind the age-old advice for acquirers: buyer beware."

Luigi de Vecchi, Chairman of EMEA banking capital markets advisory at Citigroup, has predicted "a return of state intervention, triggered not only by protectionist moves to deter unwanted takeovers, but by the sheer necessity to rescue entire industries, revive strategic assets, and, where possible, create domestic champions through consolidation."

While there have always been prospective transactions that drew scrutiny from host governments, depending on the industry and origin of investment, we are now faced with many governments erecting barriers and reviews, apparently overnight, and often without announcement or explanation.

 © 2020 EMPEA

In addition to such direct expressions of political concern, we can see the likelihood of indirect effects of the virus crisis; we would predict, for example, that the concept of "politically sensitive persons" will effectively be broadened in this new environment.

Among the issues that we have been asked to investigate over recent months:

- Beyond official, Committee on Foreign Investment in the United States (CFIUS)-like standards on deal approval, will unannounced anti-foreign standards be informally applied?
- Which competitors, merchants' associations or gadflies will stir up opposition to deals like ours?
- Does the company's lobbyist have a good reputation locally?

2. Frauds & Exaggerations Are Flourishing

Cross-border deal diligence began adapting the day that the first deal team canceled plans to fly out and lay eyes on a business. The challenge is to understand with whom one is really dealing, without handshakes, dinners, and management meetings.

With borders and air travel restricted, there is now a premium on local and hyper-local resources who can lay eyes on something for you, without needing to go through an airport.

A due diligence team who has "boots on the ground" can still ask around locally as an independent check on what a party claims. We tell our clients: You invest globally, we investigate locally.

Those local inquiries often encounter shades of gray—less often finding an outright scam (although they do happen) and more often uncovering exaggeration and artful omission. (Like the out-of-work holes in résumés that we find have been filled in by self-created "employers.")

> "In the current environment, everyone assumes that claims of solvency and buoyancy are at least out of date, if not outright optimistic. At a time like this, almost every company is stressed or distressed. Don't trust until you verify."

The best sources for a detailed, nuanced view of a local businessperson's reputation are often former employees and former partners —identify them in social media, local records, and industry directories; and then go knock on their doors.

During the pandemic, contacting and interviewing sources has gotten both harder and easier. Harder because lives have been turned upside down, but easier because, working from home, people now have more time than ever to chat with us.

Our experience would confirm the conventional wisdom that downturns expose frauds; most famously, Bernie Madoff confessed in December 2008. But THIS downturn seems to be launching as many frauds as it exposes.

Our lives are more online than ever, and so is fraud. We note a rise in completely fabricated identities (the ink isn't dry on their LinkedIn profiles); "supporters" whose social media profiles were all created by the company they endorsed; online bios with aspirational (stock) photos; and, countless other snares for those not careful.

We use a wide range of open-source and proprietary tools to dig up information, and you can incorporate some of these into your own diligence. The Internet Archive —commonly known as the "Wayback Machine"—is a database of past versions of websites. You can use it to see whether the company you are looking to acquire has changed management or focus over the years, and if the representations they are making to you actually match reality. If they've been in business for nine years, why did their 2016 website say they were founded last year? Would you be as confident in your thesis if the lighting company you are looking at was selling used books two years ago?

In other words, web-savvy diligence needs to keep pace with web-savvy fraud.

3. Each Party Is Checking the Depth of the Other's Pockets

Creditors have always asked our investigative due diligence company to check on a company's or individual's assets and financial wherewithal, but in this new environment, that particular assignment is even more common.

And we are asked by companies to check the financial bona fides of investors. We recently reported to a client that the fund offering to finance them was itself tapped out, and that the financing was actually coming from another party.

In the current environment, everyone assumes that claims of solvency and buoyancy are at least out of date, if not outright optimistic. At a time like this, almost every company is stressed or distressed. Don't trust until you verify.

4. Supply Chain Is a Business Issue, a Political Issue, and an ESG Issue

The pandemic has accelerated the rethinking of supply chains, and, again, diligence is running to keep pace. Let's say your client is thinking of investing in a company that is in the process of

Case Study: Supply Chain Diversification from China to Ethiopia

Before COVID-19, some manufacturers were already looking to shift their supply chains away from China, due mostly to rising costs, and in part from the pressure of the escalating trade war. The pandemic has fueled this trend further, as recent factory closures in China and logistical challenges forced manufacturers to seek greater diversity in their supplier bases.

In recent months, we have helped clients diligence new supply chains as they consider moving production from China to countries like Vietnam and Ethiopia. Export manufacturing zones such as Ethiopia's industrial parks—with favorable tax treatment, foreign ownership allowances, and generous staff visa requirements—present attractive opportunities, especially in the textile and garment industry. But supply chain diversification carries with it a variety of concerns that corporations and investors will want to face with their eyes wide open:

- **Business-related concerns:** Turnkey factories may be of a high standard, but industrial parks are often located in regions hungry for economic development. Local infrastructure deficiencies (e.g., electricity, road and transport links, and labor availability) can easily hamstring state-of-the-art facilities, and thus a holistic diligence process is required.
- **Political concerns:** Export manufacturing programs are usually popular at the national level, but regional support can be mixed. With national industrial policy crafted by the capital, some facilities face opposition from local leaders, which may involve protests or labor strikes. One approach is to perform a stakeholder mapping exercise, and then to conduct interviews with key actors to identify sensitive issues.
- **ESG-related concerns:** In addition to concerns around wages, housing, and working conditions, national industrial programs have faced repeated allegations of land grabs and wide-scale—sometimes violent—displacement of local groups. For one client that was facing damaging accusations in the media, we conducted a comprehensive investigation of the raw materials in its supply chain. We were able to prove that none of the cotton supplying its factory came from farms that had forcibly displaced the local community, and our client was able to use our findings to refute the accusations.

As firms increasingly seek to diversify their supply chains to Myanmar, Vietnam, Mexico, and Ethiopia, the need arises to apply multiple layers of diligence that are informed by on-the-ground knowledge of the local business, political, and ESG landscapes.

moving their supply chain from China to Vietnam. Of course, we would want to check the legitimacy and solvency of the new vendors in Vietnam. (At this point, that country's business environment is so overheated that one issue might be whether they're too busy to fulfill a new customer's orders.)

But these days, an additional issue could arise from the China side in this hypothetical: Is the jurisdiction being abandoned (China) likely to impede the company's departure, with tax penalties or holding inventory hostage? And when Chinese joint-venture partners have felt aggrieved by a Western partner moving on, local security forces have even detained departing managers. To assess these risks, you will want eyes and ears on the ground to provide local knowledge and context, such as how the government has responded in similar previous cases.

Due diligence investigating —though more difficult during the pandemic — is more important than ever. And we investigators —and I mean you too, investors —are ready to meet the new challenges.

About the Author

Randal Phillips is a Partner based in Mintz Group's Beijing office. Randy spent 28 years with the Central Intelligence Agency, most recently serving as the Chief CIA representative in China.

Founded in 1994, the Mintz Group has conducted more than 10,000 investigations in more than 100 countries, from internal fraud investigations in Dubai to due diligence background checks in China.

 © 2020 EMPEA