Are You Making This Huge Due Diligence Mistake?

Failing to conduct IT due diligence can make or break your investment strategy

Don’t fall into the “simplicity trap.”

That’s the warning from Dave Noonan, national leader of RSM US LLP’s Private Equity Consulting Group. Too often, Noonan says, investment teams analyzing a carve-out or M&A deal think that only complex businesses with complex technological infrastructure require extensive due diligence of IT systems and processes.

“If you look in the marketplace today, only half of the transactions include IT diligence,” Noonan says.

And too often that leads to costly mistakes.

What's at risk?

Without a pre-close understanding of the systems upgrades that need to be made, a 100-day improvement plan could instead take a year. And without the right systems in place, management won't be able to generate meaningful data and metrics to make informed business decisions to grow revenue—making an efficient and effective IT improvement plan a critical element of success.

It's a Strategy 'Breaker'

"A flexible IT platform can make or break an aggressive M&A strategy," explains Jonathan Caforio, principal in Technology and Management Consulting at RSM US LLP. "In some cases, 50 percent of the post-acquisition synergies are IT-dependent."

The reality is that even the most "simple" business relies on a range of hardware and software that requires integration with a platform company or, in the case of a carve-out, needs to be untethered from its corporate parent and either dispositioned or re-established.

Caforio says that extensive IT due diligence answers obvious questions, such as whether an existing phone system needs to be replaced and whether an enterprise resource planning system, customer relationship management system, or payroll system will require extensive integration work. But that due diligence also answers more fundamental questions.

"For the companies we do diligence on, you get a good leading indicator on how the business is run and the discipline in the organization," he says.

Diligence Done Wrong and Done Right

In one recent carve-out, an RSM client neglected to perform IT due diligence on a $40M deal and estimated its integration costs at approximately $125,000. Noonan says that after it began running into trouble, the company asked RSM to review its plan. The review quickly revealed about $1M worth of work.

"For every deal that they now do, they do IT diligence," Noonan says. "It could have negated the investment thesis. Luckily, it still fit in the model."

Another client engaged RSM to evaluate the acquisition of a $600M company by a $1B platform company. The diligence revealed about $10M in IT integration costs. The deal went forward.

"We were able to both do the diligence and validate the implementation timeline, helping save the company quite a bit of money because we were able to get off some IT platforms earlier," Noonan says.

Avoid the Trap

Failing to perform diligence up front can compound subsequent costs—not only in overlooked upgrade and integration expenses, but also in disrupting an ongoing business. Yet this happens again and again.

"They fall into a simplicity trap," Noonan says. "Simple IT systems often lead to expensive surprises." ■

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The Red Flags

Companies with less than $100M in sales and fewer than 300 employees are typically most susceptible to the simplicity trap. Their systems generally consist of:

- Small-business accounting software (QuickBooks, Peachtree), which often needs to be replaced with an enterprise-wide system to accommodate an increase in transaction volume or the ability to support business process and workflow improvements.
- A couple of in-house servers that are often aging and have limited capacity.
- Standard business software (Microsoft Office, etc.) where licenses may not be current and will need to be purchased.
- Outdated software and networks (e.g., Lotus Office Suite, Novell) that will need to be replaced with industry-standard systems.
- Under-resourced or underqualified IT support departments.