Jon Moulton's Diary

Dealmaking today is more about PE managers contracting outsourced services rather than the face-to-face world of old

Veteran financier Jon Moulton has been involved in buyouts, turnarounds and venture capital since 1979 with firms such as CVC, Permira, Apax, Alchemy and, most recently, Better Capital, where he has been the chair since 2009

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In the 1980s when I started in the LBO game the private equity houses did pretty well all of the negotiation, due diligence, structuring and financing and tax work involved in a transaction themselves. Frequently, post-acquisition the only non-executive director would be a staff member of the private equity fund.

Reflecting the breadth of the activity, many of the firms were largely staffed by accountants as the emphasis of the job was about buying cheaply and leveraging businesses. A great deal of the value created in these deals was in negotiating a good price and the liberal use of debt.

The ideal LBO target in those days was an asset rich, reliable cash generator in a stable industry. You needed less effort to assess these kinds of businesses.

Due diligence was not even a term much used by UK practitioners – it gradually infiltrated from across the Atlantic.

Negotiations today

Compare that with a medium or larger buyout in today's world.

Negotiation is mostly a process between corporate finance advisers. In a recent disposal from our portfolio, we (the majority shareholder) only met (by video...) the acquiring private equity firm once — for half an hour. Their representative was very unkeen about this meeting and his discomfort was reflected in distracting — and copious — perspiration.

The rest of the buyer/seller interaction on this deal was adviser to adviser, at considerable cost and with a fair amount of miscommunication.

Due diligence is now almost totally outsourced.

Financial due diligence is now a job for external accountants – who frequently charge three times the price of a full audit and then disclaim any suggestion that their work amounted to an audit. A great mystery.

Then there is commercial due diligence – unknown in the 1980s. Now we have lots. Customer surveys, market issues, regulation, employees, competitor analysis, cyber risk and intellectual property can all have a specialist reviewer each. A recent addition is having a report on the target's AI opportunity or threat.

Due diligence has grown so much over the decades, leading to more outsourcing, bigger reports and greater costs

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Last month, I received a 310-page commercial due diligence report that covered most of these areas of the above in a proposed £40m transaction in a simple business. It's a matter of opinion whether you should praise the authors of that report for the scale of the effort or berate them for failing to focus sensibly. But checklists will be ticked — and the banks want the due diligence too.

Costs of outsourcing

Quite often nowadays a corporate finance firm will negotiate the debt financing and also provide advice on the type and number of further target companies for a buy and build strategy.

AI may improve the effort of due diligence in doing things such as competitor reviews. Sadly, it may encourage even greater pagination. We will see.

All this outsourced work carries a cost. Some of that cost will be contingent on a deal completing, which carries its own risk of bias from due diligence providers.

But the cost naturally drives buyers to want to agree a plausibly good deal before they spend all the due diligence money. Inevitably, this leads to more deals failing after the due diligence actually proceeds. A painful waste of effort.

In the old days of less formal processes, an early day or two of relatively unstructured "buyer meets management" was customary and would greatly reduce the risk of a deal failing later on. Now such early meetings are rare. The very day of writing this column I saw an example of much time wasting and costs as a failure to communicate about the business (unnecessarily) cratered a much-negotiated deal.

Due diligence is like regulation — it only grows! And like regulation there are economies of scale.

What is clear is that the private equity firm's role is now much more that of a process manager marshalling contractors — no longer the glamourous deal-doer but more of a duller minder of contractors.