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## **DUE-DILIGENCE IN INITIAL PUBLIC OFFERING OF CORPORATE SECURITIES**

The article deals with a number of scientific and applied issues related to the due-diligence as an important component of preparatory work on the issue of corporate securities emission, in particular, initial public offering (IPO). Particular attention is, however, concentrated on the issue of financial due-diligence. The necessity of distinguishing such new directions of the due-diligence as compliance and sustainable development is substantiated. It is determined that the purpose of the due-diligence is to assess the value of the issuer of securities, taking into account the complex of financial, legal, market, organizational, corruption and political risks. The results of the due-diligence assessment is the basis for establishing the share issue rate and making investment decisions.

**Keywords:** share emission, due-diligence, cost of an enterprise, cost factors, financial risks, compliance.

**Introduction.** The results of emission securities depend on the adequacy of the emission rate, that is, the price of shares, which they are offered in the case of initial public offering (IPO). Issuers are interested in the maximum IPO price, and potential investors – on the contrary. For this reason, the emission rate should be the sign of fair value both from the point of view of the issuer and investors. In order to find out the optimal emission rate as an important condition for the successful IPO of corporate rights in the stock market, it is necessary to assess the market value of the company. To fulfill this successfully, it is necessary to identify all the risks and factors that affect it. To resolve this problem, due-diligence must be carried out. So, due-diligence is a detailed study, assessment and audit of an enterprise that is a potential investment object. Taking into consideration the practical absence of the capital market in Ukraine and insignificant amount of corporate securities, the demand for IPO-due-diligence is low. Besides, the number of scientific works devoted to the issues of enterprise preparation to IPO of corporate securities is also insignificant.

**Analysis of scientific research.** Some aspects of the preparatory phase for IPO are covered in the works of Tereshchenko O. O.<sup>1</sup>, Nazarenko I. M.<sup>2</sup>, Rogov G. K.<sup>3</sup>. At the same time, there is the lack of significant scientific and methodological works devoted to the issue of the due-diligence procedure.

**The purpose of the article.** The purpose of the study is to analyse the most relevant aspects of IPO due-diligence, to systematize the goals and subject of its individual areas, and to substantiate the recommendations for improving the due-diligence process as a preparatory stage for IPO.

**Results.** To ensure the successful IPO of securities, it is necessary to go through a number of preparatory stages: to update the company's business strategy; select IPO partners (IPO manager, auditor, bank, underwriter, communication experts); bring the corporate management structure into line with requirements; regulate financial reporting and controlling; carry out the due-diligence (DD); substantiate the course of securities emission; prepare a project of emission; develop a concept of communication with capital market participants; to prepare an investment proposal for potential buyers of securities. According to the structure of the IPO process, firstly, due-diligence and then the estimation of the asset value is carried out, after which the optimal price for IPO is determined and the investment offering is carried out too.

In general, due-diligence is conducted in case of securities emission, mergers and acquisitions (M&A) transactions, and the adoption of significant amounts of credit decisions. Despite the broad scope of the due-diligence usage, it was initiated by American economists precisely to reduce the lack of information

<sup>1</sup> Терещенко, О.О., Бабяк, Н.Д., Івашенко, А.І. та ін. (2017). *Інноваційний розвиток корпоративних фінансів: тенденції та перспективи: монографія*. Київ: КНЕУ.

<sup>2</sup> Назаренко, І.М. (2011). «Дью ділідженс»: сутність, призначення та послідовність проведення. *Наукові праці Кіровоградського національного технічного університету. Економічні науки*, 20, 1, 360-366.

<sup>3</sup> Рогов, Г.К. (2018). *Система фінансових механізмів корпоративного сталого розвитку та її формування в Україні*: автореферат дисертації на здобуття наукового ступеня доктора економічних наук. Одеса: Одеський національний економічний університет.

in the process of making a decision on the admission of securities to quotations on the stock exchanges. In practice, there are two types of due-diligence: buy side due-diligence and vendor due-diligence. In the first case, the DD results should help the investor to answer three questions:

- Whether to invest in the target company, that is, whether to buy the shares of the respective issuer?
- What is the maximum price you can pay for shares?
- What is the potential of market capitalization growth of the enterprise?

In the context of IPO due-diligence, the so-called Vendor-Due-Diligence is mostly carried out. It is verification of the most significant risks and cost generators in the interests of the issuer. According to the results of the audit, the customer receives information about the potential value of the company and factors that may become an obstacle to the successful securities emission. The issuer receives recommendations for the most effective emission strategy and IPO options. Relevant results of the due-diligence may be found in the project of securities emission. The customer of due-diligence may also be a lead manager, who, according to the results of the enterprise assessment develops a special investment offer for potential buyers of securities.

In scientific sources, the term "due-diligence" is defined in different ways. On the one hand, Ukrainian business has progressed to some extent in understanding the essence of Due Diligence (DD), however, quite often, the DD procedure is interpreted somewhat one-sided: with a tendency to check legal, tax or accounting issues. In this regard, it should be emphasized that in general there are various directions of due-diligence (legal, tax, commercial and others). However, the priority is the financial direction, which focuses on checking the financial aspects of the enterprise, clarifying the cost generators and assessing the value of the enterprise. Some professionals identify this procedure with an audit. However, identifying due-diligence with an audit of financial reporting is incorrect, since the purpose of the latter is to check the accounting data and indicators of financial statements of a legal entity for expressing an independent opinion about its compliance with the most significant aspects of the requirements of national accounting standards, international financial reporting standards or other requirements<sup>1</sup>. The subject, objectives of the DD procedure and methods for its achieving differ it from audit, analysis and other similar procedures. A number of authors consider the main purpose of DD "collecting information about the object and evaluating potential risks related to it." It is defined as "an accompanying audit service, including a full study of the enterprise, based on an analysis of the quantitative and qualitative indicators of the enterprise, as well as the system of management and internal control"<sup>2</sup>. According to this approach, the opinion that the risk assessment is mostly a means of solving another, more complex task – the definition of the company's marginal value from the investor's position and from the position of the issuer is not taken into account. Taking into consideration the above-mentioned fact, we state that the goal of the company's due-diligence is to assess the value of the enterprise taking into account a set of risks that can affect the generators of the enterprise cost. Table 1 summarizes the aims and subjects of the due-diligence in terms of its individual areas: financial, commercial, legal, tax, compliance, organizational, sustainable development and political.

In the process of financial DD, experts concentrate their attention on the analysis of reporting information (historical data) and on the verification of planned estimates. The key factors that affect the value of the company are predicted and scenarios for their development are forecast. The property and financial condition of the enterprise, the level of its profitability and the potential for generating cash-flow are examined. For this purpose, a comprehensive analysis of the financial condition of the company is carried out, existing ratings and their dynamics, key indicators of accountability, planned and budget calculations are analyzed. The physical availability of property assets and their fair value is also checked and in case of need, an inventory is carried out. The quality and objectivity of internal (managerial reports) and business plans are also examined. The received analytical information is the basis for assessing the potential of the market value of the enterprise, which is the basis for making a decision on investing funds.

<sup>1</sup> Закон про аудит фінансової звітності та аудиторську діяльність ст. 1. 2018 (Верховна Рада України). *Офіційний вісник України*, 9, 50.

<sup>2</sup> Назаренко, І.М. (2011). «Дью ділідженс»: сутність, призначення та послідовність проведення. *Наукові праці Кіровоградського національного технічного університету. Економічні науки*, 20, 1, 360-366.

Table 1

## Objectives and subject of company's due-diligence

Directions of Due Diligence	Objectives	Subject
<b>(Financial DD)</b>	Identification of risks related to key value drivers of a company.	Value Generators are factors that influence the discount rate, sales and cash flows forecast, net profit
<b>(Commercial DD)</b>	Estimation of operational and market risks.	Enterprise production program, product markets and supply production factors, key competitors and technologies.
<b>(Tax DD)</b>	Identification of tax risks related to the accuracy assessment and tax payments by both the investor and the target enterprise.	Tax returns, calculations and other documents characterizing actual and planned payments of enterprises for national and local taxes and fees.
<b>(Legal DD)</b>	Identification and analysis of risks related to the legal and regulatory conditions of the enterprise.	Significant legal documents for the enterprise's activity (constituent documents, contracts, licenses, authorization documents, documents on ownership).
<b>(Compliance DD)</b>	Identification of risks associated with corrupt actions of company officials, money laundering, violation of anti-monopoly legislation, imposing financial sanctions, insufficient information protection.	The rules and regulations of the enterprise, including those that are established by regulation acts and global norms.
<b>(Organisation &amp; Human Resources DD)</b>	Identification of the potential impact on the company's cost of risks related to organizational aspects of activities, management quality and personnel.	Quality of management and personnel, culture of business processes and management culture, organizational structure and possibilities for its improvement, systems of staff motivation and advanced training, etc.
<b>(Sustainable Development DD)</b>	Clarification of the potential impact on the enterprise cost, environmental, social and economic risks.	Criteria for sustainable development, including environmental, economic and social aspects of the issuer's activities. Compliance of the enterprise with the existing social standards and environmental requirements
<b>(Political DD)</b>	Identification of political risk effects on the company's business.	Political situation in the country.

In the process of IPO-DD, key indicators of the issuer's activity should be analyzed and conclusions about their impact on the potential value of the enterprise are to be substantiated. Thus, the negative value of the financial results of the latest reporting date is not a sufficient criterion of investment effectiveness of the issuer. So, out of 11 enterprises that carried out IPO on the Frankfurt Stock Exchange in 2017, five showed a negative value of the EBIT in the financial reports for the previous year. Moreover, the negative value of operating profitability (EBIT-marge) of certain issuers was quite high: HelloFresh SE (-15,2%); Delivery Hero AG (-53,8%); Voltabox AG (-29,1%); Naga Group AG (-185%). However, such a situation with financial results did not prevent these companies from carrying out successful IPO.

As part of the validation of financial statements and the reasonableness of planned indicators, assets are audited for possible reassessment and liabilities – to identify underestimated items. There are significant differences between market and book value of non-current assets. Particular attention is drawn

to the accuracy of stock assessment and debt ratio. In the latter case, the realistic amount of requirements is analysed, taking into account the payment ability of debtors. The financial DD goes beyond the purely financial analysis, as the results of testing other areas have somehow financial implications, that is, they affect the target indicators and net cash flow forecasting. That is why, the experts responsible for financial due-diligence should closely cooperate with professionals who check legal, tax, technological and other issues.

Commercial DD is aimed at assessing the current situation of the company in the market and its competitiveness. The market and technological factors of the company's activity should be analysed, in particular, the industry analysis, the assessment of the situation on the market, the product and technology analysis are to be carried out. In order to identify the risks and additional opportunities related to the marketing of products, it is necessary to assess the structure of the relevant market segment and demonstrate the ability of the enterprise to maintain and expand market share. As part of the industry analysis, it is necessary to evaluate expert results about the possible behavior of customers and competitors. The relevant information serves to verify sales volumes and net cash flows forecasts.

During the legal DD analysis the most significant legal aspects of the financial and economic activity of the enterprise are analyzed. In order to identify the risks of legal nature, constituent documents are examined, the compliance of the enterprise with the requirements for licensing certain types of activity is checked, the risks of liability, fulfilling the treaty obligations, the accuracy of the signing contracts and agreements are assessed. Particular attention is drawn to the potential risks of company's commercial contracts with suppliers, consumers, insurance companies, banks, etc.

Tax Direction of DD focuses on checking tax risks that may affect the company's activities, in particular its liquidity and financial results. The objective of the tax DD is to assess all tax risks connected with the possible investment of funds in the enterprise. The potential of increasing tax payments as a result of M&A transactions and other factors is estimated. In addition, the potential tax burden for an investor and an enterprise related to the payment of dividends is analysed.

Recently, the issue of compliance has become especially important in the context of investing in enterprises. In this regard, the so-called "Compliance Due Diligence (CDD)" is an integral part of the due-diligence process. Compliance originates from the supervisory functions (US Securities and Exchange Commission (SEC) and US Department of Justice (DoJ)). The above mentioned authorities monitor the compliance with legislation by companies in case of carrying out operations in the capital market and in the process of mergers and acquisitions (M&A). At present, the term "compliance" means verification of acting according to set of rules and regulations of the enterprise, including those that are established by regulatory acts and global norms. At the same time, CDD does not include issues that form the standard DD program, in particular, the issue of compliance with tax or environmental legislation. The risks that are audited under the CDD include the risks connected with corrupt actions of company officials, money laundering, violation of antimonopoly legislation, imposing financial sanctions, and insufficient protection of information<sup>1</sup>. Effective systems of internal control and risk management should operate at enterprises in order to prevent these risks. According to modern requirements, company management should be personally responsible for compliance omissions and errors.

As the CDD controls the risks of corruption, the compliance of the due-diligence plays an important role for the domestic practice of IPO and M&A. Another relevant issue of the CDD is the verification of the risks connected with cybersecurity. It concerns the protection of information, unauthorized interference with information systems, unauthorized disclosure of information that can negatively influence the company's reputation, etc. As practice shows, the market share of companies is quite sensitive to cyber threats. Taking into account the imposition of sanctions against Russia, Iran, the DPRK and a number of other countries, in recent years, the CDD has been largely focused on verifying compliance by one or another company with a sanctions regime. If the business of a company depends on transactions with individuals or legal persons subject to sanctions or potentially falling under them – this is a significant risk that can have a decisive impact on the market value of shares. According to stock market information, the exchange rate of shares of companies subject to sanctions and related individuals may fall by 50% and more in the first days after the disclosure of sanctions. Within CDD, in addition to analyzing publicly

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<sup>1</sup> Zimmer, L. (2016). Compliance Due Diligence als Bestandteil der Due Diligence bei Unternehmenskäufen. *Corporate Finance*, 9, 321–325.

available and internal information regarding compliance, internal control systems checks, it is advisable to interview key officials of an enterprise in order to find out their understanding of compliance risks and ways to neutralize them.

An important area of DD is to identify the potential impact on the company's cost of risks connected with organizational aspects of activities, management quality and personnel. These issues are clarified in Organization & Human Resources DD process. The quality of management and personnel, the culture of business processes and management culture, organizational structure and possibilities of its improvement, systems of personnel motivation and advanced training are examined. In addition, the organizational structure should be evaluated according to the volumes and type of the enterprise activity.

In view of the global trends in strengthening the role of the social and environmental aspects of the enterprise activities, in our opinion, the introduction of a new element in practice of IPO-due-diligence is fully justified – Sustainable Development DD's compliance with the issuer. It is related to estimation of the potential impact of environmental, social and general economic risks on the future market capitalization of the enterprise. However, the technique of quantitative assessment of this type of risk is rather complicated.

The analysis of the reports of domestic issuers of shares conducted by G. K. Rogov showed that there no information on environmental risks, labor conflicts, relations with local communities and other stakeholders in the reports of enterprises. Despite the fact that the environmental and social externalities of production activity remain an urgent problem for the state and Ukrainian society, they are not transformed into the risks of enterprises competing only in economic sphere. This indicates that there is a significant conflict of interest between society and business in relation to the choice of conceptual models of corporate development<sup>1</sup>. However, it can be assumed that simultaneously with the adaptation of domestic environmental and social standards to the EU standards, the influence of sustainable development factors on the market capitalization of enterprises will increase. In this direction of DD it is necessary to assess the impact of the enterprise activity on the environment, harmful emissions, available and possible fines, tendencies in legislation changes in this area. In addition, it is appropriate to identify the potential conflict of interest between the enterprise and different groups of stakeholders, especially with local communities and company personnel.

According to J. M. Keynes's theory, investment decisions depend on the marginal efficiency of capital, which reflects the relationship between the price of capital assets and their expected returns. This refers to the interest rate, which equates the present value of a number of annual revenues from the use of the asset with the price of its offer<sup>2</sup>. Owing to the fact that investments will be profitable until the marginal efficiency of capital equals market returns, investors tend to invest in undervalued assets. On the other hand, the share emission rate should provide the maximum emission income for the issuer.

Thus, the purpose of DD is to determine the real value of the enterprise related to the complex of diverse risks that are manifested in the implementation of different directions of the due-diligence. The stated cost is the basis for establishing the rate of corporate emission rights. In the practice of IPO, there are three ways of setting prices in the primary market: fixed pricing, auctioning and book-building. In the first case, the price, according to which investors submit applications, are fixed in advance, in the second case the price is fixed on the basis of the auction method. In case of using the book of applications in the primary market, the price range will be determined and the price will be formed<sup>3</sup>. In case of IPO in developing markets, in our opinion, the most suitable method is the method of book application formation. It is quite flexible and to a certain extent allows to take into account the price preferences of investors when fixing the final emission rate.

In order to balance the interests of investors and the issuer, the so-called zone of the agreed emission rate should be defined. It will serve as a benchmark for the price range when applying the book application form. The strategic objectives of the issuer, quantitative and qualitative characteristics of the issuer, as well as strategic guidelines for potential investors should be taken into account. Assuming the fact that the share

<sup>1</sup> Рогов, Г.К. (2018). *Система фінансових механізмів корпоративного сталого розвитку та її формування в Україні*: автореферат дисертації на здобуття наукового ступеня доктора економічних наук. Одеса: Одеський національний економічний університет.

<sup>2</sup> Кейнс, Д.М. (1999). *Трактат про грошову реформу. Загальна теорія зайнятості, процента та грошей*: реферат-дайджест. Київ: АУБ.

<sup>3</sup> Мацелюх, Н. (2015). Структурування та ціноутворення на ринку цінних паперів. *Актуальні проблеми економіки*, 6, 363-369.

issue rate of the enterprise characterizes the value of the issuer, then the maximum (marginal) rate of purchase of securities (ERIn) from the investor's point of view should be higher than the actual emission rate (ER), that is,  $ERIn > ER$ . In terms of the issuer, the emission rate will be advantageous if it is higher than the marginal stock price (ERIs), which is determined by taking into account the results of the vendor DD, that is, the condition  $ER > ERIs$  must be satisfied. Moreover, the target functions of both investors and issuers are to maximize the difference between their defined marginal rate and the fixed emission rate<sup>1</sup>. The emission rate of IPO shares will be successful in the zone of agreement (ZA):

$$ZA = ERIn - ERIs > 0.$$

This means that the value of an enterprise expected by investors should exceed the marginal value from the issuer's point of view, and the real emission rate is in the interval between the stated expectations. If the marginal cost of the issuer's calculations is higher than the marginal cost of the investor's calculations, there will be hardly any emission due to the inadequacy of the emission rate set by the issuer. The problem, however, is that the issuer is always more optimistic about the future cash flows and risks of the enterprise than the investor. It is because of differences in estimates of expected cash flows and discount rates that the value of an enterprise in terms of the seller may differ from the respective estimates of investors. These differences are mostly the result of different vision of future sales volumes, income and expenses, as well as different approaches to quantitative risk assessments.

Different estimates of value (potential market capitalization) are the result of different access by the parties to the information on which the calculations are carried out. The purpose of due-diligence is to reduce the information risks of the investor and the issuer, conceptually, it contributes to the convergence of the characteristics of ERIn and ERIs. The narrower the harmonization zone is, the higher the possibilities of a successful IPO are. To approximate the assessments of both parties in the process of due-diligence, it is necessary to analyze the reasons for the deviation of value by individual factors of influence. These factors include:

- basic interest rate;
- the value of the beta factor;
- different approaches to the definition of average market income;
- different estimates of the market potential;
- differentiated estimates of expenses ratio.

It should be noted that the higher the risks of investing in securities are, the greater the difference between the marginal purchase rate and the marginal cost of the sale will be. This is a consequence of various assessments of the above-mentioned factors of influence on the value. That is, the result of a financial due-diligence should be not only a quantitative assessment of the risks and cost of the company, but also the identification of the causes of deviations in the estimates of value obtained by different parties of the investment process. The analysis of these reasons and factors allows to substantiate recommendations for their minimization, and, therefore, to fix the agreed emission rate.

**Conclusions.** An important component of the preparatory phase of the initial public offering of corporate securities is carrying out the DD, which is a means of reducing the information asymmetry in the capital market. Taking into account the newest risks and factors influencing the market capitalization of enterprises, in addition to the traditional directions of the dividends (financial, commercial, legal, tax, organizational) it is reasonable to distinguish compliance and DD of sustainable development. Compliance should focus on identifying corruption risks and a set of threats related to money laundering, financial sanctions, cybercrime. The potential impact on the company's environmental, social and general economic risks should be clarified in the process of verifying the enterprise's activity to the criteria of sustainable development.

Information on risks and factors affecting the value of the company is the basis for the harmonization of the emission rate, which would be acceptable both for the issuer and for potential investors. The emission share rate must be in the so-called zone of cost-coordination by both parties. A prerequisite for the existence of such a zone is the excess of investors' estimates of the marginal rate of purchase of securities

<sup>1</sup> Berens, W., Brauner, H., Strauch, J., Knauer, T. (2013). *Due Diligence bei Unternehmensakquisitionen*. Stuttgart: Schäffer-Poeschel Verlag.

on the issuer's estimates of the marginal stock price. This means that estimates of the market value of the target company (the market value of the shares) by investors should exceed the value of the relevant estimates that of the issuer. According to the findings of the DD, recommendations should be made for minimizing the deviations in the assessment of the company's value and the coordination of the price of IPO. It is reasonable to use the outlined technologies of due-diligence in preparatory activity of corporate bonds.

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