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Business Intelligence Services

Deloitte Financial Advisory Services LLP



Look Before You Leap

*Investigative Due Diligence
in International Business
Relationships*

Audit • Tax • Consulting • Financial Advisory

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Overview: A Word About Investigative Due Diligence

International activity slated to increase

Executives were asked in which markets their companies had executed, or seriously considered, an investment or business relationship in the past five years, and also in which locations they expected to do so over the next three years. Across virtually all countries, significantly more executives expected their companies to be active, either through investments or business relationships, in the future. While Western Europe was the most popular location, emerging markets, including China, India, and Central/Eastern Europe, are rapidly gaining favor.

- Perhaps not surprisingly, Western Europe has been, and is expected to remain, the most popular destination for investments or business relationships. (See Exhibits 1 and 2.) More than half of the executives surveyed reported their companies had executed or seriously considered deals in Western Europe; over the next three years, more than three-fourths anticipated such activity.
- However, the popularity of emerging markets appears to be increasing rapidly. For example, in China, almost half of those surveyed reported foreign activity in the past five years but in the next three years, expectations for deal activity will be comparable with Western Europe. Moreover, roughly two-thirds of executives expected their company would be involved in deals or business relationship in Central/Eastern Europe and India in the next three years. While China, India, and Central/Eastern Europe and are expected to remain the most popular locations, executives expected business activity would more than double in virtually all emerging markets over the next few years.

How much due diligence in investigating potential risks occurs when investing or developing business relationships outside the United States?

To answer this question, Deloitte Financial Advisory Services LLP (“Deloitte FAS”) surveyed 565 executives from companies involved in investing and developing business relationships internationally. Among the executives participating in the survey, 216 were from firms that are corporate (strategic) buyers, 248 from firms that are financial buyers, and 101 from firms that are both corporate and financial buyers.

The survey was conducted from November 10 – December 5, 2006 through an online questionnaire. Deloitte FAS engaged Bayer Consulting to conduct the survey.

This survey is the second conducted by Deloitte FAS into investigative due diligence in international transactions. The results of the first survey were summarized in the report, *Look Before You Leap: Emerging market investments . . . how do you manage the risks?*

The current survey examined investigative due diligence by companies for two types of activities outside the United States:

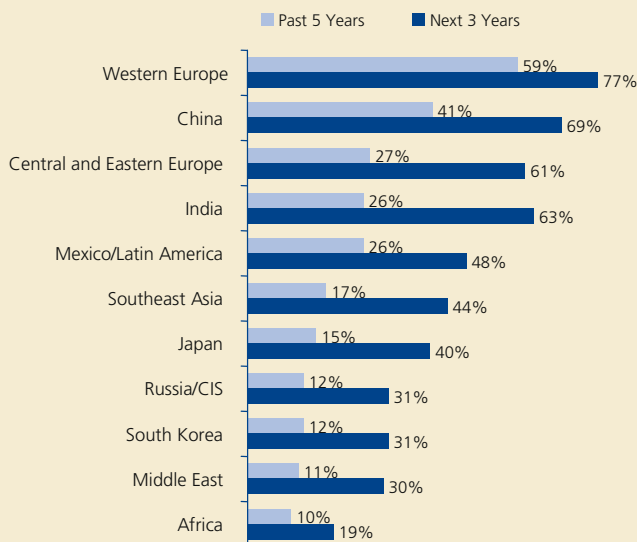
- Mergers, acquisitions, and equity investment in local companies.
- Business relationships, including joint ventures, strategic alliances, supplier/distribution agreements, and license/franchise agreements.

Our findings revealed that, while Western Europe is still the most popular location for foreign deals by U.S. companies, activities in emerging markets, especially China, India, and Central/Eastern Europe, are expected to increase dramatically in the next several years. (See sidebar, “International activity expected to increase”.) Given these trends, it seems especially important for companies to take a very careful look before they leap into foreign deals.

Exhibit 1

Locations for Mergers, Acquisitions, or Equity Investments

Locations where Company has Executed, or Seriously Considered A Transaction within Last Five Years or Expects to in Next Three Years



A Message from Wendy Schmidt



The risks that senior business executives need to manage each year only seem to grow. When unexpected problems arise after a company makes an investment or forges a new business relationship, the results may include negative publicity, regulatory violations or criminal indictments that can damage a company's reputation and impair its financial performance. These problems often become even more difficult to identify and manage when a U.S. company is operating overseas.

Conducting investigative due diligence is a critical step to identify, and forestall, potential risks in any business transaction. And it can become even more critical when investing or creating business relationships in other countries. We are pleased to present the second annual survey by the Business Intelligence Services practice of Deloitte Financial Advisory Services LLP on how financial buyers and corporate buyers are using background/integrity checks to better manage these risks.

In this year's survey, we examined the role of background investigations before U.S. companies make acquisitions or investments in other countries, and also before they enter into business relationships such as joint ventures or distribution agreements.

The survey solicited the experience of companies on such issues as the following:

- How often are background/integrity checks being conducted?
- What level of detail in background/integrity checks is taking place for specific issues?
- How often do companies renegotiate deals or pull out altogether and what are the typical reasons?
- What internal and external groups or individuals are involved in conducting background/integrity checks?

In our practice working with companies addressing these issues, we see time and again that careful consideration of potential risks prior to executing an overseas transaction can dramatically reduce the possibility of unpleasant surprises after the deal or business relationship has been finalized. We hope that the experiences of other companies summarized in these survey findings will provide you with insights that are useful to your company as it crafts its approach to identifying and managing risk in doing business overseas.

A handwritten signature in black ink that reads "Wendy C. Schmidt". The signature is written in a cursive, flowing style.

Wendy Schmidt

National Leader, Business Intelligence Services
Deloitte Financial Advisory Services LLP

Highlights of Key Findings

Only two-thirds of companies always conduct background/integrity investigations before executing an acquisition or investment outside the United States, while only half do so before entering into a business relationship, such as a joint venture. And when investigations are conducted, they often don't probe deeply into many areas which could cause serious financial and reputational damage, such as possible links to organized crime or terrorist organizations. Yet, background investigations often uncover potential problems. In fact, 70% of companies have pulled out of a planned foreign business transaction as the direct result of the findings of a background investigation.

These are some of the highlights of Deloitte FAS' second annual survey of executives at U.S. corporate and financial buyers on what they do in terms of background checks before executing international business transactions or relationships.

Given the wide variety of risks in acquisitions, investments, and business relationships outside the United States, companies committed to operating internationally should make investigative due diligence part of their standard operating procedure. Further, these investigations should examine the full range of potential problems that can afflict foreign investments and business relationships.

The following are the key findings of the latest survey by Deloitte FAS on investigative due diligence.

- Eighty-seven percent of executives said their firms always or frequently conduct background/integrity checks before any international M&A activity or equity investments, but just 67% conduct them all of the time.
- Seventy-six percent of executives reported always or frequently conducting these investigations before entering into any international business relationship, but only 49% always do them.
- Investigating the reputation of principals, regulatory issues, civil litigation, and sources of capital are the issues most likely to be investigated thoroughly when conducting background/integrity checks. Most firms are looking at these issues as part of the process, and roughly half said their investigations are very detailed.
- In contrast, firms are less likely to thoroughly investigate issues pertaining to anti-money laundering, terrorist financing, theft of intellectual property, labor practices, links to organized crime, or FCPA violations.
- Fifty-seven percent of executives said they have restructured or renegotiated potential deals as a result of information uncovered during background checks, and 70% reported having pulled out of a deal as a result of the information uncovered in an investigation.
- Reasons for having to restructure or pull out of a deal paralleled the areas that are generally investigated most thoroughly—relating to principals, civil litigation, and regulatory matters.
- In general, smaller firms are less likely than larger firms to conduct thorough investigations and are also less likely to have renegotiated/restructured or actually cancelled potential transaction.
- Although many different internal departments are likely to play a role in conducting background/integrity checks, the departments with the largest roles were legal, M&A/business development, and finance.
- Eighty-nine percent of executives indicated their firms hire outside resources to assist in conducting background/integrity checks. Outside counsel and investigative firms are the two most common kinds of outside firms used.

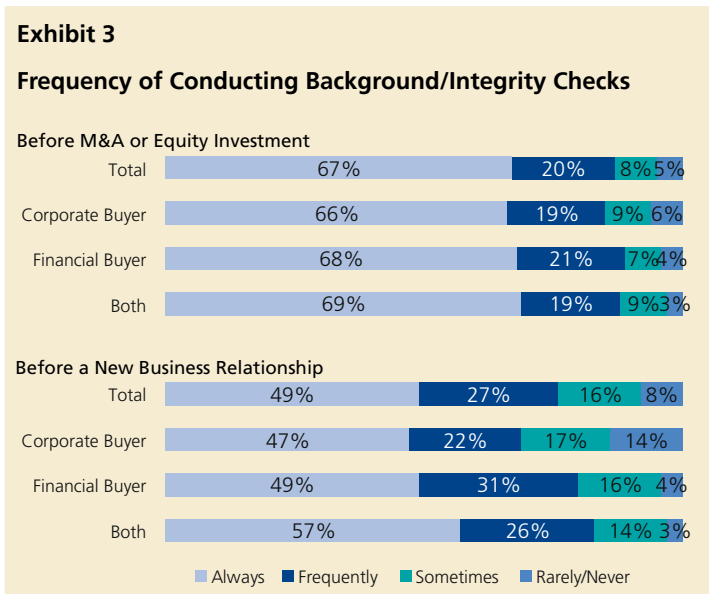
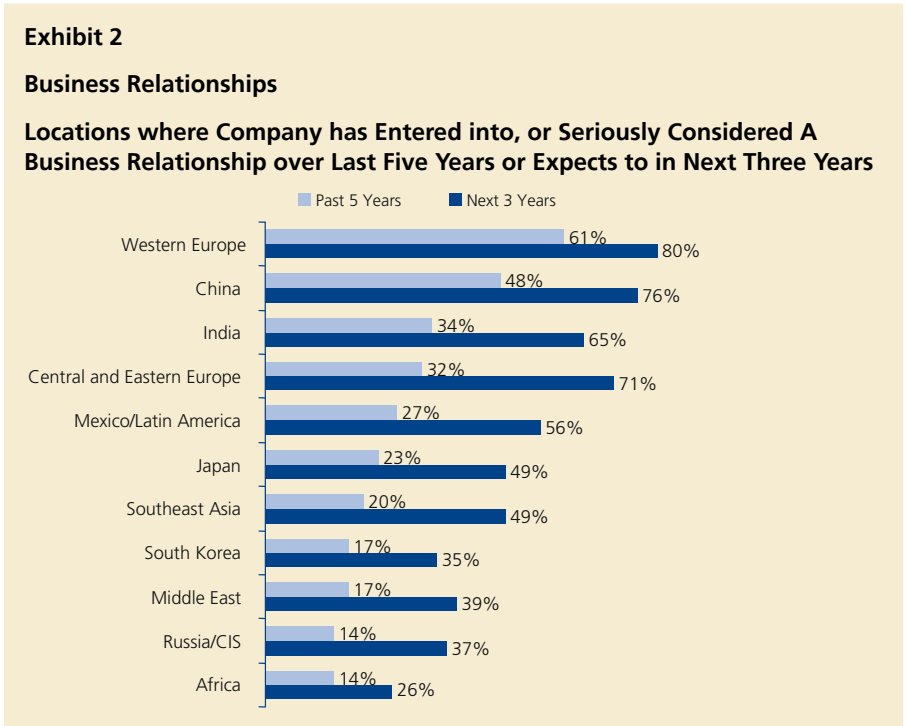


Detailed Results

Investigative due diligence not always conducted

While most executives reported conducting background/integrity checks “at least some of the time” before executing a foreign merger, acquisition, or equity investment or entering into an offshore business relationship, a significant number of executives said they do not always do so. Further, and despite increased foreign activity in general, the frequency of conducting these kinds of background/integrity checks has not increased in the past year.

- Eighty-seven percent of executives indicated that they “always” or “frequently” conduct background checks before executing an international merger, acquisition, or equity investment, and 76% said they “always” or “frequently” do so before entering into a business relationship. (See Exhibit 3.) In last year’s survey, 93% indicated that they “always” or “frequently” conducted background checks before any type of foreign deal.
- Two-thirds of executives said they “always” conduct checks before a foreign investment. However, companies were less likely to do so for foreign business relationships, with only 49% saying they “always” conduct background investigations. Yet, companies often face a variety of significant reputational, financial, and other risks in international transactions, not only for investments, but also for business relationships.



- Smaller strategic buyers (i.e., those with annual revenues of less than \$1 billion) were less likely to conduct checks before entering into a business relationship—only 44% of executives at smaller firms said they always conducted these investigations compared with 55% among larger strategic buyers. Not only are business relationships entered into by smaller companies subject to the same risks as those involving larger companies, smaller entities may have less ability to withstand any financial losses or other damage that might result.
- The likelihood of always conducting such checks is not substantially different between strategic buyers and financial buyers.

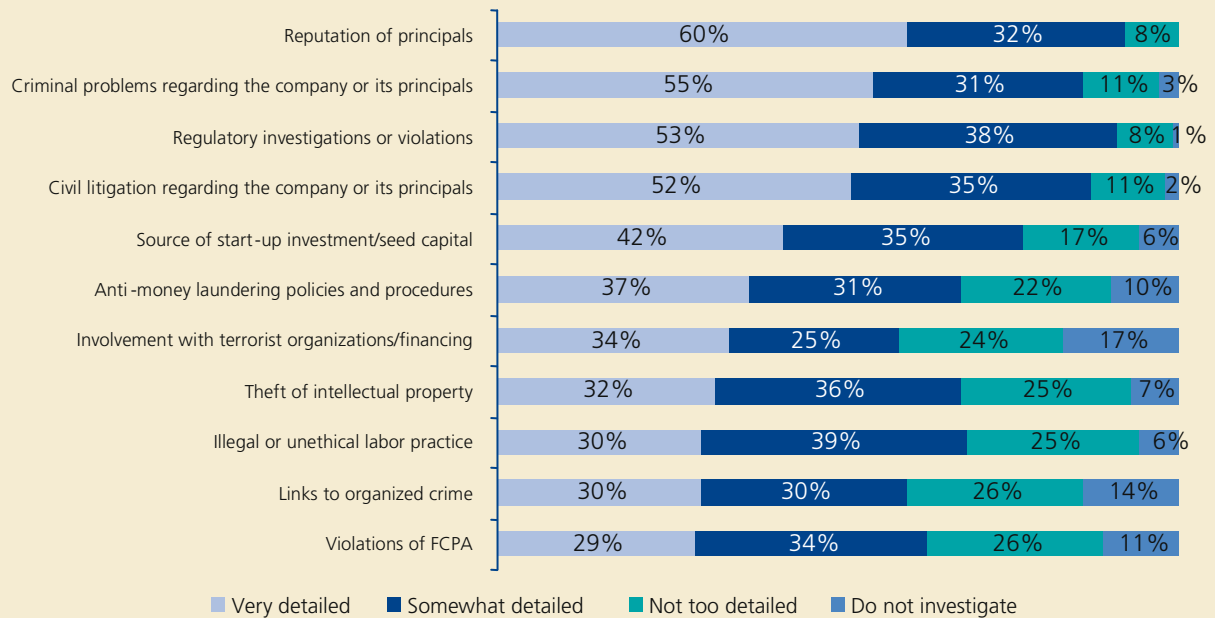
Background/integrity checks may not be thorough

There are many different issues that can and should be thoroughly investigated before concluding a foreign deal. However, it appears from the survey results that only some of these issues are likely to be given more than a cursory glance. In general, firms appear to be doing a better job investigating the reputation of the principals, pending litigation, and regulatory issues than on things like terrorism, organized crime, and other criminal activity. This roughly parallels what executives said in last year's survey, and suggests firms may be focusing more on issues they are comfortable with, such as business and financial practices, than the broader types of risks that exist, especially in a post-9/11 world.

- Few executives said their firms completely ignored any of these issues when performing investigative due diligence on their foreign transactions. (See Exhibits 4 and 5.)

Exhibit 4

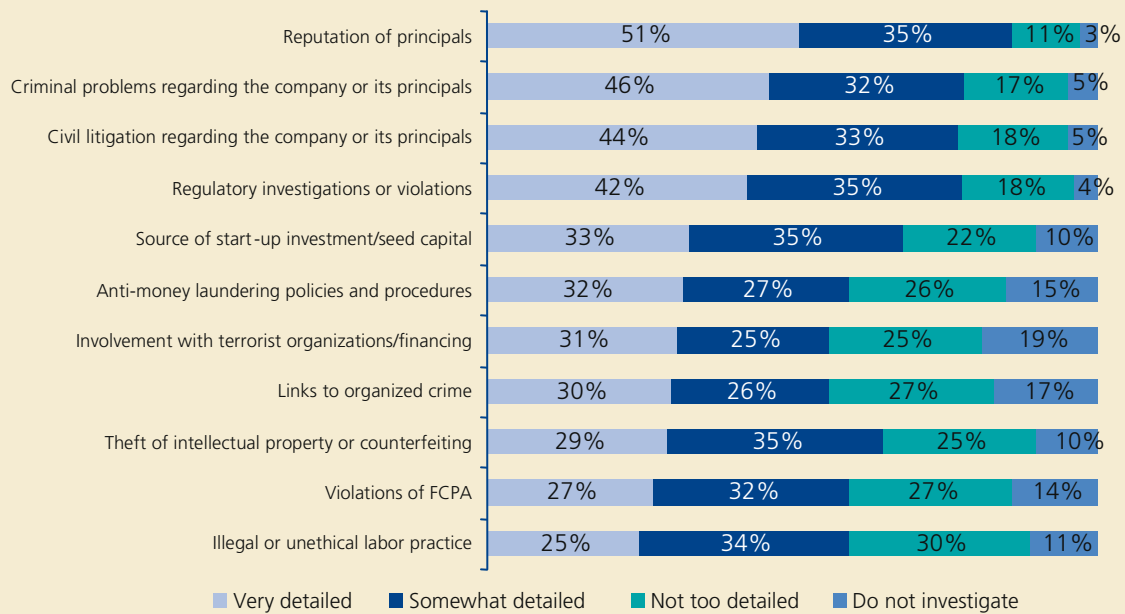
Level of Detail in Background/Integrity Checks of Specific Issues Before Mergers, Acquisitions, or Equity Investments outside the U.S.



- At the same time, none of these issues were being investigated in detail by more than about half of the firms. The only issues where executives said very detailed investigations were conducted by even half the firms were reputation of principals, criminal problems regarding the company or its principals, regulatory investigations or violations, civil litigation regarding the company or its principals, and the source of start-up/investment capital.
- In general, larger firms were more likely than smaller firms to conduct very detailed investigations on many of these issues. For example, 48% of executives at companies with \$1 billion or more in annual revenues said they conduct a very detailed investigation before a foreign acquisition or investment of the possibility of violations of FCPA, compared to just 22% of smaller companies; 49% of executives at larger companies said a very detailed investigation was conducted of any past record of intellectual property theft, compared to only 27% of executives at smaller companies. This may not be surprising, given that smaller firms may have fewer resources to put towards due diligence, but it is risky since smaller firms are just as likely to encounter problems as larger firms.

Exhibit 5

Level of Detail in Background/Integrity Checks of Specific Issues before Entering into Business Relationship outside the U.S.



When problems are discovered

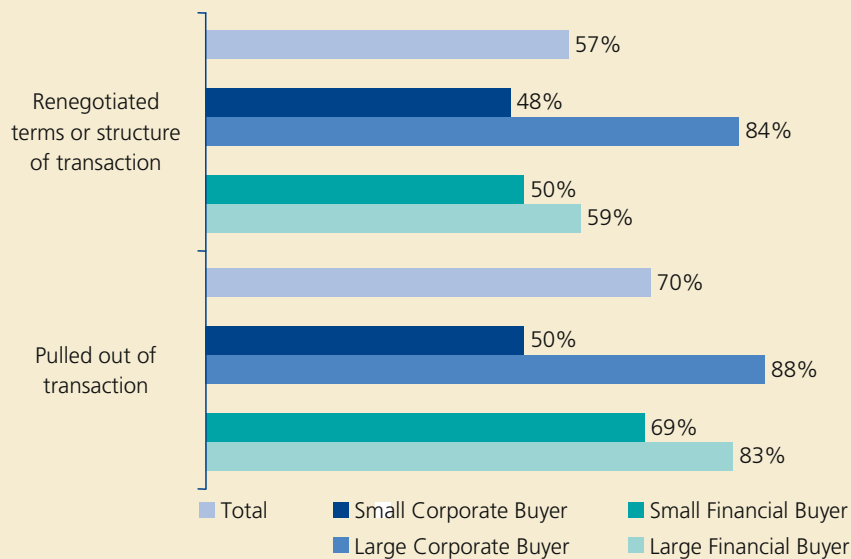


Most executives said that background/integrity investigations had led their companies to change their plans in overseas markets in the past. Fifty-seven percent said their company had renegotiated the terms or structure of a transaction as a result of a background investigation, while 70% said they had cancelled a transaction completely, similar to the results of last year's survey. Given this fact, it is surprising that companies do not conduct detailed investigations on all transactions and on a broader set of potential issues than they do currently.

- The value of conducting such checks is underscored by the fact that larger companies, which tend to be more thorough in their investigations, have been more likely to have renegotiated or pulled out of a deal as a result of an investigation than smaller companies. Among corporate buyers, 84% of the executives at companies with \$1 billion or more in annual revenues said they had restructured a deal and 88% said they had pulled out of a deal as a result of conducting background/integrity checks; in contrast, 48% of those at smaller companies said they had renegotiated a deal, and 50% said they had pulled out of a deal based on their investigations. (See Exhibit 6.) Similarly, among financial buyers, 59% of those at firms with \$500 million or more in assets said they had renegotiated a potential investment or business relationship and 83% pulled out, while 50% of executives at smaller financial buyers said they had renegotiated and 69% said they had pulled out of a transaction.

Exhibit 6

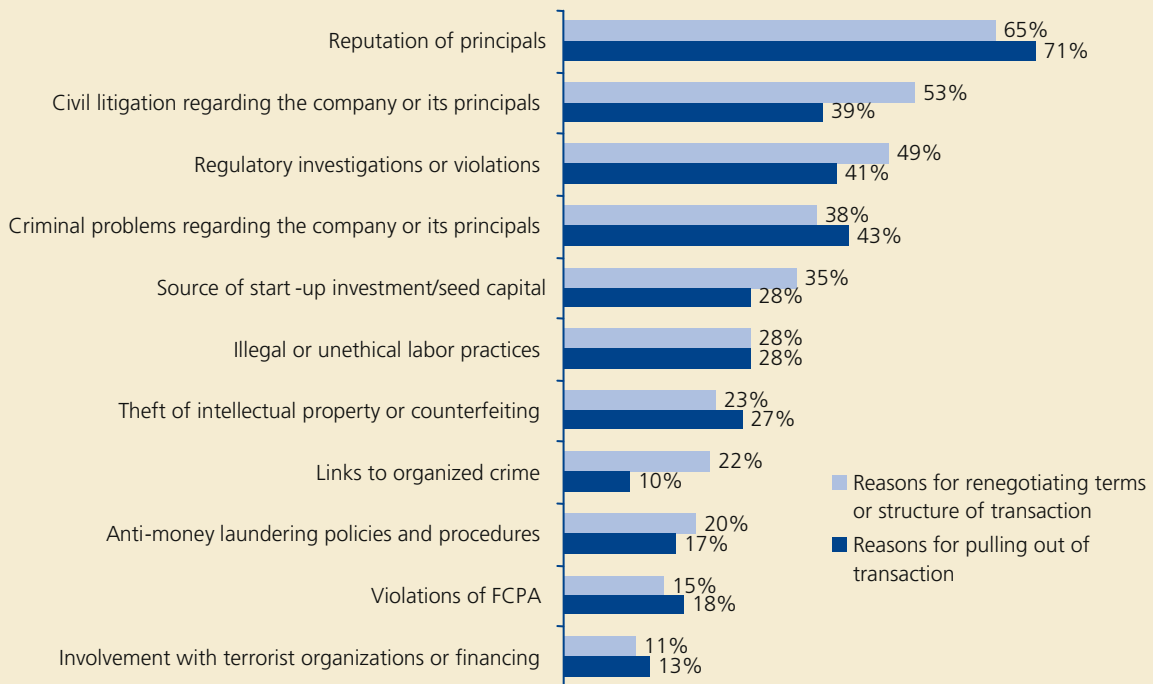
Action Taken on Potential Investment or Business Relationship Due to Background/Integrity Check



- The evidence also suggests that more detailed investigations are likely to yield dividends. The reasons companies have renegotiated/restructured or pulled out of investments or business relationship as a result of investigations parallel the areas in which the most detailed investigations are conducted, namely issues relating to the reputation of principals and those having to do with civil litigation and regulatory matters. (See Exhibit 7.)

Exhibit 7

Reasons for Action on Potential Investment or Business Relationship due to Background/Integrity Check



Organizing the effort

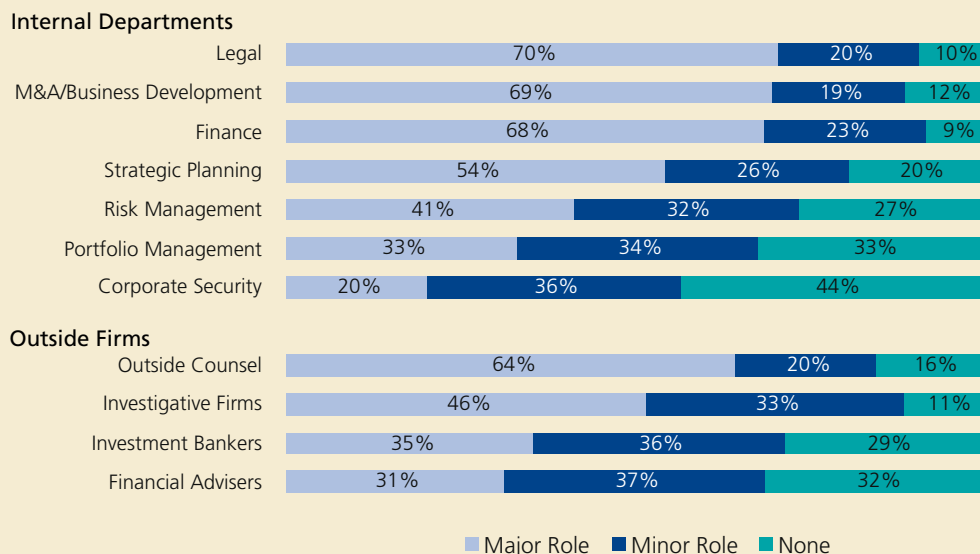
In last year's survey, 69% of executives said their firms used a combination of internal and external resources to conduct background/integrity checks. This year, the survey probed deeper into which internal departments and external resources are being brought to bear. The data indicate that investigations are conducted as a team effort, involving a variety of different types of individuals both from inside the organization as well as external entities. (See Exhibit 8.) The findings suggest that strong leadership of the investigative effort is critical to coordinate the involvement of these various parties and to conduct the investigation in an efficient and effective manner.

- Executives said there are a number of different departments within their companies that are involved in background/integrity investigations, with legal, M&A/business development, and finance playing the largest roles; roughly nine out of ten executives said these departments play a role in the process, including at least two-thirds who said they play a major role.
- Eighty-nine percent of executives reported their firm hires outside organizations to assist in conducting background/integrity checks. For most companies, outside counsel is the external resource playing the most important role, although investigative firms, investment bankers, and financial advisers are likely to be involved as well.



Exhibit 8

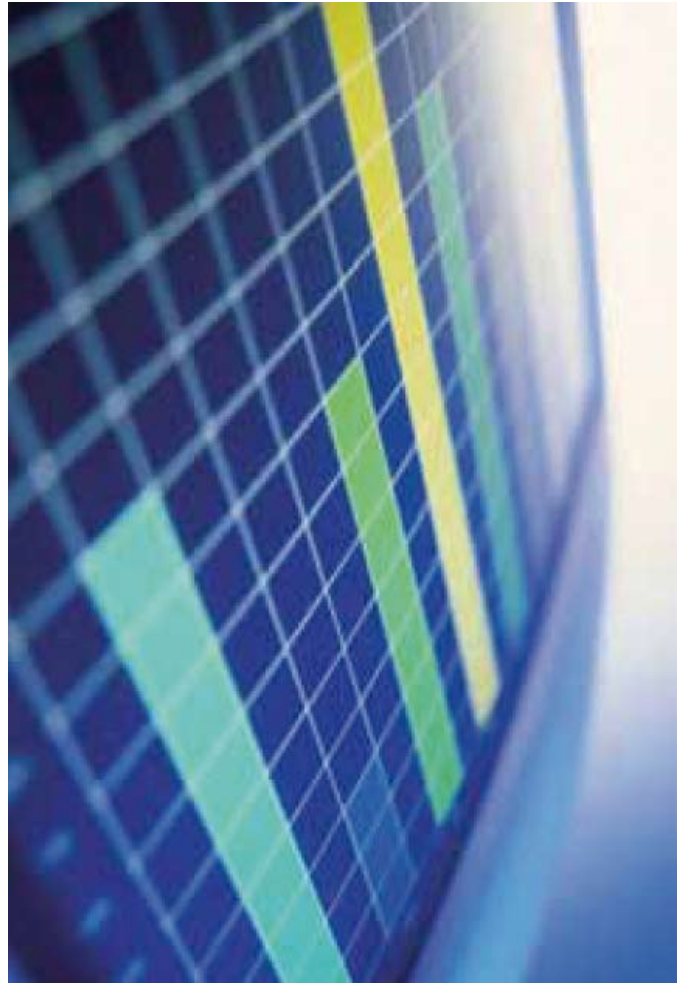
Role of Various Parties in Conducting Background/Integrity Checks for Transactions Outside the U.S.



Methodology

The Look Before You Leap survey was conducted by Bayer Consulting on behalf of the Business Intelligence Services practice of Deloitte FAS to measure the attitudes and experiences of senior executives in predominantly U.S.-based organizations with regard to investing and developing business relationships outside the United States.*

The survey was conducted online using a self-administered questionnaire between November 10 – December 5, 2006. It was completed by 565 senior executives involved in investing and developing business relationships outside the United States in emerging markets, either as financial or as strategic buyers. The responses were also compiled by Bayer Consulting.



* Participants were derived from subscribers to a popular private equity news service, PE Week Wire and from subscribers of Alpha magazine, a Hedge Fund trade publication.

About Deloitte FAS Business Intelligence Services

The Business Intelligence Services (BIS) practice of Deloitte FAS is an industry leader in investigative due diligence. We have access to multidisciplinary BIS professionals around the world through the network of Deloitte Touche Tohmatsu (“DTT”) member firms. BIS professionals are trained investigators with extensive experience in pre-transaction investigation of the reputation and integrity of companies and their executives.

The skilled investigators of Deloitte FAS and the DTT member firms are experienced at combining extensive online and public record research with information obtained from a worldwide network of industry and other knowledgeable sources. We provide comprehensive reporting that is tailored to our clients’ specific requirements and arrived at through high, professional standards and ethics.

In today’s business world, knowledge truly is power and can often make the difference between deal success and failure. We help our clients get the information they need to make informed investment decisions – and we can generally do it more efficiently and cost effectively than most organizations can achieve using internal resources.



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