# Technical Integrity Matters

September 2020

## Note #1: Deal Due Diligence: what goes wrong and why?

**We can all think of deals which have gone wrong, and the reasons for failure are many. Post-mortem analysis suggests a need for rigorous and independent due diligence.**


In the oil and gas world, acquisition of assets rather than companies are commonplace.

Companies selling assets will often hire specialist advisors to market their assets, prepare Information Memoranda (IM) and host datarooms. **Their mission is clear: to market the assets to the widest audience of suitable potential buyers and fetch the highest price for the seller**.

On the buy side, things are more difficult. There is always considerable uncertainty in the resource volumes and value of an E&P asset. **The "winner's curse" risk is that the highest bidder is the one that is most optimistic, or more often, has failed to identify critical risks and hence overpays for an asset.** Failed acquisitions often occur due to failures in the Due Diligence process to properly assess the downside risks inherent in an asset.

Some companies will assemble their due diligence teams from their experienced staff members. Often, those staff are already overstretched with their day-to-day responsibilities, and companies will hire external teams of legal, tax, finance and technical experts to perform the Due Diligence.

Over the years, Rockflow Resources have provided expert multi-disciplinary teams to perform technical due diligence on a large number of assets throughout the world. More often than not, our work unearths problems that are not evident in the vendor's sales case, or even the in dataroom, often resulting in a decision not to make a bid on an asset.

The need to perform Due Diligence is self-evident. The more interesting question in cases of failed acquisitions is

**"why didn't they see the problem**

**in Due Diligence?"**

Rockflow have been called in after failed acquisitions to investigate under-performance, and in some cases, provide expert witness evidence when disappointed buyers have sought to recover their losses through legal claims. The feedback mechanism from such post-mortem analyses has significantly informed our expertise in performing better due diligence from the outset.

**There are 4 common reasons why companies make poor E&P asset acquisitions involving failure to perform proper due diligence.**


1. **The Psychology of the Deal**: Management had already decided to do the deal, and having done so were not really interested in critical examination. They were so keen to complete the deal that they did not want to consider the objections.
2. **Bad Incentives - The Agency problem**: A new business development team is paid to make

deals, hence there is always a risk that they will be incentivised to do so, even at the expense of the shareholder. This risk can be compounded if external advisors are paid on a success fee basis.

3. **Cost**: Companies screen many more deals than they bid on, and not every bid succeeds, so Due Diligence can become an expensive process.

4. **Inexperience**: Inexperienced Due Diligence teams miss critical issues that are deeply hidden. Sometimes they tend to summarise the sales case, whereas they should be proactively searching for things that are missing.

**Inexperienced teams face a number of problems performing Due Diligence.**


Rockflow have observed **6 common problems inexperienced teams must overcome**:

1. **Summarising the Sales Case**: The Vendor's Information Memorandum is a sales document. It is designed to highlight all the upside potential of an asset. Vendors do not usually make false statements, but neither do they want to highlight or quantify key risks – that is a task for the buyers team to assess. Too often, inexperienced teams try to summarise the sales case, or make spot checks on key data, when in reality, they should throw away the IM and analyse the asset from the raw data up.

2. **Obfuscation by Data Overload:** Some datarooms will contain many thousands of files, much of them containing little of useful value. It will be impossible to read everything. Key issues requiring disclosure may be buried by excessive data disclosure, and missed by inexperienced teams struggling to "sort the wheat from the chaff". Experienced teams learn to know what they are looking for, and perform a targeted search for key information.

3. **Error by Omission:** Other datarooms will have insufficient disclosure, requiring buyers to identify and request missing information. Failure to think critically and query missing information is a common mode of failure due to inexperience.

4. **Unusable data:** Some datarooms seem to be deliberately designed to make life difficult: files may be viewed online but not downloaded, key data may be provided in poor quality image files rather than in usable spreadsheets, or scattered across many separate files.

5. **Time Constraints:** Bidding deadlines imposed by the vendor limit the time available for they buyers' teams to evaluate data, and compound the issues listed above.

6. **Cognitive failure**: There are a vast number of detailed technical ways a vendor can exaggerate the value of an asset in the Sales Case, by presenting optimistic rather than realistic assessments of uncertain parameters and forecasts. These include overestimation of recoverable volumes, underestimation of costs and operability, and over-optimistic assessments of likelihood of project approvals and schedules. Inexperienced teams may fail to properly distinguish the "real" from the "improbable" and "impossible".

**Rigorous Due Diligence with a deeply experienced and independent partner like Rocklow, who are proud of their technical integrity, can make a huge difference when it comes to going into a deal with 'eyes wide open', aware of the risks and then putting a plan in place to manage and mitigate them.**