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A framework for mergers and acquisitions due diligence: lessons from selected REITs in South Africa

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ABSTRACT

In April 2013, the South African listed property sector converted from Property Unit Trust and Property Loan Stock investment structures into a Real Estate Investment Trust (REIT) structure that is understood globally. This conversion spurred consolidations in the property market in the form of mergers and acquisitions. Research shows that mergers and acquisitions tend to have high failure rates as growth strategies.

It remains unknown how sufficient traditional due diligence is and how it can be improved to enhance the chances of successful corporate marriages within the South African REIT market. This paper reviews the aspects of the traditional due diligence scope which generally comprises of financial, legal and commercial due diligence in order to determine its adequacy as a decision making tool that helps reduce the risk of failure in REIT merger and acquisition transactions in South Africa.

There is consensus in the literature that due diligence is a means to reduce the risk of merger and acquisition failure, some studies suggest that failure occurs when due diligence is not done well. This paper uses interviews conducted with due diligence professionals from seven REIT companies listed on the Johannesburg Stock Exchange who were involved in large merger and acquisition transactions in the preceding four years. The interviews were used to ascertain how the professionals perform due diligence, whether or not they think that traditional due diligence is sufficient for REIT mergers and acquisitions and to solicit their views on how the due diligence scope can be expanded. Transcribed data from each of the interviews was analysed based on three concurrent sub-processes adapted from the works of Miles and Huberman (1994) which consist of data reduction, data display and drawing and verifying conclusions.

The results show that the traditional due diligence scope is not sufficient for REIT merger and acquisition transactions, a majority of the respondents agree with this observation. Encouragingly the professionals within the South African REIT market have a due diligence scope which is already much wider than the

traditional scope, be that as it may, there is still a high failure rate of 59% observed in the sample analysed.

Due diligence professionals have a low regard for understanding and resolving the different companies cultural issues, this is cited in the literature as one of the contributing factors for merger and acquisition failure. This is an area that can possibly augment the due diligence cycle and professionals should focus on it in order to improve the chances of success. The research proposes expanding the due diligence scope by incorporating strategic due diligence which is forward looking and it overcomes the challenges of traditional due diligence of relying on historic information. Strategic due diligence assists the acquirers understand the target's future prospects, and it allows the acquirers to determine if the target prospects fit with their own strategic objectives. This together with a higher focus on understanding and resolving cultural issues of the merging companies should augment the traditional scope and ultimately lead to transactions that yield higher shareholder value.