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Mergers & Acquisitions in Colombia

PricewaterhouseCoopers Colombia

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Foreword

Today, companies are immersed in a challenging, competitive and globalized environment, where their biggest challenge is to stay relevant in the market. For this reason, organizations resort to different strategies to potentiate their capabilities, highlight that which makes them stand out, take advantage of opportunities, confront challenges and overcome their weaknesses.

One of the most common corporate strategies today, both globally and in the Colombian market, is nonorganic growth based upon mergers and acquisitions. This practice has seen a larger number of transactions in the country. Although there is great potential here in all the sectors of our economy, the sectors which have been more impacted by these transactions are tourism, agriculture, family companies and startups or new business ventures.

In this context, mergers and acquisitions (M&A for the English initials) has become more important in the country, and carrying out any M&A transaction today has become more and more complex. Both buyers and sellers seek today a more comprehensive advisory support. This should cover not only the basic legal aspects and the tax, labor financial regulatory aspects; it should also help the parties to design a clear strategy that lays out the road ahead before, during and after the transaction, and it should even identify the interests and the needs of all the parties involved.

PwC has been an active player in this type of processes, both in Colombia and internationally. We have witnessed the evolution of the M&A practice in Colombia. In the last few years we have gained a lot of knowledge not only of the market but also about the peculiar traits of the M&A processes that are carried out in the country. This is why we have decided to share with you part of that experience in this publication. We expect that this publication, with its holistic approach, becomes the guide on the typical stages and procedures that are necessary in Colombia to carry out successful M&A transactions.

In this way, this publication is the fruit of the continuing work of five of our service areas in the M&A practice. That is why we will take a comprehensive look at these processes in the following pages, using a simple language to describe these subjects: (i) Strategy, (ii) Transaction structure, (iii) Due Diligence, (iv) Transaction documents and, finally, (v) Post deal activities.

We invite you to know more about the strategy, the due diligence and the structure of M&A transactions in Colombia. We hope that you may explore with us the opportunities that this type of processes may open up for your organizations.

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Introduction and economic perspective

Macroeconomic indicators stayed stable in Colombia during 2018. The result was the following. Real GDP growth reached 2.7%, greater than growth for the prior year (1.4%)[1], while it is expected that GDP growth will be similar this year, reaching 2.9%[2]. Additionally, in 2018 inflation closed at 3.18%, which is less than the inflation level of the prior year, at 4.09%[3]. However, already in June 2019 we saw inflation going high as compared with June 2019, as it reached 3.43%[4] at that point.

Regarding the financial system in Colombia, for 2019 the level of credit is expected to grow and the COLCAP index will recover, after the credit risk for certain economy sectors and market risk materialized towards the end of 2018. According to the last financial stability report issued by the Colombian central bank (Banco de la República), the financial system may be considered as resilient[5]; as such, it will not bring about any macroeconomic disturbance. At the same time, the debt of the Colombian government has kept the investment grade[6] during 2019, according to international rating agencies.

In the same manner, the admission of the country in the OECD and the continued work in 4G infrastructure projects also lead to expectations for moderate economic growth over the next few years and a drive for foreign investment. Besides, despite that the recent tax reform enacted in late 2018 created a certain amount of uncertainty, this law seeks to create incentives and so attract new investors by reducing the income tax rate and by eliminating the presumptive income tax calculation after two years.

Notwithstanding, the country will face several challenges over the next few years associated with the following. Political, social, economic and fiscal uncertainty; the pressure of international trade; high levels of corruption; the immigration crisis from Venezuela; the future of the Peace Agreement; and the increase in unemployment rates, which stayed as a one-digit rate in 2018 but has already amounted to a two-digit rate in 2019[7].

On the other hand, as far as M&A are concerned, the activity has increased considerably in 2019, mainly in the energy, health and financial services sectors. This is, partially, the result of certain transactions that were originated in 2018 but delayed to 2019, because of the uncertainty related to a change of government and the 2018 tax reform.

Likewise, the increased number of transactions may imply that investor confidence has recovered by exploring medium and small size market enterprises. Particularly, investments have flown to technology startups, family companies, and the conspicuous activity in tourism, agriculture, and the production of medical marijuana, which also has brought an average transaction value that is lower than that of prior years.

Finalmente, el sector de infraestructura sigue teniendo una posición muy importante en el mercado del M&A del país, con un gran dinamismo, que puede conllevar a que varias transacciones sean cerradas para finales del 2019 o 2020.

Strategy

Chapter 1

Strategy

Definition

At a global level, companies are constantly searching for ways to grow. They seek to grow not only, revenue and sales, market participation, generation of profits or dividends, but they seek to do it – which is more challenging – in a sustainable way. In addition to your own market position and your own internal capabilities, achieving such objective in any market depends upon a coherent strategy that aligns all these factors at all levels. We at PwC approach strategic coherence from the relationship that exists between the following elements or factors. (i) The capabilities system. (ii) The way to play in the market. And (iii) The products or services portfolio fit of any given company. And we do this in such a way that these elements or factors integrate effectively in the definition of organic or inorganic growth initiatives.

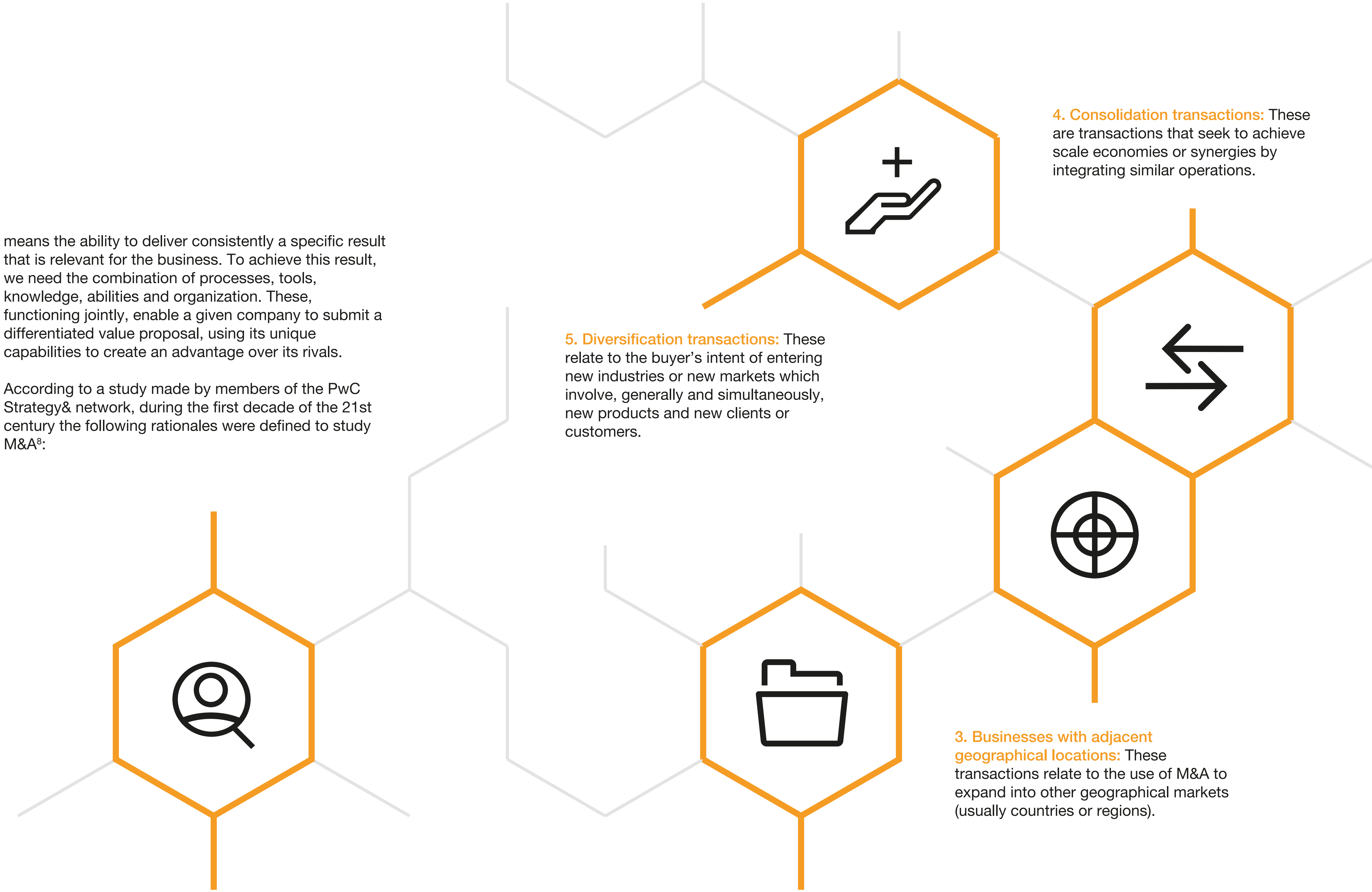
Initiatives that relate to inorganic growth include corporate restructurings through mergers and acquisitions (M&A), business integrations, spinoffs or sales. From this perspective then, it becomes crucial to generate a framework that allows the parties to better understand the rationale, the components and the challenges involved in carrying out this type of initiatives effectively. In a reveling approach, and based upon studies made by PwC Strategy&, we believe that we have found the answer to a quite frequent question: What makes companies with a successful historical record of M&A stand out from others? A business strategy that uses capabilities as the basis for inorganic growth.

Rationale

The underlying rationale of a M&A may vary to a great degree. Usually there is not only one single reason, but a set of particular elements and traits of the reality of each enterprise which justify the decision to merge, acquire, or restructure to generate value.

Some time ago, companies based their strategies and a great portion of their M&A on the concept of scale economies. Today, we at PwC believe that successful companies have changed their vision, and that they focus on long-term growth, which is based upon their differentiated capabilities. In this context, capability means the ability to deliver consistently a specific result that is relevant for the business. To achieve this result, we need the combination of processes, tools, knowledge, abilities and organization. These, functioning jointly, enable a given company to submit a differentiated value proposal, using its unique capabilities to create an advantage over its rivals.

According to a study made by members of the PwC Strategy& network, during the first decade of the 21st century the following rationales were defined to study M&A[8]:



1. Transactions to appropriate capabilities: The purpose of the transaction is to appropriate the capabilities that the target company has and that the buyer would like to have or needs.

2. Businesses with adjacent products or classes or categories: These transactions relate to the purchase of products, service or product brands that relate to the buyer's portfolio.

3. Businesses with adjacent geographical locations: These transactions relate to the use of M&A to expand into other geographical markets (usually countries or regions).

4. Consolidation transactions: These are transactions that seek to achieve scale economies or synergies by integrating similar operations.

5. Diversification transactions: These relate to the buyer’s intent of entering new industries or new markets which involve, generally and simultaneously, new products and new clients or customers.

What makes a M&A process a success story?

The study that we did at PwC shows that companies that have been successful in M&A processes make one of the following rationales their priority to make an acquisition:

1. They leverage their differentiated capabilities system. This is viewed as the acquisition of an enterprise where the buyer knows or believes that he knows that the acquisition will be adequate to exploit its current capabilities system.

2. They make their capabilities system stronger/more robust. This is viewed as those situations where the parties – by the deal – purport to transfer complementary capabilities to the buyer which he still does not have and which will enable him to make his own capability systems stronger/more robust.

3. The combination of the above two rationales.

The capabilities premium in M&A

+4%

Points

Capabilities Fit - Deals

-10%

Points

Limited Fit - Deals

Capabilities - Fit Deals =

+14%

points more return

Evidence shows that these companies have managed to secure an annualized return on investment for shareholders with respect to the M&A transaction. In the opposite way, M&A with limited aligning of the capability systems, where the buyer knows very little about the capabilities and therefore the transaction neither improves nor enhances the capability systems of the acquiring enterprise – in any substantial way.

Because of this orientation towards restructuring and M&A processes that are based upon capability systems, these companies – which we at PwC call "super-competitors" – have managed to evolve successfully by changing the dynamics of their business environment. These new actors are coming out given that, industry after industry, their few distinguishing abilities are both scalable and relevant, while at the same time other types of competitive advantages have become less important.

Given the success and the influence of super-competitors, we must no matter what recognize the role of these new players. Today, companies can trust neither concepts nor scales, and they cannot either be confined within a small number of products or services. One needs to build a constant system of capabilities; however, these are not easy to build, many of them are complex and costly[9].

Stages

Under the framework of a M&A process we can see 6 big stages. Strategy is immersed in each one of them and is applied in different environments to leverage the main rationale underlying the transaction.

Strategic evaluation:
This comprises analyzing the convenience of the transaction and also of its rationale. The evaluation usually relates to the exercise of doing the strategic planning of the company – or to other circumstantial ignition spark that triggers the need of evaluating the timeliness of the deal. This stage spreads across the entire M&A process which is fed back at every point of progress to decide whether to go on or abandon the process.

Evaluating options:
Normally, this stage comprises the making of a short list based upon strategic criteria; and so the interested party fixes a starting point for subsequent activities involving evaluating potential targets. This is usually the start of negotiations between the buyer and the seller and sometimes even the starting point of structuring the transaction.

Evaluation of the deal:
This comprises due diligence activities (whether the commercial, financial and accounting, legal, labor, or tax due diligence work). During this stage, the structuring is refined and the interested parties may start planning for the integration stage.

Negotiations and closing:
The interested parties adjust the offer based upon the inputs from the prior stage. The final negotiation is made as well as the closing agreement, which approves the transaction.

Integration/separation:
According to the nature of the agreement and the position of seller or buyer, the interested parties proceed to do their planning for integration or separation, through the 1-day and 100-day plans.

Transformation and growth:
This comprises executing the long-term activities of integration to capture value.

Success stories

According to the strategy+business article mentioned above, the industries that are ready for this change have two fundamental qualities: scalability of critical capabilities and relevant differentiation. The first one deals with the applicability of capabilities, which must be ample and able to be expanded in respect of products, services and clients or customers. In this manner, the fixed cost of any distinguishing capability (such as IT, supply-chain and talent costs) can benefit from it. The second quality deals with the number of clients that can value the distinguishing features that a capability system can offer, either through higher value (Walmart and Amazon), or differentiated products and services (Apple and Starbucks), or both (McDonald's or IKEA).

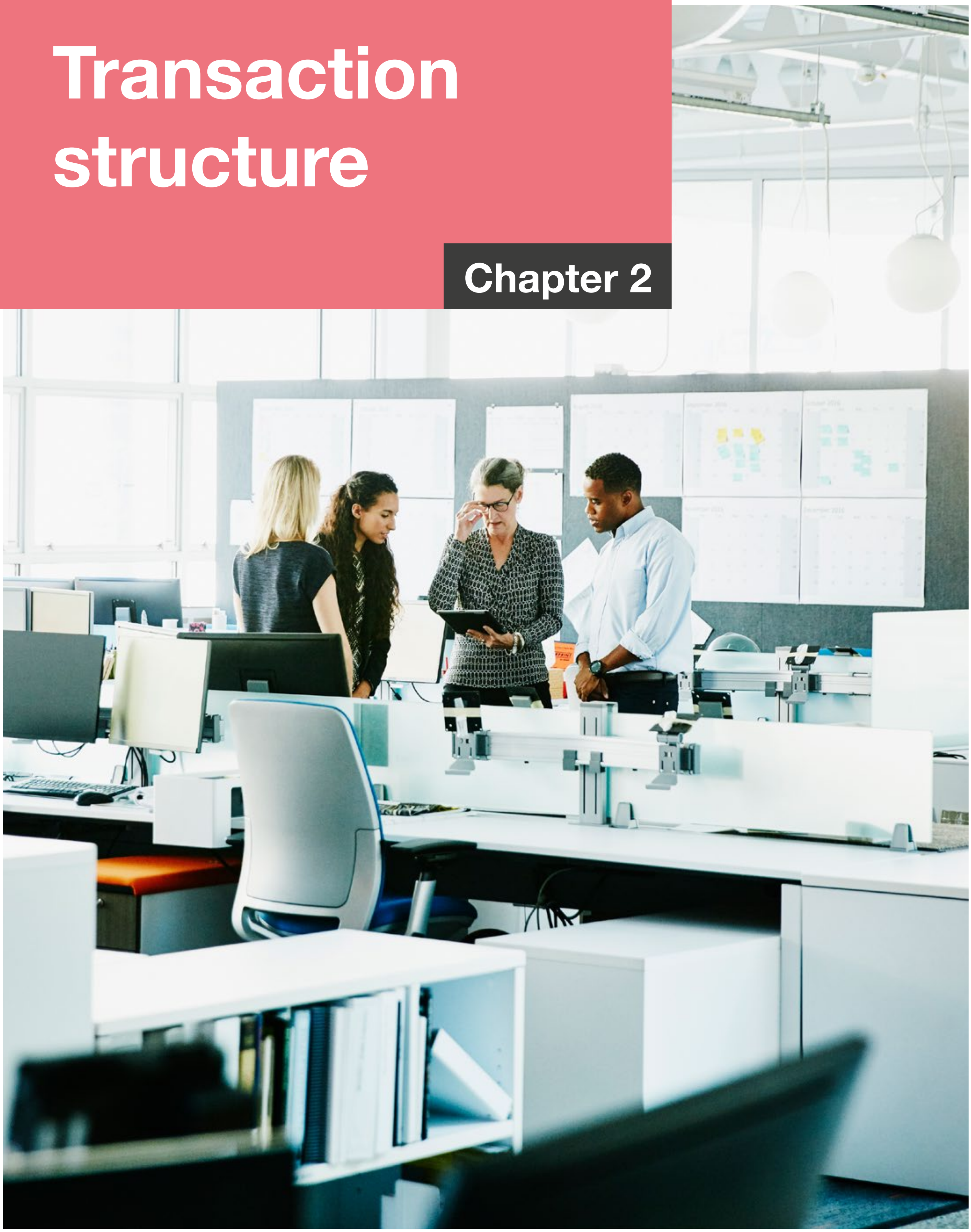
There is an example of successful implementation of the capabilities and strengths methodology of enterprises through mergers and acquisitions. This is the case of the Danaher industrial conglomerate which, through the acquisition that it has made, has managed to obtain better results. The fundamental factor for success at Danaher is focused on the knowledge of its strongest area, which allows a continuing operational improvement that reinforces the business system of Danaher[10].In other words, they always take advantage of their capabilities in the transactions that they make. That is how you guarantee success in a M&A transaction. According to a study of strategy and business, successful examples of these are Walt Disney Company and Abbott Laboratories. They are successes because they understand the importance of adopting an approach that is hinged upon capabilities for M&A; and so they focus on developing scales around a system of capabilities.

Companies that use this approach know how to switch between leverage and enhancement agreements, and so accomplish their growth objectives. Part of the success is based not only on identifying and capturing synergies, but also on finding ways of managing cultural differences, retaining key people and helping to ensure that the ideas of these people become rooted more strongly in the organization. The clear and successful example of implementation of different types of agreements is Walt Disney. They have shifted strategically between leverage and enhancement agreements over the last 15 years. In consequence, their acquisition of Pixar (which was announced in 2006) was a deal made to strengthen their capabilities (they were seeking in-depth knowledge in the area of computer-generated animation). By contrast, the acquisition of Marvel Entertainment (announced in 2009) was a leverage agreement (which created a new cast of iconic characters to drive their movie and TV channels). Finally, this approach enables companies to discover what is that in which they do not fit, and accordingly what it is that they ought to change, sell or dispose of. In short, to divest all that is not consistent with that which the company knows to do best[11].

In conclusion, those offers that are made taking into account a perspective of capabilities are far more likely to generate value over time. Accordingly, distinguishing capabilities must reinforce, back and drive the strategy of an enterprise, integrating people, processes and technologies to produce value for their clients. These capabilities must be differentiated and must supplement each other, seeking to secure specific results in a reliable and consistent way, as support for the long-term strategy and market position of any given company. [12].

Transaction structure

Chapter 2



Transaction structure

Legal

1.1 The purchase of target: shares or equity interests, and rights in branch offices of foreign companies

Currently, the most frequently used vehicles to carry out business in Colombia are the simplified stock company (or SAS) and the corporation (or S.A.), both of which are commercial companies, and branch offices of foreign companies.

SAS standout between the vehicles mentioned above. Ever since their creation in late 2008, SAS have become the vehicle of choice for foreign investors and national investors, mainly because of their flexibility in points of their incorporation and day-to-day functioning. On the other hand, branch offices of foreign companies are still used a lot, especially in the mining in hydrocarbons sector, given their eligibility for special foreign exchange benefits.

Below we set forth some relevant differences between these vehicles, in point of corporate and shareholdings, and also in point of the rules that govern their transfers.

A. The corporation (or S.A. – for sociedad anónima)

These are capital-based companies in *tuito personae*, the capital of which is represented in nominative shares of equal value for which share certificates are issued. It is divided into three classes:

Authorized capital: where a company by shares is incorporated in Colombia, the shareholders “authorize” a maximum amount of capital that the company may have. Thus, if this capital needs to be increased, then a bylaws amendment must be made according to the needs of the company. This is an agreement that indicates to the shareholders what is the maximum value of their commitment to invest monies into the company. This “authorization” does require the shareholders to subscribe the capital in case a capital increase is approved – whether majority or minority shareholders. Without detriment to the above, the authorized capital may be modified by decision of the shareholders through a bylaws amendment.

Subscribed capital: this is the amount of capital that the shareholders agreed to pay into the company, whether with cash or in-kind contributions, upon incorporation of the company or at a later time.

Paid-in capital: this is the amount of capital actually paid by the shareholders for the shares that they subscribed.

Upon incorporation of the company, 50% of the authorized capital must be subscribed at a minimum; and one third of the subscribed capital must be paid at a minimum upon incorporation.

The amount of the subscribed capital is the corporate capital. This is so because regardless of whether or not it has been paid, the shareholders are liable for the amount that they subscribed.

The shares are freely negotiable unless the shareholders have agreed upon rights of first refusal or preemptive rights; or save for the cases of preferred shares, unpaid industry shares or pledged shares, which require certain authorizations and special procedures.

Contrariwise, the transfer of shares requires the endorsement of the corresponding share certificates and the registration of the transfer or sale in the shareholders’ register kept by the company.

Finally, the actual shareholding composition of the corporate capital of these companies generally does not appear as public information included in the certificate of legal existence and signatory authority of the company.

B. The simplified stock company or S.A.S.

This kind of company is mixed in nature. It has elements that pertain to personal companies and capital companies. As is the case of corporations, in a SAS the capital is represented by nominative shares and is divided into three types of capital: authorized, subscribed, and paid-in capital.

As particular traits, it is worth noting the following:

- This type of companies may be incorporated by one or more persons, natural or legal, Colombian or foreign, who, as shareholders, will be liable only up to the amount of their respective contributions. Both the incorporation and any bylaws amendments of a SAS may be carried out through a private document.
- Subscription to and payment of the capital may be made according to conditions and terms other than those provided in the law for corporations. The term for payment of the shares may not exceed 2 years.
- The shareholders may agree upon in the bylaws the prohibition for any one of them to negotiate the shares issued by the company or any class of shares, provided that this restriction does not exceed 10 years counted from the date of issue of the shares. This term may be extended by additional terms not to exceed 10 years each, on the unanimous approval of the shareholders.
- Shareholders may also subject the negotiation of shares to approval by the shareholders meeting.

As is the case of corporations, the shares of an SAS are freely negotiable. Accordingly, their transfer only requires endorsement of the corresponding share certificates and registration of the transfer in the shareholders register kept by the company. Notwithstanding, by contrast with a corporation, the shares issued by a SAS cannot be negotiated on a stock exchange.

Finally, the actual shareholding composition of the corporate capital of these companies generally does not appear as public information included in the certificate of legal existence and signatory authority of the company.

C. Branch offices of foreign companies

A branch office is a commercial establishment owned by a foreign company that has registered the branch – the "home office" or "head office". For this reason, a branch office does not stand as a separate legal entity other than the whole company. Accordingly, any exposure, any liability of the branch office in Colombia passes through directly to the home office.

Branch offices have an assigned capital that has been assigned by the home office. In principle, this capital, as is the case of all commercial companies, functions as the general backup security of the branch creditors. Additionally, branch offices of foreign companies have a

special equity account called "supplementary capital investments". This capital functions as "floating capital" that enables the home office to remit cash and other resources to the branch office in Colombia and enables the branch office to return the resources without any of these transactions requiring any bylaws amendments nor any prior approvals.

Under the law, the branch office is a commercial establishment owned by the home office. Accordingly, the transfer of a branch office follows the rules provided for in Colombian law for the contribution of a commercial establishment into a commercial company. In this regard, the Office of the Superintendent of Companies of Colombia has indicated that the transfer of a branch office as a "bulk transfer" is a transaction totally viable under Colombian law; but that it is a transfer that carries the effects that pertain to the change of [foreign investor of record] under the law.

Finally, the Office of the Superintendent of Companies has also held – in reiterated rulings – that a branch office of a foreign company cannot hold shares or equity interests directly whether of Colombian or foreign companies.

There are other types of companies which have their own characteristics which are less used today, such as the following:

Limited liability companies:

These are personal companies (or *intuito personae* companies) which must be incorporated and operate with a minimum of 2 members and a maximum of 25 members. These companies have just one type of capital which is divided into equity interests, the par value of which must be the same, and the sale or assignment of which is subject to preemptive rights unless the bylaws provide for otherwise.

Partnerships:

These are personal companies where the prevailing trait is trust and confidence between the members or partners. In these companies, all the partners are liable not only up to the amount of their capital contributions but also up to the amount of their personal patrimony.

Limited liability partnerships::

The characteristic of this company is that it is made up of general partners and limited partners. The first are jointly and severally liable with the company for company debt; while the liability of the second type of partners is limited to the amount of their contributions. These companies are commonly used in family businesses.

Under Colombian foreign exchange regulations, any investments made by nonresident persons in shares or equity interests in Colombian companies as well as in any rights in branch offices of foreign companies qualify as foreign investment in Colombia – provided the investment is made with the intent of holding it “permanently”. In this way, any currencies involved in these transactions, and any yields that they generate, must be transacted through local foreign exchange intermediaries (e.g. local commercial banks) or through bank accounts set up in foreign currency with financial institutions abroad and which are registered with the local Central Bank (or Bank of the Republic) as “compensation accounts”.

By transferring the investment and registering the investment and related transactions according to the terms and conditions set by the Bank of the Republic, the investor is formally qualified as a foreign investor. This entitles the investor to foreign-exchange remittance rights, which consists of the ability of repatriating the capital and any profits or yields, or the ability to reinvest them through capitalization in exchange for a larger number of shares.

For foreign-exchange purposes, in order to structure a transaction involving a purchase of shares or equity interests in a Colombian company, the first elements you should identify are the following:

- Whether the buyer is a nonresident person.
- Whether the seller is a foreign investor.
- Whether the shares or equity interests are shares of a Colombian company in which the foreign investor of a nonresident is registered.

Based on the above, we may have the following scenarios:

Nonresident buyer & nonresident seller:
This requires that the nonresident seller must have registered his direct foreign investment in the past. Should this be the case, the transaction is viable, and triggers the obligation of registering a substitution of foreign investor of record with the Bank of the Republic of Colombia. Here, the substitution must be registered within the 6 months following the transaction, if the same takes place after July 26, 2017.

Nonresident buyer & resident seller:
Here, the investment of the seller was not registered as foreign investment in the target. This entails that the nonresident buyer must remit the amount of the investment as payment to the Colombian resident seller through the foreign-exchange market. Here, it is worth indicating that the resident seller is the beneficiary of the payment, and not the target, given that the shares are already issued and outstanding. The nonresident buyer’s investment in the target is registered by providing the minimum requisite data for foreign-exchange transactions involving a foreign investment (on a foreign-exchange declaration).

(i) If at the time of the purchase the investment has not been registered or (ii) the investment currencies are not remitted through the foreign-exchange market, then the buyer will not be treated as a foreign investor in Colombia and therefore will have no foreign exchange rights. In addition, the investor will be exposed to a penalty of up to 200% of the transaction for failure to remit the currency investments through the foreign-exchange market. The statute of limitation of this penalty is of 2 years, and the Office of the Superintendent of Companies is the agency in charge of imposing it.

1.2 Purchase of assets

Another very common alternative to make investments in Colombia is to acquire the assets through which the business operations are carried out, instead of acquiring the corporate vehicle that owns the operation. In other words, to carry out an asset deal instead of a share deal.

Should this be the case, the reader should take into account that any transfer of assets is subject to general rules established in Colombian law, according to the classes of specific assets being transferred. Therefore, we set forth below a few considerations on the most common assets involved in these asset deals.

Real property:

Real property conveyances in Colombia require compliance with certain formal requirements as follows: (i) The execution of a public deed or notarized deed. All conveyances of real property under any arrangements require the parties to execute a public deed before a notary public into which they will incorporate their acquisition transaction and the fundamental elements of it, including the identification of the parties, the specific description of the real property, the acquisition price and the payment terms.

This deed only creates personal obligations between the parties and is still not sufficient for the buyer to acquire ownership in the property. (ii) Registration in the land register. After the deed has been executed, the conveyance of ownership in the real property will not be complete until it is registered in the land register (which is managed in Colombia by the so-called Register Offices for Public and Private Instruments).

Once the conveyance has been registered in the public land register, ownership passes to the buyer and he can defend it against any third-party claims.

The reader should take into account that both the execution of the deed and the subsequent registration of it in the land register triggers the payment of notary fees and registration taxes. The total value of these will depend upon the transaction value.

Vehicles:

In Colombia, vehicle transfers are also acts that require compliance with certain formal requirements. These acts do not require a notarized deed; the mere private agreement of the parties is sufficient. But this contract, again, only generates obligations between the parties without ownership in the vehicle being properly transferred; this occurs only when the transfer is registered with the automobile public register, before the corresponding transit office.

As a general rule, for foreign-exchange purposes a purchase of assets does not qualify as foreign investment in Colombia, except for the case of real property (land and any constructions erected on the land). In this way, only the portion of the transaction involving the purchase of real property will be a transaction that must be “channeled” through the foreign-exchange market. In this case, the parties must follow the procedure indicated for the purchase of a target.

1.3 Corporate mergers

Under corporate law, the merger of two or more companies entails a bylaws amendment that entails integration of two or more companies into one of them or into a newly created company.

Corporate mergers in Colombia are procedures that are relatively complex, which require compliance with several stages that may be summarized as noted below:

Stage 1:

Preparation of the merger:
In this first stage, the entire work that will be the basis of the merger must be done. This includes preparing the balance sheets that are the basis of the merger.

The core document of this stage is the merger agreement which is an agreement signed by the statutory representatives of all the companies participating in the merger. In this document, the parties set forth the substantial aspects of the transaction, including the identification of the companies being merged, the grounds and the justification for the merger and the ratio for the exchange of shares.

Stage 2:

Approval of the merger:
Once the merger has been prepared, the transaction is submitted to the consideration of the shareholders or members of the companies involved, who must approve the merger by the requisite number of votes set by law or by the bylaws of each one of them.

It is worth indicating that the mere approval of the merger is not enough for the transaction to be completed and perfect.

Stage 3:

Public disclosure of the merger:
Once the merger has been approved by the shareholders or members of the companies involved, the parties must give notice to the public at large about the mentioned bylaws amendment. This must be done by publishing notices in a newspaper of wide circulation in the domicile of each one of the companies involved, and by sending out written notices to all corporate creditors, explaining the particular features of the transaction.

As from the date of publication or the date of sending out of the last notice, the creditors will have up to 30 business days to raise any objections to the merger.

Stage 4:

Special clearances:
Should this be necessary, according to the characteristics of the transaction, possibly the merger will require special prior clearances given by the Office of the Superintendent of Industry and Commerce (SIC for the Spanish initials) and the Office of the Superintendent of Companies (SS for the Spanish initials).

Each one of these clearances seeks to protect the people that may be affected by the integration, but from a different perspective. The prior control exerted by SIC seeks to verify whether the merger, as devised, could affect fair competition in the relevant market.

The control exerted by SS seeks to protect the creditors of the companies involved to prevent that the merger is used as a mechanism to avoid compliance with their obligations by the companies involved.

In both cases, the Colombian state has established certain parameters for a general authorization. In other words, these are requirements which, if met, allow the authorities to suppose that the projected merger jeopardizes neither the competition nor the relevant market, nor the position of third parties and creditors.

Stage 5:

Perfecting of merger:
Once the publication term has been exhausted; and once any special requisite authorizations have been obtained, as the case may be, the company will proceed to perfect the merger bylaws amendment. It will do so by registering the merger agreements and any other relevant documents with the Chamber of Commerce of the domicile of the companies involved.

It is worth noting that, in certain cases, depending upon the types of companies involved in the merger or of the specific property to be transferred, it may be necessary to execute a merger public deed to perfect the transaction.

For foreign-exchange purposes, a merger of companies may require making changes in foreign investment records, either for the substitution of the receiving company or of the foreign investor of record, depending on the way in which the transaction is structured. Once this has been verified, it will be necessary to register the situation with the Bank of the Republic within 6 months following the date of the transaction if the same occurred after July 26, 2017.

In certain cases, the merger also entails the disappearance of foreign investors or of investment receiving companies, with no substitution of investor occurring. In this case, the cancellation of the direct foreign investment in Colombia must be registered with the Bank of the Republic, also within the term of 6 months.

1.4 Corporate spinoffs

Under corporate law, as in the case of mergers, the spin-off of a company is a bylaws amendment that entails the total or partial separation or division of a company for the benefit of one or more existing companies or of a newly created company.

Corporate spinoffs in Colombia are procedures of certain complexity that require going through the same stages that a merger has.

For foreign-exchange purposes, as in the case of a merger, spinoffs of companies may require making changes in foreign investment records, either for the substitution of the receiving company or of the foreign investor of record, depending on the way in which the transaction is structured. Once this has been verified, it will be necessary to register the situation with the Bank of the Republic within 6 months following the date of the transaction if the same occurred after July 26th, 2017.

1.5 Incorporation of a vehicle

In many cases, doing a transaction or a deal in Colombia requires incorporating a local corporate vehicle through which the resources are channeled and the assets or shares are acquired. It is worth noting that – under local authority rulings – branch offices of foreign companies cannot hold corporate shares, although they can hold other kinds of assets. To such extent, below we set forth a summary of the procedures to incorporate simplified stock companies and to register branch offices of foreign companies.

Detailed plan for the incorporation of a S.A.S in Colombia

Required documents

- Articles of incorporation and bylaws of the new company.
- Powers of attorney (as the case may be) granted by the shareholders.
- Certificate of legal existence and signatory authority for corporate entities; ID document for natural persons.

Every document issued or executed abroad must be legalized with an apostille or via a consular office in the country of origin.

Every document written in a language other than Spanish must be translated by certified translator in Colombia.

Activities

Preparation of the documents required for the incorporation and filling out of forms.	3 business days
Registering the company with the Chamber of Commerce. Expenses: · Registration tax (between 0.7% and 1% of the subscribed capital, depending upon the city of registration; for example, the tax is 0.7% in Bogotá). · Registration fees (according to the values set by the respective Chamber of Commerce every year).	5 business days
Registration in the unified national tax register (RUT for the Spanish initials) and obtaining the tax identification number (NIT for the Spanish initials), with the national tax authorities. (The power of attorney required for this paperwork must be granted by the statutory representative of the company).	1 business day
Transfer of the corporate capital. Preparation of foreign exchange declaration form 4.	1 business day

Detailed plan for the registration of a branch office in Colombia

Required documents

- Powers of attorney (as the case may be) granted by the home office.
- Certificate of existence and signatory authority of the home office.
- A copy of the complete bylaws of the home office.
- Decision adopted by the competent body of the home office to register a branch office, and the bylaws of the branch office.

Every document issued or executed abroad must be legalized with an apostille or via a consular office in the country of origin.

Every document written in a language other than Spanish must be translated by certified translator in Colombia.

Activities

Preparation of the documents required for the registration, and filling out of forms.	3 business days
Executing the public deed for registration of the branch office before a Colombian notary public of the domicile.	3 business days
Registering the branch office with the Chamber of Commerce. Expenses · Registration tax (between 0.7% and 1% of the subscribed capital, depending upon the city of registration; for example, the tax is 0.7% in Bogotá). · Registration fees (according to the values set by the respective Chamber of Commerce every year).	5 business days
Registration in the unified national tax register (RUT for the Spanish initials), and obtaining the tax identification number (NIT for the Spanish initials), with the national tax authorities. (The power of attorney required for this paperwork must be granted by the statutory representative of the company).	1 business day
Transfer of the corporate capital. Preparation of foreign exchange declaration form 4.	1 business day

For foreign-exchange purposes, only where corporate vehicles are incorporated with foreign investors participating the interested parties must comply with the laws on direct foreign investment.

As noted above, any cash contributions made by a foreign investor must be remitted through the local foreign-exchange market and must be registered by submitting the minimum requisite data for foreign-exchange transactions for foreign investment (foreign-exchange declaration, formerly Form 4).

Additionally, nonresident investors may register in-kind contributions consisting of personal property that is imported as a "non-reimbursable" (or non-payable) import; or accounts receivable from the new corporate vehicle, for imports of personal property imported as "reimbursable" (or payable) imports; as well as contributions of other tangible personal property or intangible property that may be used as income-producing assets that may be amortized or depreciated according to Colombian accounting standards.

1.6 The transfer of the resources

In short, any transfers of cash or currency made by a nonresident for the items noted below must be remitted through the local foreign-exchange market; and it must be reported by submitting the requisite minimum data for foreign-exchange transactions for foreign investments. This is necessary for the investor to secure the corresponding remittance rights and to meet foreign-exchange regulations related to direct foreign investment. The mentioned items are the following:

(i) Initial contribution of currency for the incorporation of a vehicle in Colombia, including any type of company or branch office.
(ii) Additional contributions into said vehicles.
(iii) Purchase of shares or equity interests held in Colombian companies from local residents.
(iv) Purchase of real property.

Additionally, if the transaction is being financed with a foreign currency loan granted by a nonresident lender – whether or not a foreign financial institution –, please note that the currency underlying this transaction must also be remitted through the local foreign-exchange market (except for special cases where the disbursement is reported by filing a declaration on Form 3A); and the transaction must also be reported in proper form to the Bank of the Republic.

The procedure for reporting foreign loans and disbursing the underlying funds is the following:

1.

Obligation:
The local borrower must verify that the foreign lender appears in the list of Attachment 1 of Circular Letter DCIN 83 of the Bank of the Republic.

In case the lender has no assigned code, the local borrower must indicate the full name or company name of the lender, the country and the type of lender or creditor, on the credit reporting form. This is to obtain an assigned code for the lender through the foreign-exchange market intermediary.

Timing:
It must be made before disbursement of the loan funds; the local borrower must not receive the loan funds if the foreign lender is not registered.

2.

Obligation:
The local borrower must report the foreign debt on Form 6. The parties must have a written loan contract or document, that sets forth the conditions agreed upon by the parties (lender, borrower, currency, loan amount, amortization schedule or payment deadlines, interest rate, among others).

Timing:
It must be made before disbursement of the loan funds. By way of exception, the loan may be reported with the disbursement when the transaction is made through a foreign exchange intermediary before the loan is disbursed.

3.

Obligation:
The local borrower must report the loan remitted through the local foreign-exchange market on Form 3, except where it has been already reported on Form 6 (report of foreign debt) or where the disbursement is made directly abroad in special authorized cases, in which case the local borrower must file Form 3 A.

Timing:
At the time of disbursement by the local foreign-exchange intermediary, or within the following month if the funds are disbursed through a compensation account, and before **Form 10.** is filed online.

4.

Obligation:
The local borrower must remit the loan repayment through the local foreign-exchange market, and must report the transaction on Form 3.

Timing:
C Upon every payment if made through the local foreign-exchange intermediary; or if the repayment is made through a compensation account, before Form 10 is filed online.

These loans may be used to make Colombian investments abroad. In this case, disbursement of the loan funds is also a transaction that must be remitted through the local foreign-exchange market, except for a few cases where the investment must be registered through a special procedure by filing Form 11 directly with the Bank of the Republic within 6 months following the making of the Colombian investment abroad.

Tax aspects

The tax aspects of every transaction have become significantly relevant. Even if all of the aspects of a transaction must be viewed as a whole – and, as such, should not be isolated –, it is true that any structure that is devised without the proper analysis of the tax impact will be nothing less than an inefficient and costly structure for any of the parties. And this runs counter to one of the objectives of any transaction: economic optimization.

Indeed, there are three essential subjects for tax purposes when structuring a transaction:

1. The investment or acquisition
2. The return on the investment
3. Taxation upon exiting the country

2.1 Investment or acquisition

Before making any analysis, an essential requirement is to understand if the transaction involves an investment or an acquisition. This is so because these two types of transaction have different tax effects, as the case may be.

Thus, when we speak of "investment", we refer to a scenario where a potential investor would inject capital into a new company or into an existing company; whereas, we speak of "acquisition" when this potential investor is not seeking to increase the capital of an existing enterprise, but seeks rather to come to own the total enterprise (or its assets), whether through a common share acquisition or by other means, such as mergers or spinoffs.

Other differences that allow one to recognize the type of relevant scenario are based upon the legal aspects. Here, in an investment structure there is no transfer of ownership; instead, the existing shareholders retain their shares in the company, which is now relatively less in exchange for the new investment made by the new investor. The situation is opposite to that of an acquisition where – as a general rule – the existing shareholders assign their total shares or part of their shares in favor of this new investor.

Having seen the above, when making capital investments the investor must consider specific tax aspects such as the registration tax. This tax accrues on every capital increase and on the corresponding share issue, with the total amount of the investment being taxed at the rate of 0.7%, which can be reduced by corporate mechanisms, e.g. by using a share premium. On the other side, there are certain incidental taxes (in particular, for foreign investors), such as the financial transactions tax, a.k.a. as the "four per thousand tax" (or cuatro por mil in Spanish) – given its rate. Frequently, when remitting the funds of the investment and monetizing them, it is the Colombian company that receives the investment the party legally called to assume the cost of this tax; and this may be a factor to be debated in the course of negotiations.

On the other side, in acquisition transactions it is true that taxes accrue based upon the disposition of shares or assets that belong entirely to the seller. However, it is not a rare event to find transactions where the high tax impact (whether the income tax or the capital gains tax) may complicate the negotiation or may even lead the parties to break their deal talks.

Accordingly, it is essential for the potential buyer to know the tax situation of the seller before engaging in any talks about a possible acquisition. This is so because the seller must take into account what the tax impact will be for him, and what amount of taxes will he have to pay on the eventual gain from a transaction.

It is worth noting that with the admission of Colombia in the Organization for Economic Cooperation and Development – OECD –, the Colombian tax system has been refined through the last tax reforms, to be adapted to the tax policies of this organism. Accordingly, old tax strategies – such as using mirror companies or spinning off the target company – are no longer tax efficient as they used to be.

2.2 The return on the investment

Once the acquisition of or the investment in the company has been structured, the new investor must focus on how will the return on his investment be.

Par excellence, the return on investment is given through the distribution of dividends. There are however other distribution mechanisms (interest, royalties, among others) which the investor can analyze as efficient alternatives or as alternative ways of securing advance distributions.

With respect to dividend distributions, in the first place the foreign shareholder (investor) must understand what the tax effects that will hit him upon receipt of the dividends are. In Colombia we have a tax on dividends that taxes every dividend distribution at the rate of 7.5% where the dividends are distributed from profits that were taxes with the income tax in the hands of the distributing company. In this case, the tax is collected by the distributing company as a withholding tax.

Where the case is the opposite, i.e. where the dividends are distributed from profits that have not been subject to income tax in the hands of the distributing company, then the dividends will be subject in the first place to an “equivalent income tax” – equivalent to the corporate income tax – at the same rate, which is 33% for 2019. And after this tax has been deducted as a withholding tax, then the net dividend distribution (gross dividend minus equivalent income tax) will be subject to the aforementioned 7.5% withholding dividend tax.

By way of example, dividend distributions can be paid from earnings not taxed in the hands of the distributing company where the company has special tax deductions that are not accounting expenses or when it has net tax losses; in other words, where the accounting profits are greater than net taxable income, then the excess will correspond to nontaxable earnings of the company.

There are a series of exceptions to the above rules, both for national and foreign investors, such as the following: (i) corporate groups, (ii) corporate control situations, and (iii) special tax rates (sometimes zero tax rates) established by double taxation treaties entered into by Colombia.13

Now, in certain cases distributing dividends may not be the most efficient mechanism to secure a return on investment. This happens not only for the frequency and the corporate formal requirements that must be followed, but also in the case of tax inefficient scenarios, as the mentioned case of distribution of dividends paid from profits that went untaxed in the hands of the company. In this case, for example, the company set off tax losses the result being taxable income equal to zero.

In this particular scenario, other mechanisms may be interesting for the investors, such as the mechanism of debt. Here, even if the payment (or accrual) of interest generates income that is taxable in Colombia for the lender (regardless of whether or not the lender is a tax resident) and will as such be subject to withholding tax collection, withholding tax rates can be less than the aggregate of the equivalent income tax and the dividends tax.

Under current Colombian law, the payment (or accrual) of interest between local residents is subject to a withholding tax rate of 7% on the total interest paid (or accrued). By contrast, the withholding tax rate for nonresident lenders will be of 20% if the term of the loan is of less than one year, and of 15% where the loan term exceeds one year.

Under double taxation treaties, as a general rule interest withholding tax rates drop to 10% in the case of debt owed to private entities, and usually to much lower rates where the debt is owed to a financial institution or a governmental entity.

Lastly, it is worth noting that certain restrictions must always be taken into account when structuring a debt mechanism, mainly for purposes of deducting the interest in the head of the local debtor/borrower. This includes thin capitalization rules, which set a cap on the deduction of interest on intercompany debt where the total average amount of the debt exceeds the result of multiplying the net equity of the taxpayer times 2. Also, there are transfer pricing regulations, according to which any loan agreement with foreign related parties or with related parties operating in a free-trade zone must respect market rules; specifically, and among others, the interest rate must be similar to the interest rate that would have been agreed upon with an unrelated third party lender.

2.3 Exiting the country

Exiting the country is how we call the sale of the assets that were the subject matter of a former acquisition or investment.

In this respect, the foreign investor must keep in mind that any disposition of Colombian assets – whether shares or other assets – will be subject to Colombian income taxes or capital gain taxes.

One of these two taxes will apply depending on two fundamental reasons, namely the nature of the assets and their time of holding.

In the case of fixed assets held by the taxpayer for 2 or more years, the gain from the transaction will be subject to the capital gains tax, the rate of which is 10% of the mentioned gain. By contrast, if the fixed assets have been held by the taxpayer for less than 2 years, or if the assets sold are movable assets – regardless of the holding period –, then the gain will be subject to the income tax at the rate of 33% – which is the rate that applies to legal entities in 2019.

As is the case of dividend distributions and interest payments, there are different rates under double taxation treaties. Of these, our treaties with Spain and Switzerland stand out, where a sales transaction may be subject to a zero tax rate, provided certain requirements are met.

Now, regardless of which of the above two taxes accrues, the foreign investor will be required to file an income tax return reporting the exit transaction.

In the case of a nonresident foreign investor, he must file an income tax return within the month following the date of the transaction, regardless of whether or not there was a gain on the transaction. By contrast, a national investor will file the usual annual income tax return on or before the usual filing deadlines, which are usually set between April and May of the calendar year following the year of the transaction.

Labor aspects

Where there is a transaction between two or more legal entities that involves the workers or employees of one of them, then the following situations may arise under Colombian labor law:

3.1 Substitution of employer

There is a substitution of employer where a natural or legal person takes the place of a former employer in respect of all his labor obligations, and so becomes the new employer of the employees with the labor relationships going on uninterrupted, and without any prior approval from the employee being required, nor the intervention of the Ministry of Labor or of any other governmental authority being required either.

A substitution of employer occurs where there is a change of ownership (through exchange, sale, transfer, assignment, or inheritance), a disposition of rights of use or enjoyment (through leases or rentals, etc.), a modification of management or a modification of the company itself – through transformation or merger, liquidation or because of any other cause

- Substitution of employer
- The operations of the establishment are continued (continuity of the company).
- The employee continues to provide his services to the employer.

As these elements concur, the substitution of employer occurs by direct operation of the law, without any declaration from any judicial or administrative authority being required.

The new and the former employer will be jointly and severally liable for all the obligations that accrued through the date of the substitution; and the new employer will be solely liable for all obligations accruing after the date of the substitution of employer.

In case there is a substitution of employer, the interested parties must keep in mind the following:

A. Communicate the event to the employees

As said, a substitution of employer does not affect any existing labor relationships; in this way, all labor contracts continue to be valid and in force with no modification whatever. However, for reasons of the work atmosphere, our recommendation is to communicate this event to the employees, setting down the notice in writing for the record.

After this notice has been sent, each employer will understand clearly that his labor conditions will not be modified, but, that as from the date of the relevant transaction, he/she will have a new employer.

B. Payment of the severance pay:

The former employer must give notice to the severance pay funds with which his employees are affiliated. In the notice it will indicate that because of a substitution of employer, as from the effective date of same, the new employer will be responsible for the said employees. On his side, the new employer must do the requisite paperwork to be affiliated with the same severance pay funds with which the employees are affiliated.

C. Social Security and payroll tax agencies:

The former employer must give notice about the novelty of his withdrawal as employer to all social security agencies – healthcare, pension and worker's compensation agencies – and to the relevant payroll tax collection agencies.

On his side, the new employer must affiliate the employees with the same social security agencies with which they were affiliated. This is without detriment to the ability of any employee wishing to make a change in respect of the pensions fund or the healthcare provider.

3.2 Termination of labor contracts – collective dismissal

There is also the option for the seller to terminate all the labor contracts. In this way, the buyer will retain the personnel that is most convenient for him, after the transaction.

The labor contracts must be terminated prior to the effective date of the transaction to keep a substitution of employer from occurring.

It is worth noting the following. With respect to the option of terminating the labor contracts by the former employer, labor law allows employers to terminate labor contracts at any time and without cause, provided they pay an indemnification to the employee as required by the law. However, certain conditions may apply when there is a collective dismissal. Under the law, there is a collective dismissal where the employer terminates without cause a certain percentage of the personnel retained directly over a term of 6 months as indicated below:

30 %	for companies that have between 10 and 49 employees.
20 %	for companies that have between 50 and 99 employees.
15 %	for companies that have between 100 and 199 employees.
9 %	for companies that have between 200 and 499 employees.
7 %	for companies that have between 500 and 999 employees
5 %	for companies that have more than 1000 employees.

Where a company must carry out a dismissal that exceeds the above percentage limits, it must apply for authorization to the Ministry of Labor beforehand; and it must provide justification of why the dismissal is necessary. Any collective dismissal of employees made without the requisite prior authorization from the Ministry of Labor will be of no effect whatever. Likewise, even where the employer secures the authorization from the Ministry of Labor, he will still be required to pay the indemnification for dismissal without cause to the employees as established by labor law:

Fixed term labor contracts: The indemnification is equal to the amount of the salaries for the term that is still pending to complete the term agreed upon in the contract.

Open-ended labor contracts: In open-ended labor contracts, the indemnification will be calculated as indicated below.

For all employees earning a salary that is less than 10 minimum monthly wages:

1. Employees who have rendered their services for 1 year or less, 30 days' worth of salary.
2. Employees who have rendered their services for more than 1 year, 30 days' worth of salary for the first year of service, plus 20 additional days' worth of salary for every subsequent year, and pro rata for a fraction of a year.

For all employees earning a salary that is equal to or greater than 10 minimum monthly wages:

1. Employees who have rendered their services for 1 year or less, 20 days' worth of salary.
2. Employees who have rendered their services for more than 1 year, 20 days' worth of salary for the first year of service, plus 15 additional days' worth of salary for every subsequent year, and pro rata for a fraction of a year.

Any employees who had rendered their services for 10 or more years as of December 27, 2002, are entitled to the following indemnification: 45 days' worth of salary for the first year of service, plus 40 additional days' worth of salary for every subsequent year, and pro rata for a fraction of a year.

The procedure for securing an authorization for a collective dismissal from the Ministry of Labor may take several months, and the approval of the application is not guaranteed. Because of this, the selling company may also choose to implement a voluntary retirement plan or propose termination agreements to the employees. In these cases, the labor relationships would terminate by mutual consent and not unilaterally.

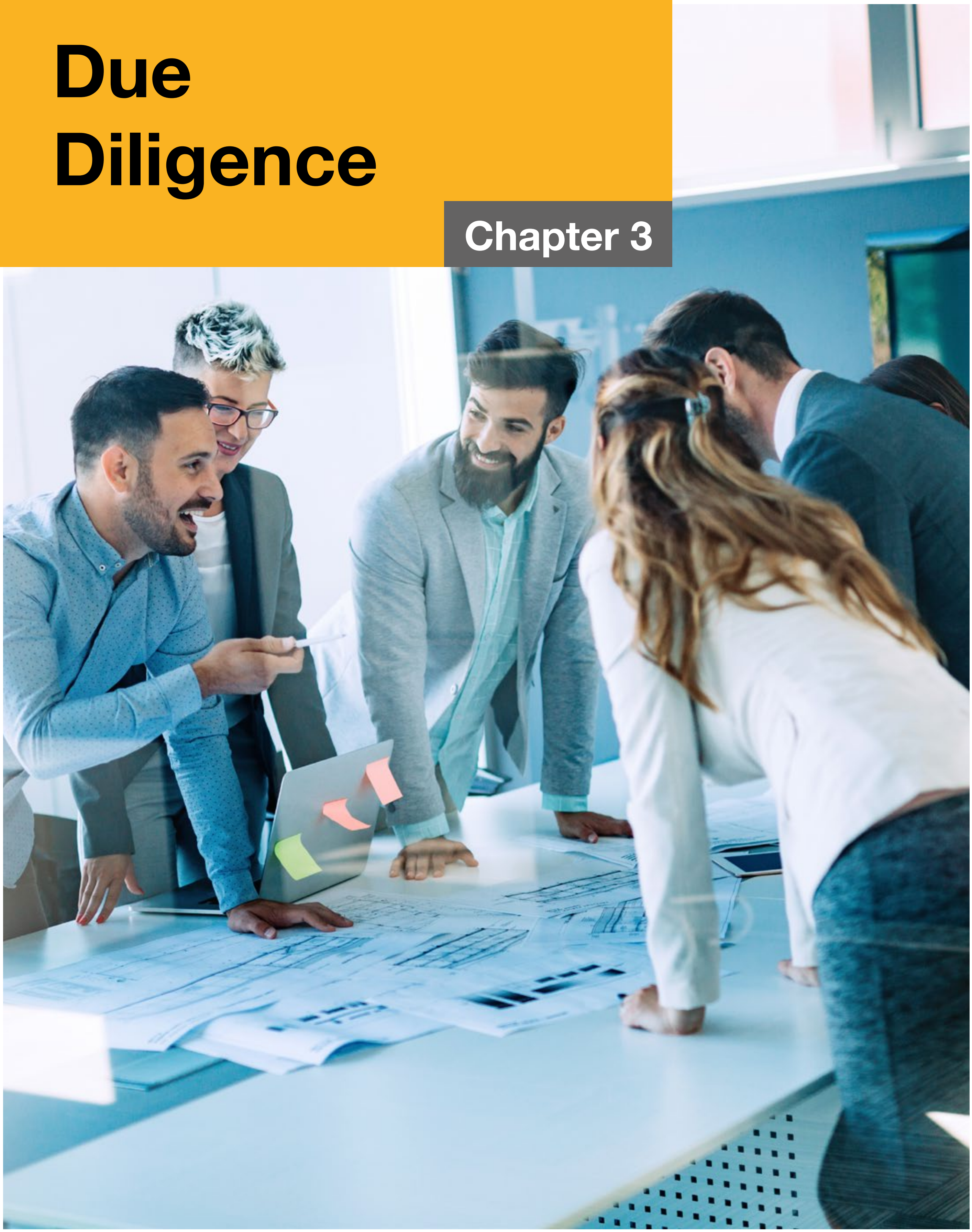
Where terminations are made by mutual consent or with proven cause, they are not counted toward the percentage set by the law as collective dismissal.

In case there is an agreement with the employee, our recommendation is to make a private settlement and compromise agreement or a labor conciliation before the Ministry of Labor or before the labor judge. By this agreement, the employee will declare that the selling company is free and clear from any obligation derived from the labor relationship that existed between them.

A settlement and compromise agreement or a labor conciliation made before the competent authority have the force of *res judicata*. In consequence, if any of these two agreements is made, then no claim alleging any uncertain and disputable rights by the employee will be admissible.

Due Diligence

Chapter 3



Due Diligence

What is due diligence and what is it for?

Due Diligence (hereinafter referred to as DD) is a special M&A consulting service with the aim to provide an objective and independent view based upon a structured querying and review procedure. This allows the parties to confirm certain assumptions about the transactions and the target company, such as the following. The operation of the business, the generation of revenues, expenses, and cash flows; business units' analysis, intercompany transactions and transactions with shareholders; as well as the analysis of the current situation of the company in accounting and financial, legal, tax, social security and labor, environmental, operating, commercial, and technological matters, among others.

Likewise, a DD enables the parties to identify the potential risks and problems that may arise during negotiations and after the purchase of the target company or business – as a result of past events of management. This includes mistakes made in tax returns, in the calculation of payroll taxes, laws and regulations compliance, cash flow and insolvency problems, accounting issues, etc.

Quantifying these contingencies is a crucial aspect of the transaction. Given that they can be taken into account in valuation models that are used in the negotiation as price adjustments. Therefore, the quality of the information is very important.

It is worth mentioning that both the financial due diligence and the tax due diligence are not at all audit or statutory audit services; and that they do not seek to provide an opinion about the fairness or reliability of the accounting figures under any generally accepted auditing standard.

Types of Due Diligence

A. Per type of client

DD may be classified by the type of client being advised, whether it is for the buyer (a buy-side or BS-DD) or for the seller (a sell-side or vendor due diligence, hereinafter referred as VDD).

A buy-side due diligence stands out as an independent and structured inquiry; one in which, as mentioned earlier, the fundamental assumptions for the buyer are analyzed and validated, so that the buyer may better understand the acquisition, adjust the valuation model, and define the terms of negotiation. Also, it is useful for structuring the transaction and planning for the post-deal integration.

On the other side, a sell-side due diligence is contracted by the seller to analyze his own business in advance, to identify in an early manner any exposures to financial, tax, labor and legal issues, among others; and to be able to share the findings with any potential buyers to facilitate the process of selling his company or business.

A VDD helps the seller to prepare better for any queries raised by the buyer; and helps the buyer to minimize his BS-DD costs, as long as the VDD is recent and similar to the scope that will be carried out in the BS-DD, in terms of periods under reviewed, topics and the depth of the analyses.

The virtual data room management service may be used as a supplementary service for the sell-side Due Diligence work.

B. Per type of area

Particularly in Colombia, the most common DD are the following. The accounting and financial DD, the tax DD, the labor and social security DD, and the legal DD, which will be explained in further detail below.

Depending upon exposure of the target company to environmental risks, the level of technological implementation and the interest that the buyer may have in commercial and trade topics, the scope of the due diligence work may be extended.

C. Per the scope and depth

DD work can be tailored to the needs of the transaction and the client's budget.

Normally, a full scope DD work is carried out over a reasonable range of time for the analysis (3 years for example). Notwithstanding, a high-level scope DD work may also be carried out, where the depth of the work will be defined with the client. However, setting limits on the scope implies leaving other aspects open to exposure without any review during the DD work.

There is also a high-level version of the sell-side due diligence, called the vendor assistance. The main trait of this work is the preparation of "factual" report, in which no point of views of the consultant being set down therein.

The consultant may also include a red flags report in its DD work. This report corresponds to the identification of the main aspects and issues of the transaction as a result of the work done during the first or first two weeks.

D. Other types of DD

Top-up DD:
This DD is similar to the buy-side DD, but it is made taking into consideration the sell-side DD report made by the target company. Accordingly, the approach here is to validate the sell-side DD report and to cover aspect that were not included in that report. This allows for the saving of time and resources, depending upon the quality of the sell-side DD report.

No-access DD:
As indicated by the name, this work is made principally where there is no access to management or private information. This may occur in nonexclusive transactions, with limited information, or where the acquisition is of a company listed on a public exchange market. The success of any no-access DD work depends upon the quality of the available public information. Normally, the report here is a red flag report.

Confirmatory DD:
Normally, this is DD work done in a second stage of negotiations. This happens either because access to information was limited during the first stage (i.e. a no-access DD) or because a binding offer was signed. The purpose here is to confirm crucial aspects to be able to close negotiations.

Assumptions for execution

Availability of the information

The flow and quality of and the access to the information have a direct impact on the success of the transaction, because they allow for satisfactory analyses and scope of work occurring such that trust is generated between the parties.

Normally, in strategic transactions (between the competitor or companies in the same industry) access to confidential information is limited. This is so due to the risk that the target company foresees in case the transaction is not carried out.

In like manner, certain investment banks that advice the sellers tend to restrict access to management and to the number of questions and inquiries that may be made during due diligence. As a result, it can generate incomplete analyses, communication issues, extended negotiation or even a lack of interest from the parties, which may lead to a deal breaker risk.

To carry out due diligence work properly, it is very important that the information is available from the scheduled start date – after the work has started, having made the corresponding, preliminary information request list.

For the same reason, it is very important to start the work by making complete and precise information requests, where the information request and delivery dates are indicated clearly, as well as the particular traits of the information delivered and received.

Exactitude and truthfulness of the information

From the preparatory contractual documents – including any memorandum of understanding (MOU) and letter of intent (LOI), the seller, target and management involved must make an express declaration that the information that they will deliver for review will be validated and confirmed beforehand in point of the exactitude and truthfulness of it.

Subsequently, a declaration of the liability that the seller, the target and the management involved assume for any falsity, lack of precision or bias in the information provided.

Work teams

Defining the work teams of all the parties involved and their advisor is relevant for purposes of defining information flow protocols precisely. In this manner, the parties will know clearly to whom must they direct their requests for information and from whom can they expect to receive it, which avoids lost time and misunderstandings.

Additionally, it is very important that all work teams centralize information requests and receipts. This allows the parties to avoid instances of annoying duplicity.

Due Diligence - Per type of area

1. Legal Due Diligence

Below we will refer to certain matters which, in our experience, are relevant in the course of any legal due diligence work.

1.1 Ownership of shares or equity interests

One of the first points that must be reviewed is the ownership of the shares or equity interests. Here, one must consider the type of company involved.

In the case of a limited liability company, the starting point is the shareholding composition that appears in the mercantile register. Based on that, the consultant or the DD reviewer must confirm that this information matches the information included in all public deeds attesting to the transfer of equity interests, the information in the register of members and the information included in the accounting records of the company. It is worth taking into account that the capital must have been fully paid in this type of companies, whether upon incorporation or upon the approval of a capital increase bylaws amendment. Accordingly, the accounting records must not show any amounts for capital yet to be disbursed to the company.

In the case of a stock company or a simplified stock company, it is important that the amounts of the authorized capital, subscribed and paid in capital that appear in the mercantile register for the company match the relevant corporate documents (bylaws and bylaws reforms) and the accounting records. In like manner, the consultant or the DD reviewer must take into account that the company must have issued share certificates, which must be endorsed to perfect the acquisition in case the shares are sold.

In any way, if the company has any foreign investment, the amounts registered with the Bank of the Republic must also match the accounting records and the remaining corporate documents.

Finally, must confirm if there are any liens or ownership restrictions set upon the shares or equity interests, by checking the register of shareholders or members, as the case may be. And he must confirm also the rules provided for transfers of the shares in the bylaws.

1.2 The situation of foreign investment records with the Bank of the Republic

The registration of any foreign investment existing in the capital of the target is one of the crucial elements that the consultant must review in the course of the due diligence. As said earlier, the ability of the foreign buyer to repatriate the capital and any related profits or dividends is contingent upon registration of the foreign investment.

Checking the foreign exchange declaration forms by which every capital contribution into the target was reported and the foreign exchange registration was secured is not enough for the purpose. We recommend additionally to verify directly with the Bank of the Republic that the registrations were made. To this end, a written authorization from the target or from the foreign investor that will enter the negotiation is required.

The confirmation from the Bank of the Republic can also be obtained by filing a right-to-petition request with that agency, asking detailed information about the historical records of foreign investment made into the target. The agency will take about 15 business days to provide an answer to the request.

1.3 Customs duties and foreign-exchange aspects

Among the aspects to be reviewed, the consultant or DD reviewer must include any foreign-exchange aspects that may involve penalties potentially imposed by the Directorate of National Taxes and Customs Duties – DIAN – which can be as high as 100% of transactions relating to imports and exports of property and goods and the handling of foreign currency accounts; or penalties potentially imposed by the Office of the Superintendent of Companies for matters relating to foreign debt and foreign investment (foreign investment in Colombia and Colombian investment abroad) – which can be as high as 200% of the pertinent transaction value.

Likewise, the DD reviewer must verify the customs duties aspects. Here, contingencies may have arisen, represented in the following:

1. Fines of up to 200% of the merchandise value.

2. Seizure and confiscation of merchandise, machinery or equipment.

3. Being disqualified or losing permits or authorizations as free trade zone user, permanent customs duties user, international sales company, among others. These events may impede carrying out operations in the manner in which they are carried out by the target.

Therefore, the consultant must review aspects such as the following and foreign-exchange and customs duties matters at least randomly:

- Foreign-currency payments.
- Using foreign-currency accounts (nonregulated market accounts and the so-called compensation accounts – traditional and special accounts).
- Import declarations and related supporting documents.
- Export declarations and related supporting documents.
- Merchandise movement forms used in free-trade zones.
- Qualifications, authorizations or declarations made by DIAN or any other foreign-exchange or customs duties authority.
- Official documents related to these matters such as the following: information requests, bills of charges, proposed assessments of customs duties, penalty resolutions, resolutions that are decisions on appeals and remedies, and all court documents, should there be any.

1.4 Relevant contractual aspects – Effects of a change in control

Reviewing contracts is a quite relevant point as part of the legal due diligence. The starting point here must be identifying the legal relationships – both active and passive – that are most relevant for the operations of target.

Once they are identified, the review must be based upon the essential elements of every contract according to the nature of it. It must cover the risk that pertains to contract performance, without leaving aside any possible contingency and situations that may affect the transaction, such as the following: prohibitions or restrictions upon any assignment in any manner; obligations to give notice of any transactions that entail a change of control, among others.

The review of contracts must include analyzing any loan or credit contracts with financial institutions or third parties in general. For this purpose, it is important to check information provided by management against the information set down in the accounting books of the company.

1.5 Litigation contingencies

Any proceedings to which the target is a party are a sensitive matter within the legal due diligence. Accordingly, those proceedings which are most significant or relevant for the deal structure must be identified.

In this context, the consultant or DD reviewer should select those administrative, court and arbitration proceedings in which the target is plaintiff or defendant, taking into account the cases that because of the underlying disputed amount or the nature of the case may affect seriously the continuity of the business. The above is without detriment to any contingencies in specific matters such as labor, tax, customs duties and foreign-exchange matters.

In any event, the review must include the analysis of any reports provided by the lawyers that are in charge of the litigation cases. Especially, it must include the qualification of the contingency that the lawyers have given, as well as the related impact in the provisions recorded by the company. Here, our recommendation is always to discuss with the lawyers the considerations that they took into account to issue their qualifications.

1.6 Personal property and real property

As explained above, there is no single rule in Colombian law about the acquisition of assets. Accordingly, our review must consider the type and nature of the most relevant assets from the patrimonial or business point of view of the target company, to determine possible contingent liabilities.

In this way, in the case of real property, the consultant must review the land register status of these properties, based upon information set down in the land register and based upon the corresponding certificates of conveyances and salability. Please take into account that the information appearing in that public register is not always reliable. Accordingly, it is always advisable to carry out a study of the chain of title of the property. This consists of the direct analysis of the deeds of sale and of any other deeds by which encumbrances were set upon or lifted from the properties, during the entire statute of limitations periods. All of this is to confirm the concept upon the legal situation of all pieces of real property and to detect any possible inconsistencies or contingencies in the land register information.

With respect to other pieces of personal property that are significant in the target, the consultant or DD reviewer must be especially careful in reviewing the legal functionality of the documents by which title to these assets passed to the target, and also about the existence of any encumbrances or any liens set upon them. It is worth indicating that not all personal property is subject to registration, meaning that there will not be a reference public register in every case.

1.7 Industrial and intellectual property rights

Regarding any intellectual property and industrial property assets of the target, such as trademarks, patents and software licenses, the DD reviewer must verify the status of registration as well as compliance with any other legal requirements set for these rights to be effective.

1.8 Compliance with sector and environmental regulations

Finally, the consultant should review the status of compliance with other legal obligations that apply to the target, according to its specific industry or operations. In particular, the DD reviewer, should review all that relates to compliance with general and specific rules of the law.

2. Labor Due Diligence

Through the due diligence work on labor and social security matters, the consultant or DD reviewer must make a general diagnostic with respect to the target company about the following:

2.1 *Headcount* - organization structure

Number of employees, direct and indirect, noting specifically the number of years with the company, the type of salary, the geographical location, and whether the company has a horizontal or vertical structure. This is the first step to assess the size and the distribution of the organization structure.

2.2 Hiring and outsourcing policies

There is a current trend in Colombia with respect to outsourcing of personnel and the legal parameters that govern outsourcing. Accordingly, it is very important to determine whether the target company has any personnel hired through temporary service companies, associate work operatives or through service agreements; and also if the target company has complied with the specific regulations that apply to each one of these types of contracts.

2.3 Compliance with the payment of labor obligations, contributions to social security and payroll taxes

The consultant must make an evaluation covering at least the last 3 years (which is the statute of limitations for labor obligations), to determine the correct calculation and payment of labor obligations established by the law, such as the following:

1. **Legal service bonuses**
2. **Severance pay**
3. **Provision of work shoes and clothing**
4. **Indemnifications paid for dismissals without cause**

The failure to pay or the inadequate payment of any labor obligations may generate not only potential claims by the employees but penalties for failures to pay and the accrual of interest.
It is equally important to review compliance with the payment of social security contributions (for healthcare, retirement pensions and workers' compensation). If the target company has not complied with this obligation, it will have to pay directly the total requisite amounts as contributions into the system.

On the other hand, the obligations that relate to retirement pensions do not prescribe under any statute of limitations. To that extent, any employee may file a claim against the company at any time for any failure by the company to pay the related contributions to the pension system. In case an adverse decision is issued against the company under any such claim, the condemnation will require the company not only to pay the amounts that it did not contribute but also to pay interest and any lost yields that the contributions would have generated – which must be calculated by actuarial calculations.

2.4 Labor litigation, administrative claims and audit reviews

It is important to know about any litigations that are pending against the company before the labor courts, as well as any administrative claims filed by the employees with the Ministry of Labor. This is to determine the following:

1. Any matter which appears under recurring claims, which determines clearly a specific event of noncompliance by the target company.
2. The estimated value of the items of relief sought.
3. The likelihood of winning or losing the cases.

In like manner, it is important to verify whether the company has had any audit reviews in labor law matters, either by the Ministry of Labor or by payroll tax collection agencies. This is to establish whether the company was subject to penalties or received any requests requiring it to recalculate the payment of payroll taxes for failures to pay or for miscalculated payments.

3. Tax Due Diligence

Through the tax due diligence, the consultant manages to establish the tax policy of a company, as well as any possible contingent liabilities that derive from the mistaken application of tax laws and regulations or from failure to comply with the corresponding formal obligations.

The main aspects that must be reviewed may be summarized as follows:

3.1 Income taxes:

The consultant must carry out a detailed review of net taxable income and of the tax equity reported in the income tax return. To this end, the following are the key elements for such determination:

- Procedures followed to establish special benefits in point of the income tax.
- Reconciliation of tax figures and accounting figures.
- Net tax losses.
- Excesses of the so-called presumptive income over actual net taxable income.
- Amortization.
- Effects of restructuring transactions.
- Depreciation.
- Costs and expenses incurred and paid abroad.
- Sales of fixed assets.
- Tax credits. Special tax treatments (items excluded from taxable income)
- Checking deductibility of labor payments, according to compliance with current labor laws and regulations with respect to salary and non-salary payments and social security contributions.

3.2 The sales tax (or VAT):

For VAT purposes, the consultant must understand the operation of the target in the first place. Specifically, he must understand if the operating revenues obtained by the company are or are not subject to VAT:

- Procedure followed by the company to prepare its sales tax returns.
- Classification of the activities carried out by the company for VAT purposes (taxable, exempt and zero rated).
- Taxable bases and the eventual application of pro rata rules.
- VAT withholding tax collections – tax collected from payments to the company or theoretical VAT withholding tax collected by the company.

3.3 Industry and commerce taxes

- Review and determine the municipalities in which the company would be liable for industry and commerce taxes.
- Compliance with formal obligations with those municipalities over the last 2 years.
- Eventual obligations that are still unpaid.
- Taxable bases and applicable rates.

3.4 Withholding taxes

On top of the three above taxes, withholding taxes (for income taxes, VAT and industry and commerce taxes) play an important role. They are not only supporting requirements for taxes, but [the target company may have made] substantive or formal mistakes in the related tax returns which may trigger the payment of penalties:

- Withholding tax bases for selected transactions. Here we speak of selected transactions, given that, because of the size of a company, reviewing the whole transactions subject to withholding tax collection may be an awfully burdensome task that may take too much time that would easily exceed the time allotted for the review.
- Procedures for withholding tax collection from labor payments, based upon selective tests.
- Procedures for withholding tax collection from payments made abroad.

3.5 Compliance with formal obligations:

The consultant must review compliance with formal obligations in respect of all the requisite tax returns. In other words, that all the tax returns that the company must file have been filed in a timely manner.

3.6 Other matters:

Lastly, depending upon the nature and the specific operations of the company being reviewed, there may be other series of taxes and obligations that can be substantial.

4. Financial and Accounting Due Diligence

4.1 Accounting framework and quality of the information

Under Law 1314 enacted on July 13, 2009, the process of harmonizing the old accounting principles and standards (Decree 2649 of 1993 and the still current articles of Law 145 of 1960) with international financial reporting standards (or IFRS) was made formal.

Ever since then, the majority of formal businesses have adopted IFRS, whether the full IFRS version or the SME version of the IFRS – for small and medium enterprises.

The possibility of using any one of these versions depends upon the criteria provided for in Article 1 of Decree 2784 of 2012, as amended by Decree 3024 of 2013, as well as in Decree 3022 of 2013, as amended by Decree 2267 of 2014, among others. Under the mentioned article, the enterprises that must apply full IFRS are the following:

1. Securities issuers: legal entities and trust companies which have securities listed in the National Register of Securities and Issuers (the RNVE for the Spanish initials), under the terms of Article 1.1.1.1.1 of Decree 2555 of 2010.

2. Legal entities and businesses of public interest.

3. Legal entities not included in the above subparts, with personnel in excess of 200 employees or with total assets in excess of 30,000 minimum monthly wages, provided they meet any of the following parameters:

   1. The entity is a subsidiary or a branch office of a foreign company applying full IFRS.

   2. The entity is a subsidiary or the parent company of a national company that must apply full IFRS.

   3. The entity is the parent company, an associate, or has a joint venture with one or more foreign entities that apply full IFRS.

4. The entity makes imports or exports which represent more than 50% of purchases or sales, respectively.

In case the above conditions are not met, an entity may choose to apply the SME version of IFRS according to Article 1 of Decree 3022 of 2013, as amended by Article 3 of Decree 2267 of 2014.

Therefore, the consultant must take into account the differences in the impacts of these two IFRS versions during the due diligence work. This is so especially if there are differences between the set of laws and regulations that apply to both the acquiring company and the acquired company.

On the other hand, once the consultant has identified the accounting and reporting framework for the analysis, DD reviewer must validate the quality of the information provided by the company and the usefulness of it for the analysis. This is not equivalent to an audit review and it does not replace it either; and the purpose of it is totally different.

Some of the following factors can point to problems in the quality of the information:

- It is evident that the information does not meet the accounting requirements (in other words, recognition of revenues by cash methods, the costs and expenses do not match the year of revenue generation, leasing agreements are not recognized appropriately, etc.).
- The information has not been audited.
- The company is a family business or there is little separation between company accounts and family expenses.
- The auditor is not a recognized firm.
- The auditor has a close relationship with the target company.
- The information includes biased or irrational assumptions (e.g., there is no impairment of any accounts receivable, there are negative liability account balances, the balance sheet does not reconcile, etc.).
- There is not enough detailed information (i.e. subaccounts, third-party information, etc.) that is consistent with the general accounts.

- There is evidence that the expenses are overestimated or underestimated.
- The accounting software is deficient, and the information is provided in formats that make processing and analysis difficult (PDF files).
- There is inconsistent treatment in the recognition of economic transactions from one year to the next.

The quality of the information has a direct impact in the quality of the results of the due diligence work. Therefore, any information issue must be disclosed to the client as soon as possible and any pertinent adjustments must be made in the analysis that are described below.

4.2 Financial due diligence in a M&A process, and determination of the transaction price

In general terms, the execution of the different types of due diligence work is made once the target has been identified, the possible legal and tax structure has been defined, a certain value has been determined, and there has been significant progress in the negotiations, etc.

The finishing of the due diligence work enables the parties to move to the step of closing their negotiation and adjusting the valuation made. Once the transaction is complete, post-closing procedures are carried out, such as the financial and operating integration, the capturing of synergies and the business combination (purchase price allocation)

Normally, determining the price for a transaction starts by estimating the value of the target company, through some technologically recognized method such as the discounted cash flows or market multiples method. Subsequently, the amount of the net debt and any other debt-like items are deducted to determine the value of equity.

Once the shareholding interest to be acquired has been defined (100% was estimated for Table 1), certain closing adjustments will be made according to the rules of a SPA (sales and purchase agreement).

Pricing components

4.3 Quality of Earnings

The analysis of the quality of earnings (QoE) is focused on determining a sustainable earnings level over a historical basis – approximately, from 2 to 3 years of analysis –, and on understanding the key factors of such historical performance.

The goal is to understand the basis for the preparation of the accounting information, and how this information reflects the economic reality of the business. This must be so and in such a manner that the consultant may estimate any adjustment resulting from any bias or mistake in the accounting recognition and may identify and normalize any risk or any substantial change in the ability to generate recurring economic benefits.

The QoE analysis starts by understanding the business and recognition of the income statement items. It goes on by inquiring annual and monthly variations and extraordinary or nonrecurring events. Also, the prospective loss of some clients or customers is questioned, as well as any newly acquired projects or clients – or projects to be executed.

The typical analyses made are the following: seasonality of sales; variation of average prices and quantities; changes in margins; results by business lines and products mix; variations in costs and expenses; business structural changes; comparability of figures; consistent application of accounting principles; impact of foreign exchange rates; evolution of personnel and salaries; etc. Based on these analyses, the consultant inquires and questions the operating nature of economic transactions, the recurrence and the adequate financial and accounting recognition of the business earnings.

The most common way of measuring the earnings of a given business is by the so-called EBITDA measurement – Earnings before Interest, Tax, Depreciation and Amortization. These are the earnings before taking into account financial interest, the income tax expenses, and the expenditure for depreciation and amortization of fixed and intangible assets. This indicator is a key component of the operating cash flow together with working capital movements.

This concept is not governed by any accounting or legal standard, but by the academic definition mentioned above. Additionally, in the context of a given transaction, the parties seek to determine an adjusted and normalized EBITDA that shows the ability of the examined business enterprise to generate sustainable earnings. Therefore, there are many interpretations as to what is an adjusted EBITDA. This creates a lot of discussion in the transactions and the negotiations.

There are two ways of making the accounting EBITDA calculation, using sales or net income as starting points.

In the first calculation, depreciation and amortization costs and expenses are added back to operating income/operating profit. In the second one, the calculation starts at net income and then interests, the income tax expense, depreciation and amortization and any non-operating items added back. Both methods must lead to the same result of accounting EBITDA for the same period (before doing the due diligence).

The recurring EBITDA of a business is determined by excluding all the abnormal, nonrecurring and non-operating effects from the earnings of the company. The adjustments that are typically made to the accounting EBITDA are the following:

1. By definition:
Evaluating that the accounting EBITDA has been calculated correctly; for example, that there are no depreciation items left within the EBITDA figure.

2. Normalization:

a. Reversions or validation of management adjustments.

b. Reclassification of any operating item (revenue and expense) that has been recorded below the EBITDA figure and vice versa.

c. Reclassification of any recurring past and future item that is below the EBITDA figure and vice versa.

d. Reviewing that all costs and expenses have been accounted for adequately in the year in which they belong.

e. Identifying and estimating the impact of accounting issues and any changes occurring in the accounting principles.

f. Inquiring about situations that are outside normal market conditions, such as salaries and other non-corporate expenses – such as family expenses – which are to be adjusted after the transaction. For example, the salary of a vice president who turns out to be a relative of the owners of the target company, and who is probably not working for the company or whose salary has been overestimated.

3. Pro forma adjustments:

a. Estimating the impact of historical structural changes of the target company, such as discontinued operations.

b. Estimating the impact of the transaction structure, of a spinoff, carve-out, exclusion of certain contracts, creation of new positions or elimination of positions, businesses that are not transferred.

Common adjustments may include the addition of recurring bank expenses into EBITDA, the exclusion of family or partners’ expenses, the restatement of revenues or expenses for changes in accounting policies, the reclassification of revenues or expenses to the adequate fiscal year, the specific sales or nonrecurring or non-operating extraordinary expenses, the spinoff or carve-out of a certain line of business in the transaction.

4.4 Quality of assets

In the same way the income statement is analyzed for purposes of the transaction, the balance statement is reviewed to check the adequate level of the working capital – normalized and recurring; the amount of net debt and of debt-like items; and capital asset investments (or CAPEX). These items are relevant to determine the value of the company and of its equity.

Some of the adjustments that are made – in addition to those mentioned in the following subsections – are the following: accounting corrections, adjustments for changes in accounting policies, spinoff or carve-out adjustments not included in the transaction, accounting adjustments for assets incorrectly capitalized or estimated, off-balance sheet assets and liabilities, additional asset impairment, etc.

Below we make a description of the main concepts.

Main fixed assets concepts

Working capital

Working capital is commonly defined as current assets minus current liabilities. However, in the context of a transaction, it is preferable to exclude cash and cash equivalents and any portion of short-term debt, and reclassify these items for the analysis of net debt. This is so due to the fact that transactions are normally negotiated free of any debt.

Working capital is important to determine valuations by cash flows; and, normally, it is used as a transaction closing adjustment mechanism. Likewise, working capital enables the buyer to know about recurring working capital needs, and to project possible savings and synergies.

As is the case of the quality-of-earnings analysis, when analyzing working capital the consultant must analyze and evaluate recurrence and operating nature of economic transactions. He/she should do this to make pro forma adjustments, reclassifications and normalizations, based upon the normal course of business and the particular features of the transaction.

Working capital is also useful to understand cash conversion cycles, and to identify trends and turnovers, the recoverability of certain items, operating leverage and liquidity, among others.

For purposes of closing their transaction, as a general rule the parties involved agree upon the manner in which working capital is to be determined at closing – in their sale and purchase agreement.

The most common analysis made in respect of working capital consist of the following: seasonality and working capital monthly trends; identification of nonrecurring events; analysis of the recoverability of trade receivables and their impairment; analysis of the aging of accounts receivables and payable (including suppliers); exclusion of debt and cash equivalents; inventory obsolescence; intercompany transactions; transactions with shareholders; changes in cash conversion cycles and in turnover ratios; pro forma analysis according to the specific transaction (e.g., a spinoff, carve out); etc.

Net debt and debt equivalents

Other balance sheet component is net debt, which is made up of financial debt, cash on hand, and debt and cash equivalents. Net debt is discounted from the enterprise value to determine the equity value.

Sometimes, there are loans from the parent company that have been recorded as operating accounts payable (as part of the accounting working capital), despite that these loans are essentially non-interest bearing loans. The consultant/can also identify financial leasing agreements which have been accounted for erroneously as mere rental agreements, which is an item that would increase the value of debt and is known as an off-balance sheet item. Likewise, the consultant can identify accounts receivable from or accounts payable to shareholders that have been recognized as accounting working capital; therefore, these items must be reclassified to net debt.

In doing the debt analysis, it is important to determine the indebtedness level of the company, credit lines and limits, the components and features of financial debt (interest rate, payment terms, etc.). It is also important to identify all the guarantees or any covenants about change of control or any caps that are set upon indebtedness levels.

Besides the above parent company or lease adjustments, there are other common adjustments such as the following: minority interests, net income tax, accrued interest, restructuring provisions, pension obligations, restricted cash, transaction fees due, contingencies, litigation, etc.

Deferred tax assets and liabilities are the result of the accounting reconciliation between the current income tax liability as calculated based upon the tax code and accounting principles; and they are

Cash flow

The above-mentioned elements may also be articulated in the cash flow analysis, based upon the accounting reconciliation of the operating, financial, and investment cash flows. This is done to determine the operating cash flow and cash flow before taxes and financial expenses. This analysis works as an input for the evaluation and understanding of all cash needs.

the product of the timing differences between one and the other tax calculation.

In theory, a deferred tax liability would result in a higher income tax payment in the future when the accounting and tax differences revert. However, annual changes in the tax laws in point of methods, rates, periods or terms, etc., can end up making that such differences do not revert after all. Accordingly, our recommendation is not to include any deferred tax liability nor any deferred tax asset in net debt nor in working capital.

Certain unquantifiable considerations should be mentioned as other items in the net debt analysis. These include environmental provisions or litigation provisions, for example.

CAPEX

The consultant must evaluate the level of investment in fixed assets (or capital expenditures – Capex) and the related disinvestments, classified by maintenance and repairs, replacement and expansions. This does not imply a technical inspection of fixed assets or an appraisal, nor the determination of an optimal or normalized level of CAPEX.

Maintenance Capex corresponds to those investments that manage to prolong the useful life of current assets and may be accounted as assets under certain accounting criteria. Replacement Capex seeks to replace current assets or the assets required for the normal course of business, such as a change in the transport fleet or in the computer equipment. Finally, investment Capex relates to the opening of a new factory, a new sales point, assets to be used in a new business line, etc.

The consultant must evaluate whether the historical budgeted Capex has been spent by the current level of assets; and he/she must query about future Capex – (the projected and committed Capex). It is also important to understand the way in which the Capex will be financed in the future, and the changes that it will bring about for the company.

Likewise, it is important to analyze the current levels of Capex production and occupation/use, as well as the physical conditions of the same. To this end, it is important to do an additional commercial and operating due diligence (e.g. fixed assets inspection and appraisals) work at the same time the financial due diligence work is being done.

In certain transactions, certain sellers purport to increase company value by means of an extraordinary future expansion Capex – which would eventually increase sales. This approach is incorrect if one does not consider the risks of said investment, the value of money over time, the future demand for the products, the recovery of said investment, and the expenses required to reach such levels of investment and sales. In other words, the seller is attempting to sell the current business plus a future investment project.

5. Commercial Due Diligence

Commercial due diligence is an analysis that involves not only one single commercial aspect, but also a strategic and a marketing aspect this DD work must be carried out in the initial stages of the transaction process and should be updated all the way through the deal process up to the monitoring of value generation (post-deal). The analysis to be made implies an exhaustive review. It includes different fronts of the company such as the market, the clients/customers, the competition (and the industry) and the business plans. The final result of this analysis generates an informed and detailed conclusion about the projected market conditions, the industry and the competition; and carries a recommendation about the decision of going on or not going on with the transaction staged before the deal (Go/No Go).

Benefits

Below we refer to some of the benefits that are – according to our experience – the most relevant to carry out a commercial due diligence.

A. Market perceptions and competition perceptions for the making of the decision Go or No Go. This is done by understanding the trends of the market in which the company operates and its performance with respect to the competition.

B. An independent analysis that makes an impact on the valuation and the price of the negotiation. This is done by going in depth in the capabilities and assumptions of the company to generate the projected revenue. These assumptions may be based upon new products, new clients and new markets, or may show a more aggressive growth as compared to recent growth rates.

C. Using primary information sources (internal and external) and using the services of experts. This allows for a more precise analysis not only of the company, but also of market dynamics and the competition.

D. Identification of potential exposure, problems or issues that could affect the transaction or the price negotiated by the parties.

Likewise, the benefits of a commercial due diligence may be classified into categories based upon the findings of the analysis, such as:

Reduction of costs:
Where a finding is made which, given its nature, could create a reduction in the price negotiated by the parties (e.g., the business model was not the only one of its kind in the market as stated in the Information Memorandum and was not so appealing to certain client/customer segments).

Reduction of risk:
Where a finding is made which does not increase any weakness disclosed by the company, meaning that it is not one that can pose a risk for the client down the road. (For example, the consultant can say that a strategy for creating an online platform will not be affected by any of the weak areas that were identified before the transaction.)

Value increase:
Where the consultant identifies or the parties identify room for improvement for the company, such that it may increase the value of the company in the future. This is done by implementing adequate strategies. (E.g., by analyzing clients and their segments, the consultant identified various opportunities to improve the online business model and the pricing strategy).

Additionally, the commercial DD work clarifies the outlook in respect of company dynamics, the industry and the market (the latter understood as demand). It does so through the understanding of these aspects and replying to questions such as the following:

The company

What is the factor that makes doing the transaction with the company worthy? Can we confirm the differential capabilities that make the acquisition meaningful?

Which is or which are its most profitable products? Why?

How secure is (are) its most profitable client (s)?

How is the market share of the company being projected as well as its contribution by business segment or unit?

The industry

What are the key factors of success of the industry?

Is this sector/industry undergoing structural changes?

Which are the main competitors?

Which is the outlook of the competition?

How does the company relate to the key benchmark [figures/ ratios]?

The market

What is the size of the company's market?

Is the company selling the correct product/service to the correct client/customer?

What is the thing that drives the demand of the company?

What are the key criteria for clients/customers to purchase the products/services of the company?

What external factors could impact the sector?

What are the threats and the opportunities of this sector?

Challenges

In our experience, there are two types of challenges that confront us in the process of any commercial DD work: the process and the client/customer. The first type – the process – refers to the main challenges that we can find when executing the administrative aspects of the service; i.e., the logistics and the general coordination of it. On the other hand, there is the client/customer challenge type, which includes challenges relating to the target, its performance, its market position and its future commitments/obligations. Through the commercial DD work, the consultant will confront and analyze the challenges to provide the client with a better vision of the target. Below we highlight the main challenges of each type:

The process

- Lack of information, unreliable information or poorly detailed information.
- Lack of focus in the process of investigating and analyzing the target.
- Lack of a clear commercial strategy; or strategy with assumptions that are too slanted or unsustainable.
- Several segments in which the client/customer participates (this requires a greater dedication – time – to study, and a wider spectrum to compare – benchmarks).
- Possibly, the initial schedule will change as the consultant makes progress in the provision of his service.

The target

- **The Hockey Stick: This comprises challenging and identifying the commitment to develop products to drive growth and keep it going; or the promise of being immerse in a dynamic market with great growth potential.**
- **Captive clients/customers: Valuing the rationale underlying the existence of deep relationships based upon trust with several clients/customers.**
- **Perpetual money machine: This refers to maintaining a diversified, stable and recurring revenue base, with high margins.**
- **Sustainable market position: This refers to maintaining a constant market share position.**

Commercial DD processes and scopes

5.1 Typical commercial DD processes

A commercial DD comprises 7 stages. These must be carried out totally to secure a complete, high-quality analysis. It is worth noting that the duration of the analysis is not standard; it depends upon the scope of the work and the needs of each client/customer. In our experience, this type of analysis can last between 2 and 8 weeks. This depends directly upon the client's/customer's requirements.

Collection of data:
Market research, company information, competition data, internal PwC information.

Interviewing upper management:
Conversations with upper management of the company.

Primary investigation:
Interviews and conversations with independent experts, PwC experts, the competition and potential clients/customers.

Interviewing clients/customers:
Key purchasing criteria, performance of the company as compared with the competition, sales outlook.

Analysis:
A synthesis of intelligence based upon data collection, interviews and discussions, identification of market trends and business topics.

PPT

Presentation:
Final results of the analysis, discussion of main findings.

Follow-up:
Following up on the work done at the request of the client/customer.

5.2 Scope of the commercial DD

Typically, a commercial DD analyzes two key and strategic dimensions: the market and the company (the target). In turn, each dimension comprises two perspectives: demand and industry and performance and business plan, respectively. Each one of these dimensions and aspects are analyzed according to the client's/customer's needs and requirements.

Market

The market dimension is very ample. This is why, in our experience, approaching it through the aspects of demand and industry makes the analysis more precise and right; and enables the consultant to identify more easily the weaknesses, the opportunities, and the potential risks and synergies that the company may offer.

Demand

The main aspects analyzed in this dimension comprise the following, among others: Identifying the main revenue drivers, evaluating market evolution perspectives and identifying demand related risks. The main objective of this section is to identify the most relevant aspects of the company's demand, to understand the company's behavior and its impact in the market. The final exercise will help and guide the client/customer in respect of the commercial situation of the company and its challenges. This allows for a surer decision-making which is focused on the main aspects of demand: defining demand, trends and drivers, products/services dynamics and client/customer behavior, and distribution channels structure.

The industry

The main aspects that the consultant is to analyze in this dimension comprise the following, among others: understanding the rules and ways of playing/acting of the industry; identifying the competition and the potential client/customer; evaluating competitive threat; evaluating and identifying potential industry risks and those that relate to demand. The main objectives of this section is to evaluate the risk levels of the competition and the changes of the industry. The final exercise will help and guide the client/customer to having a general vision of the industry and its main aspects. This allows for a surer decision-making which is focused on the main aspects of the industry: value chain and differentiation; success key factors; competitive outlook; supply dynamics and industry dynamics.

The company – the target

The dimension of the company (the target) is more limited than that of the market, because this is a more introspective analysis of the company and its dynamics. In our experience, this type of analysis must focus on aspects that relate to the company's own performance and its long-term business plan. In this way, the consultant may identify in a more precise manner the internal weaknesses, opportunities and potential risks that the company may have to respond to industry dynamics and evolution.

Performance of the company

The main aspects that are analyzed in this dimension include the following, among others: Understanding whether the historical performance may be replicated or improved; evaluating specific company risks; analyzing clients/customers, vendors and costs. The main objective of this section is to maintain the perspective of the target's supply and the demand of its current and potential clients/customers.

The final exercise will help and guide the client to understand how is the performance of the company in the market and in its industry, and what is the potential to improve and drive company performance. In consequence, the consultant must analyze aspects such as the following: product concentration and evolution; client/customer concentration; negotiation powers – among others, which will be the result of this section and will determine company performance in a more accurate way.

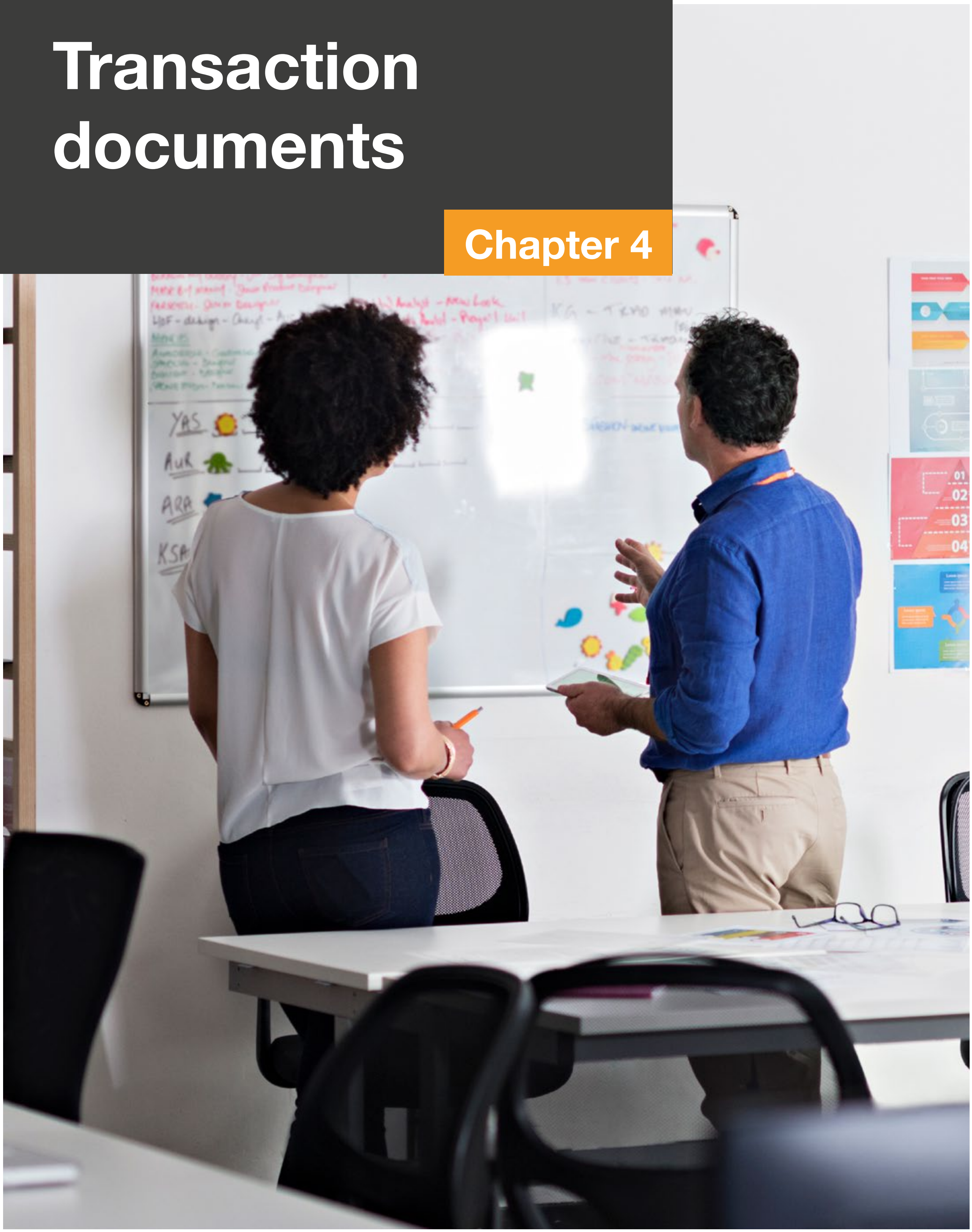
Business plan

The main intent of this dimension is to evaluate the viability of upper management's business plan, and to understand its assumptions and drivers, to study the possibility of adjusting them, should this be necessary. Using the above-described analysis as input, DD reviewer creates a detailed and in-depth evaluation of the initiatives, sensitive points and assumptions of the business model, to make recommendations for adjustments to the model.

Some of the most relevant aspects that the consultant evaluates in this section are the following: sales projections and EBIT, organic and nonorganic instances of growth, market share assumptions, volume and prices, among others. The result of these evaluations allows the consultant to create responsiveness scenarios with respect to different key variables for the industry and the company. These will affect the future performance of the company principally, and therefore can weigh upon the negotiation of price adjustments, should this be necessary.

Transaction documents

Chapter 4



Transaction documents

Pre-contractual documents

Confidentiality agreement

The main purpose of this agreement is to preserve the confidentiality of the information disclosed by the seller, the target or management during negotiations and the closing of the transaction.

Among other agreements, this document usually contains the following:

- Identification of the parties.
- Definition of the information that will be treated as confidential.
- The terms under which the confidential information will be disclosed.
- Obligation of using the information solely for the specific purposes of the transaction.
- Conditions in which confidentiality will be applied.
- Scope of the obligations between the parties with respect to this confidentiality.
- Persons that are authorized to access the information.
- Term of duration of the confidentiality obligation.
- Circumstances under which the obligor is released from his obligation to maintain confidentiality.
- Consequences of noncompliance.
- Possible return or destruction of the information.
- Procedure set for the resolution of conflicts.
- Competent jurisdiction and governing law.

It is worth noting that in many cases this agreement is established as a constituent part of the letter of intent or the memorandum of understanding.

Letter of intent or memorandum of understanding

This is a document that reflects the initial understanding of the parties with respect to the transaction, the terms under which negotiations will be carried on and the assumptions that have been taken as bases to reach those agreements.

Among other agreements, this document usually contains the following:

- Identification of the parties.
- Considerations that have driven the parties to the transaction.
- Identification of the transaction being sought.
- Terms of exclusivity – as the case may be. It is worth noting that in some cases the parties decide to regulate this matter as an agreement that is separate from the letter of intent.
- Step-by-step course of the transaction, including time frames for the preparation of contractual documents, for the due diligence work, the closing, etc.
- Structure that the parties foresee for the transaction. It is worth indicating that this particular aspect is conditioned upon the results of the DD work.
- Transaction price and adjustment formulas, as well as the accounting bases of said calculations.
- Authorizations/approvals required to perfect the transaction.
- Definition of its binding nature.
- Consequences of noncompliance.
- Procedure set for the resolution of conflicts.
- Competent jurisdiction and governing law.

Contractual documents

Stock purchase agreement

In the case of share deals, the agreements of the parties, the results of the DD work, and generally the final terms of the negotiation are set down in the stock purchase agreement.

Among other agreements, this document usually contains the following:

Place and date of subscription.	Identification of the parties.	Considerations taken as the basis of the transaction.
Definitions of the relevant contract terms, to avoid any unnecessary repetitions or misunderstandings in point of the scope of these terms.	Definition of the transaction purpose.	Declarations and guarantees of the seller (or "representations and warranties" of the seller).
Place and date of subscription.	Price and payment terms.	Consequences of noncompliance, or of having provided imprecise or inexact declarations and guarantees of the parties.
Procedure to assert and enforce contingency claims.	Quantification of damages for any disclosed contingencies.	Limitations on seller's liability.
Price adjustment formulas.	Guarantees.	Conditions precedent to the transaction.
General clauses of these contracts.	Post-deal regulations.	Closing date and conditions.

The most common refer to the following:

- Capability to execute the transaction.
- Truthfulness of the information.
- Source of the funds.
- Consequences of noncompliance, or of having provided imprecise or inexact declarations and guarantees of the parties.

Claúsulas como:

- La confidencialidad.
- Las notificaciones a las partes.
- La resolución de conflictos.
- La jurisdicción competente y la ley aplicable.
- Los anexos.

The most common refer to the following:

- Capability to execute the transaction.
- Truthfulness of the information.
- Ownership of the shares or equity interests that are the subject matter of the transaction.
- Any charges and liens that affect the transfer or the ownership of the shares or equity interests.
- Corporate aspects.
- Tax aspects.
- Labor aspects.
- Situation of the assets.
- Bank accounts.
- Financial statements.
- Solvency.
- Clients/Customers lists.
- Vendors lists.
- Items of debt.
- Insurance.
- Change-of-control situations.
- Subsidiaries.
- Litigation or contingent debt.
- Environmental situation.
- Source of the funds.

Contractual documents

Asset purchase agreement

In the case of asset deals, the agreements of the parties, the results of the DD work, and generally the final terms of the negotiation are set down in the asset purchase agreement.

Among other agreements, this document usually contains the following:

Place and date of subscription.	Identification of the parties.	Considerations taken as the basis of the transaction.
Definitions of the relevant contract terms, to avoid any unnecessary repetitions or misunderstandings in point of the scope of these terms.	Definition of the transaction purpose.	Price and payment terms.
Declarations and guarantees of the seller (or "representations and warranties" of the seller).	Price adjustment formulas.	Declarations and guarantees of the buyer (or "representations and warranties" of the buyer).
Consequences of noncompliance, or of having provided imprecise or inexact declarations and guarantees of the parties.	Quantification of damages for any disclosed contingencies.	Limitations on seller's liability.
Procedure to assert and enforce contingency claims.	Guarantees.	Conditions precedent to the transaction.
Closing date and conditions.	Post-deal regulations.	General clauses of these contracts.

The most common refer to the following: (declarations and guarantees of the seller)

- Capability to execute the transaction.
- Truthfulness of the information.
- Ownership of the assets that are the subject matter of the transaction.
- Charges and liens that affect the transfer or the ownership of the assets.
- Tax aspects.
- Registration status of the assets.
- Insurance.
- Litigation or contingent debts associated with the assets.
- Environmental situation.
- Source of the funds.

The most common refer to the following: (declarations and guarantees of the buyer)

- Capacity or ability to execute the transaction.
- Truthfulness of the information.
- Source of the funds.

Clauses such as: (general clauses)

- Confidentiality.
- Notices to the parties.
- Conflict resolution.
- Competent jurisdiction and governing law.
- Attachments.

Contractual documents

The trust agreement as security for the payment of obligations - *Escrow Account*

This is a type of guarantee. Under it, a portion of the price is set aside during a certain amount of time to cover any potential contingencies that may arise during that term and which could affect the target company.

It is worth indicating that there is no special model bank account in Colombia that can be used as an escrow account, and so here we have to resort to a trust company. It is worth noting that trust companies in Colombia are financial institutions that are regulated and surveilled by sector authorities.

Normally, commercial trust agreements are prepared by the trust companies based upon information provided by the parties. They include the general clauses approved by the Office of the Superintendent of Finance which regulate, among other subjects, the scope of liability of the trust company. In this way, the consultant must take into account the following aspects:

Clauses such as:

Confidentiality.

Notices to the parties.

Conflict resolution.

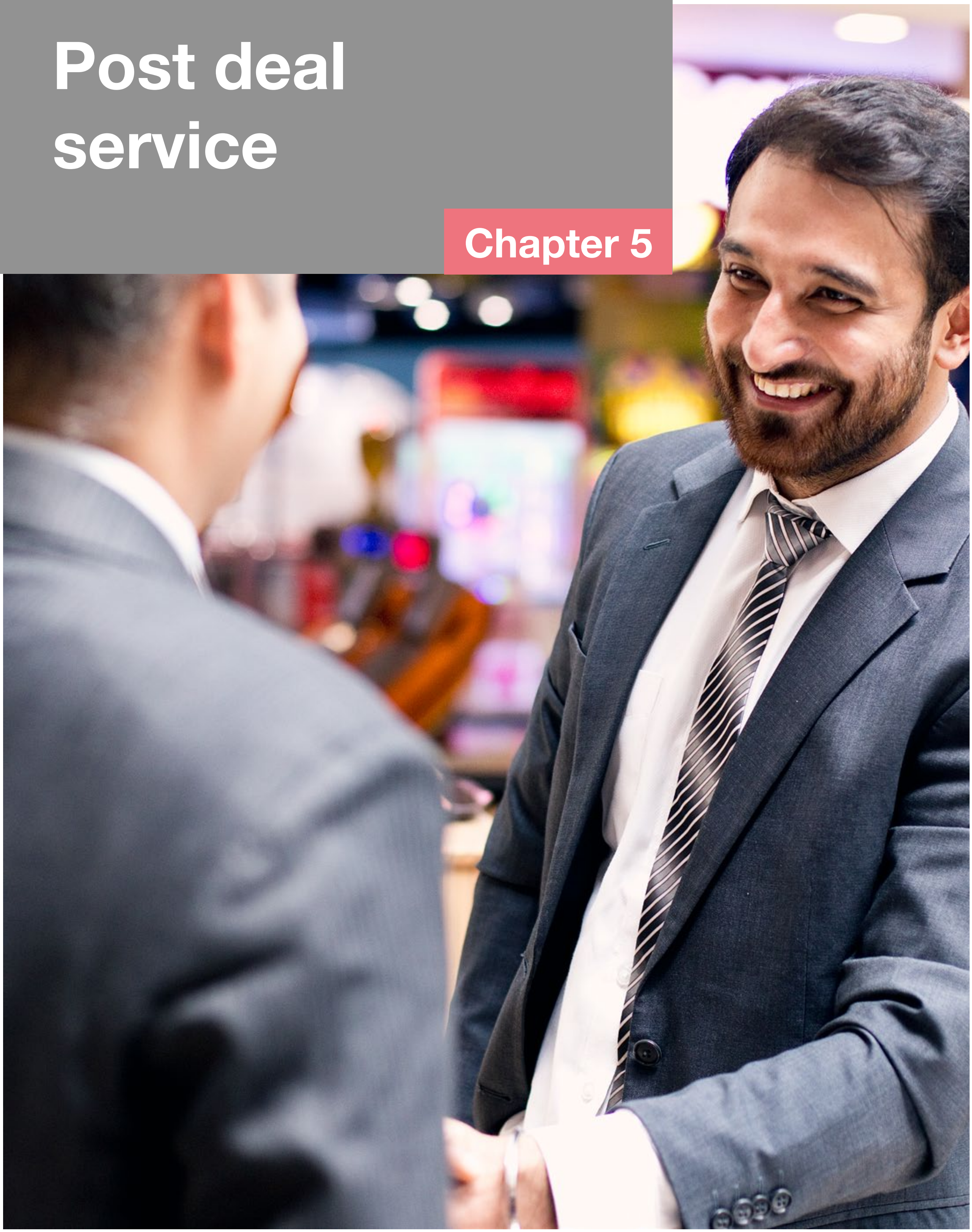
Competent jurisdiction and governing law.

Attachments.

Definition of the trust company	The escrow amount.	The general clauses.
Definition of the model trust agreement.	Definition of the model trust agreement.	Dates on which the resources will be released, totally or partially.
Agreement on the payment of the trust company costs.	Procedure to enforce the guarantee.	Manner in which the trust company will handle the escrow amount; and ownership of the eventual financial income.
Term of validity of the agreement.		

Post deal service

Chapter 5



Post deal services

Introduction and concepts

After the offer, negotiation and successful closing of the transaction stages have finished, the real work starts. On many occasions we have found that companies (national, Latin American and even multinational companies) usually underestimate the crucial stage of the post deal. In this stage, the initial purpose of the strategy for the acquisition, integration, spinoff or reorganization comes to life; hence, its execution will spell either success or failure, understood as either generating or destroying the transaction value.

The above is shown in the mentioned studies, which revealed to us that two thirds of all transactions failed to achieve operating success. The result of these studies – made of the set of M&A transactions – show that it is more difficult to accomplish the long-term operating and financial objectives than the strategic objectives. However, this should not come as a surprise to us, if we understand that the strategic objectives of nonorganic growth are achieved by the very realization of the agreement. In point of accomplishing the financial objectives, these require the parties to approach them seeking to secure any synergies or to integrate any differential capabilities – which people tend to view as the quick making of profit from the outset. Ultimately, the operating objectives are the most difficult to accomplish. This is so because they require carrying out a standing commitment by culminating long-term post deal activities. After the deal has been closed, the challenge is now renewed and the parties need to guarantee that the organization goes on operating without any commercial interruptions in the process.

Post deal services and activities are focused on strategy, planning, design, support and assistance of all post-merger integration actions, from beginning to end, spinoffs (disinvestments) and restructurings, mainly. Even if these processes relate to each other, they can be carried out separately, according to the needs of the client and the transaction stage that the client is pursuing at the time. In a way that is similar to that of the DD work, these are activities that can be carried out from the side of the buyer or the seller. Depending upon the perspective (the buyer's or the seller's), the strategy of post deal activities will change and will serve different interests.

By applying our experience and methodologies, we have created a set of fundamental pillars that enable our clients to carry out a successful transaction:

- Definition of the post deal service strategy.
- Focus on priority activities.
- Communication with all stakeholders.
- Accelerated transaction.
- Preparation for day 1.
- Definition of leadership at all levels.
- Managing the post deal process as a business process.

Post deal activities

After the initial stages of the M&A process have been finished, and the corporate and general strategy and financial transaction have been defined, the client can move on to the last stage, the implementation of the post deal. This implementation is the final step to materialize the strategy. It is focused upon preserving the continuity of the business; and, above all, on the rationale for the acquisition, which, in our view, refers to the rationale of leveraging and/or expanding capabilities to compete in the market. To develop an integration action plan, it is important to keep a more focused approach – one that is clearly connected to the general strategy. The steps to be developed and carried out in this type of services are listed below:

Determination of the main project milestones, including the following: dates, deliverables, and persons responsible, as well as the main issues that may arise throughout the project.

Designing, planning for and executing schedules and plans that work as a navigation route for the organization during the transition (post deal) stage, and within the framework of the time limits set for the project. This includes details for the activities, deliverables, persons participating and persons responsible.

Using tools to facilitate the posting process.

Designing a scheme for support and assistance and for following-up on the execution of tasks. This is to guarantee the implementation of the changes for the new model and to capture the expected benefits.

Support and assistance and follow-up on the final transition exit and closing stages.

During all these years where we have been executing post deal projects, we have found a list of the most common errors committed during the integration process. Likewise, we have identified key areas upon which all those involved must keep the focus to avoid this type of errors.

Before starting any project, it is important to define a strategy for the transition. Post deal priorities are more easy to identify when there is a clear strategy that has been communicated. Accordingly, the bases of the post deal service are the following: definition of a clear vision, definition of strategy and extent of the transition, establishing objectives, and setting up a government and decision-making structure. This will allow all the persons involved to create the correct atmosphere, stabilize and ensure value and measure the benefits delivered. Accordingly, it is important to develop plans before starting the transaction project, to ensure the full cycle of the project.

The most relevant areas to keep in mind when executing post deal activities

- Strategic vision and intent
- Capturing value
- Managing integration
- Financial aspects/regulations/legal aspects
- Technology
- Human Resources
- Communications and change

Why developing plans?

Guidelines for the spinoff/M&A.

→ **Detailed definition of the plans for day 1 and the first 100 days.**

→ **Follow-up on execution/ performance.**

Key actions:

· To establish the activities, time limits, responsibilities and decisions that each one of the business processes or areas must take (e.g. treasury, IT, human resources, sales, operations, finance, etc.).

· To monitor progress on the 100 day plans.

· To consolidate results through the project management office, and submit them to senior management.

Designing and structuring these plans will take a certain amount of time to complete; and each plan covers a set of specific activities that belong to each stage, and includes start dates, ending dates, persons responsible and dependences between duties/tasks.

The nature of the transaction and the perspective for the post deal (for the seller or the buyer) may change the methodology. But generally development comprises the following activities:

- Planning the project and setting up the team.
- Defining project governance.
- Setting up and integration management office.
- Defining the integration/separation strategy, including project premises and objectives.
- Designing the plans for day 1 and for the first 100 days.
- Evaluating the current status and designing the future status.
- Working out the plan for day 1.
- Working out the plan for the first 100 days.
- Transition to operation of the business as usual.
- Maximizing value through implementation of the future status.

Post deal challenges

As part of the main challenges of a post deal process, there is a challenge of integrating the M&A purpose effectively, and resolving this issue: How will we integrate a differential capability that the enterprise that we acquired has, without losing it, and without damaging my existing capabilities? What is the element that we must integrate and what is the element that we must keep separate? How would we foster commitment in people and attenuate their resistance to change? And how will we accelerate the integration process?

As mentioned above, one of the main challenges in the execution of post deal projects consists of accelerating the transition in the understanding that this will accelerate the securing of the benefits which translate into greater added value. The challenge arises where there is the intent to accelerate the process; but, on the other hand, we may make the mistake of omitting critical activities or doing the wrong ones for the continuity of the business, and creating spaces/time frames where it is not possible to go on operating for various reasons – things that lead to a destruction of value immediately. (For example, failure in the systems which keeps the company from issuing invoices in the usual way, failure to provide goods and services to clients, temporary factory shutdowns, among others.)

Managing to accelerate the integration process and being able at the same time to avoid disruptions of the business becomes the objective of the project integration management office. These teams are usually made up of multidisciplinary personnel, persons devoted exclusively to the project and who, with their experience in prior processes, may help the company avoid common mistakes, and, facilitate instead an ordered and fluid process between the intervening players and areas.

As M&A experts, the global alliance of Strategy& and PwC enables us to offer our clients comprehensive support and assistance, from the conception of the pre-deal strategy (targets, rationales, ability-based strategy), to evaluation of the deal (due diligence services) and through the post deal stage – hence enabling the enterprises to close their ongoing transactions successfully. This union – this alliance – has conceived a new vision that creates a preeminent strategy. This we do through a trusted advisor, with a firm that knows how to create and execute a strategy, provides high-value with the best talent, and stands out for its ability to help clients/customers to build their own differentiating abilities globally.

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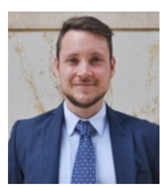

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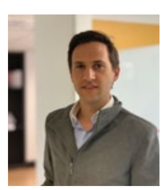

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