

# Diligence Insights

The Importance of Performing Financial Due Diligence on a Hockey Stick Growth Curve



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## Introduction

When you hear the term hockey stick, you may be impressed with uncharacterized sharp growth of a business and jump on the investment opportunity immediately. But in the era of the “unicorn” model, where companies are valued on growth projection and not on historical results, the hockey stick may be misleading. We want to share a few specific lessons learned from our recent experience and the importance of engaging financial due diligence in the acquisition process.



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Our M&A team performed diligence on two separate occasions over a four-year period on the same target, a private equity owned software company. The company’s original forecast showed a typical hockey stick growth curve, as it projected organic revenue and EBIDTA to increase by 100% and 300% over four years, respectively. Flash forward, the actuals for the previous four years revealed revenue and EBITDA growth of 25% and 50%, respectively. Because the purchase price was based on a forward EBITDA multiple, the disparity between the original projections and actual results indicates that the company was initially overvalued by 500%.

This demonstrates the **inherent risk when the seller’s projections are accepted without adequate diligence**, as the sellers can attempt to fetch higher valuations using only overly optimistic projections.

## Thorough Diligence of the Projections

The buyer's diligence process examines all aspects of the target company to support or refute the nature of all projections. **It identifies and distinguishes the growth assumptions that are defensible versus those of a wish list – unsupported and neglected.** Diligence seeks to uncover any discrepancies by comparing future projections with supportable historic performance and further corroborated by market studies and expert opinions.

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In this case, the seller's model was projecting significant growth due to annual price increases. Diligence procedures revealed that the target company had no history of increasing prices, and therefore no historical data to quantify the impact of price increases on renewal rates.



## Data to Support Growth

During the buyer’s diligence process, detailed information to support the seller’s projections is requested. Detailed schedules typically include information to supplement financial information, particularly in areas outside of the control of finance and accounting, such as:

- Pricing analysis from sales
- Sourcing and supply chain agreements from operations
- Inventory reports from purchasing
- Compensation reports from human resources

**The lack of or incomplete data to support historical and forecasted growth is a key red flag.**

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The seller in this example was not able to provide an invoice database, including customer order, SKUs, and ASP, to validate the customer renewals and price increases.



## Management Ability to Achieve Goals

It is equally important to explore with management the forecasted growth of the company. The below questions can help with your decision of whether to move forward with the deal:

- Do they have a history of achieving results, meeting or exceeding board expectations?
- How effective is their Salesforce?
- How are they going to realize their goals?
- Do they have experience growing a business?

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The example demonstrates how the seller did not meet their past projections when comparing historical results. **Additionally, the model planned for a new pricing strategy which resulted in a significant change of the business, and management had no experience implementing this strategy.**

## Buyer Should Not be Afraid to Question the Seller

The buyer can achieve a strong level of comfort by understanding the odds for achieving the forecast, preparing their own model, reaching their own conclusions, and sharing discrepancies with the seller. **The buyer, with the assistance of a strong diligence team, can gain comfort in all the assumptions used in the model before entering into the transaction.**



## Contacts

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