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THE GROWING IMPORTANCE OF SELL-SIDE DUE DILIGENCE

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A Quality of Earnings (QofE) analysis is a vital component of financial due diligence in M&A transactions. It evaluates a company's profitability, measured by its Earnings Before Interest, Taxes, Depreciation, and Amortization expense (EBITDA), while taking into account any non-recurring revenues or expense items. M&A deals are usually valued as a multiple of adjusted EBITDA, making it a crucial metric.

Besides profitability, a QofE analysis also examines the amount of net working capital required to operate the business without additional capital after the deal's closing. Transactions are often executed on a "cash-free/debt-free" basis, where the seller retains all unrestricted cash on the balance sheet and repays all outstanding debts at the close. The purchase price is adjusted based on the difference between the net working capital target and the actual net working capital delivered at close.

Given the importance of adjusted EBITDA and net working capital target in M&A deals, the QofE is a critical element of the diligence process. While it has been customary for buyers to engage QofE teams for decades, sellers have recently embraced the practice of hiring their own team before taking the transaction to market. This whitepaper highlights nine reasons why sellers should engage their own QofE team, even though buyers will likely conduct their own financial due diligence evaluation.

1. Obtaining a Higher Sales Price for the Company

A sell-side QofE analysis has the potential to boost the sales price of a company considerably. Since M&A deals are typically valued based on the profitability of the business, the higher the earnings, the higher the value. Consequently, the sell-side QofE team will scrutinize various expense adjustments that could be added back to EBITDA to increase profitability, which will then be multiplied by a market-based multiplier to determine the transaction value. For novice sellers, it may be confusing as to why these adjustments are necessary. In many cases, business owners may have paid for expenses related to prior years in the current year, which should not be counted against current earnings, known as timing adjustments. Additionally, one-time events that have no impact on the future profitability of the company may be removed from the calculation. It is worth noting that buyers are primarily concerned with the profits the business will generate in the future.

2. Counteracting the Fact That the Buyer’s Diligence Team has No Incentive

The buyer's diligence team is responsible for evaluating the financial position of the company and identifying any potential risks or issues that may affect the deal. However, their ultimate goal is to protect the buyer's interests and ensure that they are getting a fair deal. This means that they may not have the same incentive as the seller's QofE team to propose adjustments that increase the transaction value.

On the other hand, the seller's QofE team has a vested interest in identifying addbacks and other adjustments that can increase the earnings of the business. This is because a higher earnings figure will result in a higher valuation and ultimately a higher sales price for the company. As such, the seller's QofE team will likely put in more effort and be more proactive in identifying potential addbacks that can benefit their client.

In addition to identifying potential addbacks, the seller's QofE team can also help prepare the company for the due diligence process and address any potential issues before they become a problem. This can help ensure a smoother and more efficient transaction process and increase the likelihood of a successful deal.

Overall, while both the buyer's and seller's QofE teams play an important role in the M&A process, sellers should be aware of the different incentives and motivations that may impact the diligence process. By engaging their own QofE team, sellers can ensure that they are maximizing the value of their company and negotiating the best possible deal.

3. Avoiding Broken Deals

In addition to helping sellers achieve a higher sales price for their business, a sell-side Quality of Earnings analysis can help avoid broken deals. This is because buyers typically pursue deals within very specific size and industry criteria, and ifa deal is advertised at a certain level of profitability, the buyer will underwrite the deal based on that amount. If profitability ends up being substantially different during the buy-side QofE process, the deal may have to be transacted on different terms than originally agreed upon, or even fall apart completely.

In fact, a significant change in profitability expectations is often the main reason that deals fall apart during the due diligence phase. Therefore, it is in the seller's best interest to conduct a sell-side QofE analysis before the transaction goes to market to avoid any surprises during the due diligence phase that could derail the deal.

4. Ensuring That the Deal is Clean, Making it More Attractive to the Buyer

In any negotiation, buyers consider a range of prices they are willing to pay for a deal. When they perceive obstacles and unreliable accounting records, they may bid on the low end of their range. However, if they read the sell-side QofE report and gain confidence in the accounting records, as well as the ease of transacting the deal, they are more likely to bid at the upper end of their range. The purchase multiple, which is market-driven, is influenced by how clean and attractive the deal appears to be. A clean deal is more attractive to buyers, and they may be willing to pay a higher multiple on the same earnings. This could easily result in millions of dollars in favor of the seller.

Moreover, the purchase multiple is also influenced by the number of interested buyers in the market. When the seller distributes a QofE analysis that reinforces the attractiveness of the deal, it is likely to attract a greater number of interested buyers. The increased demand for the deal will inevitably drive the price up if buyers have to compete with each other. Conversely, without a sell-side QofE, the market interest may still exist, but the total demand could be weaker, resulting in downward pressure on transaction valuation. Therefore, having a clean deal, backed by a sell-side QofE, makes the deal more attractive to potential buyers and can help increase the seller's bargaining power, resulting in a higher price for the company.

5. Accelerating the Due Diligence Process to Help Mitigate Transaction Delays

The sell-side Quality of Earnings (QofE) analysis is not only crucial for enhancing the value of a company in an M&A transaction, but it can also provide a valuable opportunity for the seller and the management team to prepare for the buyer's due diligence process. As many management teams have not gone through this process before, a sell-side QofE can help them understand what to expect and what documents and data information the buyer's team will request. Moreover, the seller can assemble many of the requested documents and data during the sell-side QofE process, making the data room ready to provide the buyer access to the existing data, which can accelerate the process significantly.

The importance of accelerating the due diligence process cannot be overemphasized, as time is a significant risk factor in M&A transactions. The longer the due diligence process lasts, the higher the probability of the deal falling apart. Every day between the start of the due diligence process and the signing of the purchase agreement is an opportunity for future events to deter the buyer's interest. By having a sell-side QofE ready at the beginning of the due diligence process, sellers can mitigate the risk of transaction delays and maximize the probability of a successful transaction.

6. Uncovering Potential Issues

The sell-side QofE analysis not only helps sellers to identify addbacks and increase profitability, but it can also uncover potential issues that may negatively impact the transaction process. These problems can vary in nature and severity, ranging from operational inefficiencies to legal or compliance issues. By conducting a thorough QofE analysis before going to market, sellers can identify these issues early and develop a strategy to address them. This can help avoid surprises that may derail the deal once a buyer has expressed interest.

If an issue cannot be entirely resolved before going to market, the sell-side QofE team can assist the seller in developing a plan to communicate the resolution strategy with the potential buyer. For example, if the company has a customer concentration issue, the QofE team can help investigate reasons that mitigate this risk for a buyer. This proactive approach can help build trust with potential buyers and increase the chances of a successful transaction.

7. Having an Advocate That is on Your Side

Having an investment banker and an accounting team specialized in M&A on your side during the sales process can be a great advantage. Your investment banker will serve as your advocate and help you navigate the complexities of the transaction. Additionally, the sell-side QofE team can provide technical expertise and respond to key accounting questions that may arise during the buyer's due diligence process.

It's worth noting that the sell-side QofE team often conducts financial due diligence on behalf of buyers in other transactions, which gives them a unique perspective on the process. They can help you anticipate and address any issues that may arise during the transaction.

Furthermore, the sell-side QofE team can schedule calls with the buyer's diligence team to address any questions they may have after reading the report. These calls can swiftly handle key points of disagreement, which can be much more challenging to handle without the assistance of a team of M&A accounting specialists. Having a strong advocate and an experienced team of specialists can make all the difference in a successful transaction.

8. Developing a Net Working Capital Strategy

A QofE analysis provides more than just an evaluation of a company's profitability. It also takes a close look at the net working capital required to operate the business – the net working capital target. This target amount can significantly impact the valuation of the company because the purchase price will be adjusted at close based on the difference between the actual net working capital delivered and the agreed upon target. Engaging a sell-side QofE can help the seller establish a position in negotiations regarding an appropriate net working capital target amount.

It is in the seller's best interest to have a low net working capital target, as this reduces the possibility of a purchase price decrease due to a difference in net working capital. A sell-side QofE team can help develop a net working capital strategy tailored to the seller's specific situation and identify any trial balance accounts that may need to be removed from the calculation for various reasons. While the definition of net working capital is objective, the target amount is subject to negotiation and may depend on business-specific reasons. Having an advocate with expertise in setting net working capital targets can be beneficial for sellers.

9. Reducing the Risk of Disputes

Disputes over net working capital can be a major source of disagreement and even litigation after an M&A transaction closes. Unfortunately, many purchase agreements are written too vaguely on this subject, which can leave both parties vulnerable to misunderstandings and disagreements. The sell-side QofE team can help reduce the risk of such disputes by working with your attorneys to review the purchase agreement and ensure that it adequately addresses all possible eventualities related to net working capital. By bringing together M&A accounting and legal experts, you can craft a document that fully protects your interests and minimizes the likelihood of litigation down the line. This proactive approach can save both parties time and resources, as well as minimize the potential damage to their ongoing business relationships.

Conclusion

In conclusion, a sell-side Quality of Earnings analysis has increasingly become a crucial practice in M&A transactions, and it can generate multiple benefits. It has the potential to increase the purchase price, enhance the likelihood of closing the deal, and minimize the possibility of disputes post-closing. Addbacks that are not identified and included may result in a considerable loss in the purchase price. As a result, many investment bankers, including Charter Capital Partners, recommend their clients complete a sell-side QofE. Doing so is a valuable investment that can have a significant multiplying effect on the transaction's value.

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About Charter

Founded in 1989, Charter Capital Partners is a premier investment banking firm headquartered in Grand Rapids, Michigan. We offer a comprehensive range of investment banking advisory services, including buy-side and sell-side M&A, succession planning, business valuation and capital raise.

About the Author

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Jenny Dakoske's professional background has centered on assisting privately held companies, private equity firms, family offices and ESOPs with mergers, acquisitions, divestitures, and growth financings. Her experience includes sourcing, underwriting, negotiating, closing, and managing portfolio opportunities across industries including manufacturing, distribution, healthcare, business and financial services, and technology.

Prior to joining Charter, Jenny served as Senior Vice President with Huntington National Bank in its National Sponsor Finance Group, focused on borrowers with $3 million to $50 million of EBITDA. Her solutions-focused practice provided leveraged transactions to middle market manufacturing, distribution, and service companies on a national basis.

Jenny currently serves on the Board of the World Affairs Council of Western Michigan and is an active member of ACG Western Michigan and the Economic Club of Grand Rapids. While in Chicago, Jenny served as board member and event chair for Reading In Motion and served for multiple years as a junior board member for The Children's Place Association.

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