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WHY SHOULD M&A SELLERS CONSIDER A SELL-SIDE QUALITY OF EARNINGS ANALYSIS?

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Introduction

A Quality of Earnings analysis is the key piece of financial due diligence for M&A transactions. It identifies the profitability of the business, measured as Earnings Before Interest, Taxes, Depreciation and Amortization expense ("EBITDA") adjusted for any non-recurring revenues or expense items. M&A transactions are typically valued as a multiple of profitability quoted in adjusted EBITDA.

A Quality of Earnings analysis also examines the amount of net working capital required to operate the business without having to infuse additional capital subsequent to closing. M&A deals are commonly executed on a "cash free/debt free" basis, which means the seller keeps all unrestricted cash on the balance sheet but is required to repay all outstanding debt instruments at close. The purchase price is then adjusted up or down based upon the difference between the net working capital needed to operate the business (the "net working capital target") and the actual net working capital delivered at close.

Because adjusted EBITDA and the net working capital target are crucial aspects of all M&A transactions, the Quality of Earnings analysis ("QofE") is one of the most important aspects of the diligence process. While it has been very common for decades for buyers to engage a Quality of Earnings team, in recent years the market has embraced sellers engaging one as well before the transaction goes to market. This whitepaper details why it is best practice for sellers to engage their own QofE team even though the eventual buyer will likely also conduct its own financial due diligence evaluation.

Every Nickel Spent on a QofE Turns into a Dollar

A sell-side Quality of Earnings often results in a higher sales price for the company. Because M&A transactions are valued as a multiple of earnings, the higher the earnings the higher the value. The sell-side QofE team will likely uncover certain expense adjustments that would be considered addbacks to EBITDA to increase profitability which will then be multiplied by a market-based multiplier to calculate the transaction value.

First time sellers may wonder why adjusting addbacks are part of the process. In many cases, business owners have paid certain expenses related to prior years in the current year which should not count against the earnings in the current year. These are called timing adjustments. In other cases, there may be one-time events which should be removed because they will have no bearing on the future profitability of the company. Buyers are primarily interested in the profits the business will generate for them in the future.

As a case study example, perhaps the company being sold leases its office space from another entity owned by the seller but not included in the transaction. In this hypothetical example, the operating company is paying $100k per year in rent to the real estate company but the typical market rate for similar properties is only $40k and the buyer will enter into a new lease with the seller at this market rate. As such, $60k of the rent expense would be removed, increasing profitability by that amount. Assuming a purchase multiple of seven times, that single adjustment would increase the valuation by $420k. These types of above market payments are commonplace and just one of many possible examples of an individual expense that might be added back to profitability which may be identified as part of the QofE process.

While both the seller's QofE team and the buyer's QofE team will identify adjustments that move profitability both up and down, sellers should realize the buyer's diligence team has no incentive to go out of its way to propose addbacks that will cause their client to pay more for the business. In contrast, the seller's QofE team will put in more effort identifying addbacks because it creates a significant benefit for their client.

A Defensible EBITDA Number Avoids Broken Deals

Buyers pursue deals within very specific size and industry criteria. If a deal is advertised at a certain level of profitability, the buyer is going to underwrite the deal using that profitability amount as the underlying assumption. If profitability ends up being substantially different during the buy-side QofE process, the deal will likely have to be transacted on different terms than originally agreed upon or fall apart completely. In our experience, a significant change in profitability expectations is the main reason that deals fall apart during the due diligence phase. A recent transaction we encountered underscores this point. When the deal went to market, the investment bankers indicated the company had $1.8M in EBITDA. After the buyer's QofE process concluded, it became clear the actual EBITDA figure was $280k, which is only 16% of the profitability originally advertised. As a result, the buyer walked away from the deal and the transaction never ultimately recovered. Had the seller engaged a QofE team before going to market, they would have already understood their company's true profitability of $280k and their representatives would have pursued totally different buyers. Instead, both sides incurred significant costs without a transaction actually occurring.

Buyers Bid High When They Perceive a Deal is Clean

As is the case in any negotiation, buyers have a range of prices they would potentially be willing to pay. If they perceive a deal to have unreliable accounting records and a lot of other obstacles to overcome, they are going to bid on the low end of their range. If they read the sell-side QofE and can develop confidence in the accounting records as well as the deal being free of obvious obstacles, often they will be more comfortable bidding at the upper end of their range. While the company's profitability is based upon actual historical metrics, the purchase multiple is market driven. A buyer may be willing to pay a higher multiple on the same earnings if the deal appears to be clean and easy to transact. The difference between an additional one or two times earnings in transaction valuation could easily amount to millions of dollars in favor of the seller.

In addition, the purchase multiple dictated by the market is heavily influenced by how many interested buyers exist in the market. If the seller is able to distribute a Quality of Earnings analysis that reinforces the attractiveness of a deal, there is likely going to be a greater number of interested buyers. The increased demand for a deal will inevitably drive the price up if buyers have to compete with one another. In contrast, without a sell-side QofE there may still be market interest but the total demand could be weaker, which would exert a downward pressure on transaction valuation.

Expedited Buyer Diligence Process

The sell-side QofE could also be described as a practice run of what the seller and the management team are going to experience during the buyer's due diligence process. Since many management teams have not been through a due diligence process before, preparation in advance may be helpful. In addition, as a result of the sell-side QofE process, the company is already going to have assembled many of the documents and data information the buyer's due diligence team is going to request. Once a buyer is interested, the company can provide access to the existing data room, which will accelerate the process faster than if all materials needed to be assembled from scratch at that time. Of course, time will have passed, and some updated financial data will need to be added to the existing information, but documents like key contracts and historical bank statements will already be readily available in the data room.

Why is this significant? Quite simply: time kills deals. The longer the buyer's due diligence process lasts, the more opportunity there is for the deal to fall apart entirely as future events may deter a buyer's interest. The reality is that no deal is finished until the final purchase agreement is signed and every day in between is a chance for the deal to fall apart. Sellers can minimize this transaction delay risk by having a sell-side QofE ready to hand to the buyer at the beginning of their diligence process.

You Need to Know About Issues Before the Deal Hits the Market

The seller's QofE team may uncover significant problems which could negatively impact the transaction process. Depending on the nature of these problems, they can potentially be operationally resolved before a deal goes to market. Had the seller not been aware of these issues, they could surprise all parties and derail a deal once a buyer had expressed interest.

Even if an issue cannot be totally 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, maybe the company has a customer concentration issue but the sell-side QofE team can help investigate reasons that mitigate this risk for a buyer.

An Additional Advocate for You During Buyer Diligence

Your investment banker will be an advocate on your behalf over the course of the sales process. Also having an accounting team specializing in M&A advocating on your behalf strengthens your side in the negotiations. The sell-side QofE team frequently conducts financial due diligence on behalf of buyers in other transactions. They have the technical knowledge to respond to key accounting questions which will come up during the buyer's diligence. For our sell-side QofE projects, we commonly schedule a call with the buyer's diligence team to answer any questions they may have after reading the report. Often key points of dissention can be swiftly handled in these calls which could be much more difficult to handle without the aid of a M&A accounting specialist.

Establishing an Advantageous Net Working Capital Target

A Quality of Earnings does not only analyze a company's profitability. It also evaluates the amount of net working capital required to operate the business, which is referred to as the net working capital target. This amount can also have a significant impact on the valuation of the company because the agreed upon general purchase price will be adjusted up or down at close depending on whether the company is delivered to the buyer with more or less net working capital when compared to the agreed upon target. A sell-side QofE helps to firmly establish the seller's position in the negotiation regarding what an appropriate net working capital target amount should be.

It is generally in the seller's interest for the net working capital target to be as low as reasonably possible. Having a low net working capital target amount reduces the possibility for a purchase price decrease related to the difference between what net working capital was actually delivered and the net working capital target amount. The sell-side QofE team can help develop a net working capital strategy that is reasonable for your specific circumstances. It can also identify particular trial balance accounts which may potentially need to be removed from the net working capital calculation for various situation-specific reasons. In general, while the definition of net working capital as current assets minus current liabilities is objective, in reality a particular net working capital target for a specific situation is a matter of negotiation. Perhaps there are business specific reasons why one approach versus another should be used. As a result, having an advocate on your side who specializes in setting net working capital targets will be beneficial.

Minimize the Risk of Working Capital Disputes

Those new to the M&A process may not realize that a key area for disagreement and even litigation after a transaction closes is the parties disagreeing over net working capital. These disputes most often arise from purchase agreements that were written too vaguely on the subject of net working capital. The sell-side QofE team can work with your attorneys to review the purchase agreement and make sure it has properly addressed the possible eventualities which could arise related to net working capital. Together your M&A accounting and legal experts are more likely to craft a document which fully protects your interests and minimizes the risk of litigation after the transaction is finalized.

Conclusion

A sell-side Quality of Earnings analysis is becoming a best practice in the marketplace and an investment that is able to multiply itself in value many times over. It can potentially increase the purchase price, increase the chance of the deal closing and decrease the risk of litigation after close. Because the potential of not identifying and including a justifiable addback can represent hundreds of thousands or possibly millions of dollars in total purchase price, sellers will benefit significantly from having an advocate on their behalf who is an expert in M&A accounting matters. As a result, many investment bankers are now requiring their clients to engage a sell-side QofE group because of the significant value it brings to your transaction.

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