The Deal
BYLINE

SUPPORTING EVER INCREASING BUSINESS MULTIPLES AND VALUATIONS

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In today's highly competitive marketplace, well-established businesses and start-ups, as well as their advisors, are beginning to appreciate the need for a robust sell-side analysis when contemplating a sale or merger. Management, business owners and their advisors have realized that proactive analysis of their financial results is key to minimizing risk in the investment process and, therefore, could substantially increase valuation. The adage below by Lois Horowitz is never more appropriate than when in a buy/sell scenario.

"Not having the information you need when you need it leaves you wanting. Not knowing where to look for that information leaves you powerless. In a society where information is king, none of us can afford that."

Experience has shown that financial managers understand what the auditors want to see and what their executive teams want to analyze, but rarely do they appreciate the analysis that will be performed by potential investors or buyers of their enterprise. Therefore, the benefits of this analysis, some of which are listed below, are many while the detriment is only the effort involved and the upfront cost, which are more than made up for with reducing the time of the diligence process and the increasing valuation of the enterprise. As you might imagine increased valuations are more pronounced on a percentage basis with small-to-middle market companies, but these can be dwarfed in absolute dollars to the findings on large multinational conglomerates engagements.

The benefits include but are not limited to:

• Independent analysis – The company is provided with an independent analysis that can be used internally or with their advisors. If desired, it can also be shared with potential buyers and their due diligence teams. The deliverables focus on the relevant deal issues, but are also detail-oriented, which provide a full and robust analysis.

• Normalized vs. reported earnings – Due diligence focuses on normalized earnings to reflect the true "run-rate" of the business. Businesses, especially those that have been audited, typically report earnings in compliance with U.S. GAAP (or the accounting standards of their relevant jurisdiction). These accounting standards do not necessarily take into account revenues and expenses that will not occur post-transaction (i.e., revenue gains/geographic expansions, or conversely, the sale of a product line, a restructuring, owner's expenses, etc.). In addition, U.S. GAAP financial statements do not take into account changes to the business' results that did not have a full-year impact prior to the transaction (i.e., the business acquired another entity during the trailing twelve month period on which the valuation is based). Further, reported financial statements are not adjusted for accrual reversals and other "out-of-period" income and expense (i.e., changes in inventory variances, reserves, etc.). Basing deal multiples on normalized earnings often results in increased business valuations and, therefore, purchase price.

• Increased efficiency in the sales process –Analyses are provided that identify quality of earnings and working capital adjustments that will be of interest to the potential buyers' due diligence teams and prepare the seller's management team for future discussions with potential buyers. In addition, a good team will help create and organize supporting documentation for each adjustment to help facilitate these discussions. A provider can also assist with gathering data to satisfy other requests, significantly reducing the burden on the management team. This allows the management team to focus on their daily tasks with limited interruption from the due diligence process. Sell-side diligence reduces future demands of and simplifies the negotiation between the potential buyers/investors/financing sources. Sell-side diligence also accelerates the process and increases the likelihood of a successful completion of the transaction under terms that are favorable to the seller.

• Carve-out transactions – In the event that only a specific segment, product line or other portion of the business will be included in the transaction, assistance with preparing carve-out financial statements that will accurately reflect the prospective results of the stand-alone entity post-transaction need to be prepared. In addition, creating a bridge/reconciliation between the parent company's historical reported financial statements and the carve-out financial statements to allow potential buyers/investors/financing sources to understand how the business will be carved out of the larger entity and the associated implications post-transaction is imperative.

• Tax Analysis and other key analyses – Often times identifying potential tax exposures and alternative structuring scenarios in order to maximize value for the seller is essential before an enterprise will even think about entering into a sale process. In addition, analysis can be performed around the company's information technology and human resources/benefits functions if they are important to the organization in order to identify any potential issues and potential changes in the prospective costs of the services provided by these departments.

• Purchase agreement and other post-transaction assistance – Sell-side analysis should also include accounting and tax guidance on certain aspects of the purchase/refinancing agreement including, definitions, discussion of the purchase price and related adjustments and the tax implications of the transaction. In addition, analysis around the estimated working should be performed so that a target is established, that is not detrimental to the company. Further, in carve-out situations, thought must be given to a transition services agreement, if applicable.

• Customizable approach – There is never a one-size-fits-all scenario to any business sale. Procedures and deliverables must be tailored to meet the needs and budgets of the company and the industry in which it operates. Deliverables can range from an Excel workbook with several critical analyses, including quality of earnings, and related commentary to a full due diligence report including key deal observations, quality of earnings, quality of working capital, income statement and balance sheet analysis, discussion of tax matters and information technology and human resources/benefits due diligence, if requested.

Experience has shown that a robust analysis can pay for itself tens, if not hundreds of times over. But alas, an analysis is only as good as the scope that is set for the investigation or the information provided. This couldn't have been more evident than on two recent mandates. In one situation, a client had just completed an acquisition and was not meeting its debt covenants. The company anticipated that there were millions in savings to be actualized in the coming months and years and requested that we analyze the cost savings/restructuring adjustments and ensure that they were supported and accurately stated. We advised the company that it would be beneficial to perform a full analysis of the business, especially given the fact that they had not performed buy-side due diligence on the acquisition, but the company thought it was not necessary and would be too time consuming. After six weeks of analysis, we had validated and supported their restructuring adjustments to EBITDA, totaling millions of dollars, and systematically walked each of the potential investors' diligence teams through the analysis. The week before closing, the company uncovered an issue with its accounting for inventory and realized, due to an issue within the inventory costing system, it had been selling goods at a loss since the acquisition. This issue forced the company into insolvency and effectively made moot any benefits that were being realized from the cost savings/restructuring initiative, the lender forced a sale for $1 and six months later the company was able to refinance and its new owners took a dividend. If full scope sell-side diligence had been performed on this company, the inventory costing issue would likely have been discovered much earlier in the process, and, therefore, the valuation of the company could have possibly been preserved.

In another recent example, a seller owned and operated an unaudited, cash basis enterprise. We were able to almost double its valuation by creating analyses that normalized its earnings based on the accrual basis of accounting and accurately projected its potential earnings on a monthly basis, based upon its backlog. The company had never previously performed such projections. Proactively addressing what a buyer/investor would want to analyze created tremendous value in this situation.

A good partner, will not only save a company time and money throughout a sales process, but will also provide much needed advice so the company can navigate the transaction mine-field that often blow-up deals, while simultaneously increasing valuation.

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