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SELL-SIDE FINANCIAL DUE DILIGENCE – HOW IT IS ESSENTIAL TO SUPPORT SELLER DEAL VALUE

There are clear benefits to performing sell-side due diligence in connection with the sale of a business. More sellers are investing in sell-side financial due diligence as a key component of a well-run sales process which, for many reasons, there is no substitute for when it comes to selling a business. With sell-side financial due diligence:

- Buyers tend to have more confidence in financial data and thus the EBITDA and cash flow information they are presented with and will use to form a view on valuation.
- The risk of unwanted surprises during the buyer due diligence process is significantly reduced.
- There is a high likelihood of increased speed and certainty of the contemplated transaction closing.

Firstly, what is sell-side financial due diligence?

Sell-side financial due diligence, often referred to as sell-side quality of earnings analysis, is typically a process whereby a seller engages an independent third-party service provider to undertake a financial due diligence analysis with respect to its business, as if it were from a buyer's perspective. The goal is to explain the financial "story" of the business in a user-friendly format that can be shared with potential buyers. It is designed to identify strengths and opportunities as well as deal-closing obstacles, such as potential issues the business may have faced; how those issues impacted the reported historical financial results; and what steps the management team took in order to address them.

Similar in nature to a high-quality buy-side financial due diligence report, a good sell-side due diligence report should cover a broad range of valuation related topics, including:

- A quality of earnings analysis
- Working capital trends
- An analysis of debt and debt-like items

The sell-side due diligence report should also cover other areas which would serve to quickly inform potential buyers about the business. These areas most often include:

- A deep analysis of customer revenue trends
- A detailed income statement analysis
- Other key financial data points

These important points collectively bring the financial story of the business to life in a user-friendly format.

So what are the benefits of sell-side financial due diligence for the seller? Won't buyers seek to undertake their own due diligence anyway?

There are a number of key benefits to the seller in undertaking sell-side financial due diligence prior to buyers commencing their own due diligence.

Unlocks value for the seller in a credible way: Sell-side due diligence should be undertaken by a team of seasoned professionals who have the experience of preparing businesses for sale in a way that: (1) is credible to buyers, and (2) optimizes the sales value for sellers. For example, the identification, analysis, and detailed presentation of quality of earnings adjustments ("add-backs") to historical reported financials is a key advantage of sell-side due diligence. These adjustments could extend to the identification and disclosure of cost-savings items to which a buyer may attribute value (e.g., prospective insurance cost savings). The identification, quantification, and disclosure of these items may increase the EBITDA. Since buyers use EBITDA as the basis for their valuation of the business, these actions could unlock value for the seller. Valuable add-backs or cost savings identified in sell-side due diligence usually are considered by the seller and the buyer in deal negotiations. These findings generally add to the incentive of a buyer to move forward and purchase the business.

Leads to reduced surprises during buyer diligence: Potential issues should be identified and proactively addressed before investment bankers launch the sale process. This minimizes surprises during buyer due diligence and, in doing so, significantly reduces a buyer's ability to seek price discounts during the sale negotiation process. These price chipping, even deal-breaking, considerations generally begin early in the mindset of the buyer.

In our view, buyer due diligence discoveries, which are unwanted surprises to the seller, are the primary reason that sellers lose control in the sales process. In these instances there is a higher likelihood of a deal not succeeding – and therefore sell-side due diligence, as part of a well-controlled seller process, significantly reduces the risk of a broken deal.

Supports and expedites the sale process: The sell-side due diligence team should work with the management team and investment bankers to help define and build support for the historical story of the business and its key value propositions as well as describe the financial story of the business to buyers in the most efficient way.

The goal of sell-side due diligence is for potential buyers to read the sell-side report and be left with a few areas of focus for their own due diligence. This focuses the buyer's due diligence process on defined matters and shortens the time that buyers are "in the business". The buyer derives confidence in the quality of earnings from the quality of the report and in the solid responses in interviews with its authors and management.

Friendly challenge: The sell-side process introduces a management team to the rigors of due diligence in a "dry run" format prior to buyers commencing their own buy-side due diligence. The process is managed to minimize disruption to the management team's day jobs as much as possible, while allowing management to be better prepared to address the buyer's diligence questions related to the financial performance of the business. In this way, less time pressure is experienced by the management team once the sales process is launched.

Positive signal to potential buyers: In a world in which auction processes are more competitive and more time-demanding than ever before, bidders are more likely to expect and be engaged in a sales process in which the seller has invested in a sell-side diligence report. Buyers view this kind of preparation by the seller as allowing a potential buyer a clearer path to better understand the financial performance of a business before starting to incur its own buy-side financial due diligence costs. Further, in an auction process, prospective buyers would see they all have been provided with the same information. This helps to avoid the unfavorable perception of whether an advantage has been given to one buyer compared to another insofar as the story and financial performance of the business is concerned.

But we have audited accounts, so won't sell-side financial due diligence be duplicative?

Often, sellers do not see the need for sell-side due diligence as they have audited financial statements, and as such consider the financial records of the business to be "clean". Audited financials do not reflect "deal financials." It is the deal financials upon which buyers base their valuation. Buyer due diligence cleanses the financials for out-of-period costs, non-cash items, and illustrates pro-forma considerations to maximize value for the buyer and provide a rationale for a reduction of purchase price. Indeed, if a seller merely shares GAAP basis financial information with a buyer, the seller is likely to experience a significant loss of value.

We already hired investment bankers, so won't sell-side due diligence be unnecessary?

A quality sell-side due diligence report supports the sales process the investment bankers are managing. A detailed analysis of financial information by a diligence team improves the accuracy of the information included in the Information Memorandum prepared by the investment bankers. Furthermore, sell-side financial due diligence reporting bridges the gap between the deal financials included in the Information Memorandum and the financial records of the business. Sell-side financial due diligence builds this bridge in a credible, balanced, and objective manner; it should not be seen as a replacement for the Information Memorandum. Rather, sell-side due diligence is quality support for the Information Memorandum and complementary to it.