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Preparing for Financial Due Diligence

Best Practices for M&A Transactions

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Overview

1. What is Financial Due Diligence (“FDD”)?
2. Key Concepts – Quality of Earnings and Adjusted EBITDA
3. Best Practices and Common Pitfalls

1. Overview of Financial Due Diligence

The purpose and scope of FDD

What Is the Purpose of Financial Due Diligence? Why Is It Important?

The purpose of FDD is for the Buyer to independently validate the financial information and related facts presented by the Seller upon which the Buyer is basing its offer. To understand the importance of FDD for each side, consider the flow of information during a typical sell-side process:

Unverified information provided by Seller

Blind Teaser

- Revenue
- Profitability KPI
- Very high-level info
- Ballpark accuracy

Deal interest
(Executed NDA)

Info Memo (CIM)

- Summary financials
- Important business KPIs
- Context & narrative
- Accurate, but positive spin

First Bid
(Indication of Interest)

Limited VDR Access

- Complete financials
- Some additional details
- Info for valuation analysis
- Precise but incomplete data

Second Bid
(Letter of Intent)

Buyer-confirmed info

Confirmatory DD

- Full access to data room
- Financial DD
- Other functional DD
- Complete and correct info

Definitive Agreement
(SPA, APA, etc.)

Buyers rightly perceive that Sellers have an incentive to fluff up numbers or put a positive spin on the data to increase bids. If FDD confirms such suspicions, Buyers will renegotiate , re-trade, or walk away. If FDD alleviates such fears, buyers may be more flexible on the legal terms negotiated, leading to smoother and faster closing.

Overview of FDD Process: Scope & Key Deliverables

1. Potential Scope of Financial Due Diligence

a) Review accounting details – trial balance, key G/L transactions, AR / AP aging reports, continuity schedules, etc.

b) Review bank statements and bank recs – confirming that cash reconciles with bank statements provided.

c) Review and reconcile detailed breakout data – sales by customers, sales by product, etc.

d) Review supporting documents or data – billing / invoicing information, underlying contracts, etc.

e) Analyze any discontinued operations and related adjustments.

f) Understand owner addbacks, compensation, and discretionary expenses.

g) Understand the Company's accounting, control, and reporting processes.

2. Key Deliverables (examples)

a) Audit Report (if needed, Sellers have audits done before FDD); Audit Workpaper Review (in some circumstances)

b) Quality of Earnings Report

c) Financial Due Diligence Report (typically an internal Buyer deliverable, usually required for final deal approval)

d) Financial Inputs for SPA draft – working capital target, definition of "Debt", required cash adjustments, sample purchase price calculation exhibit, etc.

What are Buyers Looking For in an FDD Process

1 Confirmation and Validation → Foremost, buyers want to see that the business was presented to them fairly and accurately, without omission of material information.

2 High Quality Earnings → Buyers want to see sustainable profits driven by positive trends, not ephemeral windfalls or artefacts of GAAP accounting only true on paper.

3 No Undisclosed Liabilities → Buyers seek to ensure that there are no undisclosed off-balance-sheet liabilities that can affect their business going forward.

4 Potential Synergies → Skilled buyers will use the financial due diligence process to identify potential synergies and opportunities for integration.

5 Responsiveness & Smooth Process → Timely and well-organized responses from the Seller during FDD demonstrate strong accounting capabilities and reporting processes, increasing the buyer's confidence.

2. Quality of Earnings & Adjusted EBITDA

Two important concepts in FDD

Quality of Earnings: The Concept

Equal earnings may have different qualities and, therefore, may be valued differently, with higher quality earnings having a higher valuation than lower quality earnings. For example, which of the following is most valuable?

- $1m in earnings from the sale of software subscriptions to many customers on long term contracts.
- $1m in earnings from operating a chain of franchised convenience stores.
- $1m in earnings from cancelation of debt.

Traits of Quality Earnings

High Quality Earnings	Low Quality Earnings
Are Sustainable (e.g. recurring revenues, long-term contracts, etc.)	**Are Ad-Hoc and Unpredictable** (e.g. one-off sales, sales not based on any clear pattern)
Have Low Risks (e.g. low customer concentration, low risk of non-payment)	**Have High Risks** (e.g. high customer concentration, uncreditworthy customers)
Originate from Growing Markets (e.g. are likely to grow in the foreseeable future)	**Originate from Declining Markets** (e.g. are likely to decline or require winning new market share)
Are protected by Barriers of Entry (e.g. IP & patents, network effects, regulatory requirements)	**Are susceptible to Competition** (e.g. commodity services, low-margin businesses)
Produce Real Cash (Earnings actually exist in reality, with favorable payment terms)	**Primarily Exist on Paper** (e.g. deferred revenue, cancelation of debt income, etc.)

Quality of Earnings: Implications for M&A

For valuation purposes, it is typically better for Sellers to seek to increase the quality of their earnings than to maximize short-term profitability. Consider the following examples:

	Company A	Company B	Company C
EBITDA	$10M	$11M	$12M
Earnings Quality	High	Moderate	Low
Valuation Multiple	7x	6x	5x
Enterprise Value	**$70M**	**$66M**	**$60M**

Buyers account for the quality of the target's earnings in one of two ways: (a) by adjusting the low quality profits out of EBITDA; or (b) by offering a lower valuation multiple.

Adjusted EBITDA: The Concept

1. What is Adjusted EBITDA?

a) Pro-forma profitability metric used by Buyers and Sellers to discuss valuation within a common framework.

b) Adjusted EBITDA x EBITDA Multiple = Valuation

c) Adjusted EBITDA = Book EBITDA +/- Adjustments

d) It is one of the most important and most closely scrutinized (and debated) figures in a transaction.

e) The calculation of Adjusted EBITDA is fact-specific and differs from deal-to-deal.

2. When Calculating Adjusted EBITDA Objectively, the Goals Are Always the Same:

a) Describe the underlying performance of the business at the time it is sold, as it would be in the normal course of business. To that end, it should be calculated so that:

   i. It reflects any item that will affect the Buyer (as a new owner) going forward.

   ii. It does NOT reflect any item that will NOT continue, or which will not affect the Buyer going forward.

b) Provide a consistent basis for evaluating the historical trends of the business being sold when applied retroactively.

c) To eliminate the calculation impact of confounding factors.

Calculation of Adjusted EBITDA: Example

Adjustment Rationale		Adjustment Calculation	Amount
Book EBITDA			**$5.50M**
1. Discontinued Operations	+	Costs of Discontinued Ops	$500K
	-	Revenue of Discontinued Ops	($400K)
2. Extraordinary one-time events	-	Extraordinary Income	($3M)
	+	Extraordinary Costs	$300K
3. Related party transactions	±	Reverse related party transactions	$1M
	±	Pro-forma market rate transactions	($250K)
4. Remove discretionary expenses	+	Spending on new / growth initiatives	$150K
	+	Owner Addbacks	$250K
5. Remove transaction expenses	+	Any transaction expenses incurred to date	$200K
Adjusted EBITDA			**$4.25M**

As a rule of thumb, adjustments should increase the quality of the earnings – if they don't, you should reconsider whether you should make them in the first place.

Why Is Adjusted EBITDA So Important?

1. Directly Impacts Purchase Price

a) By Calculation: Adjusted EBITDA x Valuation Multiple = Transaction Value (on a cash-free & debt-free basis).

b) Attracts more/fewer buyers & bids by portraying the business in a more positive/negative light.

2. It Sets Buyer Expectations About the Business and the Sellers:

a) If Adjusted EBITDA is high, then Buyers would expect to see a profitable, cash-flow positive business. If this expectation is not met, the deal is unlikely to close.

b) If Adjusted EBITDA differs greatly from Book EBITDA, then Buyers would expect a more complex / time-consuming due diligence process to analyze the causes of the variance.

c) Dubious adjustments that fluff up EBITDA will alarm Buyers about counterparty risk and invite a tougher due diligence process across the board.

d) Obvious adjustments that are not made but which would benefit the Sellers reveal lack of sophistication.

3. It Allows Sellers to Compare Incoming Offers to the Current Market:

a) Flip the equation so that Valuation Multiple = Transaction Value / Adjusted EBITDA → you can now see whether you are offered above or below market valuation. This information helps in negotiating better terms and comparing offers in an auction process.

3. Best Practices

Employing FDD for better outcomes

Best Practices & Common Pitfalls #1: Calculating Adjusted EBITDA

Best Practices:

1. **Avoid the Need for Adjustments** – Planning ahead and preparing for an exit 2-3 years in advance will help you avoid the need to make many EBITDA adjustments. For example, there are no discontinued operations to adjust if you discontinue unprofitable businesses 3 years prior to exit.

2. **Base Adjustments on Documented Facts** – When making adjustments, use numbers that can be traced back to written documentation such as invoices, receipts, etc. Do not use estimates as a shortcut.

3. **Show Clear Reconciliation to Book EBITDA and Trial Balance** – Buyers need to understand a clear relationship between Book and Adjusted EBITDA so that they can independently reproduce the calculation of Adjusted EBITDA.

4. **Isolate "Reinvestment through Income Statement"** – If you are making a big investment in the future of the company which cannot be capitalized per GAAP (for example, hiring and training new specialized salespeople with 12 to 18 months to ramp-up period), isolate such spending (and related revenues/COGS if applicable) and show to the Buyer separately. In this example, you are making expenditures that will benefit the Buyer for which you may not get credit.

Common Pitfalls:

1. **Fluffing Up EBITDA via Adjustments** – Buyers will see through these attempts and will discount accordingly.

2. **Unsustainable Short-Term Profit Maximization** – Savy Buyers will see through these attempts as well. For example, if you delay hiring replacements for departing employees because the remaining team can hold the line for a short period, you will temporarily increase EBITDA but also increase the risk of employee turnover and crushing morale. Meanwhile, Buyers will add the replacement cost of the missing employees anyway.

Best Practices & Common Pitfalls #2: Executing Financial Due Diligence

Best Practices:

1. **Have Audited Financial Statements** – This will address common Buyer anxieties and will also help your accounting team prepare for FDD. For deals greater than $10M, audited financial statements are expected.

2. **Get a Quality of Earnings Analysis Completed Before Going to Market** – Using an independent 3rd party accounting firm to prepare a QoE will ensure that your Adjusted EBITDA is reasonable and credible. The exercise of providing the data required for an outside party to complete a QoE will provide you with a dry run for FDD, since much of the data requested will overlap with the Buyer's. This diligence rhythm learned from this process will pay dividends later.

3. **Adequately Staff Your Accounting and Admin Team** – An overworked accounting team can be an accident waiting to happen during a transaction. You *must have spare capacity in your accounting department when going into FDD*, otherwise it will be difficult to cope with the rigors of a transaction.

4. **Thoroughly Prepare** – This cannot be stated enough times and start early – the earlier the better.

Common Pitfalls:

1. **Tolerating Bad Internal Reporting and Recordkeeping Processes** – You should regularly receive quality, clear, and informative internal reports about KPIs and financial performance. These reports should allow you to drill down on operational detail easily and you will know your business better.

2. **Terrible Spreadsheets** – Sloppy spreadsheets can raise many red flags for Buyers – it not only provides unsatisfactory information (which will be caught by skilled buyers), but also undermines the credibility of all other information provided.

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