As seen in: *The Deal*

October 28, 2015

http://pipeline.thedeal.com/tdd/ViewBlog.dl?id=87030

Maximizing Value Upon Exit

by Paul Aversano

Sell-side due diligence, a critical component in maximizing the value of a company preparing for sale, is a long-established practice across Europe and is gaining traction in the U.S. in light of today's competitive and efficient market.

I estimate that less than 30 percent of exits in the U.S. include a systematic sell-side due diligence approach. However, sellers are showing a greater interest in engaging third-party firms to perform sell-side due diligence to ensure that value is maximized in the current marketplace where buyers thrive on large volumes of data and detailed analyses. Sellers can better ensure successful execution of their exit strategy by conducting a deep dive assessment of the company's quality of earnings and leveraging the findings from the sell-side due diligence process.

Whether the seller chooses a private or public sale (IPO), the key factor for success remains the same: preparation. It is critical that the management team be fully prepared for the scrutiny of a prospective investor's due diligence.

Sell-Side Due Diligence in a Private Sale Process

In a private sale, sell-side due diligence involves assessing the company from a financial and accounting, tax, operations and IT perspective to uncover any sources of overlooked value or potential red flags before the sale process starts. The third-party sell-side due diligence team knows what questions buyers ask and is practiced in how to answer them. Typically, the sell-side due diligence process should begin approximately three months prior to commencing a sales process in the market, or around the same time an investment bank is engaged to start the process.

The sell-side due diligence team performs detailed analysis on the financial results and focuses on crucial questions such as:

Are historical financial results appropriately presented? Are there historical "quality of earnings" adjustments that may enhance value? Are there matters that may detract from value such as expiring contracts or dissatisfied customers? Have issues been identified and responses proactively prepared? Is documentation supporting all financial information and adjustments transparent, supportable and reconciled?

Are the projected financials presented in a manner consistent with the adjusted historical results? Are assumptions realistic and likely to be acceptable to potential buyers?

Have the auditors appropriately addressed and documented all matters that may be of relevance to potential buyers in connection with their audits?

Are there operational matters or synergies that may impact the valuation?

Additional benefits of sell-side due diligence include the following advantages:

Sell-side due diligence creates a level playing field. When all interested buyers receive the same information, updated regularly, it makes for a faster, cleaner and more efficient sale process.

Along with putting the financials under a microscope, a group of buyers conducting due diligence will place significant pressure on a management team. It is helpful if management has "practiced" for the sale process and can anticipate a buyer's questions or likely areas of focus. Management needs to be ready to respond to significant requests for both historical and prospective/pro forma information and discuss these items in detail; however, at the same time, they also need to continue running the business successfully.

The sell-side due diligence process helps illuminate the most advantageous and realistic exit strategy for individual sellers, as well as tailor information required to address the needs and preferences of potential buyers, including private equity firms and corporates. For example, if the potential target buyer is a private equity fund, it is important to consider how the future owner will be able to increase value beyond what the present owner has achieved. This might involve capital to execute a growth strategy, new manufacturing facilities, expanded outlets or related investments in industry-specific expertise and operations. On the other hand, corporate buyers search for synergies within their existing businesses. A large corporate buyer can improve margins and take out costs via economies of scale. It can merge, push product into new markets and potentially pay more for future value than a PE fund.

Sell-Side Due Diligence for an IPO Process

If the seller feels that private buyers are not offering a fair valuation, it can look to the capital markets and work with an investment bank on an IPO. However, it is important to understand the complexities of a public offering and the pros and cons of this approach. Public offerings may prove to be a more challenging exit due to lockup periods, a longer time frame, costly reporting requirements and increased documentation required as a public company.

Business owners often underestimate the cost and rigor of future compliance and reporting requirements such as Sarbanes-Oxley compliance, quarterly and annual reporting, proxy filings, earnings releases and investor calls. Although it is natural to focus on "going public," it is critical to prepare for life as a public company before starting the registration process. It is recommended to begin the IPO readiness process at least nine to 12 months before accessing the capital markets.

The IPO readiness due diligence process scrutinizes and evaluates the company's ability to operate and report as a public company, as well as its ability to produce the information required for the registration statement. With a focus on people, processes and technology, the IPO readiness team identifies gaps and prepares a plan to transform the company into an organization that can operate and report as a public company. The IPO readiness team also helps prepare for the registration process by assessing historical financial and non-financial information required for the registration statement.

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The success of an IPO can also depend on the “IPO window,” which is largely determined by equity market performance and volatility, and fickle buyers’ appetite for new issues. Pay close attention to this window and don’t get locked into acting at the wrong time. When the window is open and buyers are hungry, valuations soar. Because the window can open and close with no warning, smart sellers often start down a dual track of preparing for a private sale and an IPO at the same time. This allows the seller to assess valuations under both a private and public sale, and to execute on either strategy without having to restart the process with a different focus.

Sell-Side Due Diligence is Low Cost / High Benefit

In today’s competitive and efficient marketplace, preparation for exit is critical in order to position a company for maximum value. The upfront cost of third-party sell-side due diligence is only a fraction of the overall value that will be created, and the controlled and efficient process allows the management team to focus on running the business and maintaining its value.

Equally important are actions to steer clear of that can derail the most carefully planned exit strategies. Don’t make any major changes in the company’s operations during the year prior to starting a sales process. Following consistent accounting policies, procedures and practices, as well as delivering steady earnings in line with projections during the year of sale, helps avoid buyers’ potential concerns.

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