SELL-SIDE DUE DILIGENCE

BEST PRACTICES AND PITFALLS

Sell-side financial due diligence is no longer just an accepted practice, but is now an expected step in transactions. Both sellers and buyers have come to realize the benefits of sell-side due diligence, including accelerating time to close, minimizing surprises, identifying and validating adjustments to EBITDA and assisting management throughout the process. Sell-side due diligence has been instrumental in maintaining a competitive transaction landscape where buyers are willing to pay top dollar for quality assets.

As the volume of sell-side due diligence reports has increased, so has the inconsistency in reporting quality. While some sell-side due diligence teams spend an adequate amount of time analyzing, vetting and discussing detailed financial information, others don't follow a similar approach.

Limited access to company management, incomplete data, a limited scope or rushed work results in poor diligence quality. When the quality of sell-side due diligence is poor, astute bidders and their advisors insist on performing all of their work from scratch, rather than being able to leverage what has been done by a sell-side team. This leads to delays and extends a transaction process.

However, high quality, unbiased sell-side due diligence puts all buyers on a level playing field, thus fostering a rapid and competitive process. With this approach, bidders spend less time questioning the quality of the sell-side materials and more time sharpening their pencil on their investment thesis and overall valuation. The following are best practices to follow and pitfalls to avoid in any sell-side due diligence process.

Best Practices

- **Management team buy-in into the sell-side process** – It is critical that each member of the management team understands and endorses the sell-side process. Without full support from the C-suite, there will likely be disruptions to the transaction process.
- **Communication is critical** – Open lines of communication between the seller, investment banking team and sell-side financial due diligence advisor should exist to address value drivers, concerns and red flags early. The sell-side diligence team also needs to have unrestricted access to the management team throughout the sell-side process.
- **Financial/accounting analysis should be performed at the most detailed level available** – Sell-side diligence should be performed at the trial balance level and when necessary, general ledger or transaction level in order to provide detailed analyses and support to potential buyers.
- **Consistency should be maintained between the sell-side diligence report, offering memorandum and any other marketing materials** – Financial data should be provided on a consistent basis and a detailed reconciliation should be provided for any discrepancies.
- **Keep a clear delineation between historically tracked "management adjustments"** and "due diligence adjustments" – Buyers want to know what adjustments have been identified during the sell-side due diligence process. Although certain situations may dictate otherwise, a sell-side report should delineate between the views of company management and the sell-side due diligence advisor.
- **Sell-side analyses should be developed on a monthly basis** – This allows for more thorough trend analysis and also enables a fast and efficient roll forward into future periods.
- **All due diligence adjustments to EBITDA should be supported** – Adjustments can be supported with a sample of third-party documentation or detailed calculations, as appropriate.
- **Recast financial statements should be presented** – A recast of historical financial statements should be prepared to illustrate the impact of all EBITDA and net working capital adjustments and provide a clean view of the Company's financial results.
- **Consider the team's involvement beyond the sell-side report** – Sell-side due diligence does not have to just consist of a report. Where appropriate, the sell-side team can act as "arms and legs" for the management team.
- **Maintain transparency of pro forma and run-rate adjustments** – Buyers need to easily understand the assumptions used to create these adjustments and support should be provided, when available (price changes, cost reduction, etc.). Grounding adjustments in reported results is the most powerful.

Common Pitfalls

- **Appearing too salesy** – Sell-side due diligence should be fact-based and unbiased. The sell-side due diligence report will lose credibility if it reads like a sales pitch.
- **Limiting the scope of a sell-side project** – This reduces the value of the sell-side work and buyers will likely need to incur additional time to gain comfort around historical earnings quality.
- **Management does not stand behind the adjustments to EBITDA** – If the management team does not understand or support quality of earnings adjustments presented in the sell-side report (even in the context of adjustments that were identified by the sell-side due diligence team), they will likely not be accepted by a buyer.
- **"Rubber stamping" management's historical adjustments to EBITDA** – Existing management adjustments must be challenged and properly supported, even if they are allowable under current lending agreements.
- **Presenting overly aggressive pro forma adjustments** – Attempting to take credit for revenue opportunities or cost savings initiatives that are theoretical and have not been executed diminishes the overall credibility of a sell-side report.
- **Presenting the net working capital target too early or not soon enough** – Every transaction is different and therefore sellers and their advisors must decide when it's best to share a view on purchase price mechanics including net working capital.

Conclusion

Sell-side due diligence, when performed correctly and from a neutral point of view, will help buyers make an informed investment decision, thus leading to a more competitive process and an enhanced exit value.

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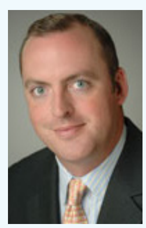

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