

# JUDGMENT CALL

## Strong medicine

*Seller due diligence as deal-closing tonic for the anemic M&A market*

BY MILTON MARCOTTE AND DAN SOLOMON

“When the economy plummeted last year, the M&A landscape changed quite dramatically,” says Hector Cuellar, president of **McGladrey Capital Markets LLC**. “Transactions were being retraded at an alarming rate, and due diligence data requests skyrocketed.” Further, he adds: “Our average days to close a deal [from letter of intent signing to deal close] increased from 95 days in 2008 to 125 days in April 2009.”

For deals to close in this environment, the gap between buyer and seller expectations needs to be bridged—allowing buyers to maintain their confidence level and protecting sellers against eroding values and retrading sales prices.

*Value retention and surety of close.* If value retention and surety of close were key goals of a transaction before, they are even more significant considerations for the foreseeable future.

This article takes collective input from transaction stakeholders—including strategic buyers and sellers, investment bankers, private equity groups and lenders—to check the street’s pulse about business sellers’ need to have their financial house in order when going to market.

Higher thresholds of scrutiny and diligence by buyers and lenders are now the norm. As a result, sellers can no longer go to market with less than optimal financial transparency and expect to attract a willing and able buyer and, at the same time, retain their perceived value.

*Seller due diligence: Bridging the deal health gap.* A key remedy to building confidence and maintaining trust is the clarity and transparency delivered through seller diligence. In seller diligence, a business owner hires a third-party due diligence firm to substantiate and prepare supporting documentation for the company’s financials before offering the company for sale. Since seller diligence teams often work on buy-side transactions, they can anticipate the buyer’s concerns. As a result, the seller’s diligence team proactively prepares the company to address requests and concerns head-on rather than being reactive to diligence issues a buyer may raise.

According to Thomas Dollhopf, principal at **Marwit Capital**, “Purchase-price reductions during buyer due diligence are common if inaccuracies or financial irregularities are uncovered. Sellers can eliminate the risk of this happening and greatly improve their credibility by hiring a firm to help them get prepared for all aspects of due diligence.”



Other antidotes are available in the seller diligence process. Assisting the seller with data-room preparation alleviates a significant burden. Optimal tax structuring and tax diligence generally becomes a major part of the transaction diagnosis. Additionally, as transaction closings are taking significantly longer, having someone on the team who can regularly update the financial health of the company is

value-added. Assistance in customizing the accounting language around earnouts, working capital and certain accounting definitions can be highly valuable. Finally, a working capital true-up is a regular deal negotiation point that can be easily addressed.

These remedies serve to increase the likelihood of a successful and timely transaction.

“Seller diligence reduces the risk of surprises surfacing in diligence,” says Cuellar. “The result is increased surety of close and value retention. Companies that cannot defend their numbers get retraded, destroying value for the seller.”

A senior M&A executive of a Fortune 50 company agrees: “You want the opportunity to position the issues before the buyer finds them—and they will find them,” he emphasizes. “Positioning of issues becomes very important in retaining value. If issues are identified early in the process and positioned well with the buyer, it takes away the buyer’s negotiating power. Not doing this can give the buyer a reason for walking away from the deal or retrading the purchase price.”

*When seller diligence makes sense.* Buyers often back away from a transaction when inadequately addressed red flags appear. Red flags—big or small—that are not addressed in a timely and satisfactory way create uncertainty and can cause an otherwise willing and able buyer to step away from the deal. Broken deal costs alone justify meaningful preparation by the seller.

Cuellar and **Sun Capital Partners Inc.** principal Matthew Garff agree that a prime candidate for seller diligence likely has at least one of the following characteristics:

- Poor financial management, accounting infrastructure and financial reporting systems (many times caused by an inexperienced CFO or controller, or even a lack of one)
- Lack of internal resources necessary to provide adequate attention to document preparation and to a buyer’s diligence requests; this is typically where the internal staff is stretched and

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only has time to focus on the day-to-day business

Closing a deal or not closing a deal may be the difference between a seller with less than optimal financial transparency and a seller with transparent financials. “It comes down to confidence in the financials,” explains Cuellar.

The Fortune 50 M&A executive introduced above also encourages seller diligence in the following situations:

- When multiple divisions or business units are being sold as a single asset, requiring pro forma financials, consolidation and elimination of intercompany transactions
- Division or product line carve-out or spinoff
- Companies that operate well, but want to keep an eye on the business and ensure no surprises come up in diligence
- Businesses with complex accounting structures, systems and confusing internal jargon

“Value retention is at the heart of the issue. Clarity in the presentation of the carved-out entity is critical to optimizing value,” this executive says.

*Don't misunderstand the role of an investment banker.* A frequent misconception exists that an investment banker's role is to be a one-stop shop for all financial aspects of the transaction. On the contrary, “an investment banker's role is to position the company in the market place, help prepare a sellable forecast and develop the deepest buyer pool possible,” says Cuellar. “When it comes to putting supporting details behind the numbers, an investment banker does not replace the role of an accountant.”

Rob Wendell, also a principal at Marwit Capital, agrees. “A good investment banker is typically focused on presenting an opportunity to a buyer universe in the best light possible—not necessarily focused on compiling professionally prepared due diligence information like an experienced accounting due diligence firm.”

When everyone's role on the deal team is properly identified and aligned, the seller begins to realize in tangible terms—surety of close, value retention, time savings, reduced stress—the value of having the right players for the transaction.

*An ounce of prevention is better than a pound of cure.* Seller diligence is preventative medicine for your transaction's health. Says Garff: “You don't want to go down the road six to eight months with imperfections that may cause the deal to fall apart. This incurs significant costs, such as missing add-on acquisitions you could have performed, management distractions and effort, and fees paid to lawyers, accountants and others.” He adds, “Seller diligence is an insurance policy against the risk that the buyer will find issues that erode value.”

Marwit's Dollhopf says, “When running a sale process, sellers need to stay focused on their core business, or they risk losing significant value. If Ebitda drops off because the seller is



distracted with issues relating to the sale process that could be managed by others, the value lost [Ebitda change multiplied by the transaction multiple] may far exceed the cost of engaging a firm to perform seller diligence.” He further emphasizes, “If Ebitda is already declining, the problem is compounded. Seller diligence pays for itself.”

Cuellar adds, “You don't want to pay for seller diligence in a retrade based on multiples. You want to pay for it by the hour.”

*Value retention: at the heart of the matter.* The prevailing theme conveyed by transaction stakeholders interviewed for this article is value retention and surety of close are at risk if sellers are not well prepared for a transaction.

Each stakeholder agrees—buyers are looking for reasons to reduce price or identify issues that will cause them to walk away. With careful preparation, sellers create a defensible position to retain value and gain the buyer's and lender's trust, resulting in more deals getting done. ■

*Milton Marcotte is a managing director and Dan Solomon is a manager with RSM McGladrey's national Transaction Support Services practice.*