Presale vendor due diligence: Seller know thyself

By William A. Chapman, CPA, CFA, Partner, Baker Tilly; Fred Floberg, Managing Director, The Chicago Corporation; and Craig McCrohon, Partner, Burke, Warren, MacKay & Serritella, P.C.

As buyers more frequently use due diligence to squeeze the purchase price, a growing number of investment bankers are recommending that companies better prepare themselves for sale. Company owners are now considering “vendor due diligence”—a presale self-investigation of the finances and operations of the target company.

Common in Europe, companies undertake vendor due diligence before the auction of the company. The practice enables the seller to control the timing and presentation of information, anticipate negotiation issues, mitigate potential risks, and maintain the pace of the sale process. The practice is becoming increasingly popular in the US as transaction-savvy businesses begin to understand the benefits.

> “If you know the enemy and know yourself, you need not fear the result of a hundred battles.”
>
> *– Sun Tzu*
> ***The Art of War***

What is vendor due diligence?

The purpose of vendor due diligence is to preempt price and deal structure disputes. The focus of the vendor due diligence may vary depending upon the facts and circumstances. However, the process commonly addresses topics that are critical to the value of the company and avoids unnecessary negotiation issues. These include:

- **Quality of earnings –** Earnings quality is viewed as high when the earnings metrics reflect sustainable cash flows. Usually this model includes add backs for discretionary expenses, nonrecurring expenses, and pro forma adjustments to reflect the sustainable cash flows.
- **Quality of assets –** Assets should be recorded accurately and include appropriate, associated liabilities and reserves in accordance with generally accepted accounting principles. Buyers often view inventory quality with a banker’s skepticism, not an auditor’s matter-of-fact valuation.
- **Debt and contingent liability –** Unrecorded debt, such as deferred compensation plans or unresolved litigation, can create significant purchase price adjustments, as they do not add value to the going concern.
- **Related-party transactions –** Significant transactions with related parties will require proof of fairness. Otherwise, the seller may need to adjust earnings and evaluate the risk of terminating the insider transaction.
- **Commercial due diligence –** If the buyer priced the deal based on continued growth of revenues and earnings, the seller may require an independent analysis of the seller’s market, including a survey of existing and prospective customers.

When should a seller consider vendor due diligence?

Larger and established organizations often undertake presale due diligence to validate the value of the company. For middle-market companies, presale due diligence may be the difference between a good price and no deal. Situations where presale due diligence is particularly critical include:

- lack of audited financial statements
- weak financial systems or controls
- complex deal structures, such as carve outs
- insufficient personnel to prepare for sale
- complex operations
- potential interest from European buyers

Reducing risk

Despite living and breathing their businesses, owners are often unaware of seemingly simple issues that can have a material effect on a buyer's perception of the relative risk of a company. Risks, if not addressed in advance, usually trigger demands for a lower price. The due diligence team can objectively assess some of the most significant risks, including:

- revenue concentrations
- gross profit concentrations
- dependence on key managers
- revenue volatility and operating leverage
- expiration of critical contracts, patents, or other competitive barriers to entry
- related-party transactions
- weak information and accounting systems

The due diligence process allows the seller and its team to generate data to mitigate risks and with it the arguments for a less favorable structure. Conversely, if the buyer's team identifies these matters, the seller will have nothing to fall back on other than bluster, which can work, but it is risky, dramatic, and unpleasant for all but the most theatrical of sellers.

Getting the best structure

Presale due diligence equips the advisors with information to determine an optimal tax structure and legal considerations. Data regarding asset locations, values, and holding periods enable tax experts to determine whether the seller should enter in to a stock, asset, merger, or other form of transaction. Similarly, legal consents and transfer of licenses can require months of planning and negotiation. These include both change-of-control clauses in license agreements and approvals from governmental authorities. Significant consents and approvals can delay a deal by months. Presale due diligence provides the information and time for such money-saving advance planning.

The better the due diligence, the better the price

The added leverage from pre-deal planning can lead to better terms. Buyers can demand long and one-sided representations, warranties, and indemnifications in situations where bad news comes late. The later the issue arises in the transaction process, the less likely the seller's team can credibly claim that the problems are known and limited. When the seller's deal team understands the company's strengths and weaknesses, the more aggressively they can seek concessions from the buyer. Like a driver swerving in the road to avoid an obstacle, the negotiators can avoid hitting a speed bump if they have advance notice.

Presale due diligence also prepares the seller's management for interviews with potential buyers. Sellers usually know their businesses intimately and instinctively, but have never needed to explain their operations to a third party. A buyer, while familiar with the industry, can never understand the business as well as the seller. Therefore, the buyer will likely dig methodically into company details. An industry buyer may also assume that the seller experiences the same kinds of issues with customers, vendors, regulators, and competitors that they experience. Preparing for the diligence process allows the seller to highlight the positive attributes of the business or explain the mitigating circumstances of negative perceptions.

Presale vendor due diligence: Seller know thyself *continued*

Unexpected issues that arise in the course of the buyer's investigation cannot be managed. With advance notice, the seller can research how the issue does not have the impact on the business as it may seem initially. In the worst case, a problem identified in advance that can be explained will keep the seller's credibility intact. Thus, the problem and the price reduction is contained to the one matter, rather than infecting all other aspects of the transaction.

For example, a buyer acquired a firm with a multiemployer pension plan. The plan was underfunded. The transaction was structured as an asset sale for tax purposes. The selling company intended to liquidate after the sale, but needed to post a bond as security for the potential, and significant, benefit plan withdrawal liability. In this case, the seller remained obligated for five years for any buyer withdrawal from the pension plan. The issue arose at the last minute, created much confusion, and delayed the transaction. All of the delay and angst could have been prevented within a presale diligence process.

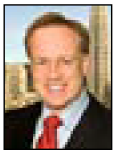
Investigate know, profit later

Vendor due diligence has been a standard operating practice for many years in Europe. In the US, the practice is quickly gaining acceptance, including within the private equity community. Presale due diligence, if properly completed, prepares the business and management for sale, accelerates the sale process, and optimizes the price and structure of a prospective transaction. If a prudent owner never skimps on preparing for a big customer, then why would he skimp on preparing for the biggest deal of his career?

Connect with the authors.

Bill Chapman, CPA, CFA
Partner
Baker Tilly
312 729 8020

Fred Floberg
Managing Director
The Chicago Corporation
312 729 8020



Craig McCrohon
Partner
Burke, Warren, MacKay & Serritella, P.C.
312 729 8020