Given the recent wave of private equity exits, in part due to the ready availability of financing and seller-friendly multiples, now is an ideal time to share some ways to help clients increase deal value and get to a quicker close.

Advisers can add value to clients’ exits by finding EBITDA add-backs, substantiating increased projections, identifying valuable tax attributes, and preparing management for the due diligence onslaught. The first step to exiting a portfolio investment successfully should be a thorough review of the financial and tax posture of the portfolio company. The most effective means to accomplish this is through sell-side due diligence.

Sell-side due diligence has become an integral part of the exit process, which more and more private equity funds are adopting as a critical aspect of exit. Many of these funds have realized the benefits of sell-side due diligence by:

1. Creating a smoother process that allows management to focus on running the business rather than running the process;
2. Minimizing surprises, which helps maximize seller credibility and buyer trust; and
3. Preparing management with appropriate responses to buyer questions and proactively implementing corrective and remedial measures where necessary.

The past 24 months has seen an increase in requests for sell-side due diligence in connection with private equity exit planning, with some private equity fund clients starting conversations as early as six to nine months prior to going to market. In general, the U.S. sell-side due diligence process differs from the traditional European-based vendor due diligence, which is typically more extensive and expensive, resulting in a diligence report that is often contractually relied upon by the buyer.

On the other hand, U.S.-based sell-side diligence may take many forms. It may take the form of a high-level review of the pertinent information, followed by discussions with management to prepare them for the buy-side due diligence process. Alternatively, it may take the form of a comprehensive due diligence report that the seller provides to potential buyers. This latter format helps in streamlining the exit by identifying material issues at the beginning of the process, as well as directing the bidders’ questions to the sell-side due diligence team so that management can continue to focus on running the business with limited distractions.

The first step in gracefully exiting a portfolio investment is a thorough review of the financial and tax posture of the company, as well as assessing the market for the industry and identifying potential buyers.

To take some advice from Mary Poppins, the beginning is a very good place to start. In this context, clients should dust off the financial and tax due diligence report that was prepared in connection with the fund’s acquisition of the portfolio company to be sold. The seller should review the report to confirm whether any adjustments to EBITDA have been addressed, whether all GAAP reporting issues have been rectified and any other issues have been appropriately addressed by Management.

While buyers use the due diligence process to propose negative quality of earnings adjustments for items like bad debt expense, insurance, legal fees, one-time adjustments, and non-recurring items, sellers can use the diligence process to identify and defend with diligence-based support, positive adjustments to EBITDA that potential buyers might otherwise fail to disclose. This includes EBITDA increases for over-accrued liabilities, loss contract reserves in the construction industry, anticipated medical claims for self-insured entities, and more mundane reserves such as inventory obsolescence and bad debt reserves.

Assisting clients with Management’s projections is another critical aspect of sell-side diligence. While buyers generally focus on contribution margins from material customers to predict future cash flows, portfolio companies may be in a transition period based on new business or product lines. The sell-side diligence process can support additional value for pipeline revenue for new customers or lines of business.

These points underscore the benefit to sellers of conducting sell-side due diligence in anticipation of a planned exit. An additional benefit of sell-side diligence comes from preparing the
CFO to competently discuss the GAAP issues with the bidders’ diligence teams. As often happens in middle market exits, the CFO’s accounting knowledge and skills may not have kept up with the complexity and growth of the business.

Like financial value drivers, tax-related value drivers should also be considered in sell-side diligence. Tax value drivers include tax shields in connection with high tax basis in PP&E and intangibles. If there was a step-up in tax basis when the portfolio company was acquired, the resulting high tax basis in PP&E and intangibles may provide a subsequent buyer with a valuable post-close tax shield. These tax shields can provide a clear cash tax benefit, thereby increasing a buyer’s free cash flow post-close. Other value drivers include NOLs (though these may become limited in the event of a change in control), and state and local business incentives if a buyer is able to combine the portfolio operations with similar operations, thereby increasing headcount and capital expenditures. Tax value drivers should be clearly identified and quantified in the confidential investment memorandum. This may include utilizing an incentives expert who can identify material tax incentives that a buyer can obtain, which may be particularly relevant in asset carve-outs.

Sell-side diligence may also carry over to the contract stage, primarily related to the calculation of post-close adjustments. In some cases, purchase adjustments based on post-close working capital changes were used as a method to capture intrinsic value that was not accounted for in the EBITDA multiple. Companies in highly dynamic industries (like healthcare, pharmaceuticals, and technology) that are heavily dependent on intellectual property assets and R&D, may find working capital adjustments to be an inadequate tool in identifying intrinsic value for assessing a fair purchase price.

To make an exit as successful as possible, accentuate the positive, understand and manage any negatives, and put your best foot forward. Sometimes this process takes time and a bit of spit and polish, as well as some thoughtful planning. Investing in sell-side due diligence can be a very useful tool in turning an otherwise uncertain process into a shorter and more lucrative result.

The views expressed herein are the authors’ views and do not represent the views of Houlihan Lokey.