Montage Partners
PEOPLE CAPITAL

SELL-SIDE QUALITY OF EARNINGS

WHAT BUSINESS OWNERS NEED TO KNOW

When selling your business, a lot goes into the preparation for the transaction. This can include long-term items such as creating a succession plan, creating systems to track and access business-level data, or even be more tactical as you approach your ideal exit date – such as hiring an investment banker or other advisors to help you through the process. One step that is becoming increasingly common in the middle (and lower middle) market is for business owners to commission a sell-side quality of earnings report.

WHAT IS A SELL-SIDE QUALITY OF EARNINGS?

Typically, in an M&A transaction, a quality of earnings (or QofE) refers to a report ordered by the buyer through a third-party accounting firm that assists in understanding a company's financial statements, appropriate adjustments to such financial statements as it relates to the business anticipated to be delivered at close, and highlights deviations from generally accepted accounting principles (GAAP).

A QofE is used by buyers to determine the normalized or "sustainable" EBITDA (earnings before interest, taxes, depreciation, and amortization) of a company, removing noise that can arise from non-recurring or non-business-related factors. If you stepped away from the company tomorrow, would any income or expenses change? Has the company been impacted by one-time revenues or expenses? These are the types of questions buyers look to answer to arrive at the EBITDA they'll use to help value the company.

A sell-side quality of earnings is essentially the same report, but commissioned by a seller in advance of launching a sale process.

What is included in a **QofE report**?

A wide range of topics related to the company is included in this report, such as:

- Basic financials: income statements, balance sheets
- Adjustments (or addbacks and deductions) to EBITDA
- Net working capital
- Net debt
- Customer concentration (or similar customer-centric analysis)
- Product (or service) revenue and margin
- Assessment of overall financials taking into account appropriate adjustments

ADDBACK EXAMPLES

Addbacks are adjustments to a company's EBITDA of certain expenses from the income statement that are non-recurring or non-operational items so that buyers have a more normalized and realistic picture of what level of EBITDA they're actually acquiring.

NON-RECURRING OWNER-RELATED COSTS

Non-recurring/one-time items that won't continue post-close

NON-RECURRING EXPENSES/REVENUES

Can be one-time legal fees, one-time consulting fees, costs related to temporary supply chain issues, one-time project revenues, etc.

OWNER COMPENSATION

For owners taking a larger-than-market salary or paying themselves a minimal/no salary, this line item is adjusted to a market salary to give the cost of the CEO (or other senior management) position going forward

RENT

If a business owner also owns the facility from which their company operates and does not charge the business rent, this will need to be expensed as part of the income statement going forward

HOW DOES A SELL-SIDE QUALITY OF EARNINGS BENEFIT A SELLER?

VALUATION VALIDATION

Most business owners have a valuation for their company in mind when they go to market that may or may not be in line with how buyers view the business. With a sell-side QofE, **you can be confident that the number you are bringing to the negotiating table is supported by independent analysis**, which can reduce fears of lowball offers. If the QofE adjusts the EBITDA upward, you've already done your homework to support this higher number. Even in cases where the EBITDA may be decreased, learning this in advance of buyer offers can eliminate an unpleasant surprise and allow you time to evaluate your options before any buyers are involved.

ELIMINATE BLIND SPOTS

Because a sell-side QofE is completed prior to launching the sale process, it functions as a "dry" diligence run. **A sell-side QofE forces you to evaluate the company from the same perspective as a potential buyer, which may uncover potential areas of buyer concern or important gaps in data.** Often these issues can be resolved by a seller prior to launching the sale process, creating a more "buttoned up" business. Issues found during buyer diligence efforts can sometimes result in renegotiation of terms such as price or escrow amounts, so it pays to avoid these arising during buyer due diligence.

Often the areas highlighted in a QofE aren't dealbreakers or issues for a buyer, but do indicate an area where the buyer may want to ask more questions during diligence, have more data, and gain a deeper understanding of the business. Knowing these in advance through the sell-side QofE gives you, your team, and your advisors a head start in anticipating these questions. **Being prepared expedites the transaction process.**

SELLER CREDIBILITY

Because a QofE incurs a cost to sellers, **it often acts a signal to potential buyers of the seriousness of your intent to sell**. It can also add legitimacy to the initial summary and data a buyer receives about your company, indicating they can expect organized data and less surprises during the due diligence phase.

SELL-SIDE QofE MYTHS

A sell-side QofE is the same as an audit

An audit is an independent evaluation of a company's financial statements, typically performed to determine the financial statements are prepared in accordance with the applicable framework in all material respects. **A QofE provides a different value in that it takes the internal financials of a business and produces "deal financials"**, which include much more detail and context about the company's past performance, usually including the latest months' operating results and balance sheets. Buyers will use these deal financials as the basis for their valuation of your company, alongside other items that buyers are considering about your business. Providing deal financials helps provide confidence to buyers and the overall deal process while sharing the very latest performance in what presumably is a growing business being marketed.

A sell-side QofE isn't necessary if I hired an investment banker

An investment banker's role is to lead the sale process from preparation of the business to closing. A sell-side QofE can be one part of this process and is increasingly recommended by investment bankers to assist in a smoother transaction and reduce the possibility of surprises. **The QofE will be used by the banker as objective support for the materials they will disseminate to buyers (such as the Information Memorandum), not as a replacement for these.** The work is complementary and often used during the investment banker's marketing process that then transitions into a buyer (or a group of buyers') diligence process.