THE BENEFITS OF CONDUCTING A QUALITY OF EARNINGS STUDY

The key to selling a business is high quality positioning. As your investment banker, we want to tell a clear and accurate story to the market, making sure that the intrinsic and extrinsic elements of value in your business are clearly understood. It is important to remember that positioning, however, is not just a verb, it is a noun. Buyers are sophisticated, and when making acquisitions they spare no expense when it comes to uncovering the truth. This often leaves even the most sophisticated sellers exposed to unknown risks after spending months of time and many dollars on a sell-side process.

Fortunately, many of these risks are avoidable through quality of earnings studies.

"Q of E"

What are Quality of Earnings Studies?

Quality of earnings studies (known in our industry as "Q of E") would be more aptly named if they were called "financial due diligence" studies. Unlike an audit, where the emphasis heavily is on the balance sheet, a Q of E is designed to provide a professional, third-party analysis of three things:

1 fact checking

EBITDA and earnings numbers are accurate (i.e., the books and records are well kept, accruals are made properly, receivables and inventory are appropriately tracked and reflected in the financial statements)

2 sustainable solutions

The variables that drive these numbers are sustainable long term (significant amounts of earnings are not tied up in accounts receivable, key customer trends are validated and strong, end-market segment reporting is accurate and precise, customer reporting information is accurate, etc.)

3 telling your story

The **"story" the investment banker is telling is empirically accurate and supportable** when buyers conduct due diligence

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What Do They Cost?

Depending on the deal and the audience of potential investors or buyers, quality of earnings studies cost between $20,000 and $80,000, but typically they are on the lower end of that spectrum.

Who Provides Them?

Q of E studies are conducted by CPA firms and specialized financial due diligence firms. It is important to use a firm that carries a reputation for quality and has the ability to withstand the rigors of private equity or strategic buyer financial due diligence.

What are the Benefits?

- Help Avoid Future Price Renegotiations
  - Defend or position large add-backs because they are validated by a third-party professional.
  - Most private equity buyers use debt to fund transactions (in whole or in part), which drives purchase price. Lenders usually will not issue final term sheets without the sellers conducting Q of E studies; therefore, having one done early helps ensure that valuations presented in letters of intent are more precise and accurate.
  - Uncover one-time, non-recurring add-backs or cost eliminations that you should get credit for. Because of the detailed nature of these studies, and the fact that you have another professional in addition to your investment banker analyzing the seller, it is not uncommon to identify add-backs for the Q of E firm to validate and the investment banker to advocate for its client.
  - Increase the likelihood of closing. Q of E firms present your financials the way buyers think about them. This process helps eliminate misunderstandings or miscommunications related to accounting interpretations.

- Shorten the Deal Timeline
  - Most buyers will not engage their legal counsel to draft closing documents until the Q of E is complete because of the risk of uncovering something important that may jeopardize the deal.
  - Nearly 40% of private equity deals in 2015 and 2016 have taken 15 or more weeks to close after the letter of intent because of financial due diligence issues that were not known prior to due diligence commencing.
  - Q of E studies typically take around 30 days. Completing this concurrently with your investment banker's process may eliminate altogether post-LOI delay.
  - The cliché "time kills all deals" comes into play. Every day that a deal is under letter of intent is another day something could change in your business.

- Positioning
  - Your investment banker is telling your story, and potential buyers devote resources (both money and time) to determine whether they believe that story. If your deal comes with third-party validation of the numbers, potential buyers are more likely to believe your story and pursue your business.
  - The objective is to package accurately an overarching great opportunity for investors. Great opportunity for investors means stronger valuations.

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