While many segments of the U.S. economy were still finding their legs in 2014, the domestic mergers and acquisitions (M&A) market sprinted forward at breathtaking speed.

According to FactSet, 11,913 merger deals closed last year, marking a 24 percent spike over the 9,609 M&A transactions recorded in 2013. While the biggest year-over-year increase (45 percent) occurred in deals over $1 billion, the middle market was close behind. In fact, mergers valued at $250 million to $500 million posted a year-over-year increase of just over 40 percent, and deals in the $100 million to $250 million bracket jumped nearly 36 percent in that same time period.

Clearly, 2015 may prove to be another hot year for M&A transactions, as investors and business leaders continue to be buoyed by a resilient U.S. stock market, plenty of cash on hand and low borrowing rates.

As a general rule, that means prospective sellers of well-run companies — including private equity stakeholders — can benefit from this competitive deal marketplace. However, firms that invest in sell-side due diligence will gain a significant edge in any transaction, since the process helps minimize surprises, while maximizing tangible value.

Using sell-side due diligence to maximize deal value, minimize negotiations

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Sell-side due diligence: a closer look

Buy-side due diligence has long been an integral part of any M&A process, mainly because it helps a prospective owner gain a complete picture of the transaction. Meanwhile, sellers historically have focused on selecting an experienced investment bank to market the business and negotiate an acceptable sales price. However, investment banks have a different focus and typically do not provide detailed assessments of accounting and financial data, forecasts on the transaction’s tax exposure or insight on issues that could derail a potential sale.

In the past couple of decades, the notion of conducting due diligence from the seller’s side gained traction in many European countries. But the trend did not start catching on in the United States until after the 2007 recession, when banks and other financial institutions tightened lending standards and steered clear of deals with even minor issues. In this environment, sell-side due diligence was vital to business owners and private equity investors, who needed every advantage to keep an M&A transaction intact.

Even with today’s improving credit availability and economic performance, investing in a sell-side due diligence process provides several distinct advantages, which are discussed below:

Verifying the accuracy of financial information. The easiest way to jeopardize a deal is to raise buyer concerns about the reliability of data offered by the seller. Because all relevant financial, operational and tax issues are reviewed for accuracy and GAAP conformance by an objective and credible third-party resource, sell-side due diligence directly addresses this issue.

Identifying adjustments that positively impact EBITDA. When prospective buyers conduct due diligence, their analysis looks specifically for any negative adjustments to EBITDA (earnings before interest, taxes, depreciation and amortization). On the other hand, a sell-side due diligence analysis can review historical financial performance, validate (or challenge) earnings assumptions and often uncover positive adjustments impacting EBITDA. That detailed, third-party assessment can not only increase the company’s purchase price, but reduce the likelihood of buyer renegotiations after a letter of intent has been signed.

Uncovering issues to avoid deal- killing surprises. No one likes to receive unexpected, last-minute information before committing to a major purchase decision. For example, if a company has a series of unresolved state and local tax liabilities in jurisdictions where it does business, those issues can represent significant tax, penalty and interest liabilities for a prospective buyer. A sell-side due diligence process would not only flag such issues, but provide management with options for fixing the problem or accurately presenting the information to prospective buyers, including the development of credible responses that address buyer concerns. This upfront disclosure helps build trust, keeps multiple buyers interested in the process, maintains deal momentum and eases final negotiations.

Navigating internal change. Sell-side due diligence can be an especially useful resource in situations where companies are trying to juggle an M&A transaction and internal role or culture shifts. These may include transformational events (such as leadership changes), the implementation of major cost-saving or process initiatives, the loss of significant customers or revenue sources and higher-than-average employee turnover. Conversely, an unexpected surge in revenue and customer growth can also cause internal stresses, which sell-side due diligence can help alleviate during the M&A process.

Allowing business leaders to stay focused on goals. When company leadership teams opt to take M&A due diligence in-house, they frequently underestimate the level of internal staff and resource support needed for adequate data gathering, analysis and reporting. When third-party, sell-side support is retained, it relieves stress on key personnel and allows the management team to focus on day-to-day operations and the achievement of key business targets in support of a transaction.¹

Addressing carve-out concerns

Sell-side due diligence is especially useful in circumstances where a specific business division is removed (or carved out) of an M&A transaction. A carve-out often has allocations between divisions, which can make it difficult to determine whether it is truly independent with dedicated management. Quite often, financial statements of the carved-out entity may be combined within other divisions, especially when the transaction only involves a specific product line.

In this type of situation, sell-side due diligence can be deployed during the divestiture process to reconcile historical financial data of the carved-out entity with comprehensive deal-based financials. This analysis can help all parties clearly understand the structure of the carve-out, how it connects to the larger business and what adjustments need to be made to the deal price because of its removal. By using sell-side due diligence, this information can be compiled quickly and accurately, helping instill confidence in potential buyers.

Sell-side due diligence: key tax issues

The tax ramifications of any prospective M&A deal are a significant issue for players on both sides of the table. By using sell-side due diligence, a business owner or private equity group can identify any significant tax issues early in the process and frame those concerns in the best possible light. For example:

Worker classifications. In recent years, the IRS has paid greater attention to how accurately businesses report information on their regular (or Form W-2) employees, where payroll taxes are deducted from each check, and Form 1099 contractors, who do not have taxes deducted from payments for completed work. This is an important issue to clarify before a business goes up for sale, as it can have a substantial effect on a buyer’s ability to accurately communicate any future liabilities for employment taxes and benefits.

Uncertain tax positions. The IRS has also been taking a closer look at uncertain tax positions, which certain corporations are required to report to the IRS if: (1) a U.S. federal income tax reserve has been recorded in audited financial statements with respect to a position, or (2) a reserve was not recorded with respect to a tax position because the corporation expects to litigate the position. Appropriate seller due diligence not only allows for a pre-sale review of this issue, but can help determine when, or if, any specific uncertain tax positions require disclosure to prospective buyers.

Accounting method changes. As part of a sound sell-side due diligence review, business leaders may learn that their current accounting methods may pose issues for a prospective buyer. This pre-sale discovery allows the company to run the numbers and determine if the business would be better positioned for sale with different accounting methods. If so, the seller would be able to make the changes before prospective buyers conducted their own review.

Aside from an early warning on potential tax issues, sell-side due diligence can also be a great tool for helping structure a transaction. A well-designed tax structure adds a significant amount of value to the seller, since it could generate a higher purchase price, while minimizing the owner’s tax liability.

Sound tax structuring can also identify key elements to make a deal more attractive to prospective buyers. If the seller has net operating losses (NOLs), or if the deal contains significant transaction or compensation expenses, these items can generate future tax deductions that can help a buyer offset post-transaction income. At the same time, the seller can use these potential tax benefits as a means to boost the company’s purchase price.

In every sale, it is critical to identify and structure a “tax shield” for the buyer that also maximizes the seller’s shareholder value. Typically, this involves a careful assessment of all potential deductions or losses that can be allocated to the buyer and a schedule of when those deductions can be taken. The elements of any tax shield are carefully scrutinized by prospective buyers, which means that sellers lacking expert due diligence resources may overlook lucrative tax opportunities. For instance, consider a company for sale where former tax advisors overlooked a new development and undervalued the company’s NOLs by $25 million. If this discovery were made by the seller’s due diligence team, it could easily result in a significant upward price adjustment and more compensation to the seller’s shareholders.

Conclusion

Having a sell-side due diligence report brings more credibility to the transaction process. It is possible to be too close to the day-to-day operations of a company and potentially miss warning signs or other concerns that could cause a red flag to be raised by a prospective buyer. Reductions in purchase price or deal failures are common if any irregularities are discovered or any issues are inadequately addressed. Sell-side due diligence helps to anticipate buyer concerns and satisfy expectations. It is a valuable tool to help the seller obtain value, save a significant amount of time in the transaction process and retain enough control to ensure that a resulting transaction is advantageous for both parties, not just the buyer.