A seller of a business should utilize all the tools available that help optimize value to ownership, management and other stakeholders and minimize disruption to the successful operations of the business. And while quality companies in the current deal environment attract abundant interest from private equity firms and strategic buyers seeking to deploy records amounts of capital, the scrutiny a target is placed under during the due diligence phase has increased fundamentally for the foreseeable future as a reaction to the shock created by the global financial crisis.

A growing trend in the U.S. to prepare a company for sale is the performance of a due diligence process before taking the company to market. Referred to as “sell-side due diligence,” this process supplements the work of the seller and their investment bankers. With an additional team member on the sell-side with financial, tax and operational expertise executing the analysis, the seller increases the speed to close, the certainty of close and the final valuation at the closing table.

By conducting this due diligence analysis prior to going to market, issues that would otherwise slow the sale are identified upfront and presented in an open and clear manner so that corrective measures can be implemented. Also, in many sale processes, investment bankers are effectively using a sell-side due diligence engagement to greatly reduce the scope of the buyer’s due diligence. These factors combine to improve the speed to closing.

Due diligence performed by a buyer and their advisors will invariably find issues that are critically important to sophisticated acquirers and investors. This is generally a result of a seller not anticipating issues because of either their focus on operating the business or their relative inexperience with

“A Growing Trend
Preparing a business for sale through sell-side due diligence

Steven E. Brady, Grant Thornton LLP

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Due diligence performed by a buyer and their advisors will invariably find issues that are critically important to sophisticated acquirers and investors. This is generally a result of a seller not anticipating issues because of either their focus on operating the business or their relative inexperience with the process of selling a business. Even sophisticated sellers and their teams will not identify all the important issues to potential buyers. Uncovered in buy-side due diligence, and not effectively anticipated by the seller, these issues can lead to renegotiations that have the potential to derail the deal. Sell-side due diligence puts these issues on the table upfront and minimizes unwelcomed surprises arising in due diligence, and thus can dramatically increase the certainty of closing the deal.

These same types of issues often lead to changes in value when discovered by the buyer. Many sellers have not had the benefit of prior experience selling a business and may not know all the factors that drive a thorough analysis of the quality of earnings, and how that analysis effects the final valuation. Sell-side due diligence provides the framework for definable and defendable positions which provide the foundation for the sell-side team to explain positions to potential buyers and their advisors, and optimize valuation at closing.

The use of this tool is increasing in the U.S., although not widely used at this time. In Europe, a similar process called vendor due diligence is commonplace. An important distinction is that in vendor due diligence the service provider has a duty of care obligation to the ultimate acquirer of the business, even though that party is unknown when the process begins. This heightened standard of care built into the process is one of the factors that has driven more and more buyers and sellers to demand it as the accepted method for due diligence in the acquisition process.

In sell-side due diligence in the U.S. the
investment banker works with their client to engage a third-party due diligence provider to work closely with all parties throughout the process. All parties need to work together to design a work approach that focuses on the key areas that would be of interest to potential investors; however, the advisors’ responsibility remains with the seller.

Perhaps the most difficult part of this process is convincing a seller of a business to engage an additional advisor to provide this service, and incur the expense before the sale process begins. It is often easier for a seller to allocate a portion of the sale proceeds to their investment bank than to write a check for sell-side due diligence upfront, yet the benefits derived from this process consistently demonstrate a high return on this investment.

As a result, the service provider, investment bank and client need to have an active dialogue before the process begins, so that the client may understand, appreciate and value the benefits this process can bring to them – especially relative to the cost.

Time and time again, sellers that do not adequately prepare for a sale process are unpleasantly surprised when financial analysis and inquiries during due diligence reduce the value the prospective buyer places in their business or exposes issues that require structural changes to the deal.

Sell-side due diligence is part of an overall strategy of transaction readiness that many effectively run businesses employ. Very simply, the sooner issues of importance to an investor are identified, the more effectively they can be mitigated through meaningful improvements to the business. This will improve speed to, certainty of, and valuation at closing of a successful deal.

Steven E. Brady is the National Managing Partner – Transaction Advisory Services at Grant Thornton LLP

Community Commentary

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