Private equity exits are expected to gradually increase this year, as the economy steadily improves. Another factor driving growth in deal activity is the looming expiration of federal capital gains tax cuts, hastening the deal process to ensure completion by the end of the year. The tax rate is set to increase from 15 to 20 percent in January 2013, and other projected increases could result in an effective tax rate of almost 24 percent. The possibility for an extension of the current rates exists, although for those already considering a transaction, now is the best opportunity to secure a lower capital gains rate.

With this heightened amount of deal activity combined with greater scrutiny from many directions, the role of sell-side due diligence has never been more critical. Concerns brought to the surface by buy-side due diligence have increasingly delayed deals, caused them to fail or eroded the value of companies due to unanticipated issues. In this atmosphere, it is imperative to retain control of the sales process and provide a transparent, balanced and credible view of the business to establish trust with a potential buyer and expedite the deal timeline.

Sell-side due diligence allows the seller to avoid surprises, maintain control of the process and minimize disruptions, preserving value and increasing the probability of a successful transaction.

Role of an investment bank

While engaging an investment bank is a good first step, their role is to market the business and receive an optimal price for the seller. However, they do not:

- Reconcile, align or scrub the data as the potential buyer and their advisors would
- Provide a “buyer’s view” of the business to be divested, including the all-important analysis of both historical pro forma and forecasted pro forma operating results (i.e., EBITDA), prior to going to market—this minimizes surprises and maximizes value and speed to close
- Provide an initial view of tax exposures and how to effectively manage and communicate them to prospective buyers
Sell-side due diligence provides these benefits, working in conjunction with the investment bank to add supporting details to the numbers. There are distinct roles in the transaction process, and when they are properly defined and filled, the seller is much more likely to receive maximum value from a buyer.

**Properly preparing for an acquisition**

The growth in sell-side due diligence is largely attributed to sellers and investment bankers recognizing the value of this service. The amount of previously failed and delayed deals have encouraged groups to seek assistance on the sell-side to ensure financial, tax and operational details are properly positioned prior to buyers evaluating the business.

Sell-side due diligence is gaining more traction as sellers understand the value of being prepared. Several questions and information requests will be presented as part of any buy-side due diligence exercise. Oftentimes, sellers underestimate the amount of diligence required to get to close. Sell-side due diligence adds valuable bandwidth to the management team, relieving stress on key personnel, allowing them to focus on the day-to-day business and ensuring that targets are attained, while historical results are successfully prepared in anticipation of a transaction. A firm providing sell-side assistance also helps to identify potential “add-backs” at a detailed level that certain investment bankers may not focus on, thus increasing the enterprise value of a business.

As an example of negative results without sell-side due diligence, our team performed the buy-side due diligence for a client, which resulted in finding a number of issues at the target company. Had that company been better prepared and understood where some of their deficiencies were ahead of time, those obstacles likely could have been overcome, and a deal may have been made. Instead, our client walked away from the transaction, losing valuable time. Months later, the seller engaged us to help them with the sales process, which resulted in an expedited transaction at a value slightly higher than originally projected.

**Carve-out concerns**

A transaction involving a carved-out division inherently presents unique issues. A carve-out often has allocations between divisions, with certain difficulty determining whether it is truly independent with dedicated management, and oftentimes, the financial statements may be combined within other divisions—especially when the transaction only involves a specific product line. Bridges are required throughout the divestiture process to reconcile historical financial data with the ultimate deal-based financials. From a seller's perspective, sell-side due diligence helps to truly understand the structure of carve-outs and historical business trends, making the situation easier for a potential buyer to comprehend.

The quicker this information can be compiled, the more confidence a potential buyer will have. If a buyer comes in, and either the structure does not make sense or the seller is not prepared to answer pertinent questions, the buyer will likely exhibit some uncertainty. That lack of confidence normally equates to a decrease in enterprise value. Every carve-out is different; however, the complicated nature of such transactions dictates that they are prime candidates for sell-side due diligence.

**Bringing issues to the forefront, especially from a tax perspective**

A company evaluating a business for purchase will find any potential issues within a company, and sell-side due diligence helps to frame those concerns in the best possible light from the outset. For example, companies often have a number of state and local tax exposures that can be jarring to a prospective buyer if the seller has not effectively thought through them. With sell-side due diligence, a seller can position those liabilities and implement corrective protocols to mitigate exposure prior to speaking with a buyer.
Assuming that a potential buyer will not discover an issue is the wrong philosophy. Not knowing that an issue exists in the first place can also be problematic. The seller should assume the buyer will have concerns from a different lens, because they likely will, potentially resulting in a deal failing or the value of the company diminishing without the right amount of support from the outset.

A sell-side report must be fair and balanced and can be very revealing about a company, but it is an opportunity to control the perception of exposures, rather than being reactive. The latter often results in the buyer and seller having differing viewpoints on the issue’s effect on the purchase price of the company. Being direct helps the seller remain in control of the process, saving time while retaining perceived value of the company and promoting trust.

**Further tax considerations**

There are several items related to tax exposures, future deductions and carryforwards that could have a significant effect on the success of a transaction. Corporate tax liabilities, such as extensive state and local tax exposures, and non-income based tax issues, such as employment tax and employee classification, can be deal killers if not properly understood and disclosed. Sell-side due diligence helps to uncover and position any tax matters before they have an opportunity to negatively affect the value of the company.

Another area where sell-side due diligence can be advantageous from a tax perspective is the ability to structure a transaction as tax beneficial as possible for the seller. A successful structuring adds a significant amount of value to the seller, providing more revenue from the sale and minimizing tax liability. If the seller has net operating losses (NOLs), substantial tax attributes, or if there are significant transaction costs or compensation expenses surrounding a transaction, those items can generate future deductions for the buyer. Sell-side due diligence can assign a value to the tax attributes that will be delivered, often referred to as a tax shield, resulting in purchase price increases in many transactions.

It is critical to identify and structure the tax shield that is delivered to the buyer in a manner that maximizes the seller’s shareholder value. Our team performed sell-side due diligence for a company that was a target for a purchase, and their former tax advisors had overlooked a new development that undervalued the amount of NOLs in the transaction by up to $25 million. This discovery resulted in a significant price adjustment and more compensation to the seller’s shareholders.

Another common feature of sell-side due diligence is an analysis of the tax shield that is going to be delivered to the buyer to outline exactly when the buyer can use any deductions and losses. Once that is determined, a framework for appropriate compensation can be developed.

In some situations, a potential buyer has already taken those tax benefits into account, but that is not always the case. The majority of buyers will negotiate the tax shield and there are subsequent purchase price adjustments made accordingly. There are no guarantees, but without sell-side due diligence, there may be lucrative tax opportunities left on the table if not pursued.

**Is sell-side due diligence a good fit?**

Companies often think they can perform the necessary due diligence requirements in-house prior to a potential sale. In certain situations, a very simple business with the proper resources and no history of transformational changes may not require an outside adviser. However, classic examples of where sell-side due diligence should be used are companies that have:
An unsophisticated or “lean” accounting team

Undergone certain transformational changes, such as leadership changes, acquired or sold business or divisions

Implemented or are in the process of implementing cost-saving initiatives

Suffered changes in the customer base or employee turnover, especially in key accounting roles

Experienced growth

These are all situations where sell-side due diligence can add significant value. If a company is unsure of whether sell-side due diligence could be beneficial, some outside companies offer an initial assessment to grade how well a company is prepared for the transaction process.

**The value of sell-side due diligence reports**

A sell-side report will often eliminate the majority of the questions that a potential buyer will ask from the outset, as answers are already contained in the report. This helps to expedite the process, removing a significant amount of deliberation that often occurs with buy-side due diligence. The remaining questions normally involve testing some of the larger assumptions or commentary in the report. Any other business or risk issues that have been identified in the process are also evaluated, as a prospective buyer will want to make sure they have a complete understanding.

Another challenge that sell-side due diligence can alleviate is managing an involved process where questions must be answered from multiple potential buyers. The service can preserve management’s time, while satisfying the demands of any number of buyers. This is certainly an important factor to consider when dealing with bidding situations.

**Conclusion**

Having an independent sell-side due diligence report that is fair and balanced certainly brings more credibility to the transaction process. Companies often think maximizing their value is accomplished by including all of their add-backs in a report, but minimizing or not including any negative issues is a problem waiting to happen. A potential buyer may discover negative issues (whether perceived or actual), so it is better to be transparent, position them in the best possible light and support those conclusions.

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. A comprehensive sell-side due diligence report (or even limited scope sell-side assistance) helps to anticipate buyer concerns and satisfy expectations. It is a valuable tool to help ensure that the seller retains value, saves a significant amount of time in the transaction process and retains enough control to ensure that a resulting transaction is advantageous for both parties, not just the buyer.
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