DUE DILIGENCE 101

Prepare

TEAM

Your team should include your CPA firm, an attorney, and other trusted business mentors. You need independent minded professionals who can help you through the process. Do not rely on the sell-side to provide you all the information needed.

TRANSPARENCY

The best company transitions happen in the open, with full access to all senior members of the management team (especially CFO and Head of Sales). If a seller and/or broker limit your access after a letter of intent is signed, beware. Your team's ability to go in and ask questions of all senior management allows you to conduct quality due diligence.

Revenues/Customers

CONCENTRATION

In general, the more diverse the customer base, the better. Concentrations always increase the risk of the company, even with top quality customers. Examine what percentage of sales the top customer accounts for, as well as the top 5 and top 10. Even better, see if you can find out how much each of these contribute in terms of profit. If the top three account for more than 35% of total, run a financial projection if two of them are lost the day after you close. If the business can still cash flow adequately, it is still a deal worth considering. Have the seller call the top customers with the buyer on the phone, to just see the state of the relationship and their plans to use the company in the future. Consider a seller note tied to retention of a key customer/ key event for the business. If the customer/event is not retained in the following year, the note should be forgiven to right-size for the loss.

- **Case Study:** Live Oak was asked to finance the acquisition of a high-precision machine shop with one customer who was accounting for 50% of sales. That customer had been with the company for several years, consistently growing sales. The seller represented a very good relationship with them. However, the loss of this customer would severely damage the company, so we declined the loan. Our borrower got another bank to approve the loan. One week before closing, that major customer called up the company and informed them they were taking all production in house, within 60 days. Luckily, our borrower got out of the deal. If that call had come one week later, that company would have tanked immediately. Don't forget to check on any suppliers that are critical to the success of the business. Make sure the company is in good standing, and that terms won't significantly change once you have purchased.

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QUALITY

Some companies may lower their credit standards prior to a sale, in order to increase revenues and profits. An examination of the Accounts Receivable (A/R) aging is vital, especially examining any accounts which have aged 60+ past the invoice date. If more than 10% of Accounts are over 90+ days, it may indicate a poor-quality customer base.

- **Case Study:** A LOB customer closed on a loan where over $100,000 of A/R was in the over 90 day category. The seller represented this was just a normal payment pattern with these three customers. However, once the loan closed, the clients all remained unpaid. The company is still doing fine, but that $100,000 loss to future cash flow hurt. It should have been a reduction in sales price.

STABILITY

Ask for the top ten customers sales volume over the past three years. Are most increasing? Are the names the same year after year? If so, it shows the company is providing a good product or service and should have a more stable revenue base to grow from. If customers drop off, find out the reasons why. New competitors?Product quality issues?

SEASONALITY

Get a quarterly historical pattern of revenues. Make sure there is enough working capital in the buyer's budget for these normal seasonal fluctuations in the business.

- **Case Study:** We closed a roofing company (replacement & repair) in December in a market where the winters are severe. As it turns out, the snowfall was above average that year, and most roofs were snow-covered until late April. Obviously, not many roofs were replaced for the first four months. This led to a shortfall in cash, and LOB increased a line of credit. By the way, the company did great once the snow finally melted.

CYCLICALITY

How susceptible is the business to an economic downturn? One way to gauge is to ask for financial statements from 2007-2010, to see what impact the last recession had. Can the company survive a similar decline in revenues and profits off the current run-rate once it has the acquisition debt on it? If the company does not have records from that time, just investigate the normal cycles of the customer base. For example, LOB will not finance any business tied to new housing starts. Historically, new residential construction dips to very low levels in a recession. Test the target company's cash flow. How far can revenues and margins decline (typically both dip in a recession) before the company is no longer able to service its obligations?

REVENUES PULLED FORWARD

If a seller is smart (and they usually are), they may be tempted to sell very hard just prior to a sale, especially if they are keeping the A/R as part of the purchase agreement. They can offer discounts, or other incentives to their customers to book sales prior to close. If they do, the buyer may experience a revenue "trough" right after closing. We have seen this behavior in many deals we have financed. Usually a company recovers from it, but it makes the first few months of ownership very stressful. To prevent, ask for monthly sales report each month prior to closing. If you see a spike, dig in and understand why.

COASTING TO THE FINISH LINE

A similar impact to the revenues pulled forward is felt by the company if the seller loses focus on driving sales in the period leading up to the sale. The buyer can experience a revenue "trough" due to the lack of leads and sales activity. To monitor this, ask for the historical sales pipeline of the company or however the company tracks future orders. Make sure you don't see a sharp decline in the months leading up to the sale.

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VERIFICATION OF REVENUES

In order to verify revenues, we suggest at a minimum to have the buyer's CPA conduct a reconciliation of the business deposits over the past year (from copies of the bank statements) to the reported cash revenues for that same period. This is probably the most common complaint of the early problem loans we have seen. The buyer says that the revenue/customers represented by the seller were overstated. We do get tax transcripts from the IRS to verify the seller tax returns, but more due diligence is needed to verify that those numbers are accurate.

- **Case Study:** We recently worked with a buyer to validate the sales and expense figures that a seller was claiming. Tax returns and interims were vastly different. LOB and the buyer both reviewed the past 2 years of bank statements in tandem to determine if the revenue and expense levels were accurate. After determining the cash collections were over $400k less than claimed, the buyer elected to walk away from the deal.

INVENTORY

Verify the inventory being purchased is salable. If the seller is willing to sell a large portion of inventory as part of the transaction, ensure that the inventory is not obsolete and has not been sitting on the shelves for a significant period. Study the company's normal cash conversion cycle and normal inventory days/turnover.

Employees

WHAT HAS THE SELLER'S ROLE BEEN WITH THE COMPANY?

If they have been passive, they can obviously be replaced. However, if they hold key relationships or hold specific key knowledge of the product or service, the transition becomes vitally important. Consider a contingent seller note to ensure their continued interest during a transition period if they are important to the business. Are there special licenses required to do business? On a side note, explore why they are selling. If the seller is still relatively young and are leaving to pursue "other interests," beware.

WHO ARE THE OTHER KEY EMPLOYEES?

Who holds the relationships with the customers? Are these people tied to the company through non-competes/non-solicitation agreements? Are they aware and supportive of the sale?Are there pending retirements? Have any key employees left in the past year? Who possess the technical knowledge to run the business? The buyer should consider incentives to keep these employees with the company.

- **Case Study:** Live Oak financed the purchase of a veterinarian practice where the main practicing vet had been promised the opportunity to buy the practice. When a new owner came in, this vet left the practice and opened next door to the buyer. He also took most of the staff with him. Of course, none of this was mentioned as a possibility by the seller. Know who is key to the business and plan how to retain and motivate.

Margins & Cash Flow

Most companies trade on a multiple of Earnings Before Interest Taxes Depreciation & Amortization, referred to as EBITDA. In most cases, the reported EBITDA is "adjusted" by the seller to reflect "normalized" operations. A vital piece of due diligence is making sure you verify any adjustments.

ADDBACKS

Many adjustments to the reported EBITDA are valid addbacks. To be valid, they must be quantifiable & verifiable. For example, the seller's salary (assuming they are leaving the company) is a valid addback. It can be quantified and verified through the company's tax return, payroll journal, or a W-2.

- **Case Study:** A client looked at a business that was marginally profitable. However, the seller represented that a portion of

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expenses were related to an internet start-up that would not recur going forward. However, the buyer discovered after closing that those expenses were core to the existing business. In this case, a quality of earnings should have been conducted since the expense allocation was critical to the deal.

TREND ANALYSIS

Seek to understand significant changes in margins or sales. Beware situations where the margins (or sales) greatly improved in the most recent period. If the reasons aren't extremely well-defined and verified, consider basing the valuation on the average margin over the past few years. Remember, in cash basis accounting, not paying your bills can lead to higher reported profits. Make sure you examine the company's Accounts Payable to guard against this.

Equipment

PHYSICAL INSPECTION OF ALL EQUIPMENT

Is it in working order? Is a clear equipment list included in the purchase agreement?

- **Case Study:** In a veterinarian practice acquisition, the buyer discovered the X-Ray machine was non-functional. Unexpected $100,000 expense to buy a new one. In another instance, a buyer of a machining business discovered two CNC machines had been damaged by water intrusion a few weeks before closing, leading to repairs exceeding $50,000.

- **Case Study:** We funded a landscaping business where the buyer claimed that a vast majority of the equipment he purchased turned out to be held by a separate legal entity of the seller. The seller took the equipment as his own after the sale and left the cupboard nearly empty.

Deal Structure

WORKING CAPITAL

Congratulations, a multiple of EBITDA as a purchase price has been agreed upon. In almost all cases, the seller retains all cash in the company, and pays all funded debt of the company. In a stock purchase transaction, the working capital (Accounts Receivable (A/R) + Inventory – Accounts Payable and other current accrued liabilities) should be set at a normalized level. At times, a "target level" is set, and the difference in working capital at closing can lead to a slight increase or decrease in the purchase price. Typically, the seller should not retain the A/R in a stock transaction. In an asset purchase, the A/R may or may not be retained by the seller. If A/R is retained by the seller, this will effectively increase the overall purchase price, since you will need cash to fill this initial hole in the balance sheet after closing. Make sure you factor this in when agreeing upon a purchase price. This is an area where a seller may attempt to get more than what their company is worth by tacking on A/R.

- **Case Study:** In a stock purchase, without a target working capital provision, a seller slowed the payments on Accounts payable prior to closing. This put our buyer behind with their creditors from the start and chewed up a lot of the deal working capital to fix.

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