Coeus Management LLC

Due diligence insights

How to Focus on “Quality” in Quality of Earnings Reports

A well-known private equity firm acquired a $40 million in sales company in the consumer brand name space based on an EBITDA estimate for the current fiscal year of $6 million. This estimate was provided by a seasoned investment banker in its Offering Memorandum. The purchase price was $36 million or 6 times estimated EBITDA. The company was only half way through the current fiscal year, but had a backlog of orders which it projected would yield $40 million in sales and a 15% EBITDA. Further, the company was experiencing recent revenue growth with its branded product for athletes and other active sports enthusiasts. As part of its due diligence, the private equity firm engaged a CPA firm to complete a quality of earnings report to validate the financial statements and make sure the books and records were being properly maintained.

Post-closing, the private equity firm then engaged an operational consulting firm to develop a detailed cash flow model to determine working capital needs and validate the order backlog, current bookings, supply chain and earnings projections.

After spending three days at the Company completing due diligence on its projected sales by customer, order backlog, returns history, existing inventory, supply chain analysis, timing of product inventory delivery from China to fill orders, cost of sales, overhead and other factors that would impact EBITDA during the year, the consulting firm determined that the projected EBITDA would only be $4 million or a 10% EBITDA during the current fiscal year and that the private equity firm had substantially overpaid for this acquisition by $12 million.

Financial buyers will often engage a CPA firm to provide a quality of earnings report as part of its pre-acquisition due diligence, primarily to make sure the financial statements are in order, that the working capital accounts of receivables, inventory and payables are properly stated, and that the books and records have been correctly maintained according to GAAP or Generally Accepted Accounting Principles.

Coeus Management LLC is a boutique management consulting and restructuring practice providing due diligence services to investors and lenders and helping companies effect change to improve financial and operational performance.

When acquiring a Company, a financial buyer is often at a disadvantage to a strategic buyer who knows the industry extremely well, understands the metrics that drive the business plan, understands the bottlenecks to increased profitability and has a strategic vision for how the acquisition will fit within its own corporate structure, including being able to add a product line or customer base, improving purchasing and reducing inventory and warehousing needs, thereby improving gross margin and reducing overhead. The traditional approach to assessing quality of earnings, however, does not tend to evaluate operational issues or the management team's capability of meeting the business plan drivers and targeted metrics. And the diligence team pursuing that traditional approach would have no reason to include those experienced in operational and hands-on management, essential to such an in depth review.

What needs to happen in the due diligence process is that the non-strategic buyer or private equity firm, if it wants to make sure it is buying what will be a good portfolio acquisition at a fair price, should ensure its quality of earnings diligence really gets to grips with how, where and why, the target company makes and loses money. This should not be separate to the Quality of Earnings ("QOE") Review but an essential part of it. It is this that enables the QOE Report to answer two of its key questions:

- Is the target's earnings performance repeatable?
- How solid is the target's cash flow, and what are the ongoing working capital and capital expenditure needs?

The traditional QOE report often focuses almost exclusively on an accounting review of performance – to have it also cover the all important commercial rationale of the target, those conducting the analysis need to have deep operating, financial and hands-on management experience.

With the engagement of such an experienced team, the private equity firm will be able to make a much more informed decision regarding management, price, the target's ability to meet performance goals, cash flow needs and viability.

Here is what is involved in completing a thorough due diligence process by the evaluation team:

Business Plan Assessment

A good business plan is a "bottoms up" plan that consists of a strategic plan for the business as well as a detailed monthly income statement, balance sheet and direct cash flow that have been fully integrated. The plan should have key metrics identified to drive the business plan, with input and sign off by all the key functional managers in the business. A warning sign would be if: (a) a company has not prepared a detailed business plan, or (b) the company has not identified specific metrics to drive the plan results, or (c) the plan has been prepared by senior management without buy in and sign off by the key operating management team responsible for running the business. Such a plan is usually called a "top down" plan.

Assuming that there is a detailed business plan in place, along with metrics, then the due diligence process would involve determining whether it is reasonable to expect the management team to be able to meet those metric targets. For example, the sales projection should be supported by a detailed list of products by selling price and margin along with a list of customers, order backlog, orders pending, pricing and margins, return history, discounts and other sales offsets. If products are licensed or patented, there should be an evaluation of the license agreements or patents.

There also needs to be an evaluation of whether the company is able to meet its targeted delivery dates by evaluating the manufacturing process, manufacturing inefficiencies, distribution or supply chain issues and other bottleneck issues. Further, there needs to be buy-in and ownership of the metrics by the key functional members of the management team, or a "bottoms up" plan.

Quality of Earnings Analysis / Financial Assessment / Cash Flow

Four areas of focus

At the heart of a truly informative Quality of Earnings Report will be an understanding of what makes money, and why, and what loses money, and why. A good grasp of these is critical for an insightful analysis of past results and projected performance, and for forming a judgment on any appropriate normalization of earnings.

An appreciation of the business' key value drivers provides a comprehensive framework for the quality of earnings assessment. The value drivers will be those that influence: sales growth, profit margins, working capital investment, fixed capital investment, income taxes, and funding availability / cost.

These in turn can be examined through the following 4 areas of focus:

Focus 1	Focus 2	Focus 3	Focus 4
Determine what drives EBITDA	Test business plan assumptions and earnings sensitivity to changes in operational and financial parameters	Review balance sheet items for potential effects on earnings and cash flow	Funding capacity, covenants, leverage, financial structure

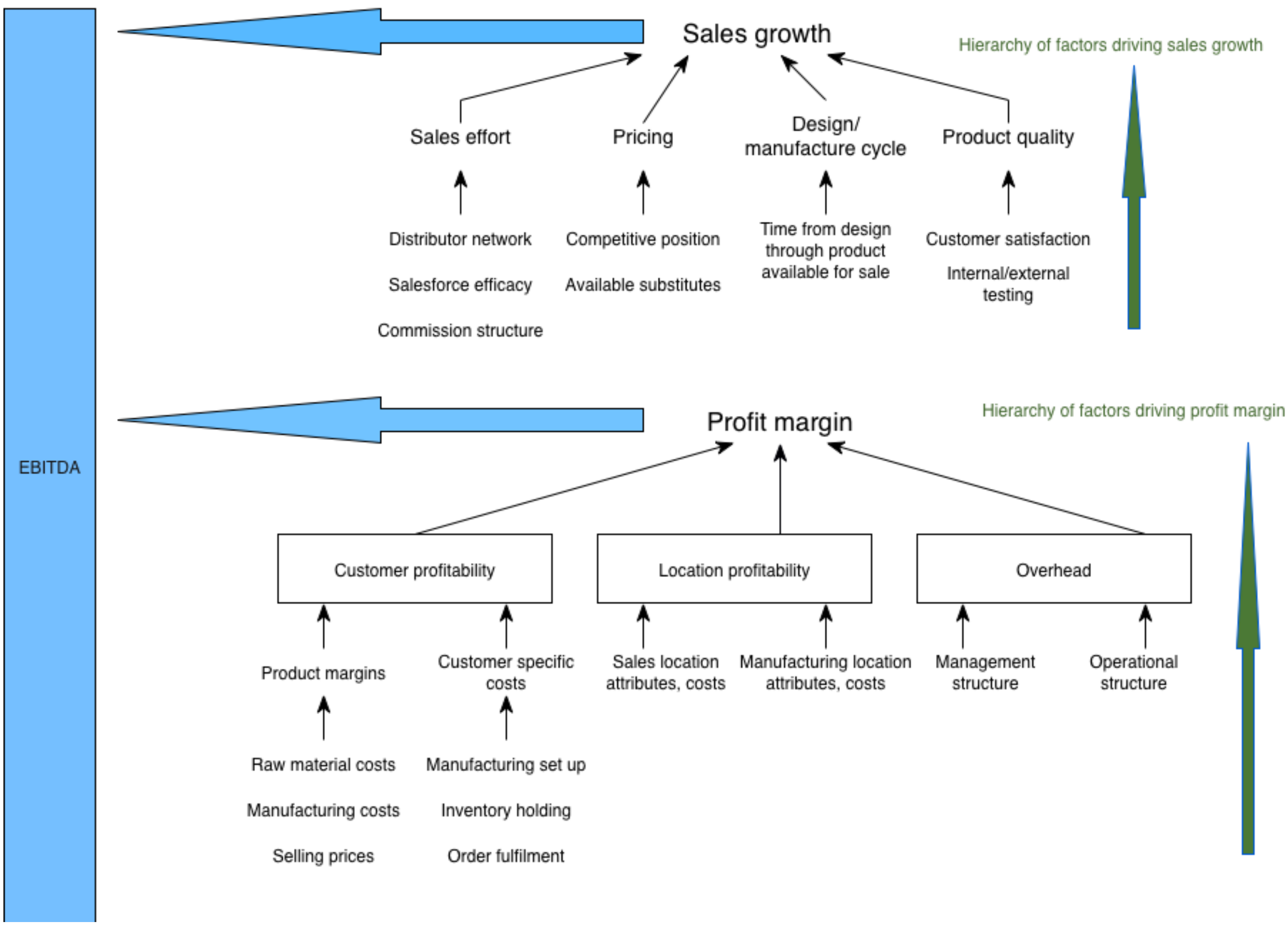
Each area of focus is explored below.

Quality of Earnings Analysis

Focus 1	What drives EBITDA

Examine the key value drivers of sales growth and profit margins to determine what really drives and impedes EBITDA. Understanding these and any other value drivers requires distillation of their contributing elements.

This is best illustrated by way of the following example applicable to a generic consumer products company.



An in depth understanding of what drivers are particularly relevant and influential to the business allows for a rigorous analysis of how the company has performed, and how it may do so in the future.

Focus 2 | Test business plan assumptions

An integrated[1] financial model should be used to facilitate:

- A testing of the assumptions incorporated into (any) projections being relied upon.
- An understanding of how changes in the (recent) past may point to future performance, and what, if any, normalization of earnings are required to provide a clearer picture of trending performance.
- An assessment of how any accounting changes impact projected earnings trends

The model will also be an effective tool for understanding cash flow and the potential impact that changes in both internal and external factors can have.

The integrated model should be reflective of:

- The key metrics that drive sales growth and profit margins
- The cyclicality of sales and inventory build
- Working capital needs (which will incorporate any cyclicality)
- Capital expenditure needs
- Income tax assumptions
- Returns to lenders and shareholders.

[1] An integrated Profit & Loss statement, Cash Flow and Balance Sheet

Focus 3 | Review Balance Sheet

The balance sheet will be reviewed for anything that may be relevant in understanding the company's past and potential future performance. The key areas of interest are typically the main working capital components of inventory, customer receivables, vendor payables and accruals, and aspects of fixed capital such as maintenance, replacement and capacity.

In the area of working capital, unusual or atypical changes in absolute dollar amounts or turns for inventory, and days' payables and receivables may point to a number of potential earnings affecting issues, such as:

Inventory

- Overstocking, with potential write downs to follow
- Obsolete, out of date inventory
- Channel stuffing, that may impact future sales levels
- Inadequate levels to support sales projections

Customer receivables

- Cash collection issues, bad debt write-offs
- Customer dissatisfaction, potentially affecting future sales

Vendor payables & Accruals

- Overdue payments may be an indicator of, or lead to, supply problems that will hinder production and sales levels.
- Unusual accrual swings over time may point to smoothing of earnings.

Focus 4	Funding capacity, financial structure

This area of focus entails a review of the business’ funding, capital structure, return on debt and equity and income taxes. The focus is to assess adequacy of funding for the business on its anticipated trajectory, and its ability to weather potential shocks. The following areas will thus be looked into:

- Cash reserves, borrowing facilities
- Borrowing costs
- Debt service
- Borrowing covenants
- Cyclical funding needs
- Risk and financial leverage
- Returns to shareholders
- Taxation

Operational Assessment

In conducting an operational assessment of a business, and depending on the nature of the business, it is important to take an in depth look at such functional areas as: order processing, purchasing, production planning, production, supply chain management, inventory management, warehousing, quality control, testing, delivery and logistics, field service and customer support. The due diligence process involves walking through these functional areas so as to understand the issues, inefficiencies, bottlenecks and other areas where the business plan results can be impaired. The best way to do this is to track an order from its inception through each of the operational areas to completion and delivery. It is also important to understand the issues that can arise during this process.

This can be done by meeting individually with the personnel directly responsible for each of the operational areas and discussing their concerns and issues. These issues may include: raw material cost increases, untimely or incorrect raw material deliveries from vendors, lack of skilled direct labor, plant bottlenecks and capacity constraints, need for additional capital equipment, poor quality control, excess overtime, errors in engineering drawings, building excess inventory, accepting orders with low gross margin, accepting orders where there is a learning curve not included in pricing, accepting orders where required delivery dates cannot be met, delivering unfinished products that will require field service, etc.

Once the interview and walk through process is complete, the due diligence evaluation team should be able to match the issues and concerns it has uncovered to the assumptions contained in the business plan, cash flow and financial statement forecast so as to determine business plan achievability and viability, as well as make recommendations concerning corrective action.

Management Assessment

The most important aspect of the management due diligence process is determining whether the business plan and key metrics have buy-in by the key functional managers in the business, including whether: (a) they each understand and agree with, and are willing to be held accountable for, meeting the business plan targets for which they are responsible, or have issues or concerns in being able to meet these targets; (b) there is a system in place that promotes ongoing communication and interaction amongst the key functional managers, so they are able to address and correct plan variances and other issues that may come up which can impact plan results; (c) the financial officer is being charged with the responsibility and authority to determine the cash flow and financial impact on management decisions that may affect cash flow and working capital availability, and (d) meetings are held on a regular basis to review plan status and that action plans have been put in place and followed through to make sure the issues that can impact performance are dealt with and followed up on a priority basis until resolved satisfactorily.

Evaluating whether the Company can meet its Business Plan targets

If the above controls and procedures are in place, the bottleneck and inefficiency issues have been addressed, and the management team is all on the same page, fully supportive of each other, focused on achieving plan, and has accepted accountability and responsibility for meeting their plan metrics, and if the financial officer is proactive in making sure the metrics, cash flow and EBITDA numbers are being met, and has no problem voicing his or her concern if not being met, then, absent a significant unforeseen event such as loss of a major customer or product line or inability to pass along unusual cost increases, etc., the plan metrics should have a good chance of being achieved.

Summary

An acquisition candidate that has the best chance of becoming a success requires due diligence that includes a comprehensive cash flow, operational and management viability assessment as a key component of a quality of earnings (QOE) report.

The traditional QOE report all too frequently is limited to an accounting review of financial statements, which approach will often fall short of being able to assess whether earnings are repeatable.

Key to any acquisition evaluation and critical to a high quality QOE report is determining management's ability to meet targeted metrics, the likelihood of achieving sales, margin and profitability goals, determining what makes money and what does not and why, an assessment of operations, including labor, production bottleneck, manufacturing and scalability issues as well as an examination of cash flow and funding needs.

As a consequence, in addition to the normal accounting review of performance, the best due diligence team to conduct a QOE assessment needs to include experienced operating and finance professionals who have hands on management experience in driving business plan goals, meeting business plan metrics and managing cash flow. This rounded team is best equipped to assess sustainability or "Quality" of earnings.

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This white paper, the first in a series on due diligence insights, was written by Barry Green and Leland B. Goldberg, partners at Coeus Management LLC.

Barry Green and Lee Goldberg together have over 50 years' experience in operating businesses and in management consulting. Prior to founding Coeus Management they were managing directors for a number of years at Getzler Henrich & Associates, a highly respected middle market turnaround management firm.

They have utilized their deep hands-on operational and financial expertise to provide a suite of due diligence services for lenders and investors. Drawing on many years of managing and restructuring companies, their investigative approach to due diligence reveals how businesses make and lose money - instructive to investors and lenders both on what to expect from the target companies, and what opportunities there are for improved performance.

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