

Economic turmoil, a sharp decline in acquisition financing and depressed EBITDA multiples have severely depressed M&A activity over the past two years, keeping a lot of private equity firms on the dealmaking sidelines.

Sales by U.S. private equity firms declined 47 percent in 2008 from 2007, and the trend has only accelerated in 2009. Less than 20 percent of the PE firms RSM McGladrey surveyed earlier this year have sold a portfolio company, division or product line in 2009 - and less than half have even *considered* a sale. Most of these PEGs are delaying the sale of portfolio companies and instead are focusing on strengthening these companies' operations and financial performance.

M&A activity to pick up

But this dealmaking drought won't last forever. According to a majority of economists surveyed by the *Wall Street Journal*, the recession has ended and growth will resume (albeit slowly), during the third quarter. And while there remains an imbalance between well-funded buyers and high quality companies for sale, pent-up demand for transactions could eventually prove helpful to PE firms interested in disposing some of their assets.

"The deal market has taken bit of a hiatus over the past 24 months, and the outlook for both the economy and M&A remains somewhat clouded," says Paul Weisbrich, a senior managing director with middle-market investment bank McGladrey Capital Markets. "But we think dealmaking activity is likely to ramp up noticeably in 2010."

Still, Weisbrich notes, both buyers and lenders have significantly tightened their standards, so "sellers need to prove the durability of their revenues and the quality of their earnings."

One thing is certain: for the foreseeable future it will be crucial for sellers to present their businesses in the best light possible while maintaining credibility among buyers. With forecasting difficult at best and transactions being subjected to intensified scrutiny, a seller's accounting and reporting must be able to withstand rigorous examination and evaluation.

The alternative: diminished values, retraded sales prices...and collapsing deals.

Combat retraded sales prices

In today's cautious environment, "transactions are being retraded at an alarming rate, and due diligence requests are skyrocketing," according to Hector J. Cueller, president of McGladrey Capital Markets. "Companies unable to defend their numbers are getting retraded, which can severely diminish value for the seller."

Accountants and investment bankers agree that the most effective way to help buyers maintain confidence while protecting sellers against eroding values is through sell-side due diligence. It is particularly important in a market beset by uncertainty.

"While sell-side due diligence almost always delivers a good return on investment, it was often neglected during the recent M&A bull market," says Milton Marcotte, a managing director in RSM McGladrey's Transaction Support Services practice. "But it has become critical in today's environment. Sellers seeking to attract buyers and maintain value are recognizing the importance of providing optimal financial transparency. They understand that discrepancies or surprises uncovered during buyer due diligence not only can torpedo a seller's credibility; they can quash a deal entirely."

Marcotte acknowledges that hiring an independent firm to perform due diligence can add to the seller's transaction expense. However, he argues that by "enhancing the seller's negotiating position and reassuring a potentially skittish buyer," the benefits provided by sell side due diligence "vastly outweigh the relatively minor increase in costs."

Benefits of seller due diligence

In addition to substantiating a company's financials and preparing the necessary supporting documentation, sell side due diligence enables the owner to carefully reassess the company before launching the sales process. It thus can help the owner identify potential problems and address them discreetly, before the company is taken to market. It also can enable the seller to craft persuasive arguments in response to potential buyer skepticism.

"We have a relationship with a midsized logistics company that enjoys margins almost twice the industry average," said Weisbrich. "As you can imagine, numbers like that can stimulate a fair amount of skepticism from potential buyers. Yet in this case there's a legitimate explanation—specifically, a software technology that enables the company to cut its costs while improving performance. In such a situation, having an independent firm validate that numeric competitive advantage can significantly enhance value."

Another benefit of sell-side due diligence is the assurance of optimal tax structuring during the deal. “Sell-side due diligence should always include a tax component, including a SALT planning and compliance review” says Marcotte. “A deal can implode if the company being sold is found to be out of compliance—especially today, when states are really cracking down on non-compliance.”

According to Marcotte, it’s a common misconception that the provision of sell side due diligence is a routine responsibility of the seller’s investment bankers – who, he says, “rarely have the resources to perform the necessary analysis.” Cuellar agrees. “An investment banker’s role is to position the company in the marketplace, help prepare a credible forecast, develop a deep pool of prospective buyers, and effectively negotiate the transaction on behalf of the client. But when it comes to putting the supporting details behind the numbers, an investment banker cannot—and should not—replace the role of the accountant.”

Performing due diligence requires an investment of time, and as the saying goes, time is money. But as Weisbrich notes, “taking shortcuts can ultimately prove extremely costly to the seller.” Moreover, he argues that the current lull in dealmaking provides an ideal opportunity for private equity firms and other business owners to invest the time necessary to properly prepare a company for sale.

“There are a variety of steps an owner can take to enhance a company’s value and make sure it’s ready to attract a premium buyer and a premium price. Retaining a well regarded firm to perform sell side due diligence is one of the smartest things an owner can do to make sure he gets the best deal possible.”

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