Dow Jones Investment Banker
DEEP INTELLIGENCE THAT CONNECTS BANKERS TO DEALS AND DEAL MAKERS

Outlook

LANDSCAPE: Sellers Spill Their Dirt To Gain An Edge On Buyers

By Gregory J. Millman
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NEW YORK—Vendor due diligence, common in Europe, is now finding a place in middle-market U.S. M&A. Investment bankers say that getting anomalies out on the table early in an auction can smooth the sale process, avoid late-stage hiccups and protect multiples.

The concept is simple: The seller hires an independent firm to probe its business and finances to unearth issues buyers are likely to be looking for.

The risk: "Sometimes sell-side due diligence is the only due diligence done," says Steve Brady, national managing partner of Grant Thornton LLP's Transaction Advisory Services practice. That's common in Europe, where the auditor that performs the vendor due diligence has a fiduciary responsibility to the buyer as well. But in the U.S., there's no such duty to other parties, so caveat emptor.

Even when buyers do conduct their own diligence, a sell-side due diligence report brings advantages for sellers.

"It is insurance against surprises when you only have one buyer left and you are in exclusive discussions with that buyer," says Eric Roth, managing director at Lazard Middle Market LLC. The negatives usually don't involve fraud or poor accounting, but rather differences between GAAP and M&A accounting.

Roth cites the example of a client who reversed accrued expenses in December for GAAP accounting purposes, then sold the business in June, six months later. Reversing the accruals made it seem as if earnings jumped in December. In fact, the higher earnings should have been spread over the entire prior year, so only half of them would have been included in LTM EBITDA when the business was sold. Sell-side due diligence put such issues on the table early and allowed the seller to see the company as a buyer would.

"We think it makes the process go more smoothly, shortens cycle time, which is the enemy in M&A, and minimizes the damage to the underlying portfolio company that can occur in a sale process," says Stewart Kohl, co-CEO of the private equity investor The Riverside Company.

Sell-side due diligence is not only a benefit to bankers doing deals: It's also an additional service that banks can provide and bill for. Houlihan Lokey launched a transaction advisory service in 2009, which includes sell-side due diligence. In many cases, that will be an adjunct to M&A advice, but not always. "We have a recent engagement where Houlihan Lokey is not the sell-side adviser," says Sam W. Clark IV, managing director in charge of the service.

Duff & Phelps Corp. also offers the service. So, of course, do the major audit firms.

Practitioners say the likeliest candidates for due diligence are middle-market firms without great depth in their accounting departments, carve-outs without independent financials and unregulated industries.

With deal-making still sluggish, the sale proposition for sell-side due diligence is that it can help prevent re-trades by surfacing issues that buyers might use to beat down a price. When the market eventually heats up again, sell-side due diligence reports and auction fever will probably prove to be a dangerous combination for more than one bidder. That can only increase its appeal for sellers.

—Gregory J. Millman is a senior columnist with Dow Jones Investment Banker.

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