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Sell-side QOEs: A Return to Utility

Assessing financial readiness and telling the economic story.

by Mark Working

"It is possible to have too much of a good thing"
- Aesop

Most modern-day sellers of middle-market businesses have conducted a sell-side quality of earnings study ("QOE"). It wasn't always so. What started out as a good idea in certain situations has proliferated and commoditized, and in doing so has marginalized its intended benefit. Now, it is viewed as just an automatic expense, a necessary procedural step in the sale process. We think it's worthwhile for the architects of the transaction process – investment bankers and investors – to revisit the original purpose of conducting a QOE and craft QOE studies to better serve specific purposes in a transaction.

This is certainly not a criticism of the transaction advisory services teams that execute these studies. A lot of talent has been accumulated in these departments of accounting firms, and they have adapted to produce what the market demands of them. They are forensic specialists and have developed skills and procedures that are very valuable. Demand for QOEs has grown dramatically and providers can't be criticized for responding to the demand. In the absence of direction from investment bankers and clients, the industry of QOE providers has created its own defined product, developing procedures to conduct analyses in repeatable processes, generating increasingly voluminous reports. Many QOEs now exceed 100 pages with very impressive graphs and tables in granular detail. Our observation is that they are beginning to look like they are coming off the assembly line in that they are less targeted and customized to address specific issues.

We were one of the first to propose using accounting firms to conduct a QOE study on behalf of the seller ("Case for a Seller Conducted QOE Study", Spr 2013) and have used them in many transactions since then. Our rationale was threefold:

- In a broad sales process, the existence of an independent review of the financial statements that supports the investment banker's articulation of the value proposition (which is not always clearly reflected in the GAAP prepared financial statements) allows buyers to rely on a more detailed analysis for their initial indications of interest, making them more meaningful;
- With detailed independent analyses having been completed, the due diligence period between initial proposals and commitments can be reduced; and
- If structured properly, an independently prepared QOE can blunt the effort by the buyer's financial expert to justify a re-trade after exclusivity is in place.

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A guiding principle of our thinking was that to make the QOE additive to the specific situation, it has to be customized. It is the investment banker's job to articulate the value proposition and identify which specific forensic analyses would support the thesis and present a defensible understanding to buyers. This can be hard and takes time and detailed analysis in advance.

> **It is in both the seller's and buyer's interest to understand the base level economics of the business in its condition as it is transferred. Often, a forensic expert can be helpful in bringing light to the situation, and they should be engaged to do so.**

As QOE studies have grown in popularity and the industry has accepted them as a normal part of a transaction, their use case has generalized. In 2018, we commented on this scope creep ("Effectively Using a QOE Study", Win 2018), pointing out how each study needs to be scoped to validate key pieces of financial information to answer specific questions, and how this approach appears to be falling out of favor. Most investment banks now suggest one as a matter of course, without any specifics as to its purpose.

It's hard to argue that this approach is in the best interests of the client. As an example of one area that is totally perplexing is the recommendation of a QOE when the seller's company has not previously had its financials reviewed or audited by an independent firm. The key question in a buyer's mind in this scenario is likely to be whether there is integrity in the underlying data—a QOE doesn't address that problem because its purpose and the procedures used are designed to interpret the (already verified) data in a manner and form a buyer is used to seeing, but doesn't question the underlying integrity of the data themselves. Conducting a detailed QOE in this situation ignores the more fundamental issue.

One issue that QOEs have taken on is the justification of "add-backs", "COVID adjustments", and "recasts." In many cases, the analyses have taken on the perspective of "if it had been different, the result would have been different." Far from validating an economic reality that is masked by accounting procedures, the job has been to just make EBITDA larger. Last summer, we published an article ("EBITDA Adjustments – A Market Update", Sum 2021) where we made the case that by taking on too much of the "what if" type of adjustments, sell-side QOEs were leading to more scrutiny, not less, and creating doubt as to the entirety of the presented results.

A buyer of a business is buying an economic proposition that implies a future cash flow stream under the buyer's stewardship. Sometimes the GAAP-prepared financial statements do not clearly present that proposition. It is in both the seller's and buyer's interest to understand the base level economics of the business

(continued p. 2)

in its condition as it is transferred. Often, a forensic expert can be helpful in bringing light to the situation, and should be engaged to do so. The transaction services departments of accounting firms are a great source of talent to do that work. It would be a good idea for sellers and their advisors to begin thinking more as buyers to anticipate those areas of concern that are likely to arise and direct the analyses to address these issues. The best value will be obtained by working up front to design the customized analyses needed for every specific situation, thereby bringing the idea of a QOE back to its origin and making them additive to the objective of shining a light on the real economic proposition. ZS

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ABOUT ZACHARY SCOTT

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