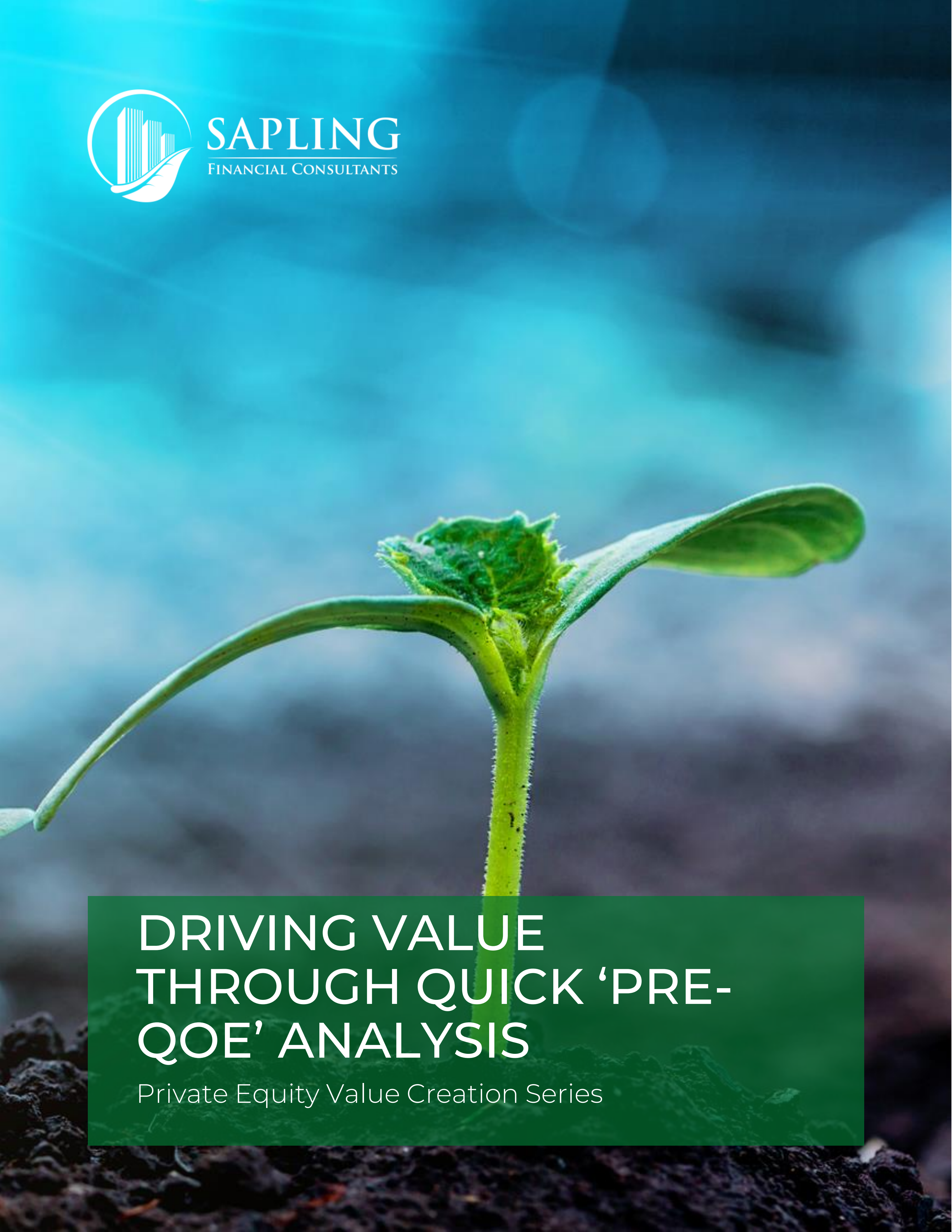

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DRIVING VALUE THROUGH QUICK ‘PRE-QOE’ ANALYSIS

Private Equity Value Creation Series

With increasing EV/EBITDA multiples amid a space overflowing with equity capital, successful private equity firms (PEs) are shifting towards a model that emphasizes Value Creation. Some firms have split this function out, analogous to the division between the “Business Development” and “Investment” Teams, with names of these teams including “Portfolio Management”, “Value” or “Value Creation”, “Portfolio Support” or (as a subsidiary function) “Data Science.” In the midmarket (<$5B of assets under management), resources are scarcer, so firms are looking to add value inexpensively and creatively. Sapling Financial Consultants Inc. (“Sapling”) assists a number of private equity firms with various aspects of Value Creation on the Finance side. This is one of a series of whitepapers covering how midmarket PEs can Drive Value at portfolio companies, in this case by saving on diligence that can be repurposed to value-driving initiatives during the hold period.

DRIVING VALUE THROUGH QUICK PRE-QOE ANALYSIS

No buyer wants to pay too much. The potential returns that any buyer can generate on an investment is a function of the price paid and the performance of the business. Buyers / investors often find themselves challenged to build an accurate snapshot of the business that they are investing in. That’s where Quality of Earnings (“QoE”) reports enter the picture.

A QoE is aimed at providing the buyers with an understanding of “How much money does the business sustainably earn”? A QoE analysis is a routine step in the due diligence process for private M&A situations, new investments and follow-on financing deals. QoE typically focuses on identifying critical issues and potential adjustments to revenue and cost line items, thereby providing a solid basis for estimating sustainable earnings. This is crucial for the buy-side as a target’s financial statements often possess some ‘noise’ which the QoE exercise attempts to eliminate to reflect true normalized performance.

Market conditions have become particularly challenging in light of the COVID-19 crisis, and the situation is still far from ‘normal’ for businesses of all sizes. While businesses are working hard to achieve a recovery, private equity General Partners (“GPs”) are exploring opportunities to deploy funds at an attractive valuation. In such times, the QoE exercise becomes all the more important for making sound investment decisions as unusual business disruptions make it more challenging to ascertain the sustainable earnings of the business.

A traditional QoE engagement covers any and all financial information, including financial statements, accounting policies, disclosures, normalization adjustments, transaction history, customer and vendor contracts, key agreements, and any other information that may be relevant to the business. Since QoE is mostly focused on an accounting review of the financial performance, typically such an exercise is performed by established CPA firms, as GPs tend to derive comfort from 'stamped' reports from these large 'branded' firms. Such reports take 30 to 60 days to produce and can cost anywhere between $50-150k. This is a large investment and time commitment made without any prior external opinion on earnings quality.

One alternative is a quicker and shorter "pre-QoE" analysis that can provide GPs with a preliminary indication of the earnings quality in a compressed timeframe, and with fewer resources. Such analysis can help GPs with early identification of the key value drivers of the business and aid them in deciding whether to proceed with a more expensive and time-consuming detailed QoE. Moreover, it can also help the QoE service provider with deciding which factors should be focused on.

At the heart of an insightful pre-QoE analysis should be an understanding of "how does the business earn money?" In any business, 'Cash is King', and what GPs are investing in is really a stream of predictable future cash flows. Hence, ideally, the pre-QoE exercise should focus mostly on performance drivers critical to deriving high-level assurance of current and future cash flows. For instance, a pre-QoE engagement may cover an analysis of the business plan, key risks, revenue and cost trends, profit transparency, capital structure, high-level adjustments for non-operational and non-recurring items, and valuation analysis. Things that can wait for the QoE itself include assessment of accounting policies and standards, recognition methods, classifications, disclosures, detailed normalizations, detailed analysis of contingencies, etc., once the GP has decided that it makes sense to proceed to the next stage. In other words, the pre-QoE exercise should be aimed at describing the forest and not the trees.

We have seen many instances where pre-QoE analysis was able to add value for GPs.

For instance, one sponsor wanted to examine the reasonability of the target's historical revenues and profits. We worked with them to analyze past sales data comprising 800k+ rows to understand the causes behind the target's growth in terms of geographical segments, customer behavior, product concentration, pricing, order patterns, etc. We also manipulated GL data to analyze variable and fixed cost trends to understand the reasons behind cost fluctuations.

As another example, a private equity firm interested in buying a fast-growing start-up worked with us to perform pre-QoE analysis to assess the purchasing behavior of the target's unique customers to determine how much repeat business they could expect from the existing client base. Unique customers were identified using a "fuzzy-matching" algorithm and then statistical tests were run on historical sales transactions to identify average client behavior.

In both instances, the GPs bought the targets. Such analysis can help investors understand key characteristics of the target's business and assist in price negotiations.

Since the pre-QoE exercise is mostly an analytical review of the target's business focused on business plan assessment, financial analysis, data analytics, modelling of key performance drivers, valuation stress tests, etc., individuals and firms with a focus on financial modelling and data analytics are in many ways a better fit for the pre-QoE than those focused more on accounting, which is a critical asset during the formal QoE.

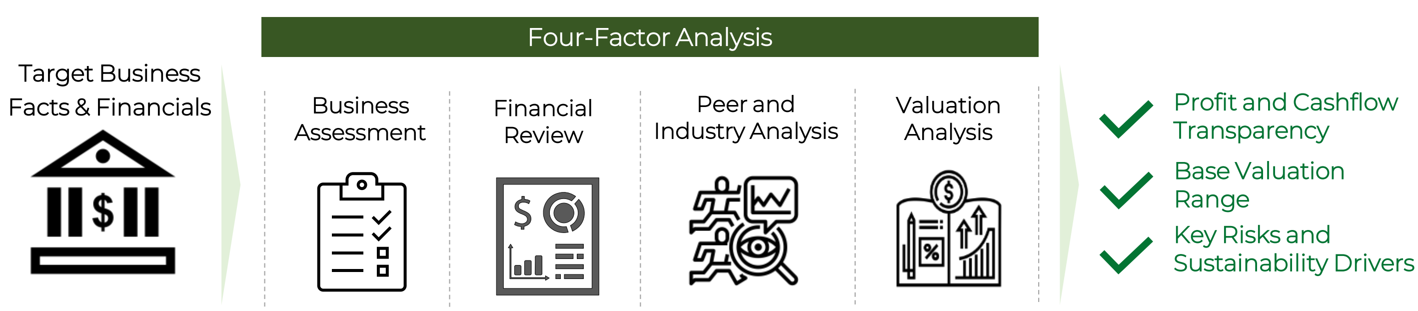
To elaborate, the ideal structure for pre-QoE analysis involves covering four key factors – (a) business plan assessment, (b) financial review, (c) industry analysis, and (d) valuation.

In the business plan assessment, a wide range of issues including business model, unique selling proposition, growth strategy, marketing plan, customers and vendors concentration, access to capital, etc., should be examined, with the aim of identifying key drivers and risks.

This should be followed by a high-level financial review focused on highlighting critical issues that can impact cash flows. A healthy skepticism is required in this phase to form an opinion on the reasonability and sustainability of cash flows. This phase will mainly include developing answers to questions such as:

- ✓ What are the key revenue sources? What is the typical cost structure of the business?

Figure: Pre-QoE Analysis - Potential Framework



- ✓ What are the historical revenue and cost trends? Are there any unusual peaks or troughs in historical revenues and profits?
- ✓ How has seasonality impacted historical results, and is it appropriately captured in forecasts? Are forecasted revenues and costs realistic and sustainable? What are the bottlenecks to increased profitability?
- ✓ What are necessary vs. non-essential costs? Are there any high-level normalization adjustments that can be made to key cost components?
- ✓ What working capital turnover trend can we see? Do existing working capital levels satisfy operational requirements? Does working capital tally with the business's payment and credit terms? What is a sustainable working capital level?
- ✓ Is forecasted maintenance capex reasonable relative to actuals?
- ✓ What are historical debt trends and how much additional borrowing capacity does the business currently have? What is the ideal capital structure for the business, taking into consideration the current lending environment?
- ✓ How much cash is generally needed to run operations smoothly? Has the business faced severe cash crunches any time in the past? What caused them? How did the business respond to them?
- ✓ What is the nature and impact of other large liabilities on the business (leases, pension plans, compensation plans, probable contingent liabilities, any off-balance sheet items)?
- ✓ Are there any assets and liabilities that should be considered cash-like or debt-like for the valuation?

In the financial review, it is important to understand the interrelationships of all these factors in order to build a holistic picture.

The financial review should be supplemented by research on the competitive landscape and industry environment. This phase will mainly focus on developing answers to questions such as:

- ✓ What are the industry trends and outlook?
- ✓ How competitive is the industry and how does the target's business differentiate itself from its competitors?
- ✓ What are the growth, profitability, working capital and capital structure metrics of the target's competitors / comparable peers?
- ✓ How different is the target's financial performance from peers, and why? Is there a need for normalization?

Peer and industry analysis helps benchmark growth, profitability, and cash flow forecasts, and allows buyers to assess the likelihood of a business meeting its planned targets.

Finally, a Valuation Analysis along with sensitivity and scenario testing should be performed to estimate the base-case valuation range and the impact of key business drivers on the buyer's potential returns.

To conclude, time-efficient and economical pre-QoE analysis can help stretch tight resources during an uncertain time that may yield a lot of good buying opportunities. Sellers will always want to maximize price, but the burden of examining the reasonability of that price stays with the buyer. In a difficult time when GPs are constrained for resources, costly and time-consuming "stamped" QoE reports without any prior external opinion can lead to squandered resources. Instead, a shorter pre-QoE analysis is a time- and cost-effective way forward to determine "Quality" early. Any savings can then be redeployed to Value Creation.

ROB HONG
Co-Founder & Partner
Sapling Financial Consultants Inc.
416-625-2633 /
rob@saplingfinancial.com

4773 Yonge St, Toronto,
ON M2N 0G2, Canada
info@saplingfinancial.com