



# GUARDIAN

Due Diligence

## The Unique Nature of QoEs for ETA Deals

Prepared for the



**ENTREPRENEURSHIP THROUGH  
ACQUISITION CLUB**

A STUDENT CLUB AT HARVARD BUSINESS SCHOOL

# What You'll Learn Today

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1. What is an ETA Quality of Earnings (QoE)
2. Why QoEs for ETA Deals are Unique
3. Why Unreliable Financials Complicate Everything
4. A Better Approach
5. War Stories & What Happens If you Miss?

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Because you will soon start your search & you need to know this to be successful

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## Takeaways (What You'll Know When We Finish)

- 1. The jobs an ETA QoE must do**
- 2. A better rubric for choosing right provider**
- 3. Common pitfalls to avoid (War Stories)**

# Why You Should Listen To Me



## Background:

- Class HBS Class of 2011 (Section F)
- Private Equity
- Strategy Consulting
- Forensic Accounting / Due Diligence Company Owner

## Practical Experience

- **I Get the Bigger Picture:** I'm a deal guy running a QoE firm
- **Experience:** I've been doing this work for 15 years. Before there was an ETA class here at HBS. I've seen thousands of deals as a buyer & a QoE provider
- **Volume:** Our firm does 40-50 ETA QoEs every year. (over 200 deals in past 5 years)

# Representative Set of Our 200+ Customers

## Business Owner Clients



## Business Buyer Clients



## Affiliations & Partnerships



1. What is a QoE

(no really, someone  
explain it for me)



# What is this thing called Quality of Earnings (QoE)?

**Click here:** <https://www.guardianduediligence.com/whitepapers/quality-of-earnings>

## Understanding QoE Reports in 5 minutes

Watch these videos to learn the key elements of a Quality of Earnings report.

### EBITDA & Add-Backs



- #1 item is the adjusted EBITDA
- We conduct a financial statement analysis and evaluate each add-back to be sure it's fair
- Total add-backs should be a reasonable percentage of adjusted EBITDA.
- That's how the experts do it

### Proof of Cash



- #2 is Proof of Cash
- Use conservatism of the bank to your advantage
- Bank version of profit is the most believable
- There may be differences but they should be small

### Profit Per Product or Service



- Consistency of margins as the business grows
- Look for the expenses that are NOT shown (but you know should be there)
- This is where your industry knowledge comes into play.

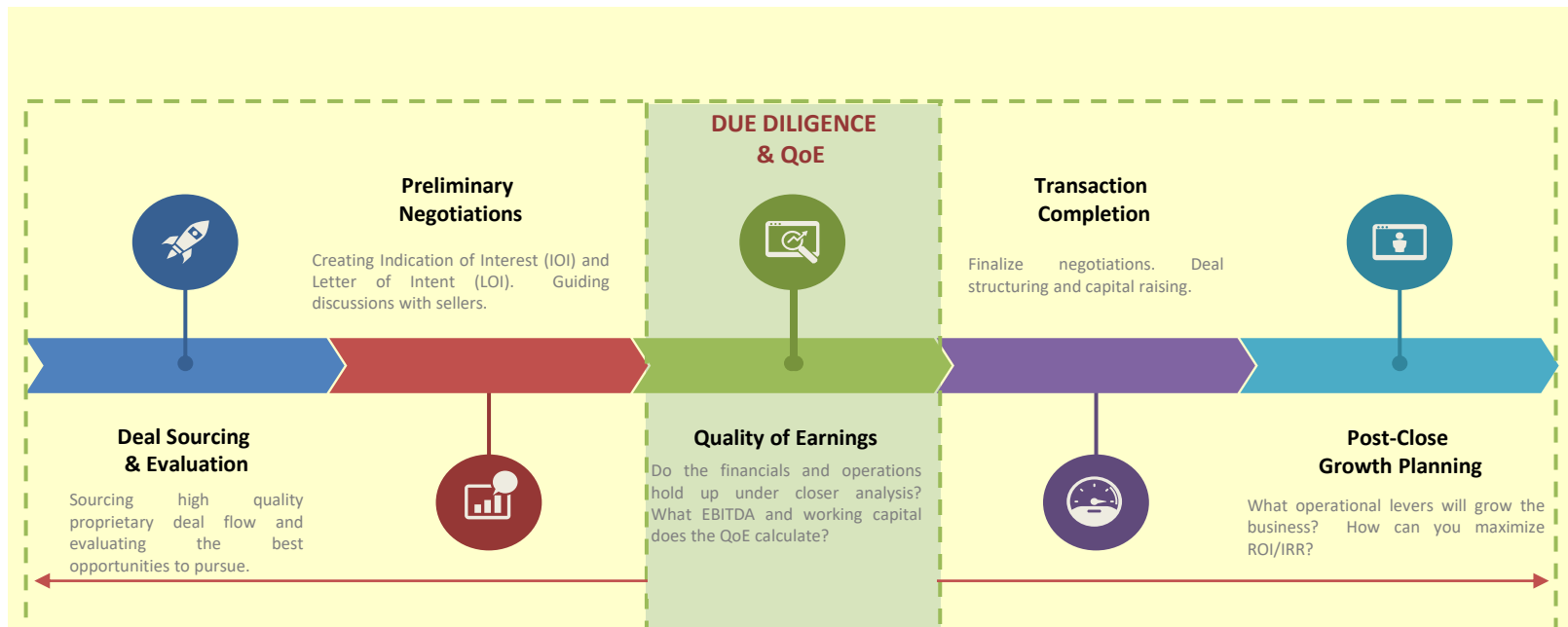
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Think of a QoE as a CPA Audit but specifically for M&A activity (Buy-side or Sell-side)

# QoE: When in the Deal Process & Why

## Better Off Doing No Deal vs. a Bad Deal

There is no return policy on a bad acquisition. It's your job to diligence the deal.



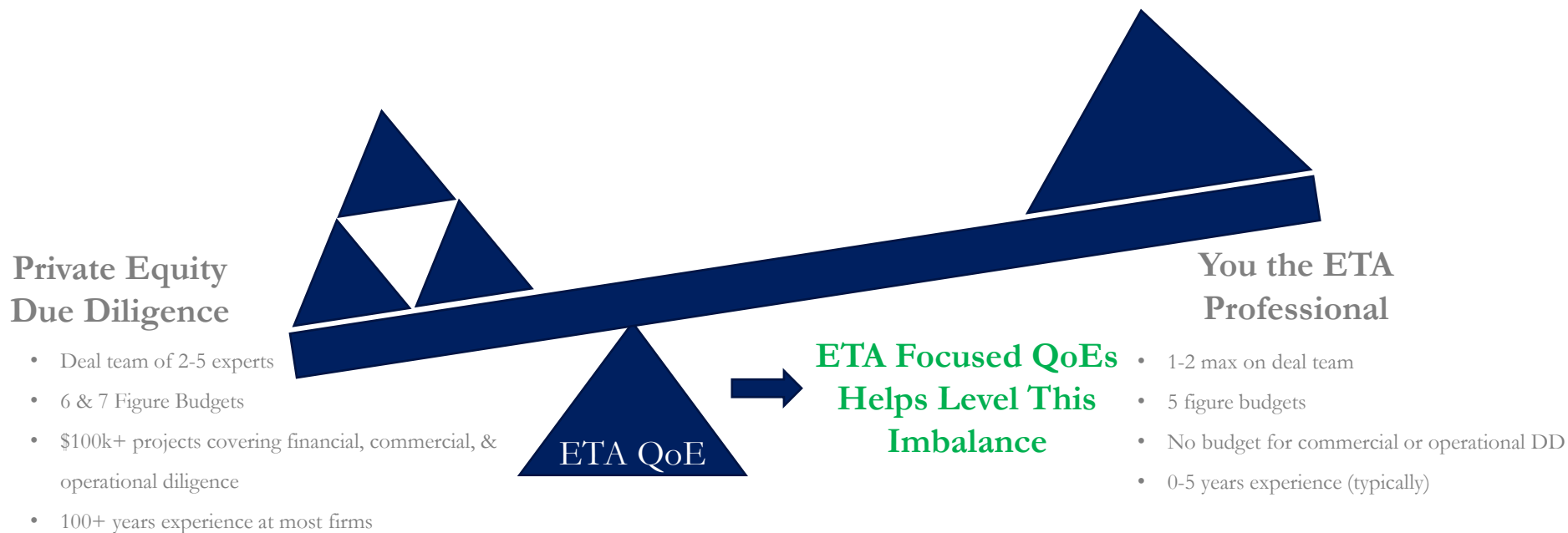




## 2. Why QoEs for ETA Deals are Unique

# The ETA Entrepreneur Manages a Delicate Balance Between World Class Due Diligence & a Limited Budget

ETA professionals have the same jobs as private equity professionals in terms of diligence with a fraction of the budget & experience.



# And It's True in both types of ETA

## In both Traditional & Self-Funded Search, the Entrepreneur Must Stretch Limited Resources to Diligence Deals

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### Traditional Search

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- \$1-4 million in EBITDA
- 1-2 person teams
- Small budget for QoE
- Medium to high growth profile
- 10-40 LPs who can help
- Location agnostic

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### Self-Funded

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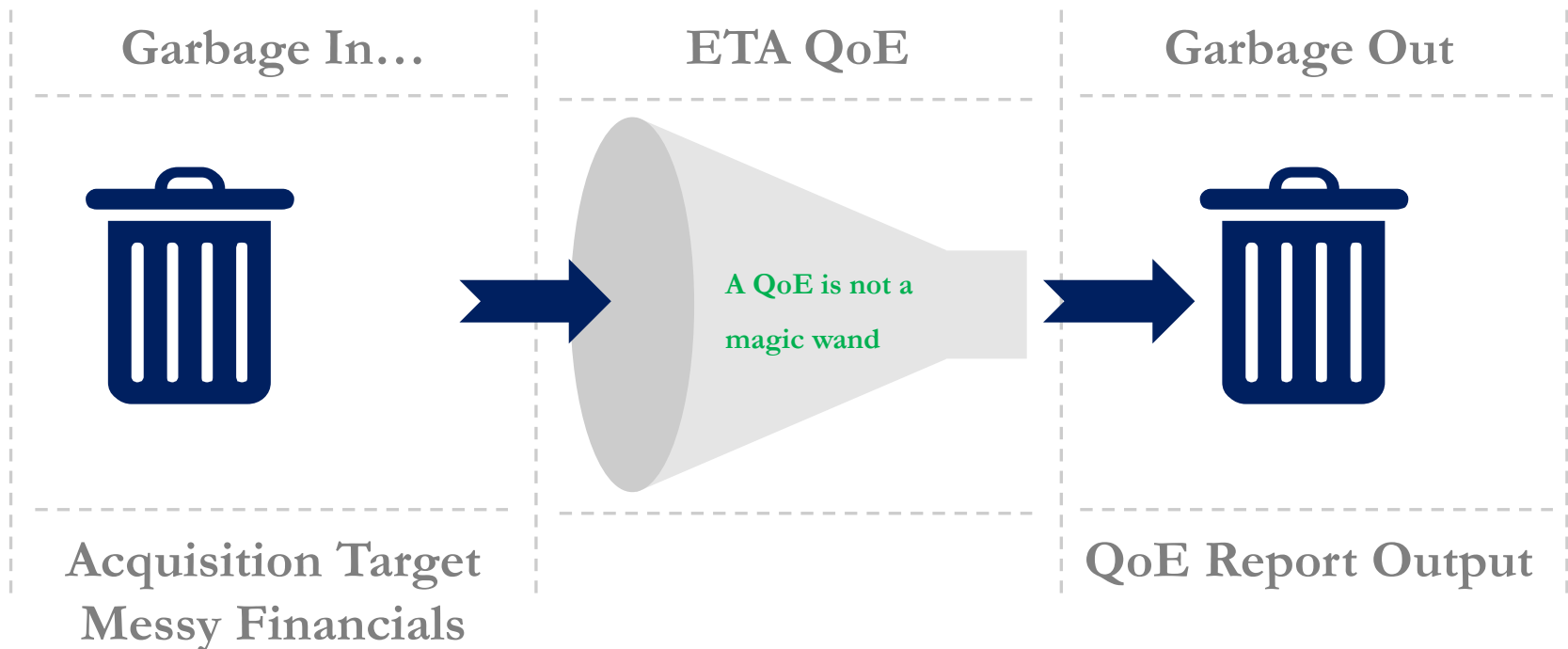
- \$500 thousand to \$2 million in EBITDA
  - 1-2 person teams
  - No budget for QoE (self pay)
  - No set criteria so Buyer must choose
  - No LPs to help. Mentors possibly.
  - Wherever & however you want
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### 3. Why Unreliable Financials Complicate Everything



# Garbage In = Garbage Out

QoEs can correct most issues with unreliable financials – but not all



What are some examples of “Garbage In” related to messy financials?

# What Do I Mean By Garbage In?

Garbage In...



Acquisition Target  
Messy Financials

## Specific Areas of Concern:

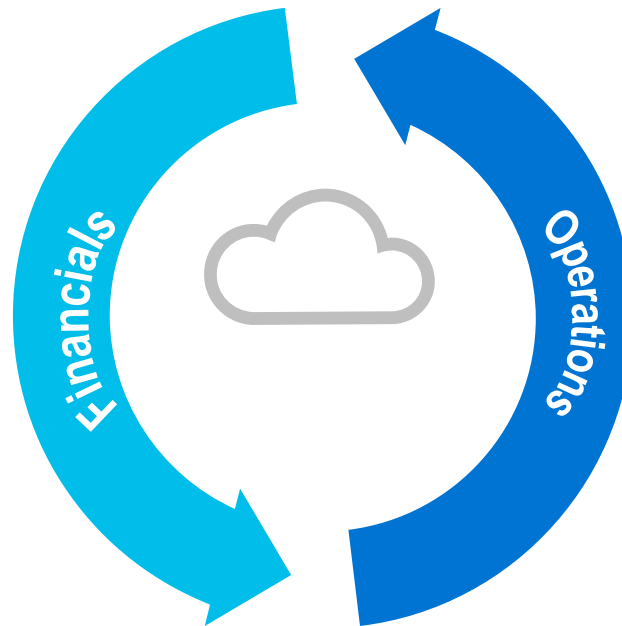
- No COGS & therefore, 100% gross margins, & all costs grouped together
- Inventory expensed instead of held on balance sheets
- Prepaid not captured correctly on the balance sheet nor reported according to accrual (GAAP) standard
- Revenue not connected to an invoice

# Why QoE Alone Isn't Enough

In ETA deals, you cannot separate the financials from the operations of the target acquisition.

## Financials

- Main Street Bookkeeper
- Financials optimized for simplicity
- Accrual-ish at best
- Never had the scrutiny of a cash flow business buyer so often woefully inadequate
- Limited work done by Brokers before Buyers see the deal



## Operations

- Every sale & cost is a direct result of something that happened in the business
- Highly dependent on 1-2 key employees
- Main Street employees with varying levels of competence in the areas they're asked to perform each day
- Might not be able to meet them before the acquisition

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You Must Look at Financials & Operations to Arrive At Sustainability of Cash Flows

## 4. A Better Approach





# A Better Approach

1. Collect QoE financials
2. Identify what key things drive EBITDA
3. Develop an opinion on sustainability of those drivers

# Get Revenue from the QoE But Then Evaluate Sustainability

## Revenue is a function of Salespeople, Process & Product or Service Quality

### Salespeople & Process

- Who does the Sales? Owners will always point to someone lower in the organization, but how can you be sure it's not the Owner you're replacing that does 100% of the sales?
- How repeatable and predictable is the sales process?
- Could you step in and sell if you realize that the owner was the salesperson and he's now gone?



Revenue

### Product or Service Quality

- How good is the product or services relative to competitive options?
- Is the product/service priced at an appropriate level for its relative quality (Kia vs. Maserati)?
- Does customer retention and other measures of quality support the narrative being told by the Seller?

There's more to revenue diligence than just a number

# Get COGS from the QoE But Then Evaluate Sustainability

## COGS is a function of Raw Materials or Platform Costs & Labor

### Raw Materials or Platform Costs

- Where are raw materials purchased & at what price (physical goods) Or what platform systems are critical to business function (software, e-commerce)?
- Are all direct costs associated with the business captured in COGS or are some buried in operating expenses?



**COGS**

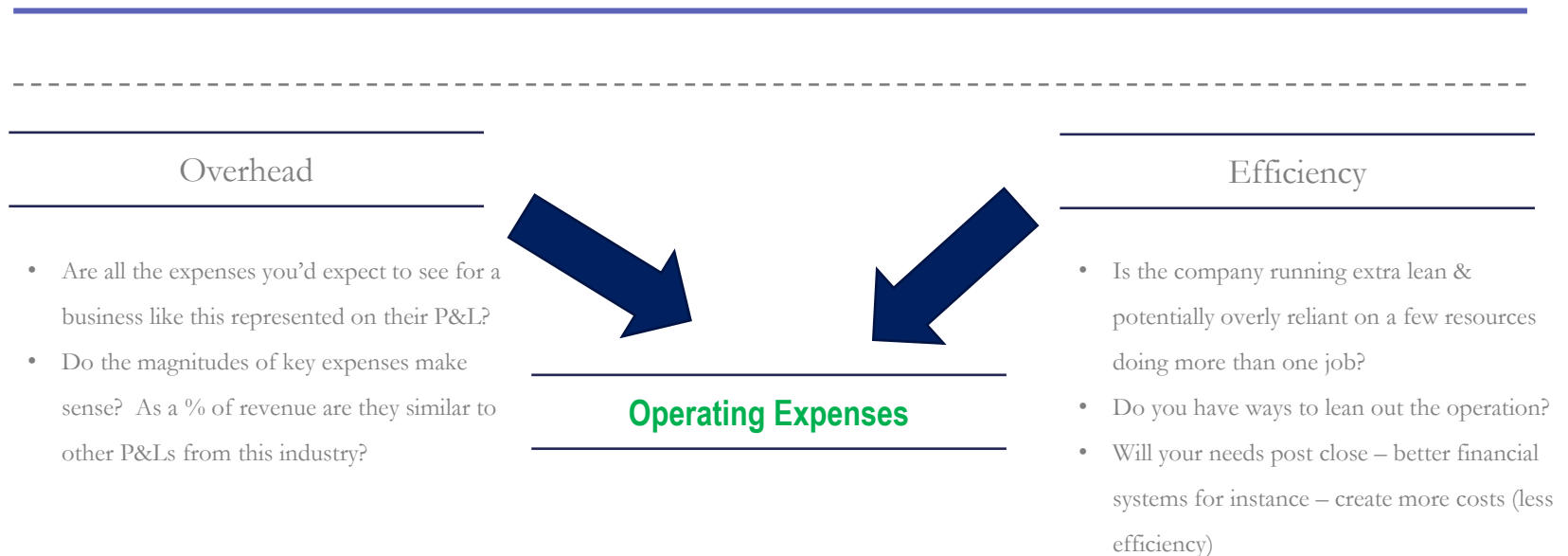
### Labor

- What labor is considered a “direct cost” and included in COGS?
- How consistent is this labor over time? Is this labor getting easier or harder to attract & retain
- Would you expect to see rises in labor costs that don’t show up in the financials?

There is more to COGS diligence than just a number

# Get Operating Expenses from the QoE But Evaluate Sustainability

## Operating Expenses are a function of Overhead & Efficiency



There is more to OpEx diligence than just a number

# Always Do the Conversion to From EBITDA to Free Cash Flow

**You cannot spend EBITDA at the grocery store  
They only accept cash!**

# QoE Providers, Cost, & Why You Choose

## Big 4 Accounting



### Highlights

- \$150 - \$250k
- Big deals, institutional investors
- When your QoE needs to be beyond reproach

## Regional Firms



### Highlights

- \$50 - \$125k
- Medium deals, less institutional investors
- Cost effective solution for a wide range of deals

## Specialized Firms Offering Advisory Support



### Highlights

- \$25 - \$55k
- More hands on, white glove service
- More flexible with messy financials
- Can advise on how to use the QoE to make deal decisions (not just deliver a report where you have to do the rest)

## Contact Info

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## 5. War Stories

(transition to 12 Public  
Diligence Fails PDF)

