Boosting divestiture value with pro forma EBITDA adjustments

Unrealized profit impact from business process improvements may increase divestiture value for sellers

Introduction: Today's M&A market

When a company decides to divest an asset or pursue an outright sale, chances are good that the sale process will attract multiple bidders. This was true in the strong deal market we saw from 2020 through early 2022, and it remains the case today even amid the headwinds slowing mergers and acquisitions (M&A) activity. From a seller's divestiture strategy perspective, a top priority should be how to elicit the best possible price from all bidders competing for an asset.

As straightforward as this may sound, sellers today are neglecting business process improvement opportunities that could move them meaningfully toward this goal. When time allows, sellers can capitalize on the months leading up to the marketing of an asset to identify, plan, and initiate new business process changes that will favorably impact results. Even when the divestiture timeline is more compressed, sellers will want to examine ongoing business improvements and highlight them. The impact of such changes can be annualized as pro forma earnings before interest, taxes, depreciation and amortization (EBITDA) adjustments and then properly substantiated and presented to potential bidders.

Why pro forma EBITDA?

Sellers need to think from the point of view of potential buyers. A bidder that has committed to participating in the process—and is incurring costs by paying bankers, lawyers, and consultants—wants to win the deal. As much as a buyer may wish for a bargain, hoping for a low price is not how bids get set in a competitive market. Rather, bidders aim to arrive at the highest possible bid that can be justified based on the financial picture of the business to be acquired. Each operates in full knowledge that other bidders are also doing this.

The valuation analysis for a buyer will typically begin with results for the last 12 months for the business under consideration, focusing on EBITDA in particular. A decade or so ago, a potential buyer might have been unwilling to look much further to justify the valuation underpinning a bid. Today, though, most will consider pro forma EBITDA adjustments related to planned or partially realized business process improvement initiatives.

Buyers, particularly private equity (PE) firms, are searching for value creation opportunities to help support more competitive bids, and that's what pro forma EBITDA represents. Buyers today are compelled to put a value on such measures to boost their chances of success.

Recognizing this, sellers need to be proactive. They should develop their own estimates of pro forma EBITDA adjustments that could potentially be extracted from the business being sold. Potential buyers may not give full credit to the sellers' estimates, but the numbers will be on the table for all to see. The seller knows the business and operations best, and the seller's analysis can't easily be ignored.

To be sure, when sellers don't provide pro forma EBITDA estimates, buyers are likely going to do their own assessment of value creation potential. But the types of business process changes that buyers might identify will vary widely, and the value placed on such changes may span a broad range. Better for the seller to set a benchmark, giving bidders something concrete to examine. Sellers benefit when each bidder knows that all competing bidders are considering the same set of numbers as their starting point.

Highlighting value creation opportunities

Sellers' efforts to find and present value creation opportunities needs to be tailored to the specific characteristics of the business that's being sold and the circumstances of the transaction. The expected timing of the sale process plays a critical role:

- **Planned marketing of the asset is four to 12 months out:** Sellers should use this time to identify and initiate new business process improvements that can favorably impact results. A bottom-up value creation diagnostic can be used to find discrete performance improvement initiatives. This effort might look for such things as cost savings from selling, general and administrative expenses, supply chain improvements, or headcount reductions.
- **One to three months remain before marketing:** Sellers should identify existing business process improvement efforts the company is undertaking, based on information and data about the business and operations. This effort can run in parallel with a thorough quality of earnings analysis for the sale.

In both cases, sellers will calculate the impact of these business initiatives as pro forma EBITDA. When there is only partial year impact on the profit statement from new or ongoing business changes, pro forma EBITDA can be annualized.

The quality of earnings report needs a clear narrative, detailed cash flow models, and other forms of substantiation to qualify the pro forma EBITDA adjustments. Articulating a track record of successful execution on prior cost reduction or process change efforts will help boost confidence that management can deliver on the pro forma EBITDA post-close.

Our experience with clients has shown us that pro forma EBITDA adjustments related to business process improvement efforts will not necessarily emerge from other aspects of the sale process. Bankers, CFOs, and consultants tend to be focused primarily on standard accounting adjustments related to EBITDA.

Proper substantiation of these pro forma EBITDA numbers will be key, giving potential buyers greater confidence that they can accept the adjustments as the basis for higher bids. At each step, sellers and their advisers will want to collect supporting materials to provide to potential buyers in a virtual data room in the sale process. Buyers may want to see how business improvement initiatives are reflected in budgeting, capital expenditure planning, incentive plans and so on.

Helping clients increase deal value

The areas that can yield pro forma EBITDA adjustments are many. Our work with clients over the past several years has provided strong examples across a range of businesses and industries. Here are several instances, from both longer time frame situations, when a focused value creation program could be pursued, and shorter timeline transactions:

Longer time frame:

- With nine months of lead time prior to marketing, we helped a $280 million consumer products manufacturer identify $10 million in value creation initiatives focused on organizational restructuring, outsourcing, and plant and equipment process improvements.
- In a 9-month period prior to sale, we assisted a $400 million health care company to identify $25 million in value creation opportunities focused on warehousing/distribution optimization, customer service offshoring, facility consolidation, and back-office restructuring.

Shorter time frame:

- We assisted a chemicals company with $370 million in sales to identify $13 million in pro forma EBITDA adjustments based on initiatives that were focused on customer pricing changes, transportation cost improvement, manufacturing efficiencies, and headcount reduction.
- Working with an industrials company that has $550 million in annual sales, we identified $7 million in pro forma EBITDA focused on manufacturing insourcing, new product launches, and footprint adjustment.

Conclusion: Impact on sale price

Even small adjustments to pro forma EBITDA can have a significant impact on the sale price for a company or a divestiture. When a multiplier is applied to the examples above, it becomes easy to see how buyers that factor in sellers' EBITDA guidance, even with a discount, may be willing to boost purchase prices by tens or hundreds of millions of dollars.

In the current market, failure to provide potential bidders with a clearly defined, well-substantiated case for pro forma EBITDA adjustments as part of the divestiture strategy is truly to leave money on the table.

For more information, please contact:

Casey Vain
Managing Director
Deloitte Consulting LLP
+1 703 403 6080
cvain@deloitte.com

We wish to thank Henning Buchholz (Deloitte Consulting senior manager) for contributing his ideas and insights.