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The Pre-QofE Underwriting Guide

Conduct a low risk analysis of your target deal's financials.

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For buyers under LOI or close to one

Conduct a low risk analysis of your target deal's financials. This is meant to give you a preliminary assessment of the quality of your target deal's earnings, growth profile, and cash flow. This guide is not considered advice and Edler Zain does not express any opinion on you or your deal's underwriting.

BEFORE YOU START

The Importance of *Adjusted EBITDA*

The valuation of your deal, capital structure, and your debt servicing capabilities will be heavily impacted by the adjusted EBITDA of your target.

Most buyers only lightly review the supporting data before the LOI stage, as sellers and brokers are hesitant to give substantial information before a letter of intent is signed.

After working on over 200+ M&A deals and over 500 prospecting calls with acquisition entrepreneurs, my team and I have developed a strong "bullshit detector" that can spot risks before our clients have to make a deposit on their diligence fees.

This document will show you how to call bullshit on a potentially bad deal before you sign an LOI.

Not only will this save you fees, but it will also save you from the psychological anchoring effect that takes place once you go under LOI.

I have acquired two companies and been under LOI for several, and I understand the "wanting" to make the deal work. I cannot tell you how many clients I have had that are extremely disappointed when EBITDA comes in light. Rather than humbly accepting reality and trying to make adjustments to the deal, most try to rationalize the changes and make their deal work as is.

This is because of the anchoring effect. The LOI acts as a gating mechanism that makes you feel like abandoning the deal would be a massive "sunk cost" both financially and time-wise.

> So use this to save yourself from your own extremely human mental anguish!

Who this is for

Searchers, independent sponsors, and acquisitive business owners who are acquiring a company with at least $750K of EBITDA and up to $10 million EBITDA.

What it won't do

A first pass won't catch everything. A real QofE ties the books to bank statements, general ledgers, tax returns, and other supporting data sets. It also tests each add-back against the GL, and evaluates detailed monthly financial trends for potential EBITDA and NWC adjustments.

This first pass scans for early risk signals and provides a gap analysis, so you have a clear roadmap of what needs to be diligenced at post-LOI kickoff.

THE FRAMEWORK

The seven tests we run before every QofE

Test	What to check
1. EBITDA trend	Your first review point should be the level of EBITDA for: • The trailing twelve months • Prior 3 fiscal years Your first look should be a sanity check for three things: Is EBITDA scaling rapidly? Is EBITDA margin consistent or varying? Does the EBITDA profile match the business model / industry? The first place to call bullshit is an unusually strong uptrend in EBITDA in recent years vs prior years. This is sometimes legitimate if the owner put in legitimate work to prepare the company for sale, but many times it is games being played with addbacks and accounting magic. Do a sanity check on EBITDA margins. If an HVAC company says they are doing 40% EBITDA margins, you can conservatively cut their estimate in half just based on the industry averages. Also, do a sanity check on EBITDA addbacks. You're mostly going to check for commercial logic at this point, not tying addbacks to receipts. See addbacks below.
2. Revenue growth rates	Is revenue jumping like crazy in a sleepy, 30 year old business that has had no change in management or business model? Beware of accounting games or cash flow manipulation being played with rev rec. Old school companies don't grow 30% YoY after growing at inflation for 20+ years…
3. Owner replacement cost	Remove owner salary AND recast your own salary and whatever replacement hires are required. Those sellers tend to be more crafty than you think. I have LEGIT seen owners who did the work of 3–4 men and threw an independent sponsor for a whirl wind post close after they realized how much more they had to hire.
4. Margins and cost structure	If gross margins are inconsistent, this is typically an inventory or classification problem that can indicate the EBITDA run rate is inaccurate.

5. Working capital	Check receivables, payables, inventory, and customer deposits. If the deal has no working capital target, the seller can collect the AR on the way out and leave you to fund the business. You should also review the balance sheet for accounting anomalies like negative accounts or extremely high balances, or stale balances. **BEWARE:** Many sellers decline to send their balance sheet until after LOI. Do not proceed without getting a view of the balance sheet for at least 1–2 fiscal years. I prefer to see the most recent month end.
6. Debt service coverage	Do a conservative recasting of EBITDA based on our checks and run your debt service coverage ratio. I prefer to see a DSCR between 1.5–2X even though some lenders will take lower.
7. Accounting methods	Get an early understanding of if you are looking at cash basis or accrual basis figures. Accrual is the gold standard, and looking at cash basis returns, only to get in and see major differences from accruals can be soul crushing.

Addback types

Type	Risk areas
Owner pay	Recast replacement cost. Also make sure owner distributions are not added back, as these are balance sheet accounts, not P&L accounts. These are called “phantom” addbacks.
Personal expenses	Ensure no business expenses are included
One-time items	Check if any should logically be recurring
Pro forma / run-rate	Acceptable when changes have already been finalized and justifiably recast historical performance. Ie. A reduction in a vendors cost rates were renegotiated because part of the work was taken in house.
Discretionary expenses	Do not accept addbacks for marketing expenses, bonuses which are considered an ordinary compensation item for employees, or software subscriptions that claim to be unnecessary.
Cash off the books	Do not do a deal that has cash or other activity off the books…

DEBT SERVICE

Make sure the business can carry the loan

Lenders look at the debt service coverage ratio (DSCR), which is cash available for debt service divided by a year of principal and interest. Many SBA lenders look for 1.25× or better. Below 1.0×, the business can't cover its payments in that scenario.

DSCR = (Underwriter's EBITDA – maintenance capex – buyer's income taxes) ÷ annual principal + interest

An example

Hypothetical figures for illustration only. The rate and terms are assumptions, not a quote.

Deal terms	Amount
Purchase price (4.0× the seller's EBITDA)	$3,000,000
Buyer equity (10%)	$300,000
Loan of $2.7M over 10 years at an assumed 10.5%	$437,000 / yr

	Seller's number	After triage
EBITDA	$750,000	$560,000
Less a replacement manager, with taxes and benefits	($120,000)	($120,000)
Less maintenance capex	($50,000)	($50,000)
Cash available for debt service	**$580,000**	**$390,000**
DSCR (before the buyer's income taxes)	**1.33×**	**0.89×**

Where a first pass stops and a QofE starts

A first pass only knows what's in the documents the seller gave you. A QofE goes underneath them. We reconcile the books to the bank month by month, test add-backs against individual GL transactions, rebuild revenue on an accrual basis, set the working capital target, and look for liabilities that never made it onto the balance sheet. That's the work that protects your price and gives your lender confidence in the deal.

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NEXT STEP

When the first pass looks good, bring in a buy-side QofE.

We're Edler Zain, an M&A-focused CPA firm. We tie the seller's numbers to the bank statements and the general ledger, trace every add-back, set the working capital target, and walk you thru what to raise with the seller and your lender.

- 200+ M&A deals
- $375M in enterprise value
- 800+ clients served since 2022

Book a free 30-minute deal call. We'll go thru your deal, the seller's numbers, and what to test first. Starting early gives you time to raise findings with the seller and your lender before closing.

Book your free deal call at edlerzain.com/buy-side-qofe

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