



QUALITY OF EARNINGS

DESCRIPTION

- Quality of earnings (QoE) refers to how accurately a company’s reported earnings reflect its true financial health & sustainability.
- It’s not just about revenue—earnings quality is influenced by cost structure, pricing power, customer retention, accounting practices, and operational efficiency.
- High-quality earnings come from core, repeatable operations, while low-quality earnings rely on one-time events or hidden risks.

WHY PRIVATE EQUITY CARES

- PE firms want to understand a business’s true profitability, not just its top-line revenue.
- Poor-quality earnings can mask operational inefficiencies, unsustainable cost structures, or underinvestment.
- A business with high-quality earnings has stable margins, predictable cash flows, and resilience to economic shifts. This also makes lenders and investors more confident in the PE firm and the deal.

IMPACTS ON SELLER

- **Higher Valuation:** Businesses with clean, reliable, and recurring earnings command higher EBITDA multiples.
- **Cost & Margin Analysis:** Buyers will assess pricing strategies, supplier relationships, and cost controls to ensure earnings are sustainable.
- **Adjustment to Price:** If earnings include temporary cost cuts, deferred expenses, or non-operating gains, buyers will adjust earnings downward, lowering valuation.

EXAMPLE

Factors	Low	Medium	High
Quality of Earnings	<50% of from core operations	50-80% from core operations	80%+ from core operations
Valuation Impact	-20-40% discount to EV	-5-15% discount to EV	+0-10% premium to EV
Buyer’s Risk Perception	Low	Moderate	High

