35th BFSICM Roundtable Discussion – A Think Tank – Finance – Mentoring Initiative

- Due Diligence for M&A transactions

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What is due diligence

In common parlance, due diligence is defined as the care a reasonable person should take before entering into an agreement or transaction with another party. (1)

In the context of M&A transactions, due diligence is

- The process by which information is gathered about:
  - A target company;
  - Its business; and
  - Its environment, whilst
  - Considering the structure of the envisaged transaction
- To ensure that prospective investors make an informed investment decision.

It is not just

- Checking the facts
- Reformulating them
- Auditing

It is about

- Analysis/evaluation
- Interpretation
- Communication

Source: (1) Investopedia

Types of due diligence

- Financial due diligence
- Tax due diligence

These are the areas CAs are normally involved in. The Big 4 as well as prominent mid-size firms such as SKP, BMR etc. are key players.

- Commercial due diligence
- Operational due diligence
- Environmental due diligence

Larger CA firms such as the Big 4 offer these services in addition to the ones mentioned above. Other players in the space include management consulting firms and other specialist advisory firms.

- Legal due diligence
- IT due diligence

These areas are handled by specialists in the field, i.e. lawyers and IT consultants respectively

Chartered Accountants are equipped to carry out financial and tax due diligence. Expanding our skills sets and acquiring primary and secondary research skills can also enable to work on commercial and operational due diligence. Working on different aspects of due diligence will give a holistic view of the transaction

Key skills required for due diligence

- **Understanding the business and key drivers** –This will determine the nature of analysis to be carried out, KPIs to be analyzed, information to be obtained from Management etc.
- **Creative ways of looking at and presenting data -** Since there is no fixed format of the final report, the role of a due diligence practitioner is to find the best possible way to present financial and other information in a manner that adds value to the client or user of the report. This includes revenue/EBITDA bridges, stacked or clustered column charts, pie charts etc.
- **High level of excel analysis -** Large deals involve working with and validating complex models for which it is imperative to have advanced excel skills. There are different kinds of analysis carried out such as sensitivity analysis, customer churn, constant currency analysis, seasonality and others to obtain deeper understanding of the trends and performance of the business being diligence and facilitate the identification of one-off items.
- **Being able to interpret financial data -** Being able to draw insights from all the data and analysis is the key in a due diligence assignment. The purpose of all the analysis is to assess the quality of its earnings (i.e. arriving at normalized EBITDA – a sustainable level of earnings that has been achieved in the historical period and can be achieved going forward), arrive at an average level of working capital and correctly identifying all the debt-like items. That is the ultimate objective of all the analysis and data processing.
- **Clear presentation in the form a report** – Succinctly presenting findings in the form of a report is an important component of a due diligence. That is the key difference with an audit. There is no standard report form, but reporting on the findings and analysis is the ultimate objective of a due diligence.

Due diligence clients

Financial/PE clients

- Valuation, exit strategy, internal rate of return
- Quality of earnings (e.g. EBITDA)
- Forecast profitability and cash flow
- Quality of assets/liabilities
- Tax impacts

- *Reports are provided to investment committees and financing banks*

- Objectives are similar to those of financial clients

Plus, for example:

- The quality of the business / operations
- The growth strategy (e.g. geographical expansion, new line of products, new distribution channel, technological development)
- Post-acquisition synergies
- Net income, EPS
- Effective tax rates

- *Reports are generally provided to investment committees*

Analysis involved in financial due

Quality of Earnings
(Historical P&L and adjusted EBITDA)

Quality of Assets/Liab.
(Historical BS and adjusted net debt)

Forecasts
(P&L and cash flows)

Cash Flows and WC
(Flows, capex and WC seasonality)

Business Overview
(Structure, operations)

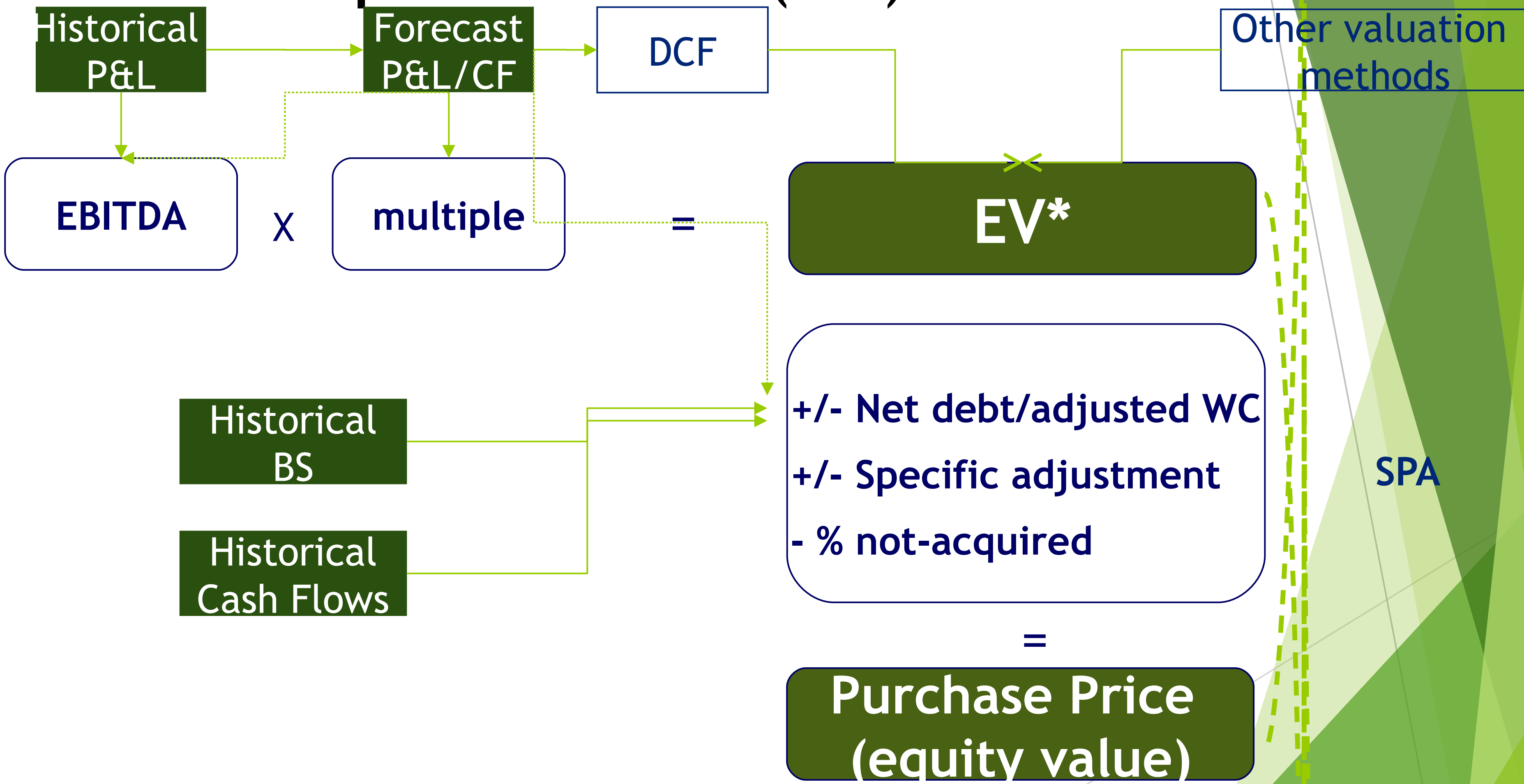
Quality of Fin. Info
(sources and reliability of the figures)

SPA Items
(Structure, specific risks)

Typical report structure

- Key findings
- Business overview
  - History, organisation and footprint
  - Legal/operational structure
  - Customers, suppliers, partners, interco
- Quality of Financial Info
  - Reporting and resources
  - Carve-out and stand-alone issues
  - Pro forma and similar issues
- Historical trading
  - P&L overview and drivers
  - Adjusted EBITDA
- Historical balance sheet
  - Balance sheet overview and key items
  - Working capital components
  - Adjusted net indebtedness
- Forecasts
  - Forecasts overview and assumptions
  - Comparison to historical performance
- Taxation, IT etc.
- Appendices
  - Scope & bases of review
  - Supporting tables/charts

The Enterprise Value (EV) model



** cash/debt free with a normal level of working capital*

Enterprise Value (EV) to Equity bridge

Case A (normal level of WC at Closing):		**Case B (low level of WC at Closing):**	
EV	€100m	EV	€100m
Cash	€10	Cash	€20
Debt	€(20)	Debt	€(20)
Net debt	€(10)m	Net debt	€0m
Purchase price	**€90m**	**Purchase price**	**€100m**
WC level (average)	€15m	WC level (low)	€5m
		Financing need	€10m
		Price + financing	**€110m**

Thank you