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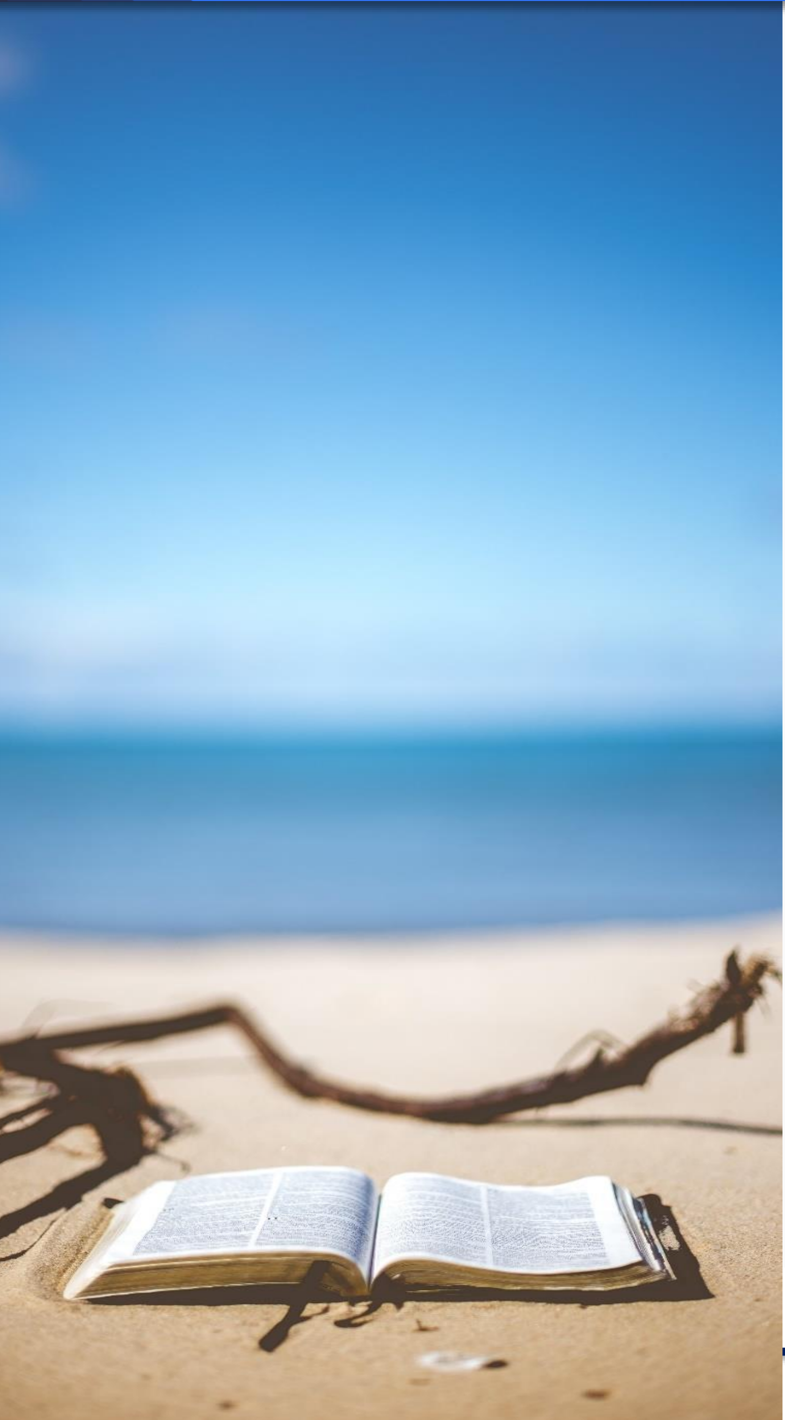
kcm Guide

Transaction Advisory

Financial Due Diligence

Deal Maker or Deal Breaker?

February 17, 2021



Background & Coverage

Due diligence is an investigative process to confirm the facts underlying a transaction under consideration, through which a potential buyer/investor evaluates a target's financial and operating performance. In an M&A transaction, a potential buyer would want to perform a detailed review of the risks and opportunities underlying the business of the acquisition target. Financial due diligence is a detailed analysis of the target's historical performance with core focus on key financial drivers including the quality of operating revenue and earnings (generally EBITDA), capital expenditures, operating working capital and net debt/debt like items.

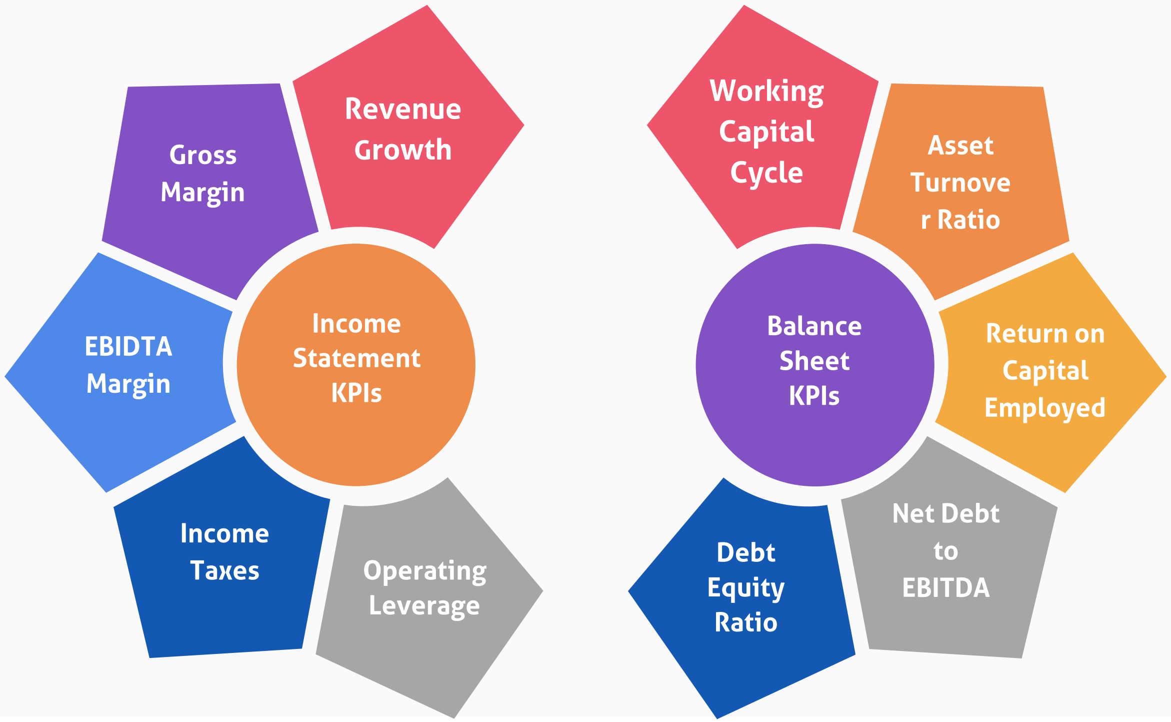
Key aspects of Financial Due Diligence

- Key Performance Indicators
- Revenue Bridge and Price-Volume Analysis
- EBITDA Bridge
- Key Deal Considerations
- Tax Due Diligence
- Impact of Financial Due Diligence findings
- Key considerations in Financial Due Diligence in times of COVID
- The Verdict

Key aspects of Financial Due Diligence

The best part about due diligence is that it is not guided or defined by any set standards and hence its scope would vary depending on the nature of the target business, nuances in the target industry, risk profile of the target and the type of transaction. As such, due diligence is not confined by standard checklists or set procedures. An independent financial due diligence helps save the cost of bad acquisitions and also identify potential red flags in a transaction. Financial due diligence would help address the following deal drivers:

Key Performance Indicators



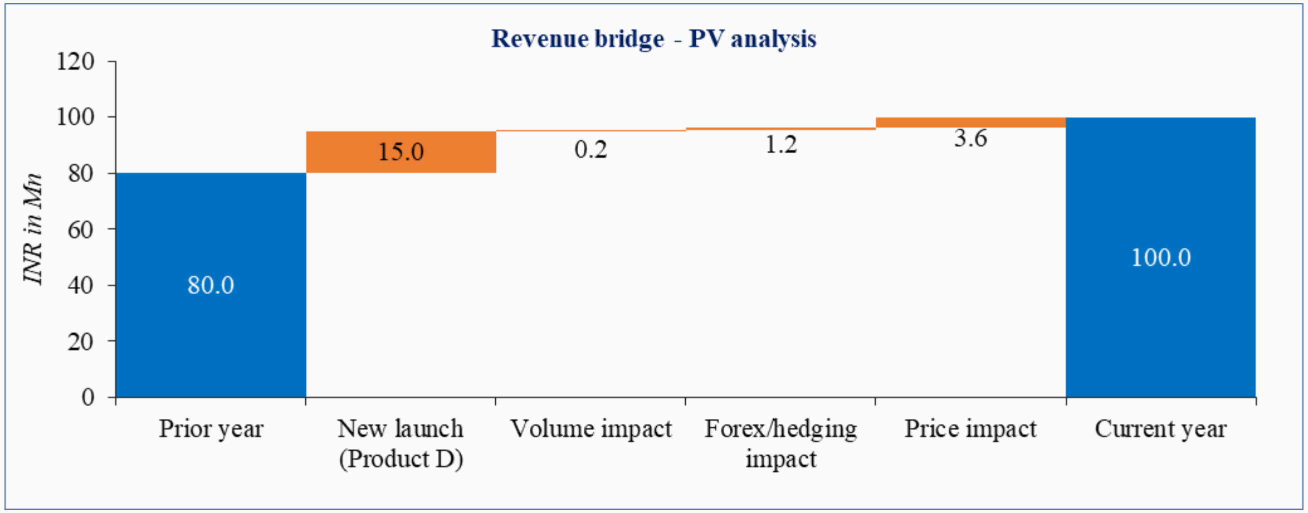
- Quality of historical financial statements of the target and understanding key financial ratios
- Cash generating capacity of the target net of its working capital and capex requirements
- Reported net debt and debt-like items including contingent liabilities
- Potential impact of due diligence findings on valuation of the target
- Reasonableness of the assumptions underlying the financial projections in the business plan
- Review of comparable businesses and competitor benchmarking
- Likely synergies that the deal would offer and means of realizing the same
- Matters to be covered as a part of the transaction documentation

Trends in aforesaid metrics are analyzed to obtain perspective of the business performance, financial position, capex requirements, working capital needs and resultant cashflows.

Revenue Bridge and Price-Volume Analysis

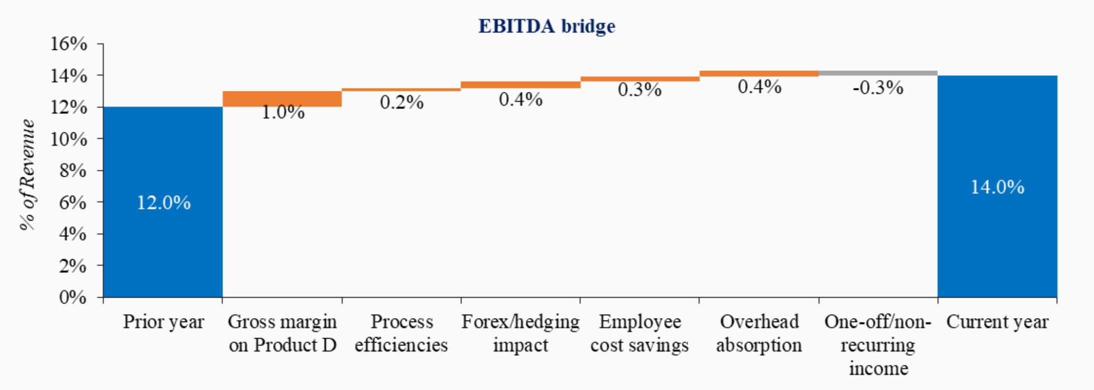
Presented below is an indicative price-volume analysis of change in revenue with a bridge highlighting the underlying drivers of the change in revenue:

	Prior year			Current year			Current year v/s Prior year		
INR in Mn	Qty (Kg)	Price (Rs.)	Sales	Qty (Kg)	Price (Rs.)	Sales	Volume	Price (Rs.)	Total
Product A	10,500	2,000	21	9,100	2,200	20	(2.8)	1.8	(1.0)
Product B	8,000	4,000	32	8,000	3,750	30	0.0	(2.0)	(2.0)
Product C	9,000	3,000	27	10,000	3,500	35	3.0	5.0	8.0
Product D	--	--	--	3,000	5,000	15	15.0	0.0	15.0
Total	**27500**		**80**	**30,100**		**100**	**15.2**	**4.8**	**20.0**



EBITDA Bridge

Presented below is an indicative EBITDA bridge highlighting key contributors to the increase in EBITDA margin:



As they say, a picture is worth a thousand words, the above bridges help clearly decipher the movement in revenue and earnings along with the underlying drivers derived after an extensive diligence exercise.

Key Deal Considerations

Quality of Earnings

- With different accounting conventions being followed, window dressing of financial statements cannot be completely ruled out. Hence, it is imperative to assess the quality of reported earnings, which in most of the deals drives the valuation.
- Quality of earnings is an analysis undertaken to arrive at the sustainable earnings of the business after reviewing its key constituents such as revenue, direct operating costs, employee costs and other overheads.
- The review also includes normalization of earnings by removing anomalies such as one-off/non-recurring incomes and expenses, accounting inconsistencies, impact of related party transactions, etc.
- Usually, an increase in revenue would lead to increase in cashflows, the absence of which indicates a red flag. It is thus imperative to track the activities from income statement to the balance sheet and the cashflow statement.
- The table on the subsequent page depicts an indicative adjusted earnings (quality of earnings) statement:

INR in Mn	Prior year	Current year
Reported revenue	**80**	**100**
Adjustments		
Cut-off adjustments and sales returns	(2)	(3)
Accounting adjustment (revenue recognition)	5	(5)
One-off/non-recurring revenue stream	-	(2)
Adjusted revenue	**83**	**90**
Reported EBITDA	**10**	**14**
Reported EBITDA %	**12%**	**14%**
Adjustments		
Margin impact of revenue adjustments	1	(4)

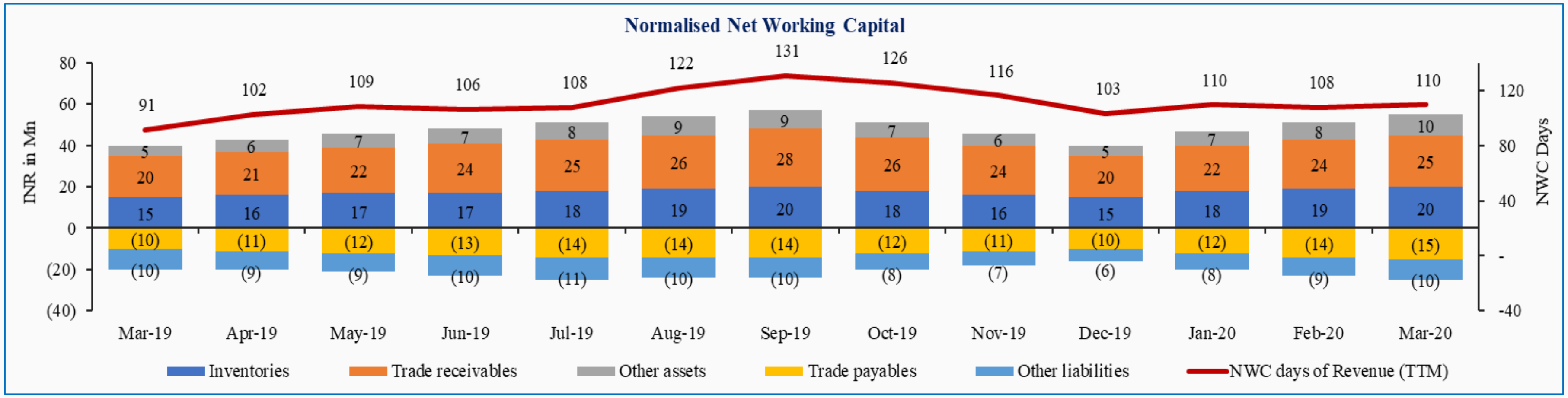
Inventory valuation adjustment	(1)	(2)
Cost of filling organizational gaps	-	(1)
Under-accrual of expenses	(1)	(1)
Provision for doubtful debts	(1)	(2)
Adjusted EBITDA	**8**	**4**
Adjusted EBITDA %	**9%**	**4%**

Referring to the above, the due diligence exercise uncovered that instead of the increasing trend in EBITDA margin as reported in the financial statements, the adjusted/normalised EBITDA showed a decreasing trend.

- It is worthwhile to note that the impact of EBITDA adjustments on valuation is manifold as generally the valuation is at multiple times the EBITDA.

Working Capital

- Working capital in accounting terminology is defined as current assets *less* current liabilities, although when investigated becomes more complicated.
- It is usually noticed in an M&A deal that the buyer would demand higher working capital while the seller would be tempted to reduce the working capital by converting it to cash. In order to avoid any dispute, parties generally agree to a normalized working capital which is a historical average subject to seasonality in operations. Such normalized working capital is compared with the closing working capital and the difference is adjusted from valuation.



- Impact of seasonality is visible from the chart outlined on the previous page with working capital peaking in Sep-19 and getting to a low in Dec-19. As such, if a transaction is expected to close in September, the buyer would demand a higher working capital and reverse would be the case in December.
- Net working capital is a significant component in any deal, hence gaining a deep understanding of it would indicate to the buyer the quantum of cash required to operate the business post deal in order to avoid unanticipated cash outflows.
- Adjusted working capital is arrived at based on due diligence by adjusting from the reported working capital the corresponding impact of earnings adjustments, debt-like items and other non-operating/non-recurring items and accounting adjustments.
- The adjacent table summarizes an indicative adjusted working capital statement:

INR in Mn	Prior yr.	Current yr.
Inventories	15	20
Trade receivables	20	25
Other assets and advances	5	10
Trade payables	(10)	(15)
Other liabilities and provisions	(10)	(10)
Reported net working capital	**20**	**30**
Adjustments to earnings		
Cut-off adjustments and sales returns	(2)	(3)
Accounting adjustment (revenue recognition)	5	(5)
Inventory valuation adjustment	(1)	(2)
Under-accrual of expenses	(1)	(1)
Provision for doubtful debts	(1)	(2)
Adjustments for debt like items		
Provision for long-term employee benefits	2	2
Stretched creditors	1	2
Capital creditors	1	1
Asset retirement obligations	2	2
Provision for income tax (net of advance tax)	2	3
Refundable advances/deposits	1	2
Total adjustments	**9**	**(1)**
Adjusted net working capital	**29**	**29**

It can be noted from the adjusted working capital statement that reported working capital which showed an increasing trend actually got normalised based on the findings of the due diligence exercise.

Net debt

- The below table shows an indicative adjusted net debt statement:

INR in Mn	Prior yr.	Current yr.
Short-term borrowings	15	20
Long-term borrowings	10	10
Cash and bank balances	(5)	(5)
Reported net debt	**20**	**25**
Adjustments for debt like items		
Restricted cash	2	3
Provision for long-term employee benefits	2	2
Stretched creditors	1	2
Capital creditors	1	1
Asset retirement obligations	2	2
Provision for income tax (net of advance tax)	2	3
Refundable advances/deposits	1	2
Deferred capex	-	5
Transaction costs	-	2
Direct and Indirect tax exposures	2	3
Total adjustments	**13**	**25**
Adjusted net debt	**33**	**50**

- Reported net debt is the aggregate of all borrowings net of cash and cash equivalents, which needs to be adjusted for certain debt like items (typically non-operating liabilities) which are not apparently visible on the face of the balance sheet and only a due diligence can uncover.
- Net debt is a very significant component in valuation as it is adjusted from the enterprise value of the business to arrive at the equity value, which means higher the net debt, lower the equity value, and vice versa. In the above example, amount of net debt actually got doubled based on the diligence exercise.

Other key considerations

- <u>Management Information System (MIS)</u>

  Monthly/quarterly MIS reports are usually referred by management for periodic decision making and also for tracking the actual business performance vis-a-vis the budgets.

  Since this is the first-hand information reviewed by management, it is important during the financial due diligence stage to understand the process of preparing the same and also providing reconciliation (if any) between the MIS and the audited financial statements.

- <u>Carve-out aspects</u>

  It could be challenging to validate the carve-out financials of a business vertical vis-a-vis the entity level financials. Accuracy and completeness of the carve-out would depend on the accounting systems and the extent of interdependency with other business verticals.

Identification of specific assets, liabilities, incomes and expenses and the ability to allocate these to the target business would also pose challenges. It is equally important to understand the standalone operating costs and one-time separation costs of the target business after carve-out from the legal entity.

- Cash flow statement

  Understanding the conversion of EBITDA to free cashflows is an important process in any valuation exercise. Hence, it is important to decipher the nature of cashflows from the cash flow statement as operating, financing and investing cashflows.

- Capital expenditure

  Capex is generally classified into either replacement capex or growth capex. While replacement capex is necessary to maintain the current level of operations, growth capex is incurred with the intention to increase the production capacity and is also referred as expansion capex. Fixed asset turnover ratio would also indicate how effectively the fixed assets are getting utilized to generate revenue.

- Key customer and vendor dependencies

  Diligence exercise also helps uncover business risks associated with significant dependencies on key customers and suppliers of the target business especially in uncertain times like these.

- Key employees and promoter expenses

  Review of employee costs would help provide insights around promoter's expenses (more like dividends), organizational gaps, employee related compliances including pension and retirement obligations, existence of golden parachutes with KMPs, ESOP plans and potential dilution of equity and analysis of employee attrition rate to name a few.

- Related party transactions

  Understanding the nature and extent of related party transactions and dependencies on the target business are crucial to the sustainability of any business. Related party transactions that are not at arm's length principle could impact the quality of earnings as also the outstanding balances would need to be adjusted from the working capital and net debt as the same may be.

Tax Due Diligence

Tax diligence is an integral part of the financial due diligence exercise as it can help uncover tax efficiencies as well as exposures. Tax efficiencies would lead to synergies going forward whereas tax exposures would reduce the valuation of the target business. Protection mechanism from tax exposures would also include obtaining indemnities from the seller/target.

Direct Tax

- Direct tax diligence would typically cover review of tax audit reports, income tax returns, assessment orders, appeal related filings, withholding tax returns, transfer pricing reports and an assessment of outstanding tax demands to identify potential tax exposures.
- Some of the key issues here would include disallowances/exposures under various provisions of the Income Tax Act (e.g., Section 14A, 37(1), 40a, 43B, 56(2) to name a few), MAT and deferred tax related

adjustments, application of ICDS, possible lapses in carry forward and set off of tax losses, deemed dividend and transfer pricing adjustments, among others.

Indirect Tax

- Scope of indirect tax diligence would generally cover review of periodic and annual returns, audit reports, applicability of tax rates and exemptions, discharge of liability under reverse charge mechanism, review of eligible ITC, reconciliation of turnover between financial statements and returns and vetting of documents relating to open litigations to identify potential exposures.
- Key issues typically encountered include ineligible and wrongful availment of ITC, mismatch in turnover and ITC per financial statements vis-a-vis returns and tax portal, wrongful discharge of tax under reverse charge mechanism, reversal of ITC in relation to exempt supplies, etc.

Impact of Financial Due Diligence findings

Valuation

- As explained earlier, the key deal considerations i.e., quality of earnings, net debt and working capital directly impact the valuation. While earnings adjustments would alter the enterprise value with a multiplier effect, net debt and working capital adjustments would impact the net equity value payable to the seller/target.
- Financial projections underlying the discounted cashflow method of valuation are reviewed in light of historical earnings and growth trajectory. Management's ability to forecast is also diligenced by way of budget vs actual analysis of financial MIS. Benchmarking financial metrics with that of the competitors would further provide insights on the historical vs projection bridge.

Definitive Agreements

- Findings out of the due diligence exercise would find place in covenants, standstill clauses, conditions precedent and conditions subsequent to the closing of the transaction depending upon the gravity of the finding and the ability of the seller/target to remedy the same.
- Certain aspects uncovered during the diligence exercise could also result in obtaining representations & warranties, disclosures and indemnification from the seller/target.
- In case of step acquisition or joint venture where the seller continues in the business post the transaction, one of the effective tools of bridging valuation gap between the buyer and the seller is by including Earnout mechanism for the seller where a part of the consideration is kept contingent upon attainment of certain milestones by the seller. Due diligence exercise can help establish future milestones for an Earnout e.g., revenue, EBITDA, customer reach, market share, etc.
- In case of an outright sale, indemnity is often secured through an Escrow arrangement where a part of the consideration is held back by the buyer which is released either upon specific performance by the seller or upon expiry of the indemnity period. Escrow arrangement provides protection to the buyer from unforeseen liabilities after the closing of the transaction.

Key considerations in Financial Due Diligence in times of COVID

The scope and methodology of undertaking financial due diligence exercise has undergone a significant change in order to adapt to the nuances and challenges faced by businesses in times of COVID. Highlighted below are certain aspects that require specific consideration while performing due diligence in recent times:

- Extensive usage of virtual data rooms and sharing of information through electronic mode
- Resorting to virtual site visits and virtual management meetings due to restriction on physical movement especially in case of cross-border transactions
- Detailed review of the liquidity position, debt servicing capacity and going concern considerations in relation to the target
- Ability to identify and measure the one-off impact of COVID on operating revenue, profitability, working capital and net debt position
- Normalization of earnings in light of loss of revenue, supply chain disruptions, employee pay-cuts/lay-offs and one-time costs as well as savings during this period
- Normalization of working capital owing to the stretched working capital cycle including potential impairment of inventories and receivables
- Scrutiny of net debt covering stretched creditors, deferred capex, off-balance sheet financing, provision for onerous contracts, retrenchment compensation, overdue regulatory payments, etc.
- Evaluating impact of change in commercial terms with customers, suppliers, contractors, agents, lenders, employees, labour union, etc.
- Increased risk of estimation uncertainty underlying the business plan and the financial projections
- Change in commercial terms with related parties and corresponding transfer pricing implications
- Recoverability of MAT credit and deferred tax asset balances
- Risk mitigation through transaction documents to include earnout arrangement, material adverse effect and force majeure clauses, disclosures to warranties, specific indemnities, closing date adjustment vis-a-vis locked box mechanism, etc.

The Verdict

Each transaction has different priorities, and one needs to be watchful throughout the deal process as appearances can be deceptive and the devil may lie in the details. While due diligence is generally considered to be a buy-side function, a vendor due diligence exercise can equally drive value for the seller/target and assist in devising effective mitigation strategies.

Due diligence exercise can be a deal maker if it effectively highlights the key risks underlying a transaction along with the mitigation strategy on the deal dynamics. It can however turn out to be a deal breaker if the findings adversely affect the potential synergies and post deal integration as initially envisaged in a transaction.

About kcmGuide

kcmGuide is a special publication prepared by area specific experts at K. C. Mehta & Co. This publication is intended to provide overall guidance on select topics / areas that may be of interest to readers. The idea is to provide to the reader an overall perspective on a particular topic in the form of a Guide which could serve as a referecer while practically dealing with the topic.

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