



Financial Due diligence – Krishna
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Need of Due diligence

Mostly sought for the following transactions:

Acquisition of shareholding interest by a strategic investor

Acquisition of an undertaking/ business

Investment by private equity funds/Venture capital Funds

Inbound and overseas investments

The changing business equation and the complexity in transactions makes focused/informed decisions imperative.

What is due diligence?



A measure of prudence or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstance.

...Blacks law dictionary

- Defined as “an investigation into the affairs of an entity prior to its acquisition, restructuring, fund raising or other similar transaction.”
- The process by which information is gathered about:
 - a target company;
 - its business; and
 - the environment in which a target company operates.
- The objective is to ensure that prospective investors make an informed investment decision

What is due diligence?



It is not just:

- Checking the facts
- Reciting them

It's about:

- Evaluation
- Interpretation
- Communication

- A business oriented analysis and not an accounting analysis.
- A fact gathering exercise with a focused analysis of information.
- Understanding the industry of the target.
- Reasonable level of enquiry into the affairs having a material impact on the prospects of the business.
- Evaluation of the business model and key business practices.
- Examination of relevant aspects of the past, present and near future of the business.
- Assessment of the benefits and liabilities of the proposed transaction.

Types of due diligence

- Accounting & tax due diligence
- Commercial due diligence
- Integrity due diligence
- Legal & regulatory due diligence
- Technical due diligence
- Environmental due diligence
- Operational due diligence
- HR due diligence
- Information technology due diligence

Extended to SPA advisory and closing due diligence



Types of financial due diligence



- Due diligence commissioned by the acquirer
- Focused on areas of interest for potential acquirers (financial or strategic)
- Reporting – generally issue based
- Auction < > exclusive

Buy side

Sell side

- “Vendor Due Diligence”
- Commissioned by the vendor
- Key tool for maximising success of the transaction in a reduced timetable through maintaining competitive tension



Types of financial due diligence

Vendor Due Diligence

It is

- Independent due diligence commissioned by the vendor
- Focused on areas of interest for potential acquirers
- Identifies potential “show stoppers” early allowing an effective strategy to be devised

It is not

- Sales focussed in the same way as an Information Memorandum
- A form of audit
- Duplication of other reports commissioned by the vendor

- Sharing of reports - use of hold harmless letters.
- Reliance on report by investors.

Types of financial due diligence

Limited

- Focus on certain key areas based on the level of comfort desired by stakeholders.
- Carve out - strictly limited to the part of business proposed to be sold.



Full scale

- Focus on all major aspects of financial statements
- Extent of focus and coverage is more comprehensive.



It is important to know what's driving value

Types of financial due diligence – Evolution of expectations

Markets in the past

- **Full access** and **exclusivity** in processes
- Significant **information** available
- Significant **access** to management
- Completion accounts and purchase price adjustments
- **Adequate** time to discuss, deliberate and negotiate due diligence findings

Markets today

- Competitive multi stage **auctions**
- **VDD** prevalent
- Limited additional information
- Limited access to management and managed Q&A processes pre exclusivity
- Locked box mechanisms

What is expected

- Top up due diligence
- Focused reporting on what is important
- Short lead times for completion of work
- Contribution to all aspects of the process including the valuation model
- Opinions
- Ability to be able to share our reports with various stakeholders including financing providers

The process



◆ Impact of Covid 19

“The steps involve an interface with management and other advisors to ensure that all aspects of the project are duly considered and reviewed. This is a pre-requisite for a well informed decision.”

The process

- Pre due diligence information
- Timing of exercise
- Resources
 - Experienced deal professionals
 - Access to industry and functional specialists with transaction experience
 - Technical thought leadership
- Integrated teams
- Focus on important issues



The process

- Logistics
 - Data room considerations
 - Paper < > electronic
 - Deadlines
- Interactions with statutory auditors
- Site visits
- Consult, collaborate, and communicate
- Confidentiality



❓ Impact of Covid 19

The process - Quality of information

1 Lack of critical information - product wise/customer wise margins, monthly/quarterly working capital etc.

Public listed companies – Insider Trading Regulations.

2

3 Information largely received through oral discussions.

Reconciliation of MIS and audited financial statements.

4

5 Unaudited/provisional financial statements

Disclosure of related parties and transactions with such entities.

6

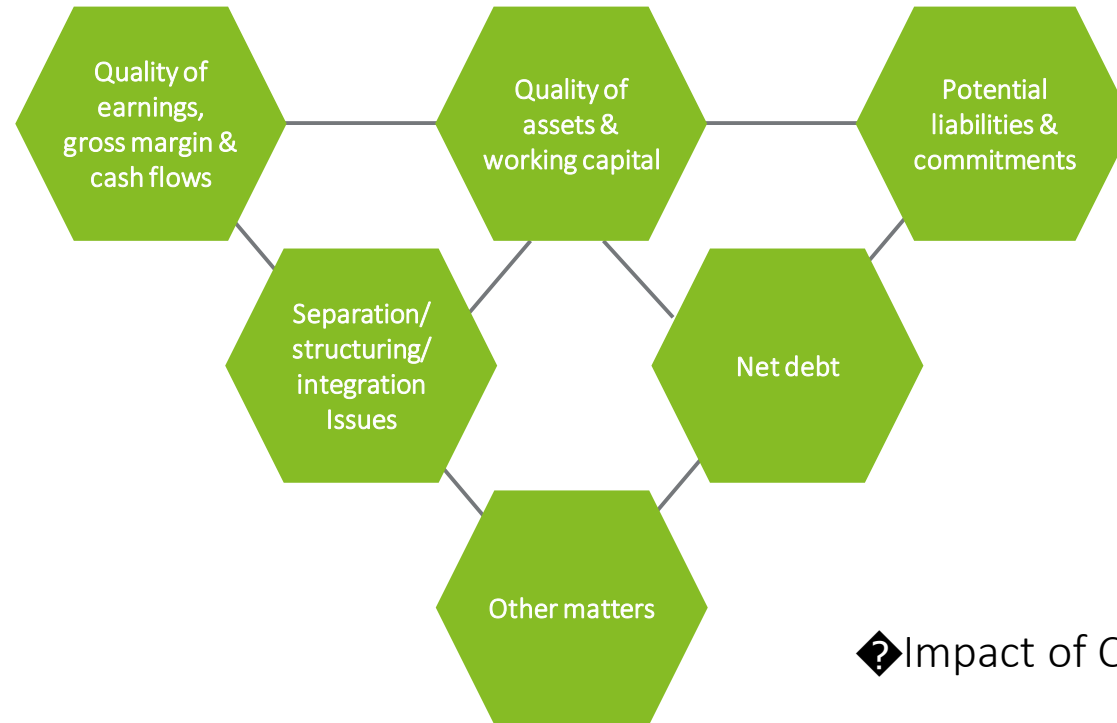
Focus areas

Basis of Valuation

Computation of Equity Value (Debt free-cash free)		
	Rs.m	Rs.m
Enterprise value		X
plus Rs. for Rs. for <u>Cash</u>		X
less Rs. for Rs. for <u>Debt</u>		(X)
plus Rs. for Rs. <u>Actual Working Capital</u>	X	
less <u>Normal Working Capital</u>	(X)	
		X
less <u>Budgeted Capex</u> minus <u>Actual Capex</u>		X
Price payable for equity		Rs.Xm

Focus areas

Nature of transaction



Co-ordination with other work streams is very important. It is an iterative process requiring prompt communication of and acting on findings.

Focus areas

Quality of earnings, gross margin & cash flows

- Identifying seasonality in sales.
- Dependency on customers/suppliers.
- Assessing the impact of customers gained / lost on the bottom line.
- Trend in gross margins – rate of growth; sustainability
- Impact of changing costs on margins (ability to pass through)
- Impact of stand alone costs.
- Impact of foreign exchange rate fluctuations.

Focus areas

Quality of earnings, gross margin & cash flows

- Application/consistency of GAAP
- Revenue recognition and cut off procedures
- 'Normalized', 'pro-forma', 'adjusted' EBITDA
- Items of one off / non recurring nature
- Expenses not incurred exclusively for the business
- Cash flows from operations - stability, timing and certainty

Focus areas

Quality of assets – fixed assets

- Historical capex; growth and maintenance capex.
- Capital WIP – potential commitments.
- Assets on lease – potential increase in lease premium in case of change of control.
- Depreciation policy - assets fully depreciated still being used.
- Capitalization of 'soft costs'.
- Capacity constraints to meet operating growth projections
- Assets used but not owned; owned but not used

Focus areas

Quality of assets - working capital

- Working capital: seasonality and impact on financing considerations; 'normal/average levels'.
- Working capital: quality of receivables and inventories.
 - Realization in the short term - receivables outstanding over six months
 - Valuation of work in progress
- 'Fixed working capital' - deposits with tax authorities and retention money.
- Treatment and presentation of cheques issued but not cleared.

Focus areas

Net Debt

- Definition of 'net debt': surplus cash, investments
 - transaction is on a debt free / cash free basis
- Debt-like items (pension underfunding, severance and other non-operating liabilities)
- Negative covenants in loan agreements (change of control)
- Compliance with terms of debt restructuring schemes
- Impact of right of recompense of lenders in respect of waivers, reliefs and concessions granted to the Target

Focus areas

Potential liabilities & commitments

- Provisioning policy – qualitative (aggressive / conservative)
- Contingent liabilities and off balance sheet items
- Change of control matters (financing, employees, key agreements, etc.)
- Pension and related obligations
- Earn outs / contingent consideration from prior business combinations

Focus areas

Separation/ Structuring/ Integration Issues

- Synergies
- MIS and accounting systems
- Transition services agreement
- Standalone considerations (impact of economies of scale, support functions)
- Potential changes in supply chain management
- Integration issues

Focus areas

Related party transactions

- Financial appropriateness of transactions within family run businesses (arms length pricing).
- Target operating within a 'group'.
- Sharing of resources / common costs
- Financing arrangements with related parties.

HR

- Provision/funding of gratuity and leave encashment.
- Contractual employees; casual labour.
- Retention of key employees.

Focus areas

Strategic investor

- Historical earnings
- Quality of assets and liabilities
- Contingent liabilities
- GAAP effects on consolidation and effect on EPS
- Fit with current tax structure
- Synergy and integration risks

Financial investor

- Cash flows – sustainability/ reliability
- Strong and clear track record of Normalised EBITDA
- Normalised working capital, net debt
- Assumptions behind projections
- Capex – present and future
- Quality of management
- Quality and capacity of IT systems

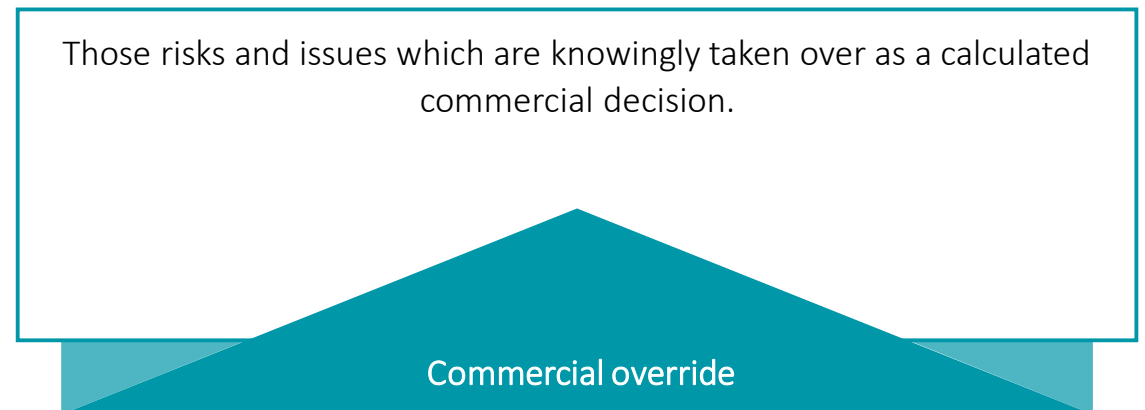
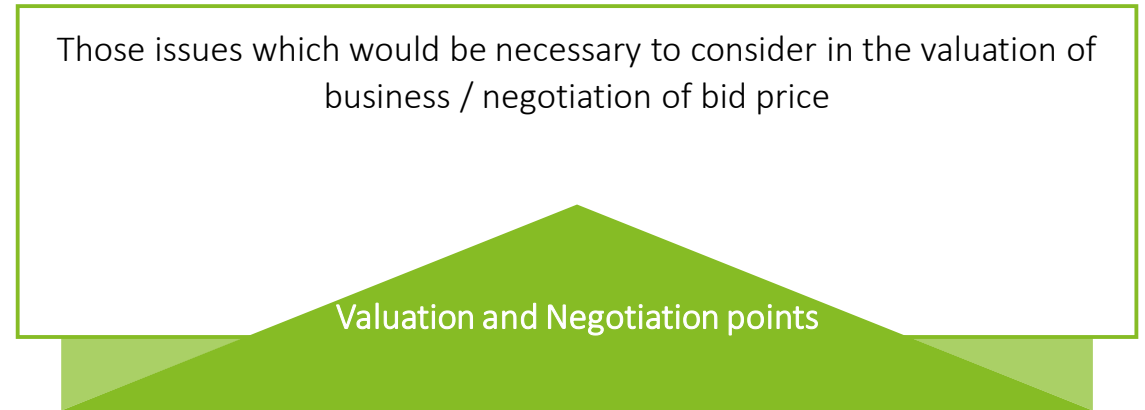
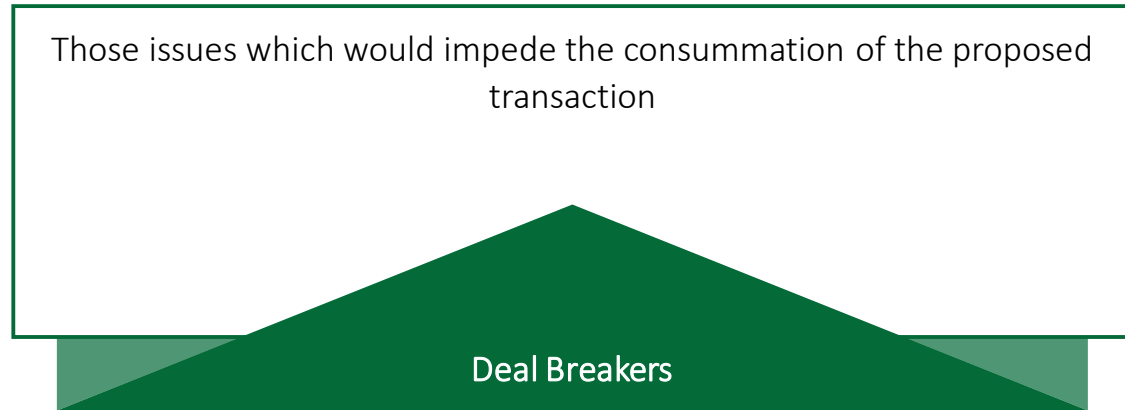
However, needs are converging very quickly...

Focus areas - Due diligence findings

- Anticipate problems and opportunities
 - Early identification of and discussion of preliminary issues
- Measure exposures and seek solutions
 - Quantify estimated amounts and likelihood of exposures resulting in future cash outflows (range/sensitivity analysis)
- Interpret findings
 - Focus on material issues
 - Use plain English – many of the decision makers will not understand or appreciate a detailed technical GAAP or tax answer to a question
- Timely communication of findings

Key benefits

- Inputs for making Go/No go decision, valuation, risk mitigation in transaction documents and matters to be addressed post acquisition



Limitations

1

Not equivalent to an audit conducted in accordance with generally accepted auditing standards.

2

Not an examination of internal controls.

3

Not attestation or review services or services to perform agreed upon procedures in accordance with standards established by the ICAI.

Limitations

4

Dependency on Target

- Information and explanations provided (verbal or written) are materially correct.
- Financial information, details and other documents provided for analysis are materially correct and complete.
- Various documents furnished are genuine.



To conclude...

1

Due Diligence plays an important role in identifying, quantifying and reducing the risks related to an acquisition.

2

Although due diligence focuses on negative information, the aim is not to raise obstacles to transactions, but rather to facilitate transactions by identifying problems and risks and by devising solutions to problems or mechanisms to reduce or manage the risks involved in acquisitions.

Questions/Comments

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