



Bridging Theory with Practice: Basics of Financial Due Diligence

Lesson #3: Income statement and Cash flow

8th May 2025

Bridging Theory with Practice: Basics of Financial Due Diligence

Full Program

10th April 2025

1.FDD at a glance. Base financial data and reclassification

- *The deal continuum;*
- *The Financial Due Diligence*
- *Vendor vs Buy Side Due Diligence;*
- *Our clients;*
- *Integrity, validation and comprehension of financial data;*
- *Balance sheet and income statement reclassification;*
- *DD Report structure*
- *Groups formation for conducting a real FDD.*

11th April 2025

2. Balance sheet and net debt analysis

- *Focus on balance sheet;*
- *Focus on working capital;*
- *Net Debt and adjusted net financial position;*
- *Case study.*

8th May 2025

3.Income statement and Cash flow

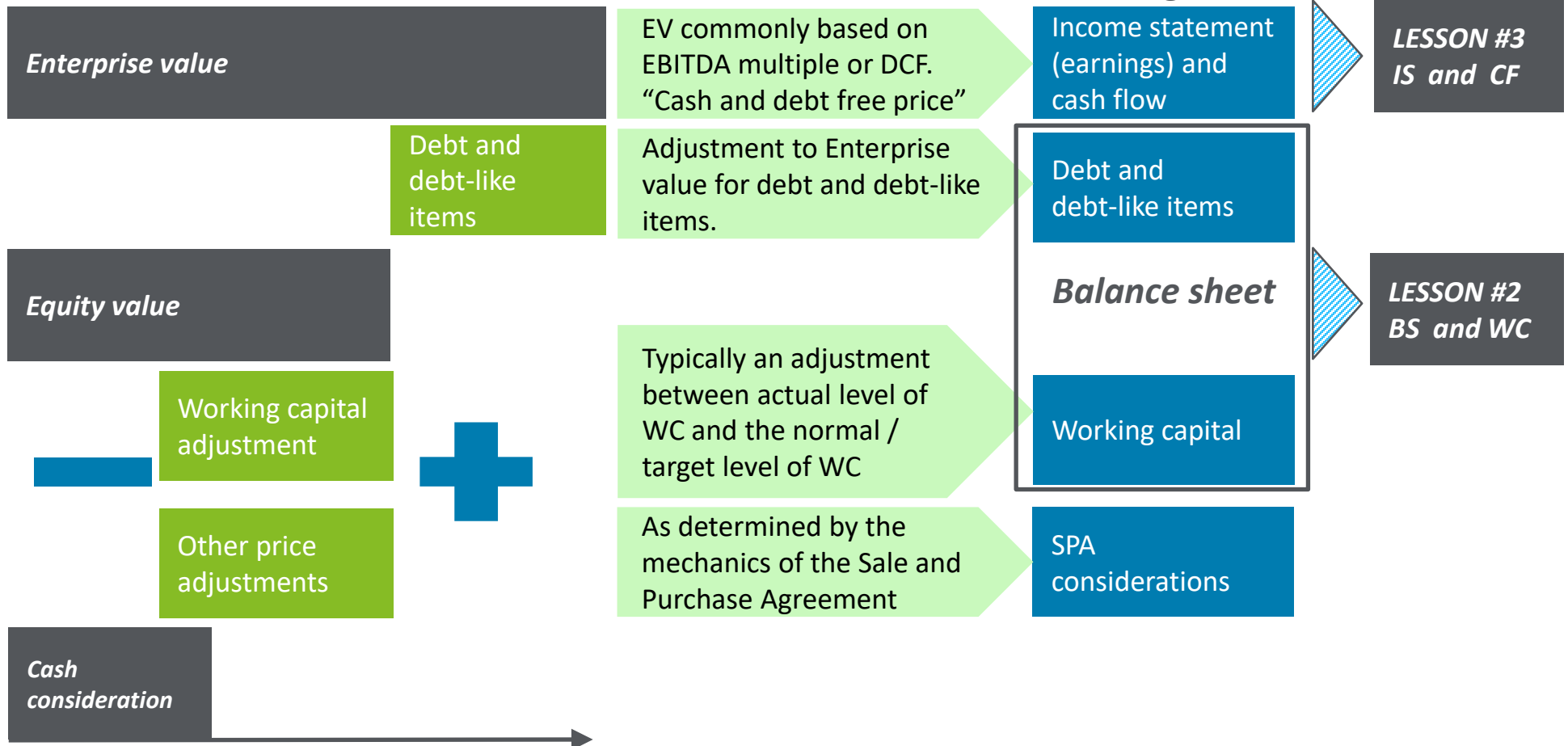
- *Historical performance analysis;*
- *Volume/Price effect and other analysis;*
- *Quality of Earnings;*
- *Overview of cash flow;*
- *Case study.*

22nd May 2025

4. Project works presentation and final remarks

What's our focus?

Typical purchase price components



Contents

Balance sheet

Working capital

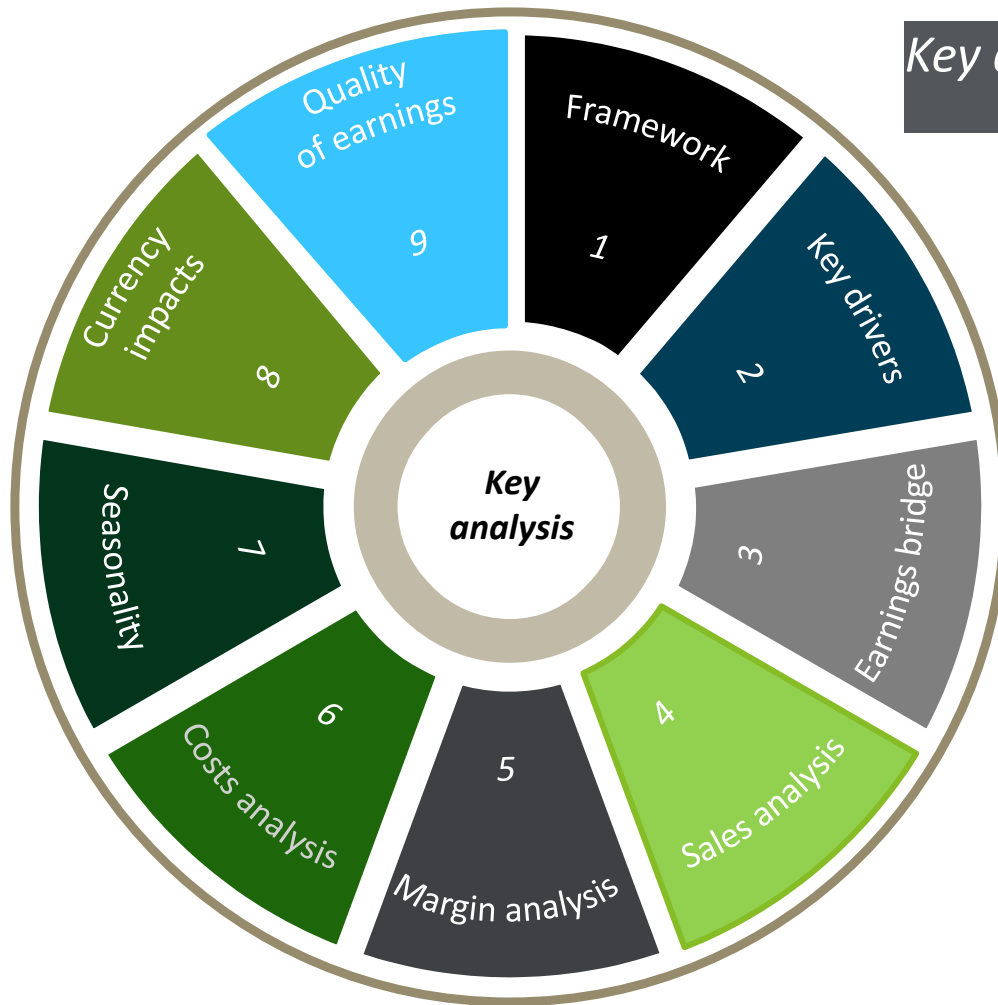
Net Debt

Adjusted net debt exercise

Historical performance analysis

Historical performance

What is important?



Key questions

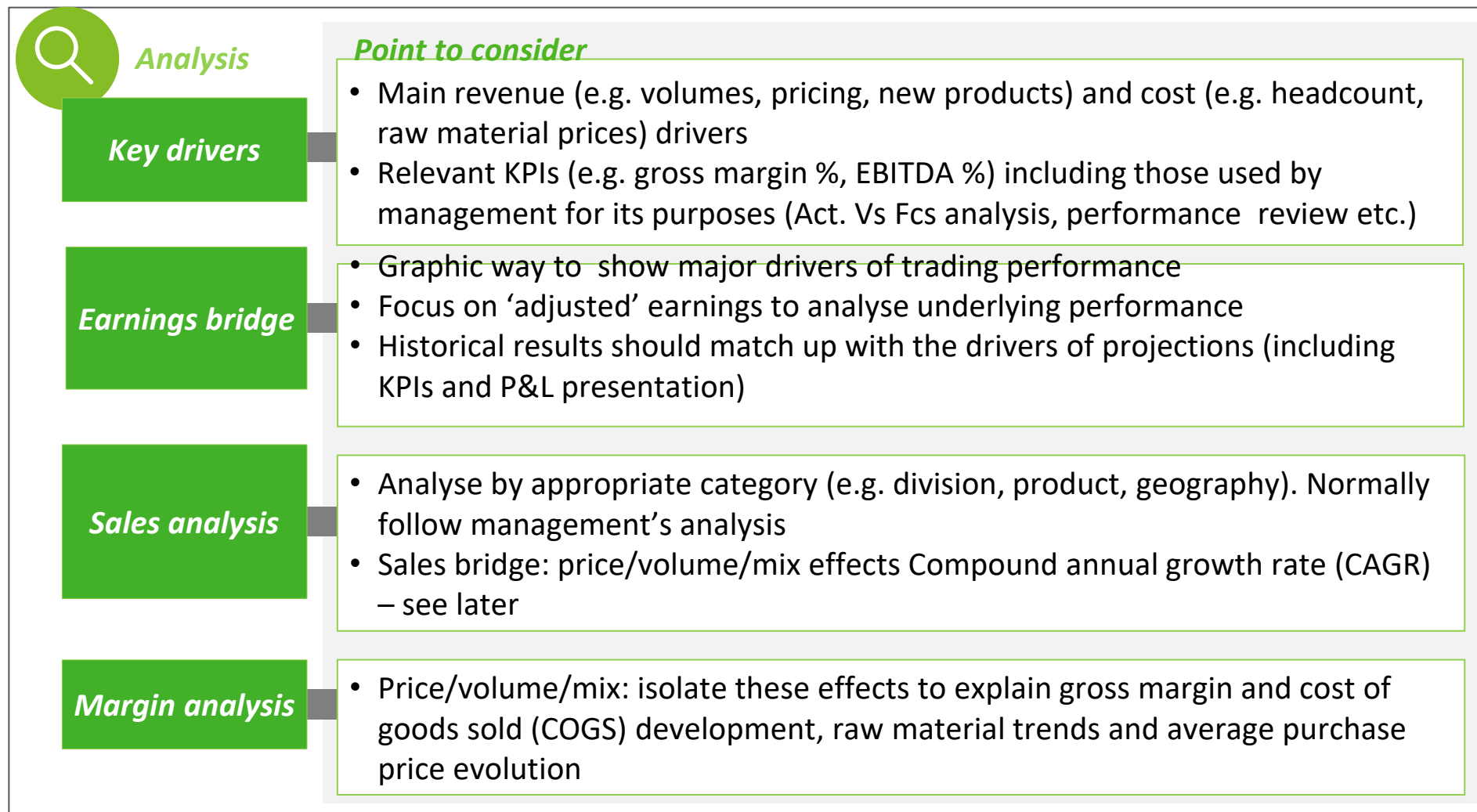
1. What is the underlying level of earnings?
2. What are the key drivers of historical performance?

Approach

1. Understand the basis of preparation to get under the 'skin' of the business.
2. Tell the real story – underlying trading performance may not be as reported.
3. Look to identify key deal issues within the trading results.


Historical performance

How should we evaluate? (1 of 2)



Historical performance

How should we evaluate? (2 of 2)

 <i>Analysis</i>	<i>Point to consider</i>
<i>Cost analysis</i>	<ul style="list-style-type: none">• Identify the key drivers of overheads (e.g. personnel costs)• Fixed vs variable, direct vs indirect, internal vs external• Costs as a percentage of revenue analysis• Link to balance sheet items and cash flow
<i>Seasonality</i>	<ul style="list-style-type: none">• Identify seasonal fluctuations – assess whether trends are recurring or one-off• Find out if the seasonal pattern makes sense• Consider implications for the working capital review and the timing of closing the deal
<i>Currency impacts</i>	<ul style="list-style-type: none">• Strip out the FX impact and present on a constant currency basis (if possible)• Evaluate trading trends in the local currency but reconcile to group reported figures• Check the impact of hedging contracts on FX (derivative contracts and impact on BS)
<i>Quality of earnings analysis</i>	<ul style="list-style-type: none">• As a result of the analysis listed above, QoE aim is to:<ul style="list-style-type: none">– Eliminate impact of one-off transactions– Assess pro-forma adjustments– Analyse management adjustments– Arrive at adjusted sustainable level of earnings for pricing considerations

The income statement

Examples of the analyses and graphs we may use to understand historical earnings (1 of 2)

Profit & loss

€000	FY n	FY n+1	as % of revenues		YoY change
			FY n	FY n+1	(n+1)-n
Revenues	163,4	148,5	100,0%	100,0%	(9,1%)
Raw material	(35,1)	(34,2)	(21,5%)	(23,0%)	(2,6%)
Rental costs	(15,0)	(14,5)	(9,2%)	(9,8%)	(3,3%)
Personnel costs (direct)	(23,7)	(22,4)	(14,5%)	(15,1%)	(5,5%)
Gross Margin	89,6	77,4	54,8%	52,1%	(13,6%)
Personnel costs (indirect)	(15,3)	(17,4)	(9,4%)	(11,7%)	13,7%
Services	(7,7)	(8,1)	(4,7%)	(5,5%)	5,2%
Bad debt provision accrual	(4,4)	(5,5)	(2,7%)	(3,7%)	25,0%
Provision for risks	(2,3)	(3,5)	(1,4%)	(2,4%)	52,2%
Other costs	(12,4)	(13,4)	(7,6%)	(9,0%)	8,1%
EBITDA	47,5	29,5	29,1%	19,9%	(37,9%)
D&A	(13,4)	(13,4)	(8,2%)	(9,0%)	-
EBIT	34,1	16,1	20,9%	10,8%	(52,8%)
Financial items, net	(34,3)	(44,5)	(21,0%)	(30,0%)	29,7%
Gains/losses on FX	(1,3)	13,4	(0,8%)	9,0%	(1.130,8%)
EBT	(1,5)	(15,0)	(0,9%)	(10,1%)	900,0%
Income taxes	0,3	0,0	0,2%	0,0%	(96,7%)
Net result	(1,2)	(15,0)	(0,7%)	(10,1%)	1.149,2%
<u>As % of revenues</u>					
Gros Margin	(59,4%)	52,1%			111,5ppt
Personnel costs (indirect)	(15,8%)	(15,1%)			0,7ppt
Other costs	(13,3%)	(9,0%)			4,2ppt
EBITDA	(6,0%)	19,9%			25,9ppt
EBIT	(0,7%)	10,8%			11,6ppt

Source: Management information

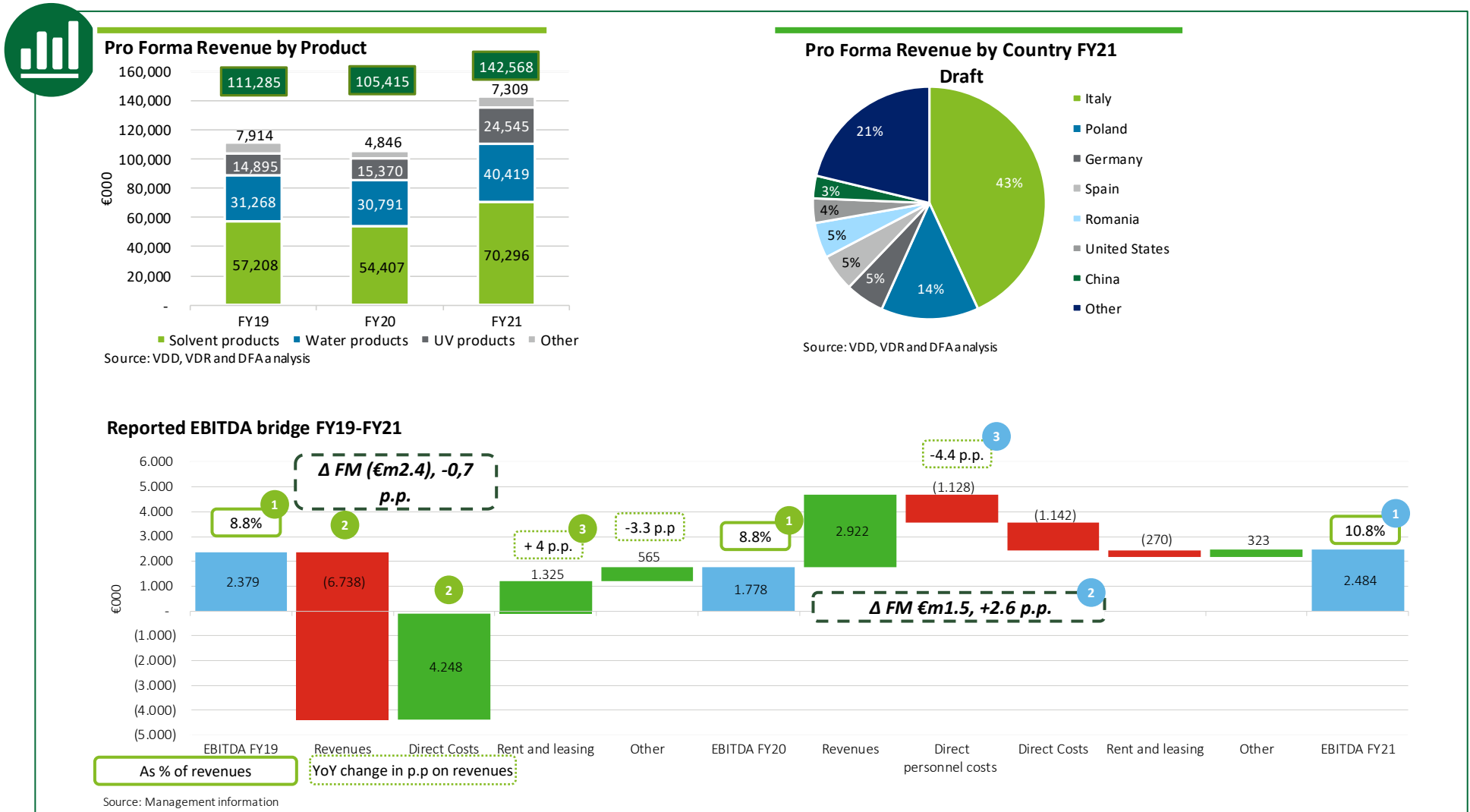


Guidance

- Reclassify historical income statement in order to highlight Gross Margin and EBITDA or other IS classifications used by management;
- Ensure it is straightforward and easy to read – don't include too many lines as it will lose its impact;
- Include a small number of KPIs (i.e. Gross Margin %, EBITDA Margin %);
- Margins analysis (EBITDA / EBIT);
- Understand the business in order to create an expectation on
 - Revenues trends, costs of sale and margins;
 - Seasonality;
- Overheads analysis (e.g. distribution costs, O&M, Marketing costs, etc.);
- Changes in accounting principles;
- One-off items analysis.

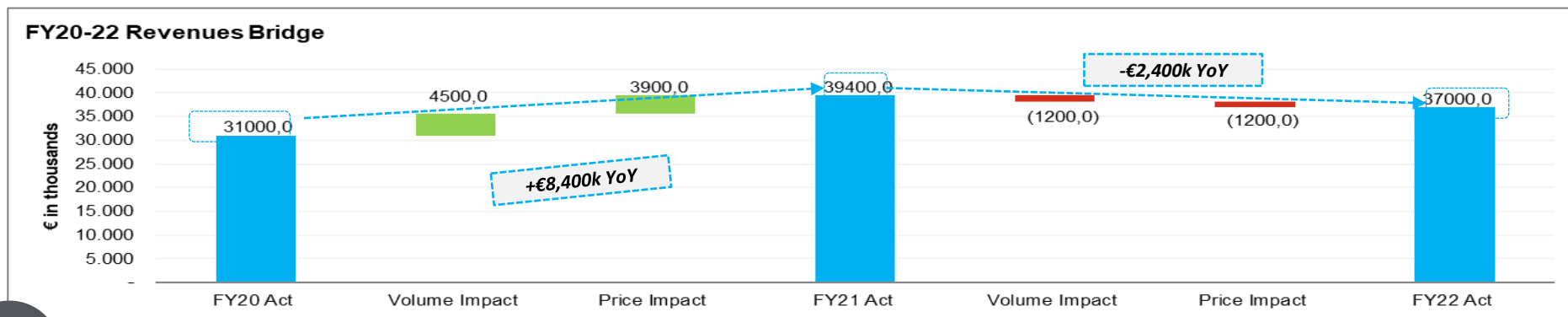
The income statement

Examples of the analyses and graphs we may use to assist understanding of historical earnings (2 of 2)



Revenues Bridge

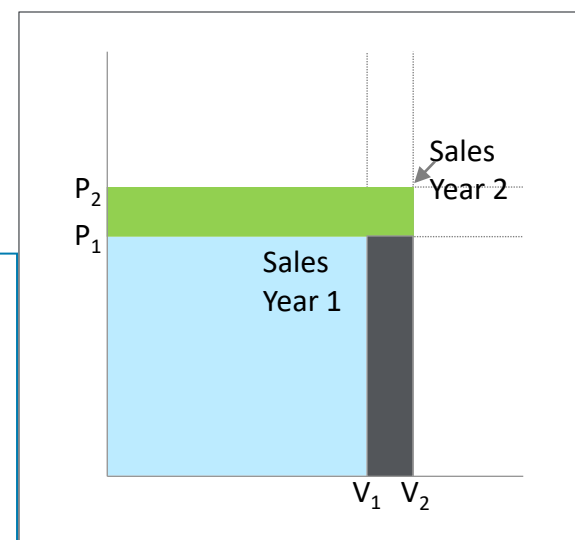
Price - Volume analysis



Revenues Bridge is performed to highlight individual drivers of sales or margin development over the period under analysis.

- Price/volume analysis (graph);
- Revenues by product;
- Revenues by companies (if the Target is a Group);
- Other analysis ... based on the Information available.

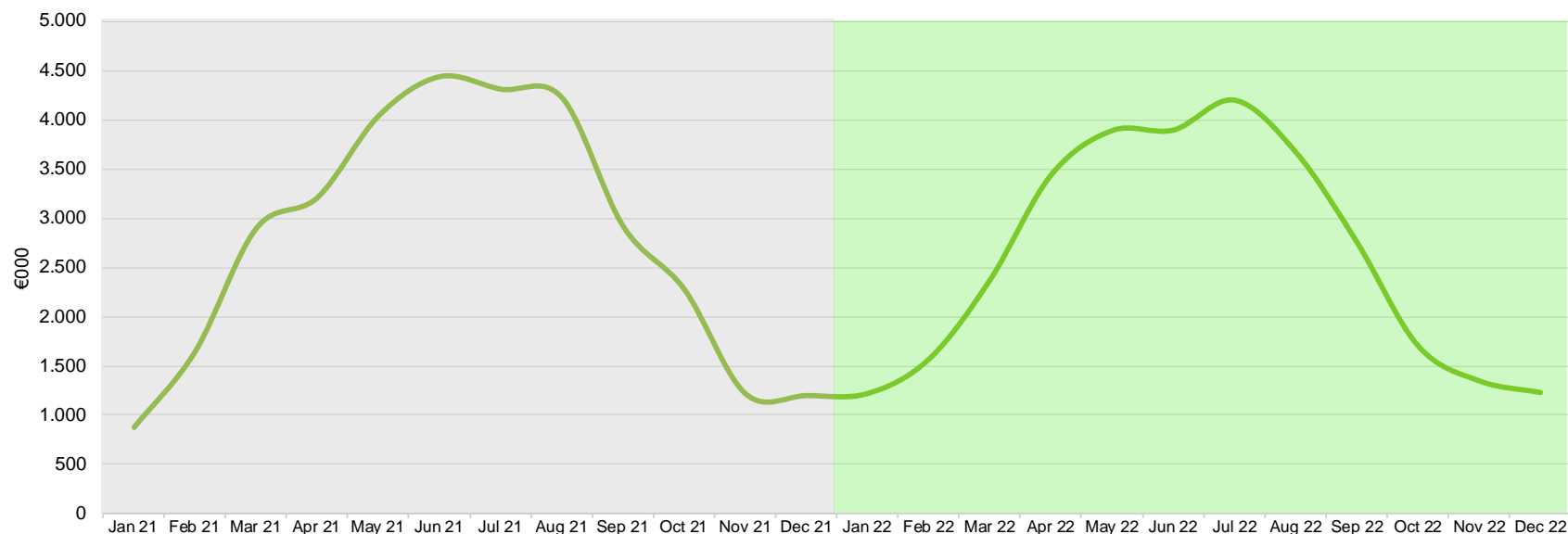
- Sales Year 1 = area
- Sales Year 2 = area + area + area
- Volume variance = $(V_2 - V_1) \times P_1$ Sales increase due to volume
- Price variance = $(P_2 - P_1) \times V_2$ Sales increase due to price



Revenues Seasonality

Some businesses show seasonality with peaks in revenue and orders at particular times of the year

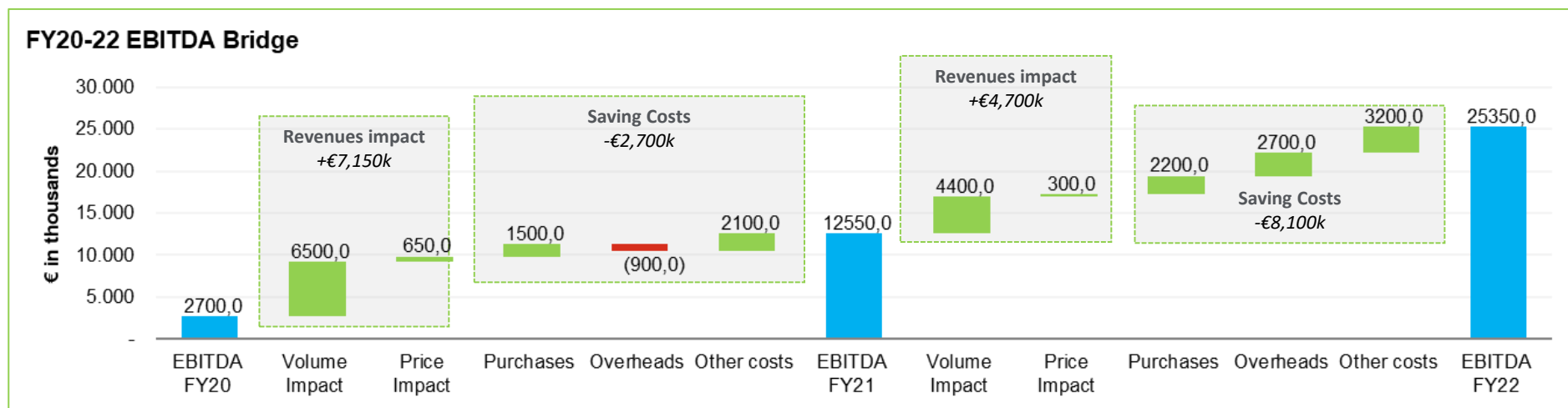
Feed-in tariff FY21-22 aggregated revenues



- Some businesses show seasonality with peaks and troughs in revenue and orders at particular times of the year.
- The analysis of monthly/quarterly trends helps us to focus our due diligence on certain areas, with impact on NWC.
- The graph above is an example of a business highly impacted by seasonality, a Group operating in the photovoltaic market.

EBITDA Bridge

The EBITDA bridge highlights the different items that impact EBITDA changes over the period under analysis.

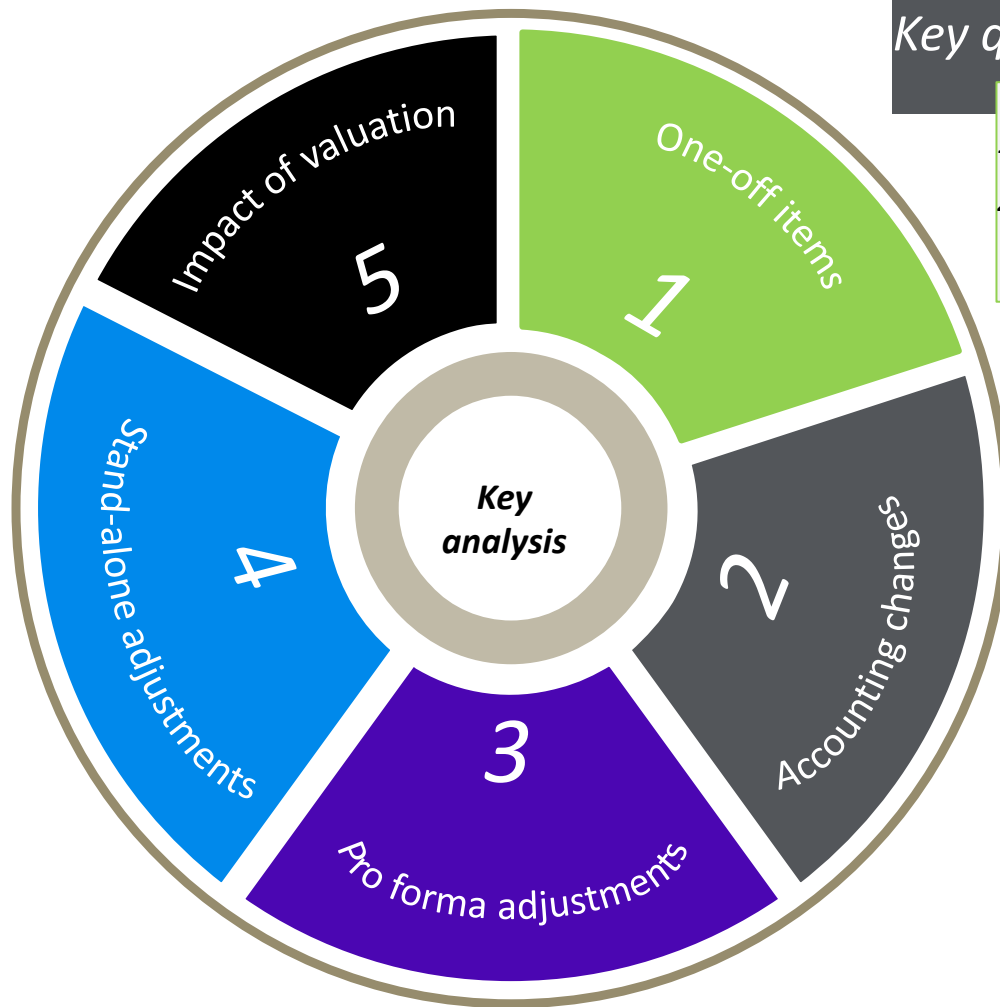


- The EBITDA is determined by:
 - ✓ Prices/volumes of sales;
 - ✓ Costs and volumes of purchase;
 - ✓ *Overheads*, fixed and variable costs that the company bears for the production.

Quality of earnings

Quality of earnings

What is important?



Key questions

1. What is the normal level of earnings?
2. What level of EBITDA should be considered by a potential buyer to calculate enterprise value?

Approach

1. Establish the sustainable earnings trend of the business going forward;
2. Identify, quantify and adjust for normalisations in order to illustrate the recurring earnings of the business;
3. Identify, quantify and adjust for pro forma items which illustrate structural changes in the business (e.g. acquisitions) and future buyer costs (e.g. additional management).

What does EBITDA represent?



EBITDA : Earnings Before Interest Taxes Depreciation and Amortization

- EBITDA measures the “Core Business Performances” as opposed to the other performances (Financial, Fiscal and Extraordinary);
- EBITDA represents the cash flows from a business before capital expenditures (i.e. cash flows generated from operations);
- EBITDA and Free Cash Flow are commonly used as benchmarks for measuring and modelling the cash flows of a business:
 - EBITDA excludes the impact of CAPEX (Capital Expenditures) and the change of Working Capital;
 - Prospective Free Cash Flow is used in models to provide a proxy for valuation.

Why focus on EBITDA?

- More sophisticated measurement of company’s performance;
- Deal community think in terms of EBITDA;
- Note, however, that it is not currently recognized/ defined by IFRS.

Why Quality of Earnings (QoE) is so important?

- **Reported EBITDA ('unadjusted')** – represents the audited and/or internal calculation of EBITDA of a business unadjusted for non-recurring and proforma events;
 - **Management adjusted EBITDA** – reflects management's view of EBITDA considering the impacts of non-recurring and pro-forma adjustments (eg. FX effect adjustments);
 - **Diligence adjusted EBITDA** – represents EBITDA normalized for nonrecurring and pro-forma adjustments based on diligence findings and the assessment of management's adjustments.
-
- It allows to understand the Historical Performance of Business in terms of **expecting profitability**, in particular:
 - The Historical Performances maintainable in the future, can be defined only with the elimination of non-recurring items, changes of accounting principles, non-operating items from the data "reported";
 - The Adjusted EBITDA will represent the base for the Budget construction and for the Financial plan.
-
- The Adjusted EBITDA represents the base of **Business Valuation** and it is used for the Pricing (i.e. as EBITDA Multiple);
 - The Quality of Earnings Analysis allows to understand the **Operating Income Post-Deal**, that reflects the new structure of costs going forward, potentials synergies and economies of scale.

Quality of Earning Adjustments

Normalisation adjustments

- Non-recurring gains and losses (litigation settlements, plant relocation);
- Non-operating revenues and expenses (gain or loss on sale of fixed assets if not primary business activity), stock-based compensation expense;
- Sustainable earnings (final year of a three year contract, advance supplier payment, deposit on future business, etc.);
- Changes to customer base (if not replaced by new customer or replaced at lower margin);
- Personal expenses or savings (temporary layoff – CIGO/CIGS).

Pro-forma adjustments

- Stand alone costs (when the Target is being “carved out” from a larger corporation);
- Prospective changes in management compensation, bonuses, increased / decreased raw material costs, new property leases, etc;
- Conforming accounting policies to the buyers policies;
- Synergies that will take place after consummation of the proposed transaction (use caution).

Other adjustments

- Bank commissions: they can be considered service costs, but can be classified below EBITDA (Financial items);
- FX effect: classified as financial item but related to the operating activities of the Company.

QoE exercise

QoE exercise (1 of 4)

- You have been engaged by PE private equity firm to perform limited phase 1 due diligence on a clothing company that they are interested in.
- HaPPy LTD is a British company that produces and commercializes clothing for men and women.
- PE is interested in HaPPy because of its strong reputation as a quality brand in the UK - which they believe can be expanded to Continental Europe.
- PE have been provided with limited information on Sales and EBITDA and have asked You to perform a preliminary analysis to help them to understand the normal level of EBITDA over the last 3 years.

HaPPy Ltd reported results			
€ in thousands	FY20	FY21	FY22
Revenues	102.784	110.567	118.224
EBITDA	12.385	14.288	14.655

QoE exercise (2 of 4)

- You will meet with PE in 20 minutes time to discuss your preliminary findings related to EBITDA Adjusted taking into consideration, where appropriate, the information and events contained below.
- Please identify separately 1) normalisation/proforma adjustments, 2) other adjustments.

€ in thousands	FY20	FY21	FY22
(1) Foreign exchange gain/(loss) on transaction in foreign currencies classified in financial items	95	(121)	34
(2) Earnings from a significant business unit disposed of on 31 December 2022.	633	488	502
(3) Profit on disposal of significant business unit	-	1.234	-
(4) Release of a €144k bad debt provision, provided in 2020, due to cash being received in 2022	-	-	144
(5) Bank fees and commissions classified between financial items	(130)	(150)	(185)
(6) One-off costs for legal consultancies (Health and securities procedures)	-	(55)	-
(7) Releases of provisions for risk in the amount of €244k in 2020 and €115k in 2021 accrued in FY18, accounted for above the EBITDA		244	115
(8) Cost savings deriving from temporary lay-offs ("CIGS") in the amount of €105k in 2022.			105

QoE exercise (3 of 4)

Quality of Earnings

€ in thousands

	Ref.	FY20	FY21	FY22
EBITDA reported				
Revenues				
% EBITDA Reported Margin				
Normalisation/proforma adjustments:				
[...]				
[...]				
[...]				
Total pro-forma adjustments				
Other adjustments:				
[...]				
[...]				
[...]				
Total other adjustments		-	-	-
EBITDA adjusted				
% EBITDA Adjusted Margin				

Cash flow

Cash

Cash Flow analysis

What is important?



Cash flows are important because 'Cash is King'

1. *For a company, cash is the ultimate outcome of their operation.*
2. *For an investor, their financial model and investment decision is often based on cash flows.*
3. *For a transaction, analyses on cash flows validate buyers' findings on earnings and balance sheets.*

Which Cash Flows do we focus on?

We often focus on:

- Reported and **normalised cash flow**.
- Operating and **free cash flow before financing and tax**.

Our Key Analysis

1. *Analysis of EBITDA, working capital and capex to understand the key drivers of free cash flows before financing and tax.*
2. *Analysis of the unwinding of non-operating items, where relevant.*
3. *Analysis of intra-month cash movements.*
4. *Reconciliation of findings on cash flows to those on earnings and balance sheets, to ensure a solid understanding of the business and flow of funds.*

Cash Flow Statement as per stats vs CF in FDD

(1 of 2)

Example of Cash Flow Statement included in SFS

B.4. Statement of Cash Flows

<i>In Euro thousands</i>	2019	2018
Opening cash and cash equivalents	35,612	34,873
Operating activities		
Profit for the year	7,379	2,314
Amortisation and depreciation	25,415	20,202
Impairment losses	-	1,077
Non-monetary (income)/charges	617	6
Trade working capital	(184)	10,825
Other working capital accounts	5,679	880
Income taxes paid	(4,809)	(6,169)
Change in provisions	1,724	4,161
Other changes	126	36
Cash flow from operating activities	35,946	33,333
Investing activities		
Investments		
- Intangible assets	(8,474)	(8,334)
- Property, plant and equipment	(12,772)	(19,459)
- Rights-of-use	(3,218)	-
Cash flow used in investing activities	(24,463)	(27,794)
Financing activities		
(Acquisition)/Sale of treasury shares and investments (maintaining of control)	2,540	9,731
Dividends	(1,479)	(1,356)
Increase (decrease) financial liabilities	(9,190)	(12,299)
Increase/(decrease) in lease liabilities - IFRS 16	(32)	-
Net changes in other financial assets/liabilities	(821)	354
Interest paid	(3,227)	(1,857)
Cash flow used in financing activities	(12,209)	(5,428)
Increase/(Decrease) in cash and cash equivalents	(727)	111
Net translation effect on cash and cash equivalents	728	628
Closing cash and cash equivalents	35,613	35,612

The Group has adopted IFRS 16 from January 1, 2019 using the extended retrospective application method. The comparative figures have not been restated.

Income statement and Cash flow

Example of Cash Flow in a transaction view

Historical cashflow

€000	FY20 Reclass	FY21 Reclass	FY22 Reclass
Reported EBITDA	4,348	6,175	6,791
Tax paid	(856)	(1,471)	(770)
TFR accrual	70	155	141
BDP accrual	141	24	53
Reported EBITDA net of taxes, TFR and BDP	3,704	4,884	6,215
Change in inventory	(175)	(113)	46
Change in trade receivables	315	(798)	(108)
Change in trade payables	199	407	114
Change in TWC	338	(504)	53
Change in other assets	383	(1,068)	(71)
Change in other liabilities	858	1,197	389
Change in NWC	1,579	(375)	370
Operating cash flow (OCF)	5,283	4,509	6,585
Capex	(1,789)	(2,839)	(2,882)
Provisions	50	50	50
Staff leaving indemnity	(44)	(81)	(78)
Free cash flow before taxes (FCF)	3,500	1,639	3,675
Change in financial assets	(1,750)	(1,310)	(302)
Financial items, net	1	14	17
Other net equity movements	-	-	100
Dividend	(500)	(500)	(4,000)
Net cash flow (NCF)	1,251	(157)	(510)
Net financial position - BoP	2,022	3,273	3,116
Net financial position - EoP	3,273	3,116	2,606
Change in Net financial position	1,251	(157)	(510)
OCF/EBITDA conversion rate	121.5%	73.0%	97.0%
FCF/EBITDA conversion rate	80.5%	26.5%	54.1%

Source: Management information

Cash Flow Statement as per stats vs CF in FDD

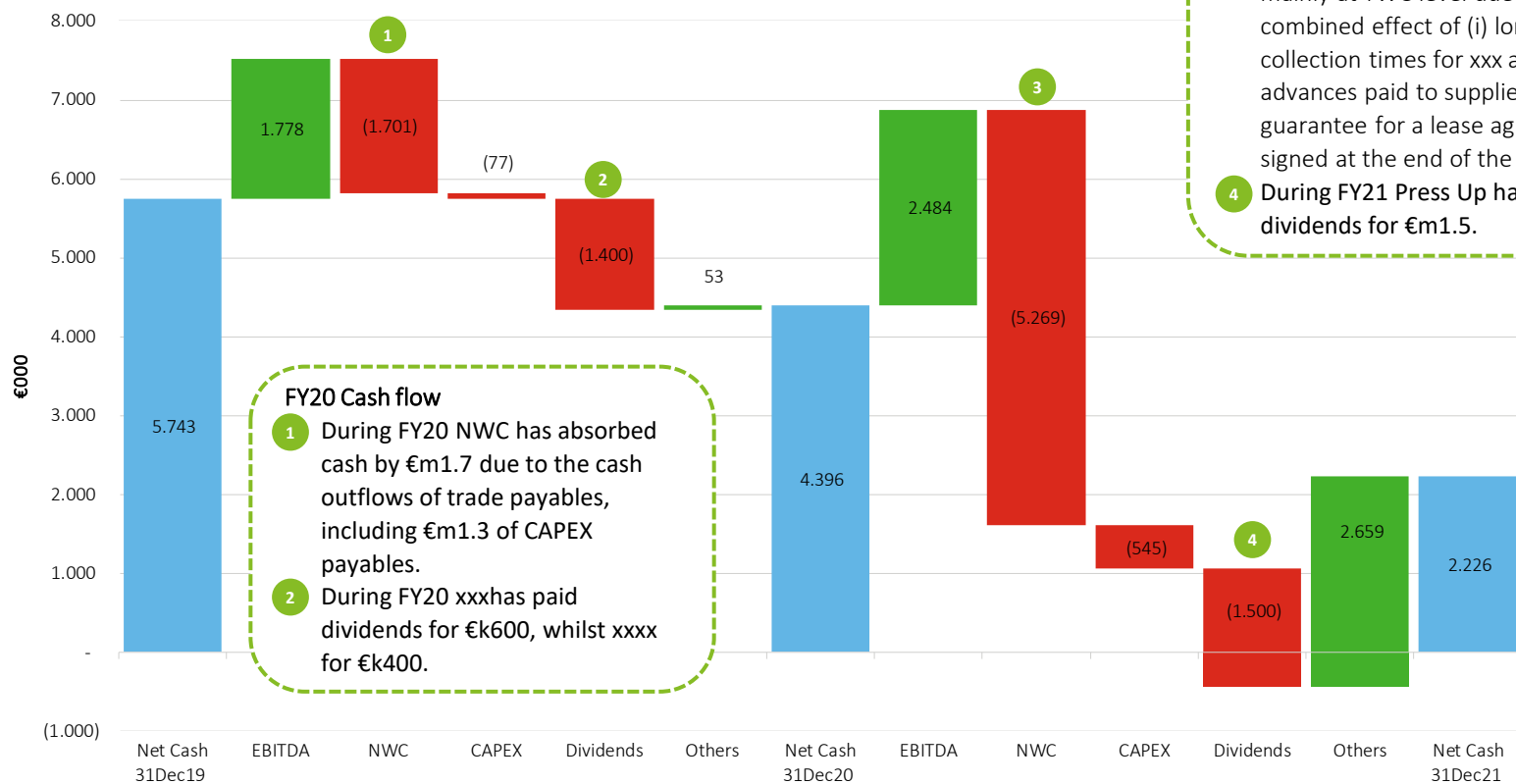
(2 of 2)

Main differences between Cash Flow Statement included in SFS and a Cash Flow Statement reclassified

- Respect to the Cash Flow Statement included in the Statutory Financial Statement that generally starts from the Net Income (or includes the Income Taxes), the Cash Flow Statement is reclassified in accordance with international standards;
 - It provides a proxy of cash generated by the Operating Business, starting from the EBITDA considering the working capital requirement and of the necessary investments for the business (Capital Expenditure - CAPEX);
 - It gives an indication of the Cash-In / Cash-Out not directly related to the Operating Business (Financial Costs and Fiscal Costs, etc.);
 - The **Net Cash Flow** must be necessarily equal to the variation of Financial Net Debt, and it is expression of the Cash generated or absorbed in the period (generally from Tn-1 to T1).
- The Cash Flow Analysis is fundamental in the definition / comprehension of:
 - Valuation Model (usually a Discounted Cash Flow - DCF);
 - Structuring of funding sources between Debt or Capital;
 - Cash Conversion Ratio;
 - Payment of dividends.
- For the construction of the Cash Flow is necessary:
 - Two Balance Sheet (comparable to each other respect to the perimeter of the transaction);
 - One Income Statement related to the Balance Sheet.

How to present a Cash Flow

Cash flow bridge FY19-FY21



Source: Management information

Cash flow exercise

Cash Flow Exercise (1 of 4)

- You have been engaged by PE private equity firm to perform limited phase 1 due diligence on a shoe company that they are interested in.
- Maddy's is a shoe manufacturer and retailer headquartered in Sussex. It has a small factory in the UK at which it makes approximately 40% of the shoes it sells. The remaining production is outsourced to Italian producers.
- PE have been provided with limited information on cash generation and related drivers and have asked You to help them with this issue.
- We have been provided with the Balance Sheet and PL for the two years ended 31Dec22.
- **We have to prepare the Cash flow incurred in FY22 and present the finding to the PE in 30min.**

Cash Flow Exercise (2 of 4)

Maddy's - Profit & Loss FY21 and FY22

€ in thousands	FY21Act	FY22Act
Net Sales	204.659	226.456
Other revenues	3.759	4.611
Revenues	208.418	231.067
Materials	(125.607)	(139.988)
Services	(28.407)	(30.970)
Personnel	(20.618)	(22.966)
Other expenses	(9.314)	(7.880)
Other provisions	-	(800)
Bad debt provision	(462)	(499)
EBITDA	24.011	27.965
D&A	(16.654)	(17.125)
EBIT	7.357	10.840
Financial items, net	(4.396)	(2.899)
Extraordinary items, net	740	205
EBT	3.701	8.147
Taxes	(6.227)	(7.493)
Net income	(2.526)	654
<i>KPI's on Net Sales</i>		
Materials	61,4%	61,8%
Services	13,9%	13,7%
EBITDA	11,7%	12,3%
EBIT	3,6%	4,8%

Source: SFS

Income statement and Cash flow

Maddy's - Balance sheet as of 31Dec21 and 31Dec22

€ in thousands	31Dec21 Act	31Dec22 Act
Intangible assets	113.720	101.029
Tangible assets	12.814	12.661
Financial assets	3.407	4.110
Fixed assets	129.942	117.800
Inventory	17.706	20.602
Trade receivables	40.414	33.143
Trade payables	(27.852)	(29.207)
TWC	30.268	24.537
Other assets	737	649
Other liabilities	(1.198)	(500)
NWC	29.807	24.687
Provision	(969)	(1.589)
Leaving indemnities	(2.162)	(2.255)
Deferred taxes	(1.491)	(1.897)
Capital employed	155.127	136.746
Cash	2.940	3.522
Bank loan	(71.286)	(52.674)
Net Debt	(68.345)	(49.152)
Net equity	86.782	87.593

Source: SFS

Cash Flow Exercise (3 of 4)

Maddy's - Cash flow

€ in thousands	FY22 Act
EBITDA	
Inventory chg	
Trade receivables chg	
Trade payables chg	
Chg. In TWC	-
Other assets chg	
Other liabilities chg	
Chg. In NWC	-
Provision	
Leaving indemnities	
Deferred taxes	
Operating Cash Flow before Capex and taxes (OCF)	-
CCR% [OCF / EBITDA]	n.a.
Taxes	
Chg in tangible assets	
Chg in intangible assets	
D&A	
Capex	-
Free Cash Flow (FCF)	-
CCR% [FCF / EBITDA]	n.a.
Chg in financial assets	
Financial items, net	
Extraordinary items, net	
Chg in equity	
Net cash flow	-
Opening Net Debt	(68.345)
Delta	19.193
Closing Net Debt	(49.152)

Source: SFS

THANK YOU!