



Bridging Theory with Practice: Basics of Financial Due Diligence

Lesson #2: Balance sheet and net debt analysis

12th May 2022

Bridging Theory with Practice: Basics of Financial Due Diligence

Full Programme

27th April 2022

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.

12th May 2022

2. Balance sheet and net debt analysis

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

4th May 2022

3. Income statement and Cash flow

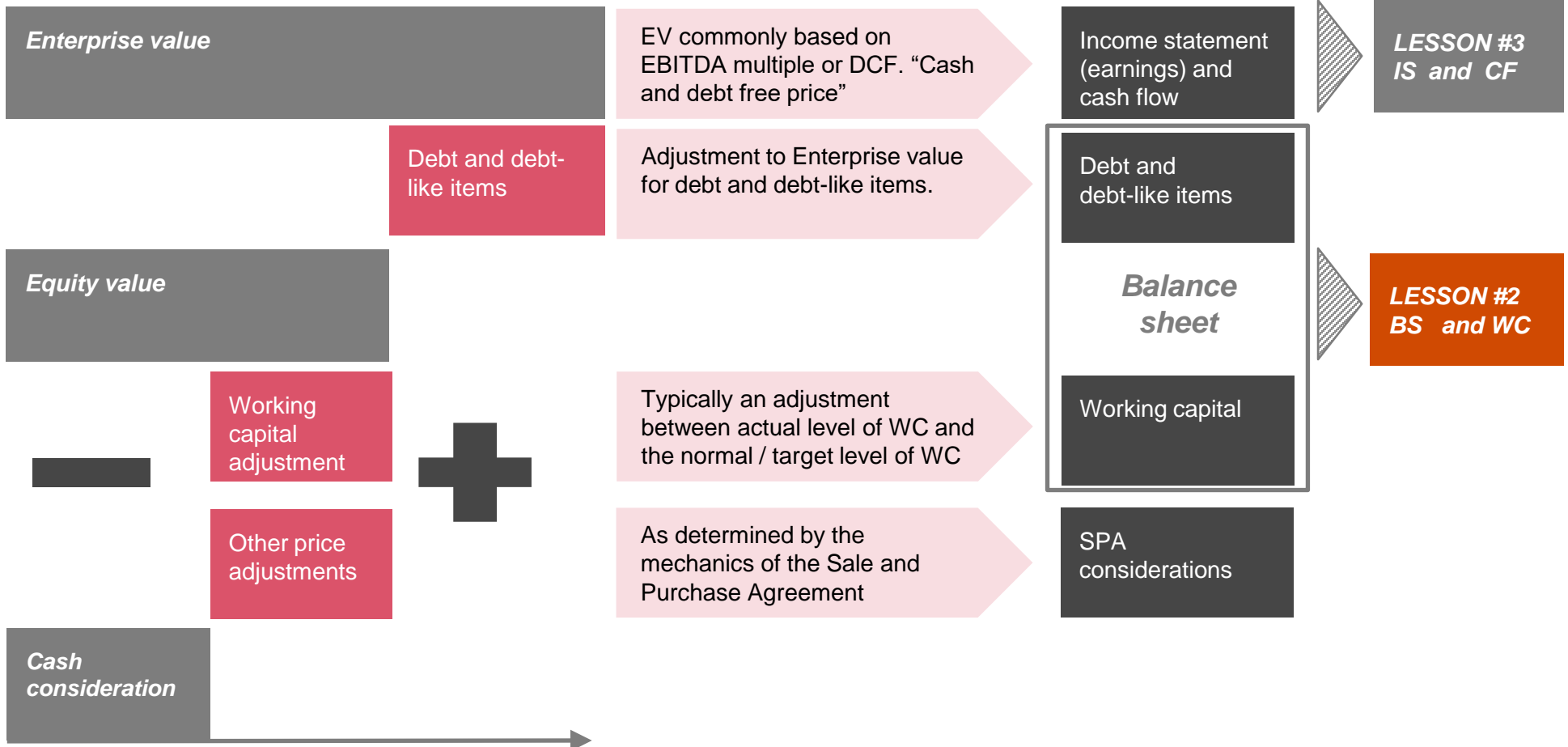
- Historical performance analysis;
- Volume/Price effect and other analysis;
- Quality of Earnings;
- Overview of cash flow;
- Case study.

19th May 2022

4. Project works presentation and final remarks

What's our focus?

Typical purchase price components



Contents

Balance sheet

Working capital

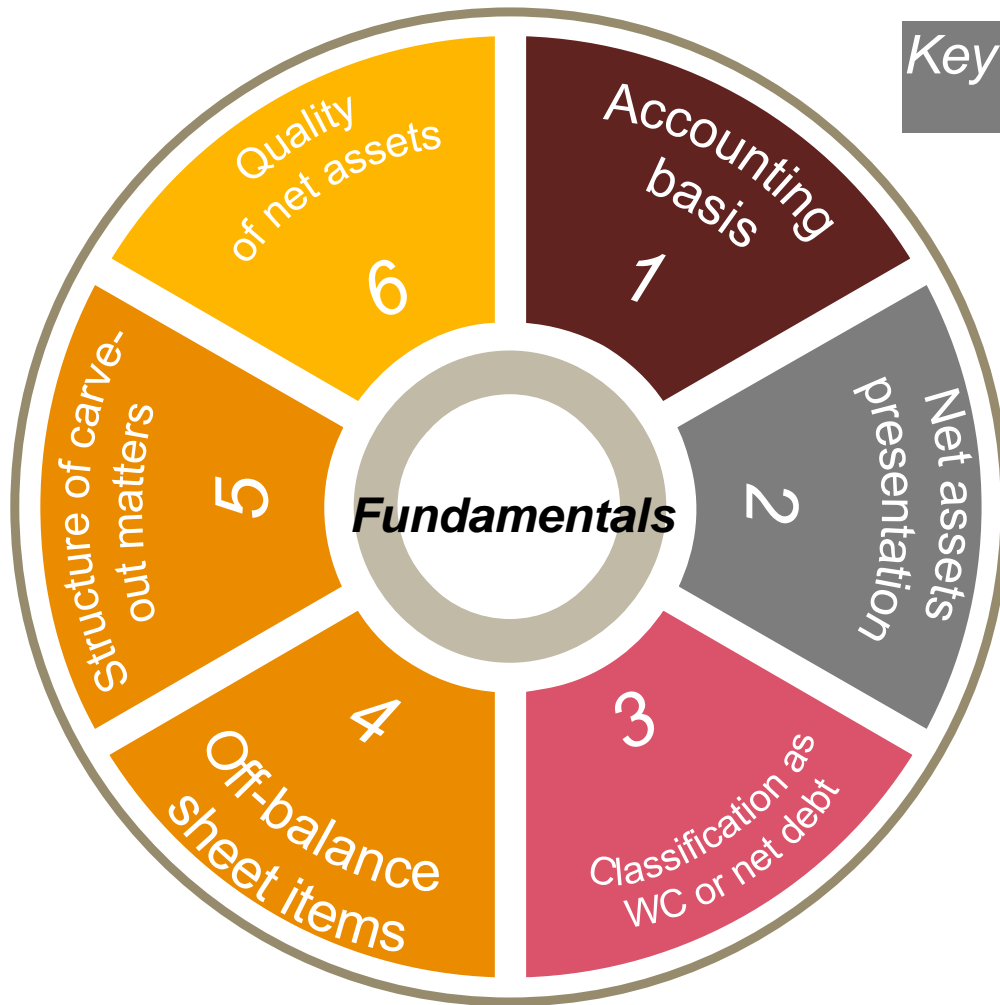
Net Debt

Adjusted net debt exercise

Balance sheet

Balance Sheet

What is important?



Key questions

1. What are the **net assets**?
2. What is the **working capital** of the business?
3. What is the **net debt position** of the business?

Approach

1. We evaluate net assets in a top-down manner.
2. We identify the fixed assets, net working capital and net debt position - **that's why we present the balance sheet in the net assets format.**

Balance Sheet

How should we evaluate?



Analysis

Balance Sheet

€ in millions	31Dec n-1	31Dec n
Intangible assets	149	163
Tangible assets	539	521
Financial assets	56	104
Fixed Assets	744	788
Inventory	90	92
Trade receivables	9	25
Trade payables	(80)	(111)
TWC	19	6
Other Assets	15	18
Other liabilities	(12)	(15)
NWC	21	9
Provisions	(23)	(26)
Capital Employed	743	771
Cash and cash equivalents	90	20
Bank loans	(647)	(693)
NFP	(557)	(673)
Net Equity	185	99
KPI:		
DOI (Inventory/RM)*365	57	74
DSO ((TR/1,2)/Revenues)*365	75	93
DPO ((TP/1,2)/(RM, Services, other))*365	97	50
TWC / EBITDA	6	4
NFP / EBITDA	1.8	2.1

Source: Statutory Financial Statement as at 31Dic n-1 - n

Point to consider

Balance Sheet analysis focuses on:

- *Intangible, tangible and financial assets that represent the Fixed assets;*
- *Net Working Capital (NWC)= TWC + Other assets - Other liabilities;*
- *Provisions for risks and charges;*
- *Net Financial Position (NFP)*

From this analysis we identify:

- *Over / Undervaluation of Fixed Assets;*
- *Unrecorded liabilities;*
- *Off-balance sheet items;*
- *Financial debt and debt-like items.*

Fixed assets

How should we evaluate? (1 of 2)



Analysis

Tangible assets

Point to consider

- *Aim: understand the production capacity and the expected level of Capex*
- Our analysis include:
 - Description of the plants;
 - Checking on the capitalization of costs;
 - Verify of the depreciation policies (eg. Fair Value);
 - Analysis of production capacity;
 - Identify of non operating assets;
 - Historical and expected Capex.

Intangible assets

- *Aim: identify the hidden values or capitalizations worthless*
- Our analysis include:
 - Verify the accounting policies;
 - Impairment tests (eg. Application of IAS 36/38);
 - Valuation of recoverability ;
 - Verify of the amortization policies (eg. Fair Value).

Fixed assets

How should we evaluate? (2 of 2)



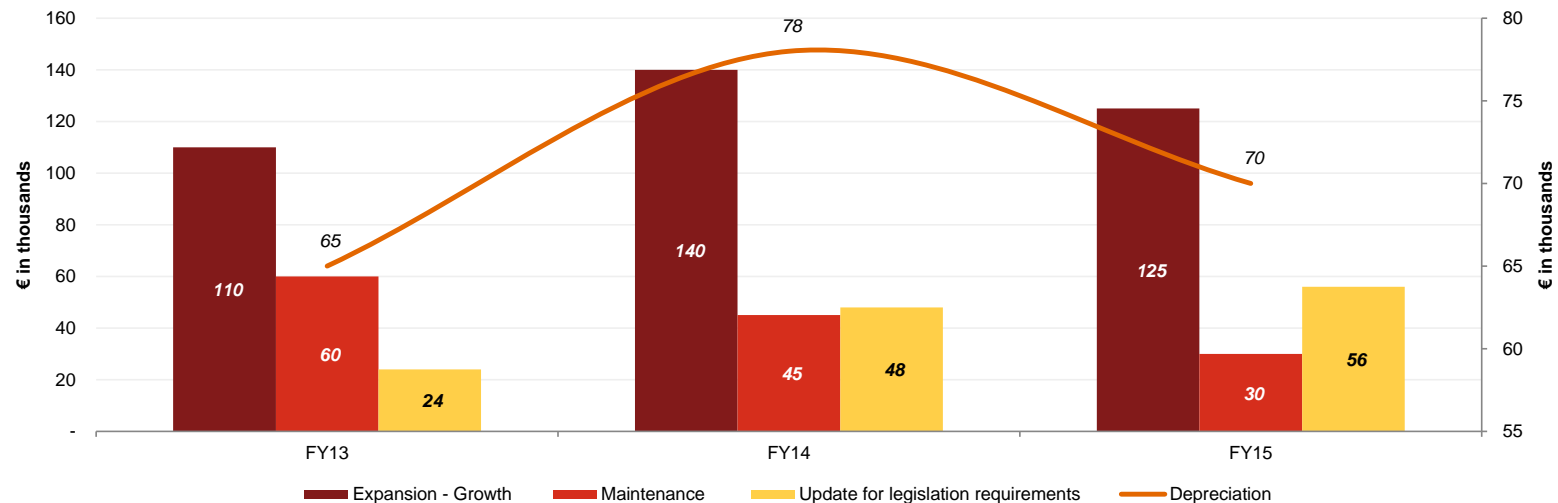
Analysis

Capex analysis

Point to consider

- Aim: historical capex analysis allows us to assess the need for investments in order to maintain and expand the targets fixed assets and the related cash flows.
- Our analysis include:
 - Investment for the growth of the business (expansion vs maintenance capex);
 - Ordinary or extraordinary maintenance of the business;
 - Compliance or update for legislation requirements (eg. Safety and environmental infrastructure).

Capex FY13-15



Working capital

Working Capital

What is important?



Key questions

1. What are the **normal working capital** requirements of the business?
2. What is the high, low, and maximum month-to-month swing?
3. What are the **key drivers** and trends?
4. Is there potential for improving working capital levels?
5. What is the impact on cash flows?

Approach

1. Analysis of peaks, troughs and **average level of TWC** to determinate the correct amount of credit lines needed for financing the company.
2. Understanding the **nature of the business** in which the company operates (e.g. retail business will have a TWC mainly composed by inventories and TP with low or none TR, meanwhile a company that operates in the industrial sector will have a TWC mainly composed by TR and inventory partially compensated by TP).

Working Capital

(1/2)



Working capital shows the resources on which the company is based and are used to finance the operating activities of the company. In other words Working Capital represents the company economic requirements due to the operations of purchase, transformation and selling of the core business products.

Usually working capital is distinguished between:

1. $TWC = Trade\ receivables - Trade\ payables + Inventory$

TWC measures the financial efficiency that results from the assets of goods and/or services selling.

2. $NWC - Net\ Working\ Capital = TWC + Other\ assets - Other\ liabilities$

In this case the NWC is an expression of companies short-term financial situation.

Working Capital

(2/2)



Accounts payable and accrued expenses

(Creditors) are financial obligations to the creditors who have a claim on the assets of the business. Always consider scrutinising terms of trade to see if they are more like *vendor financing*.

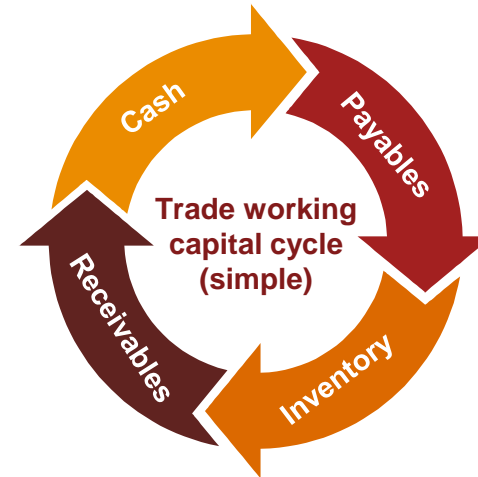
Inventories (Stocks) are a company's merchandise - finished or unfinished goods that have yet to be sold. As assets, inventory may be pledged as *collateral* or *security* for loans. This is asset-based inventory financing.

Receivables (Debtors) constitute money that is owed to a company but not yet received. As assets, they may be factored or securitised by the company to provide financing. If factoring is used, present analyses of receivables on a gross basis.

Working capital cycle – With every turn of the cycle, cash pays the suppliers for goods that are produced and then sold (on credit) to customers for a profit.



Impact on Cash Flow



In a typical business, purchases are converted into goods and sold to customers for a profit.

Trade working capital

Case studies

Case #1

- A retail company that sells shoes spent a total of 80€ of cost of goods sold. Later the company sells the shoes for 100€, the customer payment of the amount due is made with cash and the collection takes place on the spot.
- What impacts do we have on TWC, revenues, COGS and profit?

€ in thousands	31Dec15
Trade receivables	-
Trade payables	-
Inventory	-
TWC	-
Revenues	100
COGS	(80)
Net profit	20
Cash & cash equivalents	20

Case #2

- The same company later on acquires the same amount of materials (80€) but half of the payment to the supplier occurs at the moment, meanwhile the other half is postponed. The customer that buys the shoes for 100€ will make a deferred payment for the full amount.
- What impacts do we have on TWC, revenues, COGS and profit?

€ in thousands	31Dec15
Trade receivables	100
Trade payables	(40)
Inventory	-
TWC	60
Revenues	100
COGS	(80)
Net profit	20
Cash & cash equivalents	(40)

Case #3

- Let's now assume that the shop buys materials for 110€ but sells only for 80€ (generating revenues for 100€) meanwhile the other assumptions remain unchanged (50% of suppliers payment postponed and customer cash collection postponed).
- What impacts do we have on TWC, revenues, COGS and profit?

€ in thousands	31Dec15
Trade receivables	100
Trade payables	(55)
Inventory	30
TWC	75
Revenues	100
COGS	(80)
Net profit	20
Cash & cash equivalents	(55)

Trade working capital

Why TWC analysis is useful?

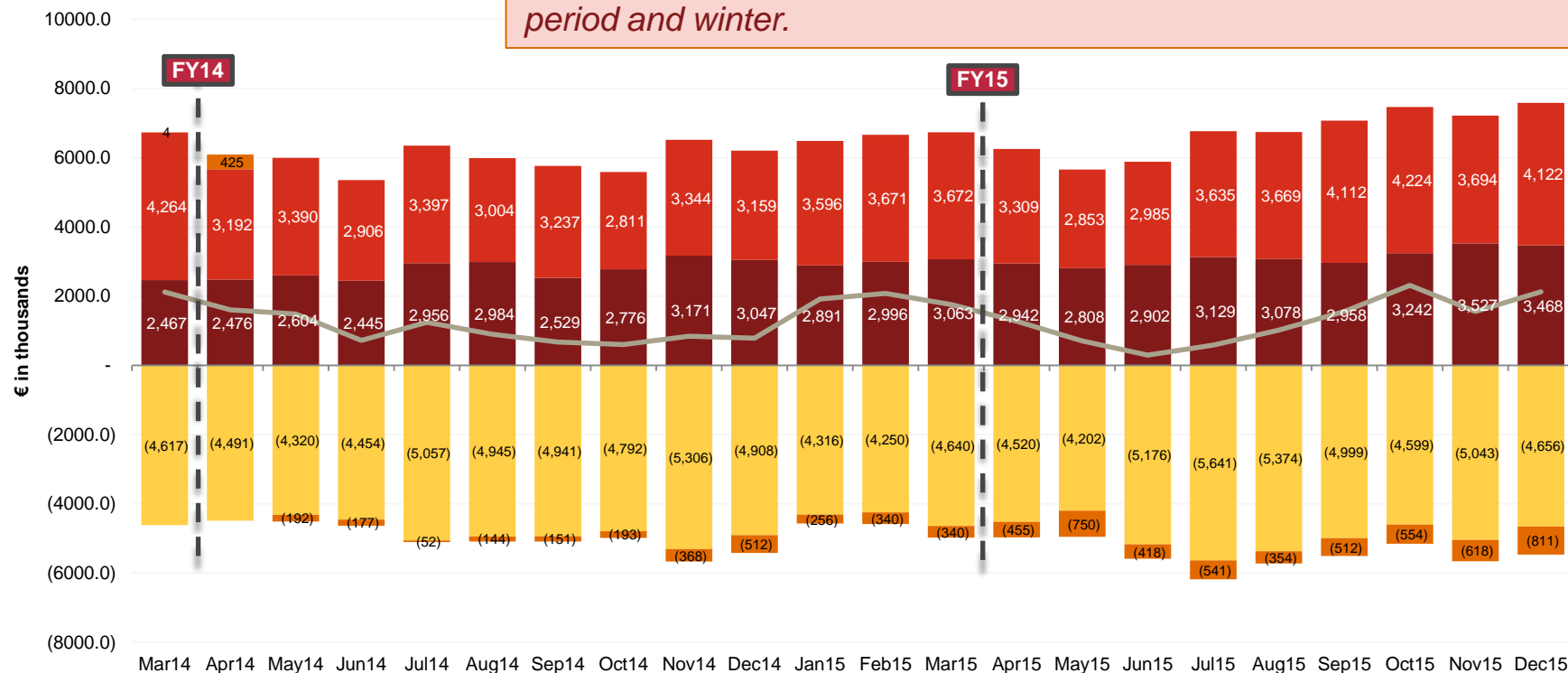
- In cash-flows analysis the TWC trend is fundamental for tracking the absorption or the ***release of financial resources***;
- TWC analysis is a key element for developing a structured company growth. Start-ups and companies that want to increase their business often fail to achieve their targets mainly due to a high level of TWC that does not match with their financial capacity;
- Last but not least, during periods of economics crisis optimizing the TWC of a company leads to a fundamental competitive advantage, since it assures to the company the cash needed to survive and reach a profitable growth.

Seasonality and TWC

Some business show seasonality with peaks in revenues and orders in particular moments of the year.

Monthly NWC by component

In this case NWC trend shows a seasonality pattern limited to the summer period and winter.



Monthly NWC and Net Debt

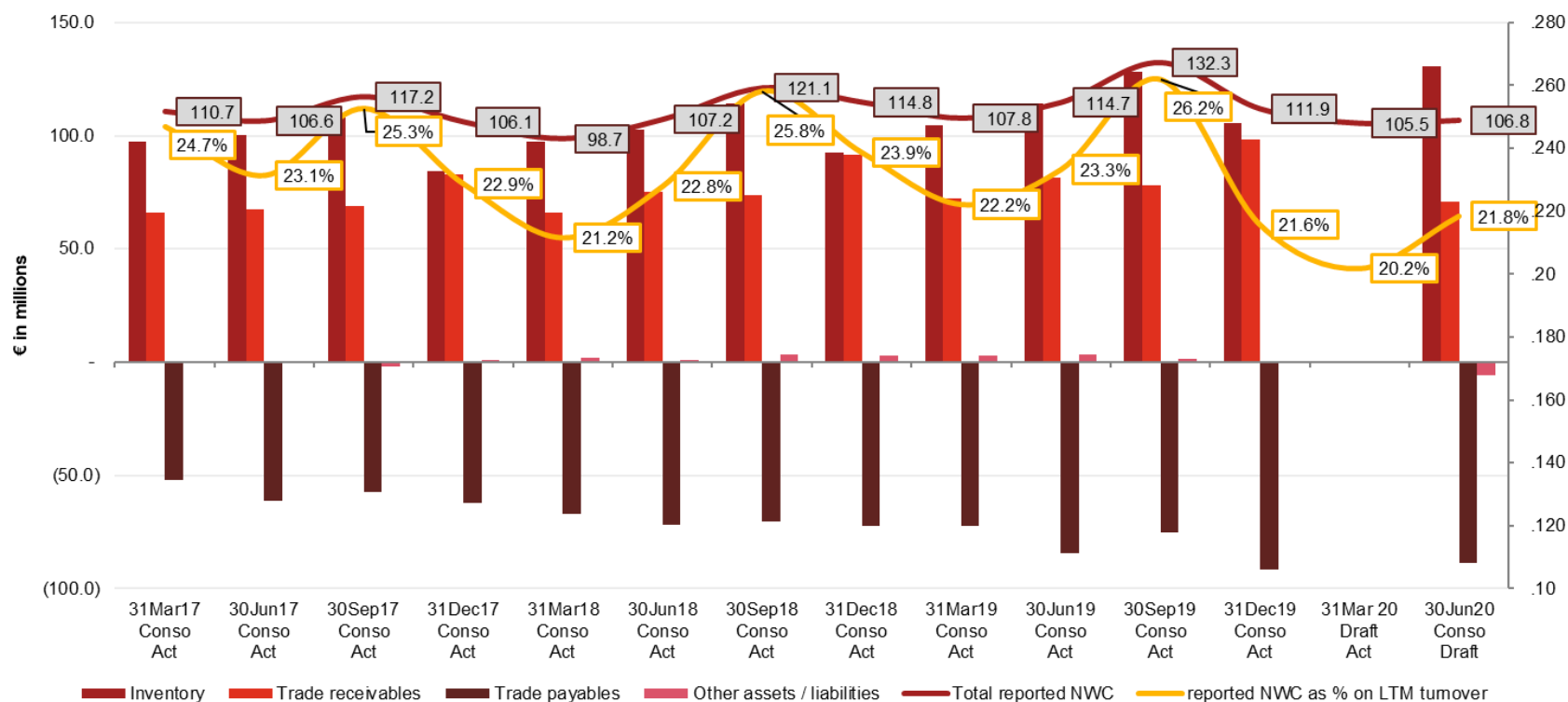
€ in thousands	Mar14	Apr14	May14	Jun14	Jul14	Aug14	Sep14	Oct14	Nov14	Dec14	Jan15	Feb15	Mar15	Apr15	May15	Jun15	Jul15	Aug15	Sep15	Oct15	Nov15	Dec15
Inventory	2,467	2,476	2,604	2,445	2,956	2,984	2,529	2,776	3,171	3,047	2,891	2,996	3,063	2,942	2,808	2,902	3,129	3,078	2,958	3,242	3,527	3,468
Trade receivables	4,264	3,192	3,390	2,906	3,397	3,004	3,237	2,811	3,344	3,159	3,596	3,671	3,672	3,309	2,853	2,985	3,635	3,669	4,112	4,224	3,694	4,122
Trade payables	(4,617)	(4,491)	(4,320)	(4,454)	(5,057)	(4,945)	(4,941)	(4,792)	(5,306)	(4,908)	(4,316)	(4,250)	(4,640)	(4,520)	(4,202)	(5,176)	(5,641)	(5,374)	(4,999)	(4,599)	(5,043)	(4,656)
Other assets/liabilities	4	425	(192)	(177)	(52)	(144)	(151)	(193)	(368)	(512)	(256)	(340)	(340)	(455)	(750)	(418)	(541)	(354)	(512)	(554)	(618)	(811)
NWC	2,117	1,603	1,483	719	1,244	900	675	602	842	786	1,915	2,077	1,755	1,276	708	294	583	1,019	1,558	2,312	1,559	2,123
Net debt	(7,029)	(6,666)	(6,850)	(5,943)	(6,201)	(5,738)	(5,573)	(5,377)	(5,443)	(5,185)	(6,078)	(6,082)	(5,275)	(4,732)	(3,989)	(3,323)	(3,296)	(3,590)	(3,879)	(4,486)	(3,544)	(3,835)

Source: Management Information

Seasonality and TWC

In this case NWC shows a peak in 3Q due to high stock (to phase 4Q sales – coffee high season of sales).

31Mar17-30Jul20 NWC evolution

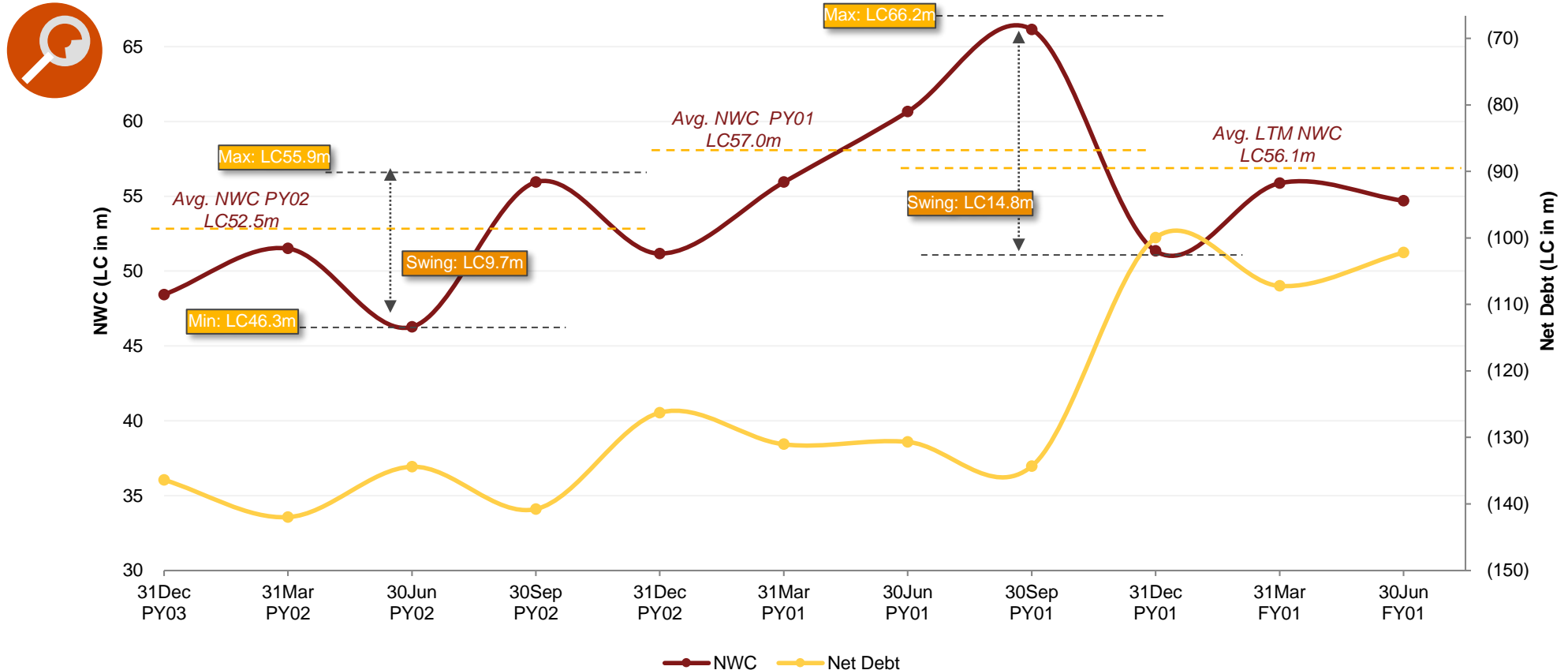


FY17-1H20 Reported NWC evolution and swings

€ in millions	FY17	FY18	FY19	1H20
Min	106.1 4Q17	98.7 1Q18	107.8 1Q19	105.5 1Q20
Max	117.2 3Q17	121.1 3Q18	132.3 3Q19	106.8 2Q20
Avg	110.1	110.5	116.6	106.2
Swing	11.1	22.4	24.6	1.3

Monthly Net Working Capital analysis

Generally NWC and Net Debt trends show a mirroring pattern

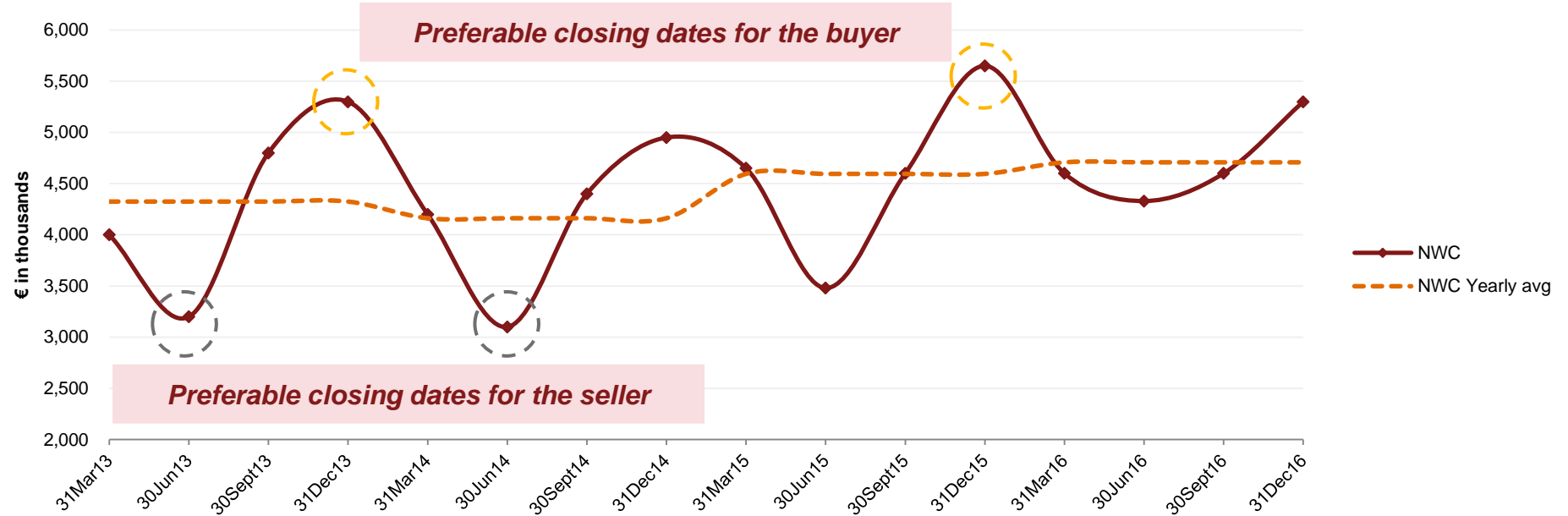


- This analysis shows NWC and Net Debt trends (which generally present a mirroring pattern). The aim of this analysis is to show any seasonality of the Target Company by **highlighting peaks and swings**.
- Buyers take NWC requirements into consideration when assessing the business valuation and will be interested in better understanding the seasonality pattern of NWC.

Net working capital and negotiation

NWC from Vendor and buyer view

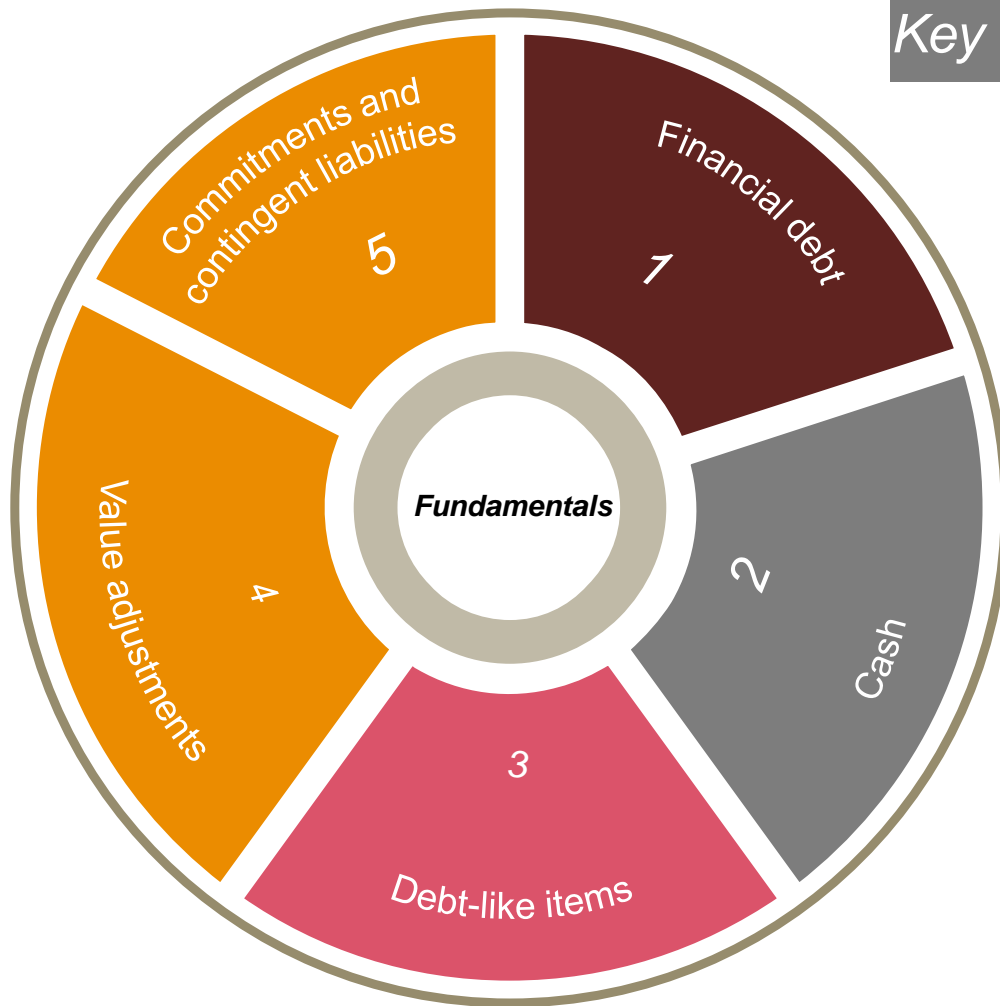
Net working capital trends



Net Debt

Net Debt

What is important?



Key questions

1. Net debt is cash less debt;
2. Net debt is important because any adjustment in its size is an adjustment in the purchase price of the same size;
3. The terms 'cash' and 'debt' are defined in the SPA. The definition can also include certain adjustments (e.g. trapped cash and debt like items).

Approach

1. Identify and segregate net debt components;
2. Agree the approach to net debt with the client;
3. Consider value adjustments;
4. Identify the cash profile of net debt (unwinding of commitments);
5. Identify off-balance sheet commitments and contingencies.

Net Debt

Overview of main components (1 of 2)

Component	Points to consider
Cash and cash equivalents	<ul style="list-style-type: none">Defined as actual cash and highly liquid assets that can readily be turned into cash without a loss. Cash equivalents have an original maturity of less than three months – they are not based on the date of the transaction. In other words: petty cash, bank accounts and short term government bonds.
Financial debt	<ul style="list-style-type: none">Defined as amounts owed to individuals or institutions with defined terms and maturities. Financial debt identified by management is a useful starting point and often what they use to assess leverage or gearing (e.g. bank debt, capital leases, etc.). It is important to separate financial debt for valuation as it will typically be assumed or refinanced by the purchaser.In other words: bank overdraft, bank advances, short term mortgages, short term bank loans, long term mortgages
Debt-like items	<ul style="list-style-type: none">Defined as balances more similar to debt than operational (e.g. vendor financing arrangements, overdue payables, restructuring provisions, etc.) and including all other debt-like items identified (e.g. pensions, deferred purchase prices on acquisitions, etc.) throughout the course of our work. Understand how the cash impact of these items unwinds.

Net Debt

Overview of main components (2 of 2)

<i>Component</i>	<i>Points to consider</i>
<i>Value adjustments</i>	<ul style="list-style-type: none">• Trapped cash and restricted cash could be considered for exclusion. Consider updated valuations of unfunded pension obligations and other employee benefit matters. Value adjustments should be made with an understanding of how the client is approaching their valuation of net debt.
<i>Commitments and contingencies</i>	<ul style="list-style-type: none">• Defined as off-balance sheet future cash commitments (e.g. operating leases) or potential pay-outs dependent on the outcome of a future uncertainty (e.g. litigation). These items are not included in the net debt table, but should be disclosed below the table. These items are never aggregated with net debt – they are always disclosed separately.• The rationale is to provide the reader with as complete a picture as possible based on our diligence - this can be very difficult from a risk management perspective – a caveat on completeness should be considered. Discussions with the legal advisors are encouraged to cross-check facts and understanding.
<i>Reclassifications from NWC</i>	<ul style="list-style-type: none">• Financial-like items identified during NWC analysis such as:<ul style="list-style-type: none">• Capex payables• Factorised trade receivables• Overdue trade payables

Adjusted Net Debt

- There are generally three main types of QoND adjustments:
 - Reclassifications from NWC;
 - NWC effect of seasonality;
 - Debt like items;
 - Off-balance sheet commitments and contingencies.

Net Financial Position

€ in thousands	31Dec18	31Dec19	31Dec20
Cash and cash equivalent	10,000	10,000	15,000
Short term borrowings	(4,500)	(4,500)	(4,000)
Non current potion on LT loan	(1,000)	(1,000)	(800)
Bonds	(2,000)	(2,000)	(2,000)
Lon term borrowing	(3,000)	(3,000)	(2,800)
Shareholders borrowings	(6,624)	(6,624)	(13,086)
Lease related liabilities	(100)	(10,000)	(9,000)
Reported Net Debt	(4,224)	(14,124)	(13,886)

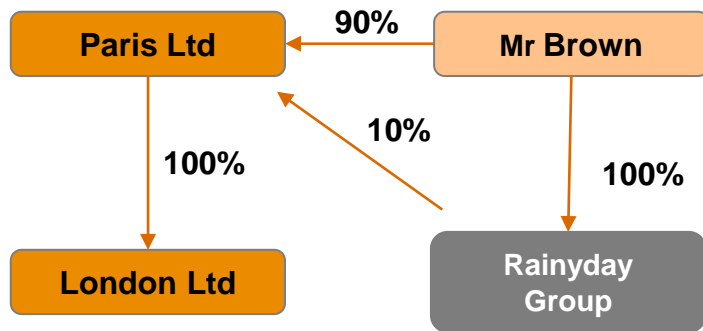


Adjusted net debt


€ in thousands	31Dec18	31Dec19	31Dec20
Reported Net Debt	(4,224)	(14,124)	(13,886)
Reclassifications from net working capital			
Factoring without recourse	(50)	(86)	(111)
Corporate income tax liabilities	(33)	(38)	(42)
Capex payables	(201)	(180)	(300)
Overdue trade receivables >90 days	(12)	(25)	(50)
Debt like items			
Severance indemnity (TFR)	(958)	(938)	(821)
Agents leaving indemnity	(58)	(59)	(60)
Provision for risks	(532)	(532)	(532)
Transaction costs	[-]	[-]	[-]
Adjusted net debt before seasonality	(6,068)	(15,982)	(15,802)
NWC seasonality	(686)	(500)	(678)
Adj. ND after seasonality	(6,754)	(16,482)	(16,480)
TIFRS16 impact	-	(9,900)	(9,800)
Adj. ND after seasonality net of IFRS16	(6,754)	(26,382)	(26,280)
Other items for considerations			
Off balance sheet items	(12)	(12)	(12)
Tax DD findings	[-]	[-]	[-]
Legal DD findings	[-]	[-]	[-]

Adjusted net debt exercise

AdjND Exercise - The Rainyday Group



 *Real estate company (excluded from the perimeter)*

 *Transaction perimeter*

 *Shareholders*

- Rainyday Group is the market leader in the production of raincoats, through three production units located in Europe (Rome, Paris and London) and some distribution facilities located throughout the world.
- The graph represents the structure of the group as at 31Dec20.
- The proposed transaction includes 100% of the share capital of Rainyday Group.
- The headquarters of the Group companies are located in properties owned by the Paris Ltd and its subsidiary London Ltd.. It is noted, however, that the properties belonging to the two real estate companies have already been the subject of negotiation between the parties and will be acquired by the buyer through a separate agreement.

QoND Exercise - The Rainyday Group (2 of 7)

Rainyday Group - Balance Sheet

	31Dec19	31Dec20
€ in millions	Act	Act
Intangible assets	7.5	9.0
Tangible assets	70.8	67.2
Financial assets	1.5	2.1
Fixed assets	79.8	78.3
Inventory	23.1	27.0
Trade receivables	33.0	37.5
Trade payables	(30.0)	(36.0)
TWC	26.1	28.5
Other assets	6.5	7.2
Other liabilities	(41.7)	(49.2)
NWC	(9.2)	(13.5)
Provision	(17.4)	(17.4)
Capital employed	53.3	47.4
Net Debt	(9.6)	(7.8)
Net equity	43.7	39.6

Source: SFS

- Following the Group's productive nature, tangible assets are mainly composed of the three production sites located in Europe.
- The decrease in the net book value of tangible fixed assets is mainly attributable to the amortization of the year.

QoND Exercise - The Rainyday Group (3 of 7)

Rainyday Group - Trade Working Capital

€ in millions	31Dec19	31Dec20
	Act	Act
Inventory	23.1	27.0
Trade receivables	33.0	37.5
Trade payables	(30.0)	(36.0)
TWC	26.1	28.5
of which cash received in advance according to the contract	8.8	10.0

Source: SFS and Management Information

- Management informed us that the Company made an extensive use of advances on factoring with recourse in order to immediately monetize the receivables from third parties.
- In case of no cash collection from the factorized invoice, the bank has the right to claim compensation from the customer.
- The company has to book a liability toward the bank as long as the bank communicate him to have collected the factorized amount.

QoND Exercise - The Rainyday Group (4 of 7)

Rainyday Group - Other assets

€ in millions	31Dec19	31Dec20
	Act	Act
Prepayments	2.3	3.0
Financial investments (Short Term)	1.7	1.8
VAT receivables	1.4	1.5
Other	1.2	0.9
Other assets	6.5	7.2

Source: SFS and Management Information

Rainyday Group - Provisions

€ in millions	31Dec19	31Dec20
	Act	Act
Leaving indemnities	(6.9)	(7.2)
Asbestos	(9.0)	(9.0)
Legal disputes	(1.5)	(1.2)
Provisions	(17.4)	(17.4)

Source: SFS and Management Information

Rainyday Group - Other Liabilities

€ in millions	31Dec19	31Dec20
	Act	Act
Factoring with recourse	(26.3)	(30.0)
Wages and salaries to be paid	(4.4)	(5.3)
Capex liabilities	(1.8)	(3.8)
Social Security	(3.6)	(3.8)
VAT liabilities	(3.0)	(3.5)
Tax liabilities	(1.5)	(1.5)
Other	(1.2)	(1.5)
Other liabilities	(41.7)	(49.2)

Source: SFS and Management Information

The provision “asbestos”, amounting to € 9.0m, is related to asbestos removal costs at some locations of the Group.

The provision “legal disputes” is mainly related to unfair dismissal of some employees.

QoND Exercise - The Rainyday Group(5 of 7)

Rainyday Group - Net Debt

€ in millions	31Dec19 Act	31Dec20 Act
Cash and cash equivalents	24.0	26.7
Bank accounts	(9.6)	(9.0)
Net Cash	14.4	17.7
HSBC financing	(16.5)	(17.3)
Barclays financing	(6.0)	(6.8)
Other financing	(1.5)	(1.5)
Financing	(24.0)	(25.5)
Net Debt	(9.6)	(7.8)

Source: SFS and Management Information

Board of directors note

Dividends:

With reference to the FY20, the BoD held on 31Mar21 has approved the distribution of dividends for an amount of €9.0m. The dividends will be paid in 2H21.

Aspects related to the transaction:

In relation to the proposed transaction the costs related to the various analysis (i.e. Financial, Tax, Legal and Operational Due Diligence) amounted to c.€3.0m.

Furthermore, given the important role that the Management has done in order to make the operation successful, the Seller proposed to them the recognition of a special bonus of € 3.0m, bound to the success of the transaction.

Rainyday Group - Cash and cash equivalents by countries

€ in millions	31Dec19 Act	31Dec20 Act
UK	12.0	15.0
USA	6.0	6.0
China	4.5	4.5
Canada	0.9	0.6
Other	0.6	0.6
Cash and cash equivalents	24.0	26.7

Source: SFS and Management Information

QoND Exercise - The Rainyday Group (6 of 7)

Adjusted Net Debt

€ in millions	31Dec19	31Dec20
	Act	Act

Reported Net Debt	-	-
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Reclassification from NWC

Other cash/ debt like items

Adjusted Net Debt	-	-
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Other matters to be considered

*The information above and the table
aside are included in the xls file sent
You have 20 minutes to complete
your adjusted net debt analysis*

QoND Exercise - The Rainyday Group (7 of 7)

Adjusted Net Debt

€ in millions	31Dec19 Act	31Dec20 Act
Cash and cash equivalents	24.0	26.7
Bank accounts	(9.6)	(9.0)
HSBC financing	(16.5)	(17.3)
Barclays financing	(6.0)	(6.8)
Other financing	(1.5)	(1.5)
Reported Net Debt	(9.6)	(7.8)
Reclassification from NWC		
Financial investments (Short Term)	1.7	1.8
Capex liabilities	(1.8)	(3.8)
Factoring with recourse	(26.3)	(30.0)
Tax liabilities	(1.5)	(1.5)
Overdue Trade payables > 30days	[]	[]
Other financial items included in other liabilities	[]	[]
Other cash/ debt like items		
Leaving indemnities	(6.9)	(7.2)
Asbestos	(9.0)	(9.0)
Legal disputes	(1.5)	(1.2)
Dividend payables	-	(9.0)
Adjusted Net Debt	(54.9)	(67.7)
Other matters to be considered		
Transaction costs	-	(3.0)
Management bonus	-	(3.0)

Source: SFS, Management Information and Pw C Analysis

Thank you