Introduction to Due Diligence

Anthony Wilson
5 November 2012
What is DD?
Who requires a DD?
Why is DD needed?
Types of DD
WHAT IS DUE DILIGENCE

• _Due diligence is an investigation into the affairs of an entity before its acquisition, disposal, flotation, refinancing, restructuring or other similar transactions._

• _The process by which information is gathered about:_
  – a target company,
  – its business, and
  – the environment in which a target company operates

• _To ensure that prospective investors make an informed investment decision_
Types of due diligence

• Financial DD (for the buyer, or «vendor due diligence»)
• Commercial DD
• Legal DD
• Tax DD
• Technical DD
• Environmental DD
• Pensions / HR DD
• Reputational DD
Why is due diligence needed

• A clear understanding of the target business: a balanced view
• Understanding of the market, competitors, trends
• Protection from risks
• A document to present to the Board of Directors
• A document to present to lending banks
Due diligence findings assist the buyer:

- identifying «deal killers»
- structuring and valuing the transaction
- preparing financing strategies and documents (including projections)
- negotiating purchase price and purchase agreements
- negotiating financial covenants in credit agreements
- identifying operational areas upon which to concentrate after the deal closes
- assessing the financial statement impact of the transaction
Purposes of due diligence

- Confirm information already provided,
- Identify and quantify possible risks
- Minimise risk of failure of post-acquisition,
- Gain a deeper understanding,
- Confirm assumptions and facts upon which the transaction and the purchase price are based
- Validate the reasons for the acquisition
- Estimate risks and factor them into negotiations etc.
WHO REQUIRES A DD

• Private Equities

Deloitte.
Transaction services advisory to
In the acquisition of
2008

Deloitte.
Transaction services advisory to
In the acquisition of
Pronet
Transaction Value $200 mn
2012

Deloitte.
Transaction services advisory to
The Carlyle Group
bidding for
Transaction Value $1,100 mn
2007

Note: strangely, in most deals, the price is agreed in US dollars.
WHO REQUIRES A DD

- Strategic investors

**Deloitte.**
Transaction services advisory to

**ACCCELL GROUP**
In the acquisition of Bianchi Bisiklet

**Bianchi**

**Deloitte.**
Transaction services advisory to

**Dabur**
In the acquisition of Hobby Cosmetics

**Hobby Cosmetics**
Transaction Value $67 mn

2010

**Deloitte.**
Transaction services advisory to

**LUKOIL**
In the acquisition of

**akpet**
Transaction Value $353 mn

2008
Financial / tax DD: what the Clients are looking for

• Financial Clients
  – Valuation, exit strategy, internal rate of return ("IRR")
  – EBITDA
  – Cash flows
  – Report communicated to financing banks
  – Hidden liabilities / financial risks

• Strategic Clients
  – Similar to PEIs: EBITDA, cash flows, plus hidden liabilities
  – Equally considered factors are revenues, earnings, EPS impact, effective tax rate impact
  – Other factors including geographic expansion, new product lines, post-acquisition synergies, new distribution channels
What is the Financial DD approach?
Setting priorities

In case of profitability and growth potential
More focus on;
• Normalised EBITDA and cash flow
• Any balance sheet risks

In case of bankruptcy / cash flow problems
More focus on;
• Reps and warranties
• potential liabilities / off balance sheet items
PLANNING THE ENGAGEMENT

• Making the scope clear to everybody: team, client etc
• Making the deadlines clear to everybody
• Coordination with the tax due diligence team, legal due diligence team and operational team
• Allocation of responsibilities among staff.
• The nightmare of different accounts: statutory, management, IFRS, etc.
INVESTIGATION VALUE CHAIN

1. Quick Appraisal
2. Fact Finding
3. Analysis
4. Interpretation
5. Oral Presentation
6. Written report
7. Debriefing
1. **QUICK APPRAISAL**

- Why do a quick appraisal
  - Understand business and industry
  - Tailor terms of reference

- Various approaches to a quick appraisal
  - Information memorandum
  - Site visit and meeting
  - Dataroom

- Initial visit to target company (or dataroom)

- Focus feedback on potential deal breakers, major issues and negotiating points

- May result in amendments to scope
4. **INTERPRETATION**

- Gain a detailed understanding of the issues identified and their implications,

- Highlight problems and provide solutions,

- Identify areas requiring further investigation.
5. ORAL PRESENTATIONS

- Regular communication throughout the investigation
- High impact face to face presentation of the key issues stressing implementation points
Data management
Sources of information (target)

- Management interviews
- Information Memorandum
- Letter of intent
- Transaction documents
- Consolidated Accounts
- Statutory accounts
- Trial balances
- Subsidiary balances
- Ageing balances
- Pro forma accounts
- Audited accounts
- Accounting data

- Management reporting
- Commercial / industrial reporting
- Statutes
- Board and Shareholder meeting minutes
- Legal Correspondance
- Corporate and legal documents

Other:
- Regulatory Documentation
- Other advisors (lawyers, tax, actuarial, etc.)
Principles of financial analysis

Business Overview (Structure, operations)
- Provide relevant context for the reader
- Describe target structure and operations in one section instead of throughout

Quality of Fin. Info (sources and reliability of the figures)
- Describe the construction and reliability of the figures analysed
- Set out key accounting policies
- Describe financial resources and reporting

Quality of Earnings (Historical P&L and adjusted EBITDA)
- Revenue and profitability drivers
- Current trading
- One off and non-recurring items
Principles of financial analysis

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

- (Latest) balance sheet breakdown
- Corroborate P&L and cash flow analyses
- Net debt and cash/debt-like items
- Working capital

Forecasts
(P&L and cash flows)

- Forecasts construction
- Key assumptions
- Corroborate with historical/other data
Quality of Earnings
### An example

#### Income statements

<table>
<thead>
<tr>
<th>Olive Oil A.Ş.</th>
<th>2009</th>
<th>2010</th>
<th>H1 2010</th>
<th>H1 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>157,233</td>
<td>195,250</td>
<td>94,532</td>
<td>133,268</td>
</tr>
<tr>
<td><strong>Cost of sales</strong></td>
<td>(117,458)</td>
<td>(137,753)</td>
<td>(64,071)</td>
<td>(92,092)</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td>39,775</td>
<td>57,496</td>
<td>30,461</td>
<td>41,176</td>
</tr>
<tr>
<td><strong>Operating expenses</strong></td>
<td>(28,272)</td>
<td>(31,511)</td>
<td>(14,901)</td>
<td>(17,822)</td>
</tr>
<tr>
<td><strong>EBIT</strong></td>
<td>11,503</td>
<td>25,986</td>
<td>15,560</td>
<td>23,354</td>
</tr>
<tr>
<td><strong>Depreciation</strong></td>
<td>8,984</td>
<td>10,242</td>
<td>4,795</td>
<td>5,348</td>
</tr>
<tr>
<td><strong>EBITDA</strong></td>
<td>20,487</td>
<td>36,228</td>
<td>20,355</td>
<td>28,702</td>
</tr>
<tr>
<td><strong>Finance (expense) net</strong></td>
<td>(4,903)</td>
<td>(5,914)</td>
<td>(1,040)</td>
<td>(11,781)</td>
</tr>
<tr>
<td><strong>Other (expense) net</strong></td>
<td>(1,069)</td>
<td>(856)</td>
<td>(774)</td>
<td>(904)</td>
</tr>
<tr>
<td><strong>Net profit before tax</strong></td>
<td>5,530</td>
<td>19,216</td>
<td>13,746</td>
<td>10,669</td>
</tr>
<tr>
<td><strong>Taxation</strong></td>
<td>-</td>
<td>(2,379)</td>
<td>(1,079)</td>
<td>(2,469)</td>
</tr>
<tr>
<td><strong>Net profit</strong></td>
<td>5,530</td>
<td>16,837</td>
<td>12,667</td>
<td>8,201</td>
</tr>
</tbody>
</table>

What is missing for the analysis?
An example

**Income statements**

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<table>
<thead>
<tr>
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<th>2009</th>
<th>2010</th>
<th>H1 2010</th>
<th>H1 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross margin</td>
<td>25.3%</td>
<td>29.4%</td>
<td>32.2%</td>
<td>30.9%</td>
</tr>
<tr>
<td>EBITDA margin</td>
<td>13.0%</td>
<td>18.6%</td>
<td>21.5%</td>
<td>21.5%</td>
</tr>
<tr>
<td>OPEX as percentage of sales</td>
<td>18.0%</td>
<td>16.1%</td>
<td>15.8%</td>
<td>13.4%</td>
</tr>
<tr>
<td>Sales growth</td>
<td>18.1%</td>
<td>24.2%</td>
<td>18.0%</td>
<td>41.0%</td>
</tr>
</tbody>
</table>

What questions should we ask to the Target?
An example – How is the sales growth managed

- Increase in sales is in all regions.
- Both prices and quantities have increased.
- The sales growth is ascribed to the customer and profit focused expansion strategy applied by Management starting from 2009.
An example – How is the sales growth managed

- Prices were managed to increase via elimination of loss making customers.
An example – Analysis of cost increase

- Raw material costs have increased in the second half of 2010
- Because of exchange rates increase or increase in unit costs?
Depth of analysis - example

• Standard profit and loss account
  – What does this analysis tell us?
  – How can this analysis be improved?

<table>
<thead>
<tr>
<th></th>
<th>2007  € 000</th>
<th>2008  € 000</th>
<th>2009  € 000</th>
<th>2010  € 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>1,822</td>
<td>1,950</td>
<td>2,067</td>
<td>2,170</td>
</tr>
<tr>
<td>Cost of sales:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Materials</td>
<td>(523)</td>
<td>(560)</td>
<td>(591)</td>
<td>(626)</td>
</tr>
<tr>
<td>Labour</td>
<td>(340)</td>
<td>(364)</td>
<td>(382)</td>
<td>(485)</td>
</tr>
<tr>
<td>Overheads</td>
<td>(196)</td>
<td>(210)</td>
<td>(223)</td>
<td>(235)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>763</td>
<td>816</td>
<td>871</td>
<td>824</td>
</tr>
</tbody>
</table>
Depth of analysis

• Analyse the gross profit margin
  – How can this analysis be improved?

<table>
<thead>
<tr>
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<td>Gross profit</td>
<td>763</td>
<td>816</td>
<td>871</td>
<td>824</td>
</tr>
<tr>
<td>Gross profit percentage</td>
<td>42%</td>
<td>42%</td>
<td>42%</td>
<td>38%</td>
</tr>
</tbody>
</table>
Depth of analysis

- Analyse the direct cost margins

<table>
<thead>
<tr>
<th></th>
<th>2007 € 000</th>
<th>2008 € 000</th>
<th>2009 € 000</th>
<th>2010 € 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Materials</td>
<td>29%</td>
<td>29%</td>
<td>29%</td>
<td>29%</td>
</tr>
<tr>
<td>Labour</td>
<td>19%</td>
<td>19%</td>
<td>18%</td>
<td>22%</td>
</tr>
<tr>
<td>Overheads</td>
<td>11%</td>
<td>11%</td>
<td>11%</td>
<td>11%</td>
</tr>
</tbody>
</table>

- Therefore, focus on labour costs – what next?
## Depth of analysis

- Payroll analytical review

<table>
<thead>
<tr>
<th></th>
<th>Number of employees</th>
<th>Total gross pay</th>
<th>Average gross pay</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar</td>
<td>20</td>
<td>25,500</td>
<td>1,275</td>
</tr>
<tr>
<td>Apr</td>
<td>21</td>
<td>27,200</td>
<td>1,295</td>
</tr>
<tr>
<td>May</td>
<td>26</td>
<td>35,630</td>
<td>1,370</td>
</tr>
<tr>
<td>Jun</td>
<td>27</td>
<td>59,080</td>
<td>2,188</td>
</tr>
<tr>
<td>Jul</td>
<td>31</td>
<td>69,000</td>
<td>2,226</td>
</tr>
<tr>
<td>Aug</td>
<td>31</td>
<td>74,030</td>
<td>2,388</td>
</tr>
<tr>
<td>Sep</td>
<td>31</td>
<td>43,920</td>
<td>1,417</td>
</tr>
<tr>
<td>Oct</td>
<td>24</td>
<td>27,200</td>
<td>1,133</td>
</tr>
<tr>
<td>Nov</td>
<td>24</td>
<td>32,300</td>
<td>1,346</td>
</tr>
<tr>
<td>Dec</td>
<td>24</td>
<td>30,600</td>
<td>1,275</td>
</tr>
<tr>
<td>Jan</td>
<td>23</td>
<td>29,750</td>
<td>1,293</td>
</tr>
<tr>
<td>Feb</td>
<td>21</td>
<td>27,200</td>
<td>1,295</td>
</tr>
</tbody>
</table>

- Consider hours worked in indicated months

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Depth of analysis

• Hours worked
  – Graph total hours worked and also hours for a one-off large contract
ANALYSIS : HISTORICAL TRADING PERFORMANCE

• Review of Company’s historical profit generation, i.e. for the last 3 years:
  • Determination of the key factors driving sales and profitability
  • Examination of cost structure and cost of sales base by fixed / variable nature,
  • Examination of the reasons for the trends observed
  • Analysis by division/product/customer type.
  • Analysis of gross and operating profit margin by cost / volume and price / volume variances, etc.
• Seasonality
• Carve-outs
## AN EXAMPLE: A Pharmaceutical Company Historical Trading Performance

<table>
<thead>
<tr>
<th>TL 000</th>
<th>2009</th>
<th>2010</th>
<th>2010 H1</th>
<th>2011 H1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Sales</td>
<td>47,391</td>
<td>66,785</td>
<td>27,397</td>
<td>45,171</td>
</tr>
<tr>
<td>Cost of Sales</td>
<td>(34,559)</td>
<td>(47,736)</td>
<td>(19,709)</td>
<td>(34,165)</td>
</tr>
<tr>
<td>Gross Profit /(Loss)</td>
<td>12,832</td>
<td>19,050</td>
<td>7,688</td>
<td>11,005</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>(6,718)</td>
<td>(9,905)</td>
<td>(4,067)</td>
<td>(6,511)</td>
</tr>
<tr>
<td>Operating Profit /(Loss)</td>
<td>6,114</td>
<td>9,145</td>
<td>3,620</td>
<td>4,494</td>
</tr>
<tr>
<td>Other income/(expenses)</td>
<td>(3,990)</td>
<td>(1,017)</td>
<td>(113)</td>
<td>(1,816)</td>
</tr>
<tr>
<td>Finance income/(expenses)</td>
<td>(1,473)</td>
<td>(620)</td>
<td>899</td>
<td>(3,924)</td>
</tr>
<tr>
<td>Income Before Tax</td>
<td>651</td>
<td>7,508</td>
<td>4,407</td>
<td>(1,246)</td>
</tr>
<tr>
<td>Taxation</td>
<td>(657)</td>
<td>(846)</td>
<td>(438)</td>
<td>(152)</td>
</tr>
<tr>
<td>Net Income</td>
<td>(6)</td>
<td>6,662</td>
<td>3,969</td>
<td>(1,398)</td>
</tr>
<tr>
<td>Depreciation</td>
<td>91</td>
<td>239</td>
<td>34</td>
<td>144</td>
</tr>
<tr>
<td>EBITDA (*)</td>
<td>6,205</td>
<td>9,384</td>
<td>3,654</td>
<td>4,638</td>
</tr>
<tr>
<td>Normalised EBITDA</td>
<td>6,072</td>
<td>8,571</td>
<td>[ ]</td>
<td>4,633</td>
</tr>
<tr>
<td>% Gross Margin</td>
<td>27.1%</td>
<td>28.5%</td>
<td>28.1%</td>
<td>24.4%</td>
</tr>
<tr>
<td>% EBITDA Margin</td>
<td>13.1%</td>
<td>14.1%</td>
<td>13.3%</td>
<td>10.3%</td>
</tr>
</tbody>
</table>

- What should be analysed?
AN EXAMPLE: HISTORICAL TRADING PERFORMANCE

- One major product dominates the sales and growth.
- 65% of sales is retail sales.
AN EXAMPLE : HOW BRIDGES CAN HELP TO IDENTIFY

Any comments on the gross profit bridge?
AN EXAMPLE: HOW BRIDGES CAN HELP TO IDENTIFY

- The average TL/Euro exchange rate has increased from 1.99 in 2010 to 2.19 in H12011. The effect of FX rate changes in the declining gross profit margins between 2010 and 2011 is 5.7%, 2% of which is coming from the Fleb purchases solely.

- Euro purchase prices increase for Fleb whereas they have been mainly decreased for the remaining major products, causing a net positive effect of 0.6% on gross margin.

- Sales prices increase for Fleb along with the increase in FX rates. Competition in retail market and tenders, as well as the 9.5% additional government discount applied to some of the products led to sales price decreases in the remaining products.

- 0.99% decrease in gross profit margin is due to the change in product mix.
Why normalize EBITDA?
Free Cash Flow

A reminder of the free cash flow

• Free cash flow = EBITDA – Taxes Paid – \( \Delta \)WCR – Net capital expenditures

• and EBITDA = Sales – COGS – SG&A expenses

• This free cash flow is the cash available to suppliers of capital to the firm: the lenders and shareholders.
EBITDA NORMALIZATION

- A company’s current EBITDA (earnings before income taxes, depreciation and amortization) is one of the starting points to estimate future cash flow and earnings.
- The primary type of income used for such a purposes is EBITDA, adjusted for normalization or economic effects to show a more accurate presentation of economic earnings. Potential adjustments to “normalize” EBITDA include AR and inventory reserves, leases, market value compensation adjustments and contingencies.
Reported EBITDA

- Last financial year’s results
- Last twelve month’s trading (LTM) (if middle of financial year)
- Reported numbers agree to audited numbers
- Diligence should be relatively straightforward
  - Understand underlying trends
  - Has business been “dressed for sale”?
  - Trading influenced by one-off items?
Normalising Items

• No hard and fast definitions

“Our involvement in the calculation of normalised EBITDA consisted of reviewing documentation and information of items made available in the course of our review. Because there is no authoritative literature or common standard with respect to the calculation of normalised EBITDA, there is no basis to state whether all appropriate and comparable adjustments have been made. In addition, while the identified adjustments may indeed be unusual or infrequently occurring, it is possible that there may have been other items not included in the calculation, and it is possible that future periods may also include such items, although they would be different from the historical items.”

………but we are going to have a go at doing it anyway

• Commonly seen areas
  - IFRS adjustments
  - Adjustments for one-off items
  - Adjustments for non-market prices on related party transactions
  - Elimination of EBITDA from any part of the business which will not continue («carve-out»)
  - Adjustments to include «out-of-book» transactions, and their tax effects if they had been accounted for properly.
An EBITDA normalisation example
## EBITDA

<table>
<thead>
<tr>
<th>TL'000</th>
<th>2009</th>
<th>2010</th>
<th>2011 H1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reported EBITDA</td>
<td>6,205</td>
<td>9,385</td>
<td>4,638</td>
</tr>
</tbody>
</table>

### Normalizations:

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011 H1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Related party personnel expense</td>
<td>1</td>
<td>(209)</td>
<td>(545)</td>
</tr>
<tr>
<td>Allocation of the costs of the expired products</td>
<td>2</td>
<td>(39)</td>
<td>(336)</td>
</tr>
<tr>
<td>Cut-off error related to bonus payments</td>
<td>3</td>
<td>-</td>
<td>(219)</td>
</tr>
<tr>
<td>One-time payment made to ex-cow orker</td>
<td>4</td>
<td>-</td>
<td>434</td>
</tr>
<tr>
<td>Bad debt adjustment</td>
<td>5</td>
<td>(125)</td>
<td>(376)</td>
</tr>
<tr>
<td>Normalization of rent expense</td>
<td>6</td>
<td>240</td>
<td>240</td>
</tr>
<tr>
<td>Retirement pay provisions</td>
<td>7</td>
<td>[ ]</td>
<td>(11)</td>
</tr>
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</table>

**Normalized EBITDA**

<table>
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<th>6,072</th>
<th>8,571</th>
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</tr>
</thead>
</table>
Normalization Adjustments

1. As management informed us, all personnel who are under the RP payroll, actually work for Pharma. Therefore, we have allocated the related salary expenses of these personnel to Pharma EBITDA.

2. The Company destroyed expired pharmaceuticals after the completion of approvals from the government and expensed TL 397 k in 2011 H1. We have allocated this expense to related years in our EBITDA normalisation schedule.

3. We have noticed cut-off errors related to bonuses paid in 2011 due to lack of bonus accruals at 2010 year end. We have adjusted TL 219 k related to 2010 bonuses in the normalised EBITDA schedule.

4. The Company paid one time payment in the amount of TL 434k to ex-worker in 2010.

5. We have booked a total provision of TL 501k for the receivables from warehouses MF (TL376k), and UF (TL125k) in the related periods since they are stated by the Management to be uncollectable.

6. Before moving to its own offices, the Company had rental offices with monthly rental cost of TL 20k. We have excluded the rent cost related to these offices which has been paid until April 2011, since this expense will not continue.

7. In the statutory accounts, no provisions are booked for severance pay.
Seasonality vs LTM
LTM (Last Twelve Months) analysis

• Represents last twelve months sales (or EBITDA, etc.) at any given data point

• Continuous LTM analysis strips out underlying seasonality and shows the true trend…. because each LTM point has 12 months of data
LTM analysis (2)

• Example
  – Sales from Jan 03 to Dec 05
  – What does that tell us?
LTM analysis (3)

• Example (continued)
  – Why is this better?

– Plot LTM Dec 03 to LTM Dec 05
  – LTM Dec 03 = Jan to Dec 03
  – LTM Dec 05 = Jan to Dec 05
LTM analysis (4)

• LTM analysis also provides the most recent actual annual information

• For example, LTM EBITDA is useful because
  – FY05 actual EBITDA is old; and
  – FY06 YTD EBITDA is not a full year

• How do you calculate LTM EBITDA as at YTD 06?
  – LTM = FY05 Actual + YTD 06 – YTD 05

<table>
<thead>
<tr>
<th></th>
<th>Q1</th>
<th>Annual</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY05 Actual</td>
<td>40.0</td>
<td>100.0</td>
</tr>
<tr>
<td>YTD FY05 Actual</td>
<td>45.0</td>
<td></td>
</tr>
</tbody>
</table>

– LTM EBITDA = 105.0
Balance Sheet Analysis
Balance Sheet Analysis

Objectives

• Sort/reclassify the balance sheet in order to separate it into its different financial components.

• Identify/analyse long term assets (fixed, intangible, financial)

• Identify/analyse the components of trade and other working capital (what items to include/exclude from the WC definition and potential adjustments)

• Identify/analyse the components of net indebtedness (what items to include/exclude from the WC definition and potential adjustments)

• Identify/analyse provisions and similar items (under-provisioning, assets without value, etc.) to cover in the SPA

• Analyse shareholders’ equity

• Identify/analyse off balance sheet items (e.g. contingent liabilities, pensions)
Balance Sheet Analysis
Components ("financial" balance sheet)

- Long term assets
  - Fixed, intangible, financial
- Working capital
  - Trade, other
- Other assets/liabilities
  - Other balance sheet items
- Provisions
  - Pensions, doubtful rec., other
- Net indebtedness
  - Cash and equivalents, financial debt, finance leases, bonds, shareholder loans
- Net assets
- Shareholders’ equity
AN EXAMPLE: REVIEW OF BALANCE SHEET

Balance Sheet
TL’000

<table>
<thead>
<tr>
<th>Current assets</th>
<th>Dec-09</th>
<th>Dec-10</th>
<th>Jun-11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and bank balances</td>
<td>154</td>
<td>1,953</td>
<td>478</td>
</tr>
<tr>
<td>Trade receivables</td>
<td>19,685</td>
<td>30,342</td>
<td>30,701</td>
</tr>
<tr>
<td>Inventories</td>
<td>4,928</td>
<td>8,907</td>
<td>5,687</td>
</tr>
<tr>
<td>Other current assets</td>
<td>35</td>
<td>874</td>
<td>597</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>24,801</td>
<td>42,077</td>
<td>37,463</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Non-current assets</th>
<th>Dec-09</th>
<th>Dec-10</th>
<th>Jun-11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade receivables</td>
<td>3</td>
<td>5</td>
<td>11</td>
</tr>
<tr>
<td>Tangible fixed assets</td>
<td>327</td>
<td>7,054</td>
<td>7,990</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>37</td>
<td>107</td>
<td>80</td>
</tr>
<tr>
<td>Prepaid expenses and accrued income</td>
<td>2</td>
<td>-</td>
<td>2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>370</td>
<td>7,166</td>
<td>8,083</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Current liabilities</th>
<th>Dec-09</th>
<th>Dec-10</th>
<th>Jun-11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Borrowings</td>
<td>7,103</td>
<td>14,976</td>
<td>14,851</td>
</tr>
<tr>
<td>Trade payables</td>
<td>20,240</td>
<td>25,943</td>
<td>25,407</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>707</td>
<td>697</td>
<td>1,342</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>28,050</td>
<td>41,616</td>
<td>41,600</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Non-current liabilities</th>
<th>Dec-09</th>
<th>Dec-10</th>
<th>Jun-11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Borrowings</td>
<td>32</td>
<td>5,846</td>
<td>5,846</td>
</tr>
<tr>
<td></td>
<td>32</td>
<td>5,846</td>
<td>5,846</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Shareholders’ equity</th>
<th>Dec-09</th>
<th>Dec-10</th>
<th>Jun-11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital</td>
<td>2,844</td>
<td>6,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Capital reserves</td>
<td>(4,374)</td>
<td>(8,885)</td>
<td>(6,096)</td>
</tr>
<tr>
<td>Profit for the period</td>
<td>(1,382)</td>
<td>4,666</td>
<td>(1,804)</td>
</tr>
<tr>
<td></td>
<td>(2,911)</td>
<td>1,781</td>
<td>(1,900)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>25,171</td>
<td>49,243</td>
<td>45,546</td>
</tr>
</tbody>
</table>

Source: Adjusted statutory financials

- What is the relation of the business growth and the balance sheet?
Working Capital Analysis
Components - examples

Trade WC (core)

Trade receivables
Trade payables

Trade WC (enlarged)

Customer advances
Advances to suppliers
Taxes receivable/payable

Other WC

Other current assets and liabilities

Total WC
## A Typical Working Capital Analysis

### Net Working Capital

<table>
<thead>
<tr>
<th></th>
<th>TL'000</th>
<th>Dec-09</th>
<th>Dec-10</th>
<th>Jun-11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade receivables</td>
<td>19,685</td>
<td>30,342</td>
<td>30,701</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>4,928</td>
<td>8,907</td>
<td>5,687</td>
<td></td>
</tr>
<tr>
<td>Trade payables</td>
<td>(20,240)</td>
<td>(25,943)</td>
<td>(25,407)</td>
<td></td>
</tr>
<tr>
<td><strong>Reclass of CapEx payable to ND</strong></td>
<td>-</td>
<td>2,406</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td><strong>Adjusted trade working capital items</strong></td>
<td>4,372</td>
<td>15,713</td>
<td>11,081</td>
<td></td>
</tr>
<tr>
<td>Other current assets and liabilities</td>
<td>(678)</td>
<td>177</td>
<td>(745)</td>
<td></td>
</tr>
<tr>
<td><strong>Reclass of net debt items</strong></td>
<td>352</td>
<td>293</td>
<td>595</td>
<td></td>
</tr>
<tr>
<td><strong>Other working capital items</strong></td>
<td>(326)</td>
<td>470</td>
<td>(150)</td>
<td></td>
</tr>
<tr>
<td><strong>Adjusted NWC</strong></td>
<td>4,046</td>
<td>16,183</td>
<td>10,932</td>
<td></td>
</tr>
</tbody>
</table>

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales</strong></td>
<td>47,391</td>
<td>66,785</td>
<td>86,936</td>
</tr>
<tr>
<td><strong>Purchases - Imported products</strong></td>
<td>(33,149)</td>
<td>(48,908)</td>
<td>(29,939)</td>
</tr>
<tr>
<td><strong>%Trade receivables/Sales</strong></td>
<td>41.5%</td>
<td>45.4%</td>
<td>35.3%</td>
</tr>
<tr>
<td><strong>%Inventory/Sales</strong></td>
<td>10.4%</td>
<td>13.3%</td>
<td>6.5%</td>
</tr>
<tr>
<td><strong>%Payables/Sales</strong></td>
<td>(42.7)%</td>
<td>(35.2)%</td>
<td>(30.4)%</td>
</tr>
<tr>
<td><strong>%NWC/Sales</strong></td>
<td>8.5%</td>
<td>24.2%</td>
<td>12.6%</td>
</tr>
<tr>
<td>Days sales outstanding</td>
<td>150</td>
<td>164</td>
<td>127</td>
</tr>
<tr>
<td>Days sales of inventory - Domestic products</td>
<td>76</td>
<td>101</td>
<td>378</td>
</tr>
<tr>
<td>Days sales of inventory - Imported products</td>
<td>34</td>
<td>47</td>
<td>18</td>
</tr>
<tr>
<td>Days payable outstanding - Imported products</td>
<td>199</td>
<td>168</td>
<td>142</td>
</tr>
<tr>
<td><strong>Cash conversion cycle - Imported products</strong></td>
<td>(16)</td>
<td>43</td>
<td>3</td>
</tr>
</tbody>
</table>

*Source: Statutory financials, Deloitte analysis

*2011 Sales are LTM sales.

Quarterly inventory figures excludes the expired products and the advances given to suppliers.
A Typical Working Capital Analysis

Trade Working Capital

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Trade receivables</th>
<th>Trade payables</th>
<th>Inventory (imported)</th>
<th>Inventory (domestic)</th>
<th>Quarterly sales</th>
<th>NWC</th>
</tr>
</thead>
<tbody>
<tr>
<td>1Q2009</td>
<td>9,662</td>
<td>11,181</td>
<td>13,350</td>
<td>(12,340)</td>
<td>(13,427)</td>
<td>(16,431)</td>
</tr>
<tr>
<td>2Q2009</td>
<td>19,685</td>
<td>16,921</td>
<td>19,629</td>
<td>(20,240)</td>
<td>(19,734)</td>
<td>(19,118)</td>
</tr>
<tr>
<td>3Q2009</td>
<td>3,094</td>
<td>3,430</td>
<td>6,219</td>
<td>(29,943)</td>
<td>(27,625)</td>
<td>(25,407)</td>
</tr>
<tr>
<td>4Q2009</td>
<td>3,972</td>
<td>713</td>
<td>3,382</td>
<td>1,907</td>
<td>2,347</td>
<td>2,573</td>
</tr>
<tr>
<td>1Q2010</td>
<td>24,612</td>
<td>6,219</td>
<td>30,701</td>
<td>(25,943)</td>
<td>(27,625)</td>
<td>(25,407)</td>
</tr>
<tr>
<td>2Q2010</td>
<td>30,342</td>
<td>31,792</td>
<td>(10,000)</td>
<td>10,000</td>
<td>20,000</td>
<td>30,000</td>
</tr>
<tr>
<td>3Q2010</td>
<td>30,701</td>
<td>30,701</td>
<td>(10,000)</td>
<td>10,000</td>
<td>20,000</td>
<td>30,000</td>
</tr>
<tr>
<td>4Q2010</td>
<td>30,701</td>
<td>30,701</td>
<td>(10,000)</td>
<td>10,000</td>
<td>20,000</td>
<td>30,000</td>
</tr>
<tr>
<td>1Q2011</td>
<td>30,701</td>
<td>30,701</td>
<td>(10,000)</td>
<td>10,000</td>
<td>20,000</td>
<td>30,000</td>
</tr>
<tr>
<td>2Q2011</td>
<td>30,701</td>
<td>30,701</td>
<td>(10,000)</td>
<td>10,000</td>
<td>20,000</td>
<td>30,000</td>
</tr>
</tbody>
</table>

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‘Target’ Working capital

To set the target we need to remove distorting items by identifying…

• one-off, non recurring items – disposal proceeds, redundancy or restructuring costs, one-off bonuses

• items which are artificially high at year end e.g. delay of trade creditors run, disputed invoices

• trade debtors which have been factored

• capex payables

• liabilities which are debt in nature e.g. deferred income,

• provisions which have a cash impact post closing
Net indebtedness analysis

Net debt items

Available cash (BS) → Cash which can be distributed immediately

- Financial debt (BS) → Loans, finance leases, etc.

= “Reported” net debt

-/+ Debt-like items → The balance sheet items of the business which represent future cash out not strictly related to current operations

= “Adjusted” net debt
AN EXAMPLE: REVIEW OF CASH FLOW

Free Cash Flow (TL'000)

- Adjusted EBITDA
- Cash normalisations
- Transfer to shareholders' accounts
- Change in NWC
- CAPEX (-)
- Free Cash Flow
ANALYSIS : REVIEW OF CASH FLOW

• Our aim is to:
  • Try to identify whether (and why) the Company is cash generative before and after financing costs and CAPEX, (i.e. is the Company cash self sufficient?)
  
  • Try to identify the Company’s working capital position, and the internal and external factors that cause this, (maybe on a monthly basis)

  • Identify the Company’s stock holding position, debtor management policy, creditor settlement policies, material capital expenditure projects over the last three years, etc.
Reporting and Key Issues
Effective reporting
Our deliverables – typical report organisation

Key findings
- History, organisation and footprint
- Legal/operational structure
- Customers, suppliers, partners, interco

Business overview
- Reporting and resources
- Carve-out and stand-alone issues

Quality of Financial Info
- P&L overview and drivers
- Adjusted EBITDA

Historical trading
- Balance sheet overview and key items
- Working capital components
- Adjusted net indebtedness

Historical balance sheet
- Forecasts overview and assumptions
- Comparison to historical performance

Forecasts

Taxation, Pensions, etc.

Appendices
- Engagement letter
- Scope & bases of review
- Supporting tables/charts
## Key Issues

<table>
<thead>
<tr>
<th>Topics</th>
<th>Observations</th>
<th>Implications</th>
</tr>
</thead>
</table>
| **The Company is the guarantor of a sister company bank loans.** The amount of outstanding sister company loans as of June 2011 is TL 16m. | • We have been informed that there are personal guarantees of the shareholders on all of the Company’s bank loans and the office building is pledged. The customer cheques are given as collateral for the Company’s short term bank loans.  
• Additionally the Company and its shareholders have been so the guarantors of sister A.Ş. bank loans amounting up to TL 30m in total. Outstanding bank loan of sister a.ş as of June 2011 is TL 16m. | • Bank guarantees given on behalf of the related parties should be considered before the potential transaction. |
| **Technical insolvency** | • As a result of the adjustments made to the Company’s statutory accounts to include the effects of unrecorded expenses in equity, the Company’s equity turned negative in 2009 and 2011. Statutory and adjusted equity as at 30 June 2011 is TL 39k and negative TL1.8m, respectively.  
• We have not been informed of any bank covenants on the bank loans regarding technical insolvency issue. | • Technical insolvency risk should be assessed by the Company’s board of directors taking into account TL6m of capital and low equity figure as of June 2011.  
• Please also consult with your legal consultants. |
| **Unrecorded FX losses** | • We have noted that the Company has not included TL682k of FX losses arising from trade payables valuation in the income statement in June 2011 financial statements. The reason was to present higher profits to the creditors. We have included the effect of the accurate valuation difference in trade payables and exchange losses in the adjusted financial statements. | • We have not been provided with detailed calculation of exchange gains and losses for 2009 and 2010. We can not be sure whether the effects of all revaluations have been included in the financial statements in the previous periods. |
| **Warranty regarding inventory balances** | • Although the Company has material inventory balances, Management stated that the Company has no slow moving or obsolete inventory.  
• We were informed that as of the balance sheet date, there are no materials inventory held at the suppliers’ premises. | • Reps and warranties from the management should be obtained stating that there is no material obsolete or significant consigned inventory. |
Homework: which of the following items would you «normalize»?

In 2012 EBITDA:

1. The company bought a lottery ticket and it won TL 50 million, which is recorded in 2012 «other income» below EBITDA.

2. Sales rose in 2012 because a new law was passed which made the company's product compulsory for all farmers.

3. There was stormy weather in November which reduced demand for the company’s products, because (management believe that) customers did not go to the shops as much as normal.

4. The company recorded research expenses as an asset, but IFRS require that they are recorded as an operating expense.

5. There was a fire at the company in 2010. The insurance company paid slowly, so the insurance money was received in 2012 and recorded as an operating income.

6. The Company management say that they had TL 10m of out-of-book sales and TL 5m of out-of-book wages costs (before income tax)

In 2012 Net Working Capital:

1. The company paid its creditors just after the year end instead of just before, because Hurricane Mine Hanım hit the head office on 29 December.

2. The company’s new season product range was less successful than normal at the shops, so stocks of product at the year end were TL 10m higher than normal.

3. The company’s stocks at 31 December 2012 will include TL 20m from the ABC division, but the ABC division will be carved out and will not form part of the sale of the business to the new investor.