

2021



Financial Due Diligence Online Course
Supporting Slides

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Financial Due Diligence are mostly required in the context of a Deal

When do we Need Due Diligence?

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Most Common Types of Deals Requiring Due Diligence

- ✓ A transfer of ownership of part or all of a company's equity (e.g. a sale)
- ✓ A capital raise involving private equity investors
- ✓ An IPO (initial public offering), e.g. a private company becoming public
- ✓ A public-to-private transaction (eg. a listed company acquired by a privately own company)
- ✓ A debt financing event
- ✓ A merger between two strategic players on a given market

What is the Purpose of Due Diligence?

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Provides buyers with the most objective and comprehensive understanding of the Target's business

Different types of Due Diligence

- ✓ Financial Due Diligence (FDD)
- ✓ Commercial (i.e. analysis of the market)
- ✓ Tax (i.e. assessing risk around tax structure and tax-related risk of unpaid tax litigation)
- ✓ Legal (i.e. do contracts abide by the law? Are there any ongoing litigation? Etc.)
- ✓ Operational (including synergy / carve-out assessment etc.)
- ✓ IT (e.g., assessing the security of the IT, analyzing the software, code, etc.)

Financial Due Diligence (FDD)

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3 Main Goals of FDD

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01 Explain Business Model

Provide a clear and deep understanding of the revenue generation and profitability structure of the Target.

02 Normalize Financials

Provide a normalized view of financial indicators and aggregate impacting deal value (EBITDA, Net Debt, Cash Flow, Net Working Capital etc.)



A FDD
consultant is
meant to be
independent
and **objective**

03 Assess Forecast Feasibility

Use a fact-based approach of the historical performance to assess the feasibility of forecast.

A FDD is NOT an accounting Audit

- Accounting audit's purpose is to verify that financial statement have been prepared in accordance to legally accepted principles (GAAP, IFRS etc.)
- FDD is there to explain
 - historical and current trends
 - give a normalized view of what EBITDA is and what it should be on an ongoing basis
 - give a better definition of Net Working Capital and of Net Debt
 - Assess and challenge forecast based on facts

In some instances, generally accepted accounting principle are not accurately reflective of the situation in a Transaction context (e.g. Lease Accounting)

In short, accounting audit is **complementary** to the FDD.

A FDD does not provide a valuation

Independent valuation reports are a different set of skills than financial analysis.

Valuation team however, can use the work from the FDD (e.g. QofE and Forecast review).

A FDD does not provide or a buy / don't buy recommendation

The purpose of conducting FDD is to provide a report stating the facts and pointing out the risks. Then, the client can make their own conclusions on the analysis.

A FDD team does NOT build forecast

FDD reviews and challenges forecasts, however the team does not build forecasts as part of a Due Diligence engagement.*

*Please note that this is based on my experience as part of a Big 4 firm. Smaller advisory firms or independent consultants may not abide by the same rules).

What Are the Big Types of Projects for FDD Teams?

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3 major types of engagement a FDD team will be working on in major firms providing M&A Transaction Services

Vendor Due Diligence (VDD)

Vendor Due Diligence (VDD)

- Client is the Seller
- Report will be shared with all prospective buyers
- More comprehensive than a Buy-Side
- Last longer than a buy-side (several months)
- VDD teams generally also handles Q&A sessions from buyers

Buy-Side Due Diligence

- Client is the buyer / investor
- Access to information may be more limited
- Scope of work can be tailored to client's needs
- If a VDD was commissioned by Seller, the VDD will be the starting point of the Buy-Side work

Vendor Assistance

- In a vendor assistance engagement, the team is here to prepare the client for an M&A process
- It is different from due diligence as no reliance is provided
- As such, in a VA the team can help management prepare their financial reporting and assist on building out forecasts
- Generally, no report is issued as part of a VA engagement
- A team **cannot** perform a VA and a VDD for the same client

A FDD report
may be useful
to more than
just the buyer

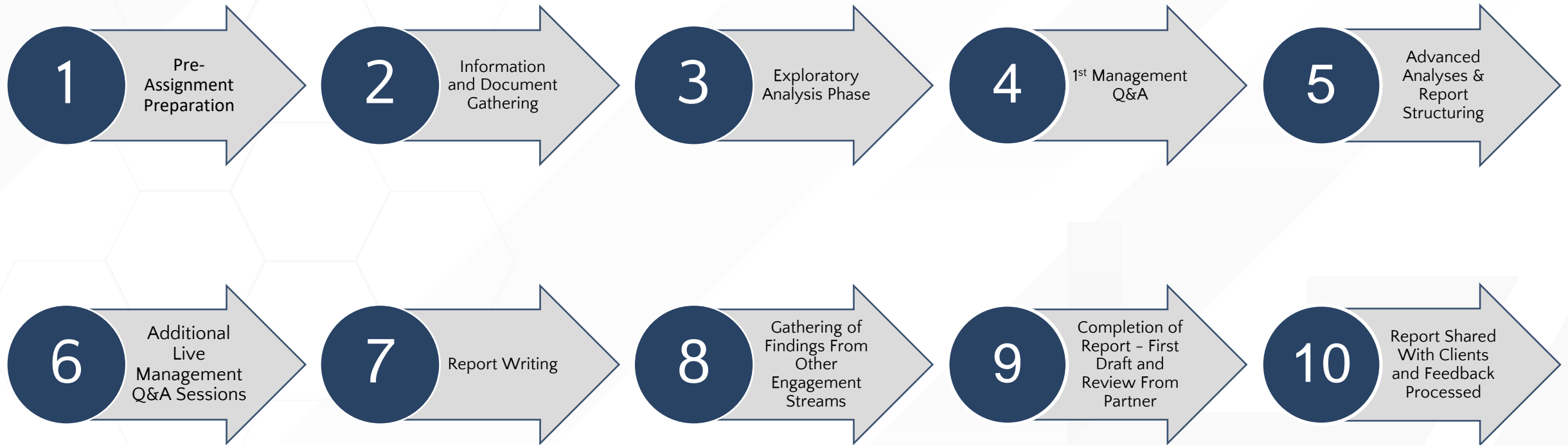
Stakeholders Who Will Rely on a FDD Report

- ✓ Buyer, to prepare their own forecast and refine their valuation of a Target company.
- ✓ Banks, to agree on a certain amount of financing
- ✓ Board of directors to agree on the details of a Transaction
- ✓ Findings from the Due Diligence phase may also be used post acquisition for strategy purposes
- ✓ By providing reliance, a FDD will give decision makers the confidence to proceed with a Transaction
- ✓ A FDD report from a respected firm may also weight in the negotiations by providing an expert eye on technical points

Usual FDD Process

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Every process is different, however based on my experience, here would be a description of a "typical" project.



Pre assignment

Few days to a few weeks

Information and Document Gathering

1 to 2 weeks

Exploratory Analysis Phase

1 to 2 weeks

First Management Q&A

1 or 2 days

Advanced Analysis Phase and Report Structuring

2 to 4 weeks

- Scope of work prepared and agreed with client
- Generally handled by more senior staff (Senior managers / directors)
- It is recommended to start learning about the industry and usual KPIs during that phase

- Start by sending an exhaustive request list to client
- On top of usual financial statements and revenue and costs data, it should cover every type of documents where you can find relevant info for QofE and net debt
- Ask for most granular level of financial info (eg. Trial balances)

- Digest information received and start putting together an excel datapack
- Include all sources with the most granularity and rebuild financials from these
- Include CHECKS everywhere!
- Start with high-level view and then dig into monthly review of data
- Gather all your suspicions of adjustments in one tab
- Prepare questions for Mgt

- Confirm all your doubts about your understanding of files shares
- Prioritize your questions as you may not be able to ask them all
- Ask questions about the first business trends you've seen in your preliminary analysis. Management is a source of qualitative information that you will not find in documents!

- Huge difference in access to Management between VDD and Buy-side in this phase
- Incorporate and challenge Management comments from first Q&A
- Along that process, update request list with new document requests and add new question to Q&A file.
- At this stage the report structure should be finalized

Additional Live Management Q&A

1 to 2 days

Report Writing

1 to 2 weeks

Gathering of Findings From Other Engagement Streams

Few days to a week

Completion of Report - First Draft and Partner's Review

Few days to a week

Final Draft Shared With Client to Collect Feedback

Few days to a week

- In the process and in the lights of the advanced analyses done, a few live conversation with Management are key to clarify any key points outstanding
- It is usual to have different conversation with head of finance, head of operation, CEO etc. based on the needs

- Generally, there is a bit of overlap between this phase and the advanced analysis phase as it is quite common to start writing pieces of the report as soon as possible
- A typical report structure is detailed later in this course

- It regularly happens that the Tax team, Market DD, Synergy, Legal teams work in parallel
- It is quite common that their work will serve as a base for QofE or net debt adjustment that will be incorporated into the FDD report
- It's not uncommon that the tax and legal reports become part of the same final report (if from the same firm)

- Once you're confident with your report, the time comes for Partners to review
- Partners will always have comments and requests, from simple wording changes to request for additional analyses to be made
- Expect to have to reach out to Management or add to the Q&A list to answer some of the concerns raised by the Partner

- Sharing the report to client is followed by a call or an in-person presentation
- Clients may challenge your findings and give feedback / ask additional question
- In some instances clients may also ask to modify how message is delivered to fit their own agenda in which case your professional integrity should come first before agreeing

Typical FDD Report Structure

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Summary of Scope and Process

Summary of Major Points and Key Issues

Executive Report – Outlining the Key Points and Issues

- i. Summary of key accounting standards
- ii. Quick business overview
- iii. Quality of earnings
- iv. Review of net debt
- v. Adjusted net working capital
- vi. Cash flow statement
- vii. Key analyses (depending on the company under review and specific problematics. Forecast review fall within this section)

Additional Analyses

- i. Elaborate on exec. report findings and business overview
- ii. Allows to present other relevant secondary analyses and findings

Appendix

- i. Appendix will almost always include reconciliation between different sources of information used and bridges between Reported and Adjusted financials

Glossary

P&L Analyses

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Start From a High Level View and Drill Down to Specific Analyses

- Start with a High Level overview. You want to get the big picture before deep diving into more specific analyses
- Do the same thing in your report. First introduce the reader with a nice, easy to understand summarized view before deep diving

Always Track Your Analyses Back to Numbers That Management Can Recognize

- A big part of your work will be dependent on Management's explanation. If you present them with numbers they can't recognize, they won't be able to explain the trends you're showing. That means:
 - **Always tie back / reconcile your numbers to Management source / audited financials**

If You Can, the Preferred Way to Look at Annual Financials is on a Fiscal Year Basis

- Again, makes it easier for Management to recognize
- Some industries have a industry-wide common fiscal year. Sticking to it will help buyers make comparisons
- Some audit adjustment and bookings only occur at year-end. Presenting numbers in a different way will be more work to allocate / estimate these adjustments
- Some sources of information will not be broken down by month, only by fiscal year
- However, it is HIGHLY recommended to request monthly financials as well, and a LTM column is always welcome

Presentation and Formatting

- Good formatting is almost as important as your analyses. Find one that you like and stick to it. It make your work more professional and save you a lot of time
- Always organize your charts and tables in a way that it is the easiest to read for a client. For your tables for instance, always reorganize your rows based on descending order by value
- Similarly, if you are explaining movement between two periods, you can sort data based on larger to smaller movement
- Do not present too much details, and regroup the smaller amounts under a “other” line. You can always add a quick description in your report of what that other is made of
- Try to stay consistent in your colour coding as much as possible. If sales from product A are in green on one chart, try representing these sales in green in the other charts as well

Example of a Summarised View of a P&L

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