DUE DILIGENCE IN BUSINESS RESTRUCTURING

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"..Byju's acquires Aakash Educational Services in nearly $1-billion deal
Groww acquires Indiabulls Housing Fin's MF
Joint-partnership between BharatPe and Centrum Finance to infuse funds in PMC Bank
Pharmeasy bought controlling stake in Thyrocare.."

In an ever-growing deal making landscape, smaller and mid-sized companies are now seeking the smartest route forward in their growth strategies. The big highlight for this year has been the rally in ambitions of Indian start-ups who are taking bold bets by acquiring established businesses that could be arguably described as old economy.

Majority of the companies have resorted to route through private equity/venture capitalists funding orinorganic growth for improved business synergies and access to greater customer base. Mergers & Acquisitions are at the core of business growth and restructuring life cycle. However, there also exist other restructuring options like (i) joint ventures, (ii) strategic alliance, (iii) reverse merger, (iv) divestiture, (v) IPOs, (vi) buybacks, and so on.

It is of prime importance that the buyers in any transaction should carefully examine their business strategy and then align themselves with any of the above-mentioned restructuring options for successful acquisition or partnerships.

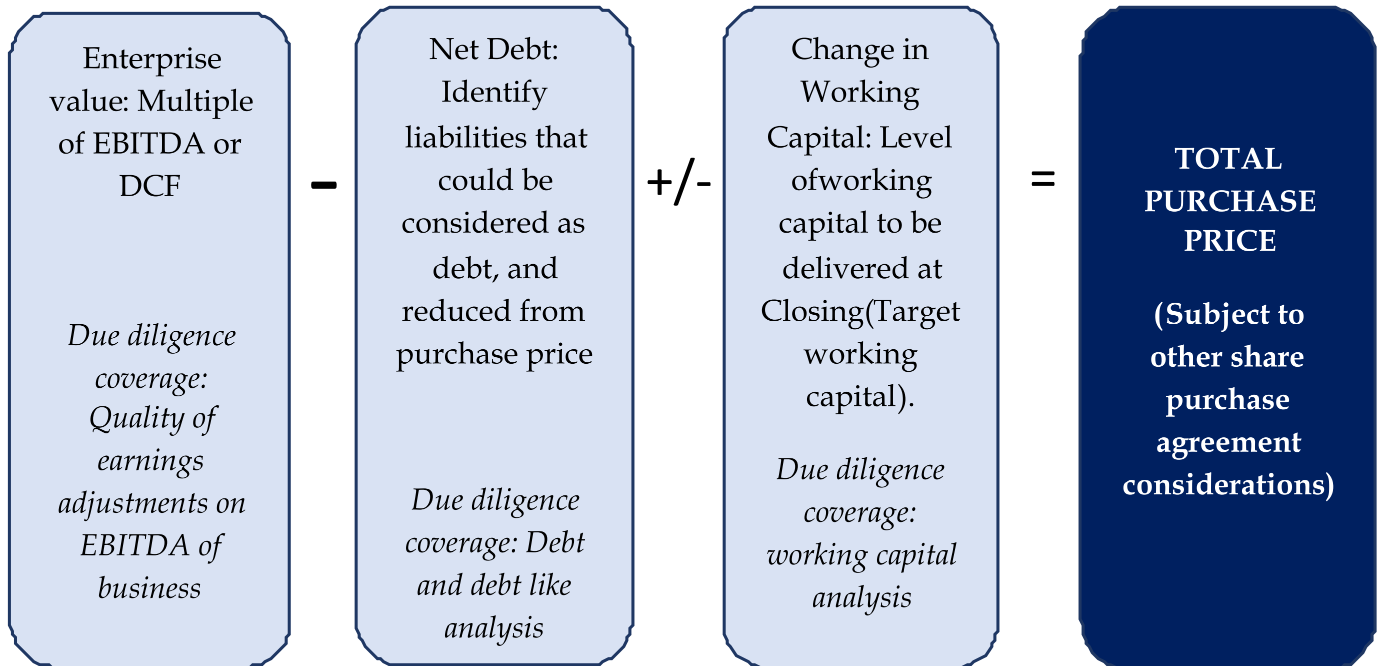
➢ Background

In this article we will learn that to thrive amidst competitive conditions, timely and accurate intelligence isn't just an option, it's a necessity – and that means a professionally executed due diligence process.

Due Diligence process equips buyers as well as investment partners and lenders with a clear understanding of the story behind the numbers, different than conventional reporting or audits can reveal. Due diligence ordinarily incorporates investigative measures directed against all relevant matters pertaining to restructuring, a series of operations including data analysis and field surveys amongst others.

There are different due diligence processes such as financial due diligence, legal due diligence, human resources due diligence, operational due diligence and the list goes on. Today we will focus on financial due diligence.

Let's understand, why financial due diligence is to be performed? Prime reason for conducting diligence is to showcase the corrective purchase price, also highlight any red flags in terms of 'go or no-go' situation for buyer (considering it is a buy side diligence). Below is the pictorial presentation of impact on purchase price of key due diligence processes collectively known as statement of adjustments.



- **Quality of earnings (QofE) analysis**

The goal of a QofE is to adjust the reported EBITDA to calculate a proforma restated EBITDA that best reflects the current state of the company on an ongoing basis. The analysis also presents a historical adjusted EBITDA that is comparable throughout the last two or three years, thus reflecting the normalized EBITDA over the period of analysis.

The purpose of normalizing EBITDA is to assist clients with valuation, also safeguarding value erosion and leakage up to the date of closing. QofE adjustments are differences between the value of the business as stated at the reporting date and value arrived at the closing date. These adjustments are subjective as there are no strict rules for the same. Following are few illustrative adjustments that are provided to restate the EBITDA-

Type	Example
Accounting/ gap adjustments	• Inappropriate iGAAP policies (revenue recognition, lease accounting, etc) • Cut-off adjustments/ period adjustments • Recognition adjustments • Non provision of doubtful debts/ warranty/ guarantee/ employee
Non-recurring transactions	• "One-time" transactions such as legal settlements, unusual transactions, etc. • Restructuring initiatives • Sundry balances written-off/ written-back
Proforma adjustments	• Run-rate or ramp-up margin adjustments • Increase in salary going forward • Bonus/ incentives held back for previous years • Hiring for vacant positions • Impact of foreign exchange
Management adjustments	• Out of deal perimeter margins • Personal expenditure (if any) • Non-core activity margins • Off book sales/ cash sales

Above mentioned EBITDA adjustments are to arrive at the proforma adjusted EBITDA from the reported EBITDA. Likewise, the reported revenue of the seller can be adjusted to arrive at proforma adjusted revenue in a similar fashion by giving adjustments like one-off revenue, discontinued sales, revenue recognition changes, cut-off adjustments, etc.

➢ **Debt and debt-like analysis**

Most mergers and acquisition deals are negotiated on a cash-free and debt-free basis (CFDF). In simple terms, this means that the seller keeps all the cash and pays off the debt at the time of the sale of business. The idea seems straightforward, however, to arrive at the actual CFDF terms can be contentious point of the negotiation and thus affect the pricing of the deal.

The term cash-free means that the cash and cash equivalents like cash on hand, balance with banks, term deposits with banks, petty cash, etc will be subtracted from the reported debt, however, restricted cash, restricted fixed deposits are not subtracted, as they might be placed as security/lien for availing letter of credits, term Loans, forward contracts, and cash credit facilities. It becomes paramount to understand another term 'cash-like items', these are non-operational surplus assets, which are reduced from the reported net debt amount. Few examples of such assets are non-operating investments, government and marketable securities, obsolete assets, capex advances given, loans to directors, loans to related parties, etc.

The term net debt includes term loans, working capital loans, unsecured borrowings, vehicle loans, loans from related parties etc. Following are few illustrative adjustments that are provided to restate the net debt-

Type	Example
Financial items within net working capital (NWC) reclassified to debt	• Current maturities of long-term debts • Overdue trade payables • Capex creditors net off advances given • Accrued financial liabilities (such
Obligations to pay cash with no additional benefit to the company	• Proposed dividend and tax thereon • Advance tax net of provision for
Obligations that may/ may not result in cash outflows during the buyer's investment horizon	• Unfunded pensions, gratuity, leave encashments • Deferred tax liabilities • Exposure to direct/ indirect tax liabilities
Commitments and contingencies	• Minimum purchase agreements • Letter of credit • Outstanding bank guarantees • Capital commitments
Other matters for consideration	• Upgrades required for accounting, HR, or IT systems

➢ **Working capital analysis**

In a transaction, working capital is calculated as current assets minus current liabilities, subject to all cash or debt balances which are excluded (including any cash-like or debt-like items). Furthermore, working capital is broken down in trade working capital and other working capital.

Trade working capital includes accounts for the business operations, mostly being inventories, trade receivables and trade payables. Other working capital includes the remainder of the working capital accounts, such as personnel liabilities, taxes payables and other current payables and receivables.

As the working capital is used to finance the day-to-day operations of the business, for a buyer it is important they receive a business after acquisition with sufficient working capital. The level of sufficient working capital is defined as the normal level of net working capital, also known as normalized working capital. The normalized working capital is to be then compared with the benchmark working capital levels also known as target working capital. Any excess/ shortfall between normalized and target working capital should be adjusted to the enterprise value.

Another way to understand the net debt and working capital would be to bifurcate/ tag each of the balance sheet items into either a debt-like item or working capital item, excluding the shareholders' funds and fixed assets which are neither of both. This exercise will make sure that none of the balance sheet items are inadvertently overlooked in the calculations.

In net working capital, seasonality is important to understand, because that indicates the maximum and minimum financing requirements in a yearly pattern. Buyer would then understand the peak seasons requiring greater funding as well as the slack seasons. The required level of working capital is generally calculated as the average of the last twelve months (LTM). By taking twelve months any seasonality impact is included.

For a transaction, it does not matter if the working capital is positive or negative. As long as it reflects the normal level needed to operate the business and there is no need for an additional capital contribution. For example, a normal negative level of working capital could be applicable in case of direct cash sales (i.e., shops or supermarkets) or business with a high level of prepayments.

➢ **Few general pointers for other key areas in due diligence processes**

- Before analysing any area in financial due diligence, any consultant should answer three questions, basis which they would have a perspective of key figures in analysis carried out,
    - What are the key performance indicators,as per the seller company's Management?
    - What are the key performance indicators,as per the buyer company's Management?
    - How are the industry dynamics currently viewed in this business?
- Analysing the year-on-year growth or fall, will help in better understanding of the delta in the business and eventually understand whether the same forms part of one-off expense/ income or any other QofE adjustment.
- Customer concentration or even excessive dependence on location, product/ service stream, could be a possible red flag.
- Transactions or contracts entered with related parties should be scrutinized for any possible abnormalities.
- Specific clauses in contracts or agreements entered with the customers or suppliers should be checked such as minimum commitment of revenue/ purchase, penalty clauses, guarantees, etc.
- General understanding of the industry with regards to market demand, supply chain, competitors, benefits offered or curtailed by the government, etc.

➢ **Due diligence processes in pandemic era**

While conducting due diligence under pandemic period with imposed travel restrictions, face-to-face meetings, on-site visits, physical verifications are no longer an option. Consulting firms are doing away with the traditional means of due diligences and now resorting to digital technology, thus using virtual data rooms with data protection and control access facilities.

With due diligence under pandemic era, the buyers/investors are trying to understand the short-term direct impact as well as seller management's long-term planning and operations. Below are few areas of financial due diligence that should be considered-

- **Revenue:** Analyse the top line impact with the sales trend before and after pandemic. Consider the supply chain and value chain to find potential laggard pandemic impacts. Consultants should also focus on demand for the products/ services in the post pandemic era. Also, the forecasts laid down by the Management should be given due importance while analysing revenue.

- **EBITDA margins:**Months directly affected by COVID cannot be indicative of the historical performance nor of the future outlook, therefore consultants should try to normalize the EBITDA and compare EBITDA with trends for the period before COVID-19 (on a seasonally adjusted basis) to impacted months. Comparison with peers in the industry and management's near-term forecasts could also be resorted.

- **Employee cost:** Understanding whether the company has resorted to employee lay-offs, suspension of pay, salary pay-cuts, deferred bonuses/ increments. In such cases, a run-rate and proforma adjustment wherein salaries/ bonuses have not been paid will need to be considered. Also, it becomes salient to analyse whether the current employee workforce is normative and there are no vacancies or shortages to sustain the revenue or EBITDA levels.

- **Other SG&A costs:** Adjustments for one-time expenses due to COVID-19 must be factored, force majeure clause in rental agreements must be referred in case of shutting down of premises, other expenses such as transportation costs, electricity, advertisement, and other SG&A costs will be analysed considering past year expenses and current absorption rates.

- **Working capital:** Due to pandemic, assessing the payment cycle of trade receivables and payables for bad debts and overdue payables became crucial. Monthly/ quarterly working capital and cash requirements analysis could be performed and then marry it with the financial position of the company.

- **Debt-like items:** Assessing whether the target has acquired additional loans to resolve the financial crises. Comprehending whether financial covenants and onerous clauses are met. Ability to repay debt post moratorium period will need to closely be looked upon along with the tag of 'going concern'.

➢ **Conclusion**

To conclude, while it is impossible to forecast the long-term effects of the outbreak, there is still a way out for well-informed parties to continue with their deals: by altering due diligence to serve as means of accelerating the transaction, rather than treating it as an obstacle, on account of the inability to conduct it in the traditional way.

Undoubtedly, in times to come "cash is the king", buyers with funding would be able to dominate and leverage their position to obtain favourable deals. Seller on the other hand, would want to adopt "wait and watch" approach rather than diluting their stake at lower side of the valuations. However, all said and done, buyers and sellers, both are flexing their muscles and there are no holdbacks from their sideswith M&A activities in India beingon rise and continuing higher.

Note: Views expressed in this article can be subjective and that of the readers on the same topic may differ.