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# The importance of Due Diligence

by **Stefano Marchetti**, partner Grant Thornton FAS

## Expert's opinion

### *Between dynamism and discontinued evolution*

**Antonio Aiuto**

*Senior Manager Grant Thornton FAS*

As far as Grant Thornton is concerned, the M&A market and, consequently, the Due Diligence one, recorded an organic growth over the last four years; in particular, a marked growth was recorded in 2021, a trend confirmed also by the data of the first months of 2022. In our opinion, this growth was mainly driven by: (i) an increased opening on the part of Italian entrepreneurs towards capital market and M&A in particular, seen as a growth tool (for example, to enter new markets or to integrate their offer), as well as a way to consolidate their position within their reference industry and as an alternative tool to the traditional debt market; (ii) the undeniable and now consolidated attractiveness of Italy to foreign investors (mainly in some industries, such as agri-food, medical and scientific, industrial...

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## Overview

### *Reducing the information gap between seller and buyer*

**Alberto Alverà**

*Senior Manager Grant Thornton FAS*

In an extraordinary operation, external consultants are usually involved besides the potential seller and buyer to facilitate and support either one or the other party; these are usually legal consultants, financial advisors, professionals in charge of Due Diligence and operation structuring activities. In order to reduce the information gap between Seller and Buyer, these engage an independent third party to carry out an assessment activity with "due diligence". A Due Diligence is mainly aimed at...

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## Focus on

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As mentioned above, a Financial Due Diligence examines and analyses in depth, among other things, three key elements: EBITDA, Net Financial Position and Net Working Capital. These actually represent the basis to determine the value of a company (or group of companies or business unit) object of the transaction. Typically, for the purposes of a brief valuation (thus excluding the discounting methods of prospective cash flows) the following formula is applied:

Price/value = Enterprise value* +/- Net Financial Position + Net Working Capital at Closing - Level of Normal Working Capital; **Enterprise Value (EV) = EBITDA x Multiple.*

Of course, there can be countless deviations from the basic formula, which depend on the...

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In an extraordinary operation, external consultants are usually involved besides the potential seller and buyer to facilitate and support either one or the other party; these are usually legal consultants, financial advisors, professionals in charge of Due Diligence and operation structuring activities.

In order to reduce the information gap between Seller and Buyer, these engage an independent third party to carry out an assessment activity with "due diligence". A Due Diligence is mainly aimed at:

- confirming the strategic rationale of the transaction;
- confirming the preliminary valuation included in the letter of intent;
- identifying any risk factors, critical issues and opportunities.

Due Diligence activities can be of different nature, i.e.: Financial/Accounting, Commercial, Tax, Legal, HR/Payroll, IT, Reputational and ESG.

### Financial due diligence

Financial Due Diligence plays an essential role within an M&A transaction, since it analyses the company's performance, in order to explain its economic/financial evolution, it identifies possible risks and opportunities and substantiates the valuation criteria previously agreed upon by the Seller and the Buyer. The recipients of a Financial Due Diligence are not only the potential buyers, but also those who, either directly or indirectly, are exposed to the success of the transaction (e.g. debt financiers).

As mentioned above, one of the key objectives of a Financial Due Diligence is that of validating the economic/asset foundations underpinning the valuation of the company object of the transaction. The following three analyses are therefore essential:

- analysis of the normalised EBITDA;
- analysis of the seasonality of the normalised Net Working Capital;
- analysis of the normalised Net Financial Position.

To this end, a clarification is necessary: the calculation and the determination of the three indicators above are irrespective of the mere application of mathematical formulas, since their determination mainly depends from: (i) market praxis, (ii) negotiations between the parties and (iii) subjective expectations of the potential buyers in the post-acquisition scenario (e.g. a competitor has different expectations compared to a financial buyer). In addition to the above, a Financial Due Diligence will focus on the analysis of:

- the main revenue and marginality growth drivers;
- the cost structure;
- the cash generation capacity;
- the investment policies adopted;
- the Net Working Capital structure; and
- the structure of the net debt and of potential liabilities.

A Financial Due Diligence is usually carried out considering a three-year timeframe, since such period guarantees a more stable outlook of the company's economic and assets' trends, identifying possible non-operational or non-recurring phenomena which may have distorted its historical performance.

Basing on the assisted company, a Due Diligence can be:

- ***Buy-side***, i.e. supporting the buyer. The Buy Side Due Diligence report is aimed at confirming the valuation and strategic rationale assumed by the Buyer for a given acquisition;
- ***Vendor-side***, i.e. supporting the vendor/ seller. The Vendor Due Diligence report, or Vendor Assistance report, includes all the analyses present in a Buy-Side report, but with more in-depth details, since there is full access to the corporate information.

  A Vendor Due Diligence has a twofold aim: (i) that of allowing the Vendor and its consultants to identify in advance possible issues and opportunities related to the transaction and, thus, devise a better drafting of the agreement in terms of perimeter and/or timelines, and (ii) streamlining the acquisition process both in case of competitive bidding and of exclusive negotiation, since the Due Diligence activity helps identifying potential issues or liabilities from the start (with the exclusion of negotiation or subjective issues) also for potential Buyers.

Due Diligence is not a mandatory activity in an M&A operation, but is increasingly more used, also in middle market operations (i.e. those in which the target company has a turnover between €5m and €250m). Since there is no authoritative literature or common standards on how to perform a Financial Due Diligence, it is key to contact a team of professionals with a significant market experience.

In short, a Due Diligence is always useful, both when it confirms the Buyer's expectations and the deal is closed, and when (most importantly) the operation is not successful, as it prevents the investor from closing a bad deal.

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Typically, for the purposes of a brief valuation (thus excluding the discounting methods of prospective cash flows) the following formula is applied:

***Price/value = Enterprise value* +/- Net Financial Position + Net Working Capital at Closing - Level of Normal Working Capital***

Of course, there can be countless deviations from the basic formula, which depend on the intrinsic characteristics of the company being analysed or by the specific features of a given industry. Actually, additional elements are often added to the formula above, such as for example surplus assets (real estate and assets which did not generate EBITDA in the reference period).

Without entering into the details of valuation theory, we can define EV as the "gross" value of the company under analysis, which depends on its profitability, EBITDA, and on the market multiple, which is a summary of several elements which the investor considers with reference to a specific company operating in a given industry. EV can be defined as the "gross" value of the company, since it does not consider its capital structure, i.e. the mix of risk capital and of debt financing corporate activities. To this end, it is key to analyse the net financial position and the net working capital in order to determine the company's equity value (i.e. the price for 100% of the company).

For the reasons above, the Financial Due Diligence focuses on the analysis of the EBITDA, of the Net Financial Position and on the Net Working Capital dynamics.

#### Analysis of the normalised EBITDA

The key question when analysing EBITDA is:
*Is the EBITDA resulting from the accounts representative of the company's ability to generate income?*

Here's where Due Diligence comes into play: starting from the EBITDA, as resulting from the corporate accounts, it identifies all those distorting elements to be included and excluded, thus leading to the normalised EBITDA, i.e. the most representative indicator of the company's situation and of more interest to the buyer and to the other subjects involved (e.g. the funders of the operation).

** Enterprise Value (EV) = EBITDA x Multiple*

Determining the normalised EBITDA means identifying all cost and revenue items which have a distorting effect thereon, which can be divided into four groups:

1. **Accounting elements**, these concern distortions of the EBITDA due to accounting errors or to the peculiarity of some accounting rules or principles. The typical example is lease accounting: according to the Italian accounting standards, a lease is reported in the accounts as if it were an operating element, whereas according to the valuation and M&A praxis, a lease is considered as a financing method and thus a liability, leading to the exclusion of lease rentals from the EBITDA.
2. **Non recurring or terminating elements**, in the life of a company there can be countless cases of non-recurring costs or revenues, for example restoration cost after an exceptional weather event or a grant received.
3. **Normalisations** ,this is the case of values correctly reported in the accounts but which, for their nature, may positively or negatively impact the EBITDA of a given year. The typical example is the write down of bad debts: a company may write down in a single FY a significant number of receivables accrued over more years, negatively impacting the EBITDA of that FY and implicitly benefitting the other FYs.
4. **Pro-forma accounts**: this is the exclusion or inclusion of revenues/costs which are not reflected in the current perimeter of the operation, but which will be in the future. This is the case for example of a production line which is going to be terminated, or of a line operating only in the last few months of the FY considered for the Due Diligence.

The analysis of all these elements leads to determine the normalised EBITDA.

It is worth underling that the Financial Due Diligence is not limited to this economic analysis. The key elements of the company's profitability are also analysed, such as the trend and concentration of revenues, the marginality of products and services and fixed overheads. There are many types of analyses which can be carried out depending on the industry and on the specific features of the company considered.

## The analysis of the Net Financial Position (or NFP)

The Net Financial Position is the sum of financial liabilities net of cash and cash equivalents. Nonetheless, within an M&A operation, there are a series of elements which impact this value, and also in this case the indicator is called normalised NFP.

A Financial Due Diligence aims at identifying the elements which can be included in the calculation of the NFP, namely cash-like items, i.e. items similar to cash which improve thr NFP and debt-like items, i.e. elements which worsen the NFP as they are comparable to payables.

Among cash-like items are for example investment in short-term financial instruments.

Among debt-like items, instead, are all debt items which can be considered as financial liabilities; a typical example is overdue trade payables. Moreover, it is important to consider the off-balance sheet items, which do not appear in the corporate accounting or financial statements. These are the future disbursements which the investor will have to bear after acquiring a shareholding in the corporate capital. The most common example is probably the operating lease debt recorded in the accounts basing on Italian accounting principles, as mentioned above.

In principle, all the items excluded from the EBITDA are included in the calculation of the normalised NFP, whereas all items included in the EBITDA (net of assets and surplus assets/ liabilities) is part of the Net Working Capital.

### Analysis of the seasonality of the normalised Net Working Capital

The Net Working Capital (or NWC) is defined as the algebraic sum of trade receivables, trade payables, stocks and other current receivables and payables. The NWC dynamics are very important as they have a direct impact on the company's cash. We can actually say that the NWC mirrors the company's cash, i.e. the changes therein are diametrically opposite to cash flows.

For example, the Net Working Capital of a company operating in an industry characterised by a marked seasonality will be strongly influenced by its business, depending on the timing of its sales and supplies.

The seasonality impacts the amount of funds available in a given moment and consequently the company's NFP, the latter being a snapshot of the corporate situation at a specific moment in time.

Therefore, buyer and seller could benefit or suffer from the fact that the company has a low NWC (higher cash) or a surplus NWC (lower cash).

The Financial Due Diligence focuses on these aspects to understand the NWC profile (and, thus, the cash profile) of the company being transacted, in order to define a mechanism which can grant a fair price for the transaction, not influenced by the effects of the business seasonality.

In general, a reference NWC level is established through a cash compensation mechanism based on the NWC value at the closing of the transaction. Two different scenarios are possible: (i) an adjustment in favour of the buyer if the NWC is lower than the reference one, and (ii) an adjustment in favour of the seller if the NWC is higher that the reference one.

# Expert's opinion

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This article provides an overview of the experience accrued by Grant Thornton in the last four years (2018-2021) with reference to the following aspects:

1. Overview of the M&A and Due Diligence market;
2. Main trends observed on transactions (with a focus on the last 2 years);
3. Current context and forecasted trends for 2022.

### Overview of the M&A and Due Diligence market

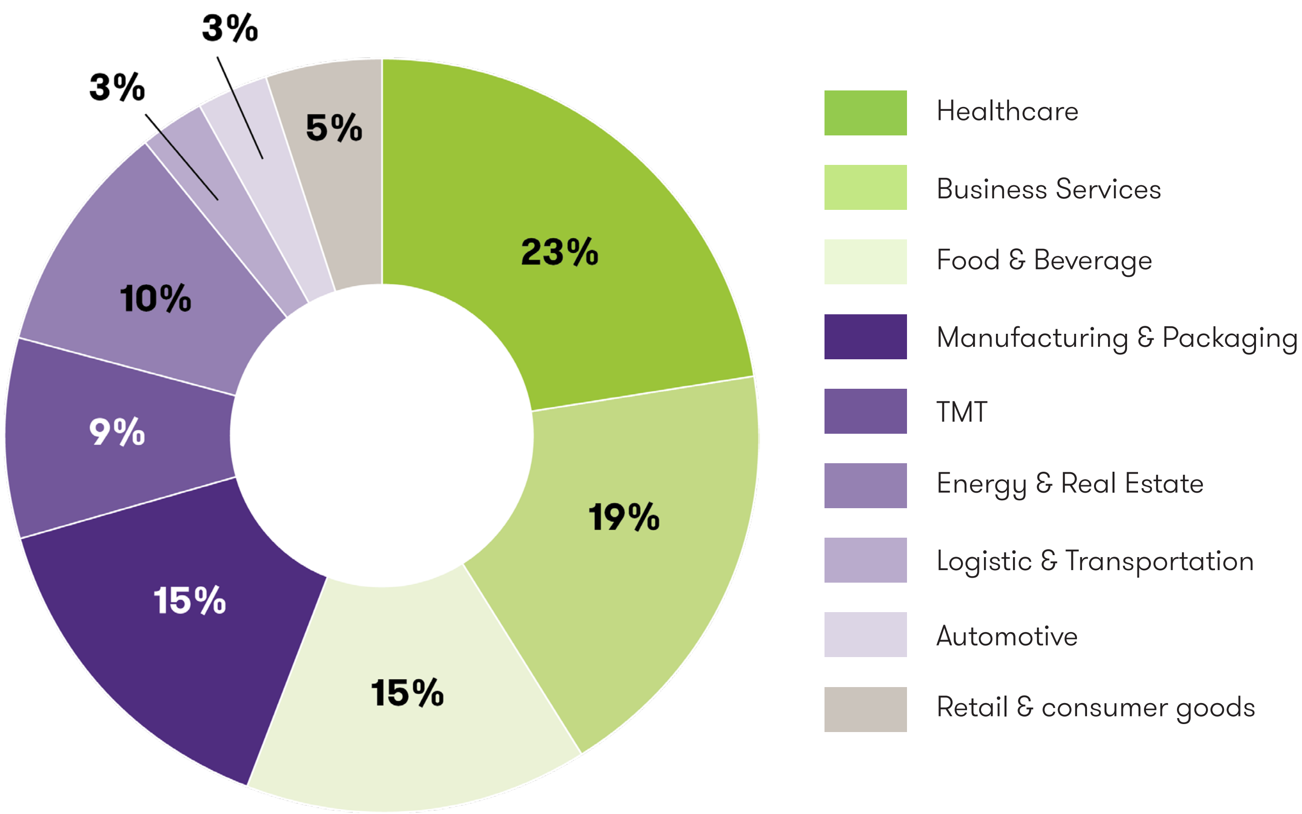
As far as Grant Thornton is concerned, the M&A market and, consequently, the Due Diligence one, recorded an organic growth over the last four years; in particular, a marked growth was recorded in 2021, a trend confirmed also by the data of the first months of 2022.

In our opinion, this growth was mainly driven by:

1. an increased opening on the part of Italian entrepreneurs towards capital market and M&A in particular, seen as a growth tool (for example, to enter new markets or to integrate their offer), as well as a way to consolidate their position within their reference industry and as an alternative tool to the traditional debt market;
2. the undeniable and now consolidated attractiveness of Italy to foreign investors (mainly in some industries, such as agri-food, medical and scientific, industrial, etc.);

3. a low cost of money and of debt, at least until the end of 2021, which allowed buyers to apply a financial leverage at advantageous conditions (benefitting from a less aggressive approach to financial leverage on average, compared to English speaking countries), besides a significant liquidity characterising markets and financial players.

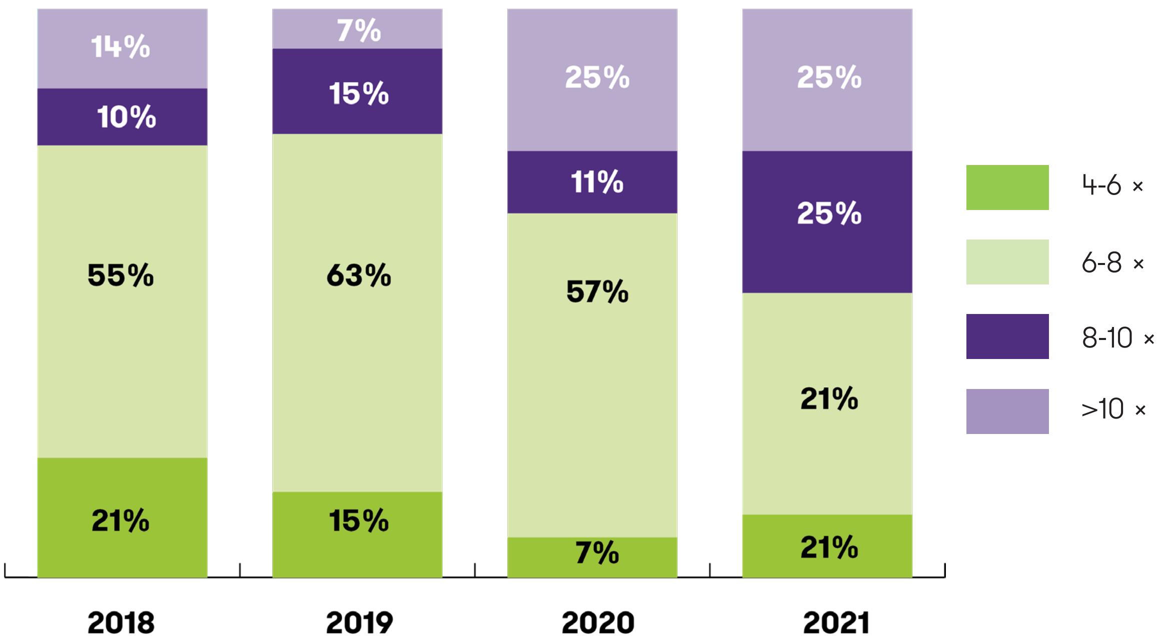
The industries on which our Due Diligence engagements mainly focused in the last four years are shown in the graph below.



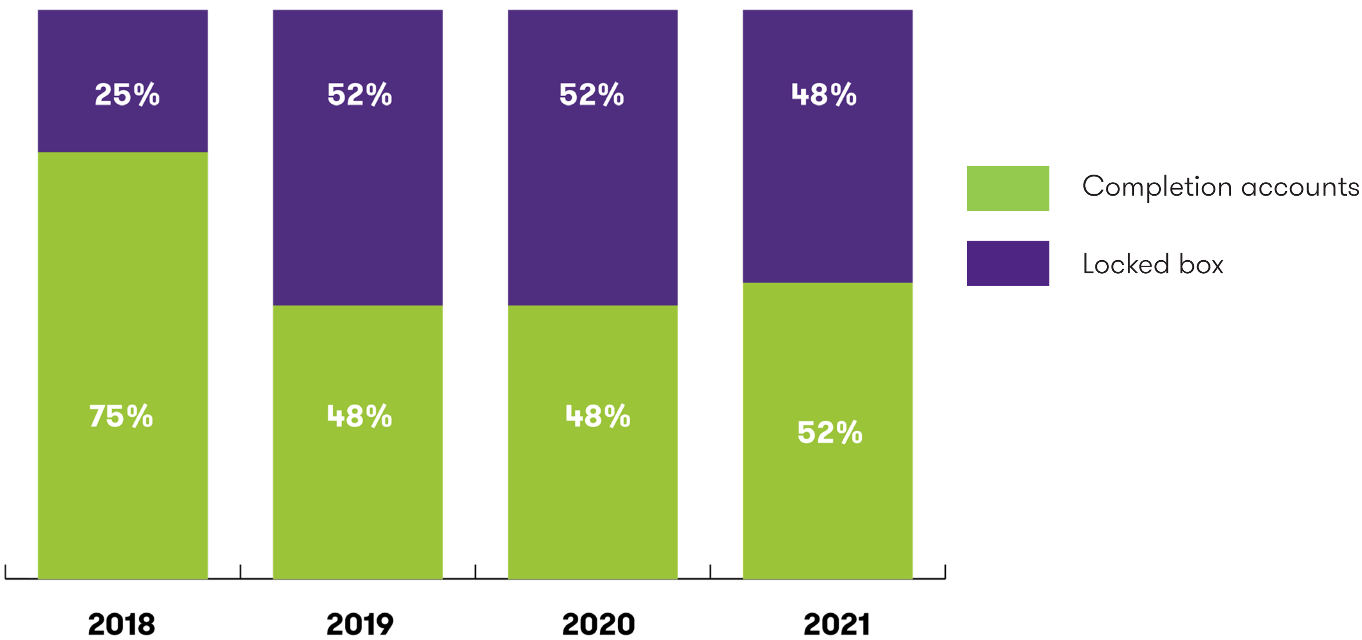
## Main transaction dynamics observed (focus on the last 24 months)

As for the trends which characterised the transactions in the last four years and, more in detail, in the last 24 months, it is worth specifying that, from our point of view, the global Covid-19 pandemic in 2020 and 2021, though with different effects depending on the industries and locations, did not lead to significant and prolonged setbacks (in terms of volumes and value) of the M&A market. The pandemic probably contributed to accelerating and consolidating some trends which is worth examining in the light of the following factors.

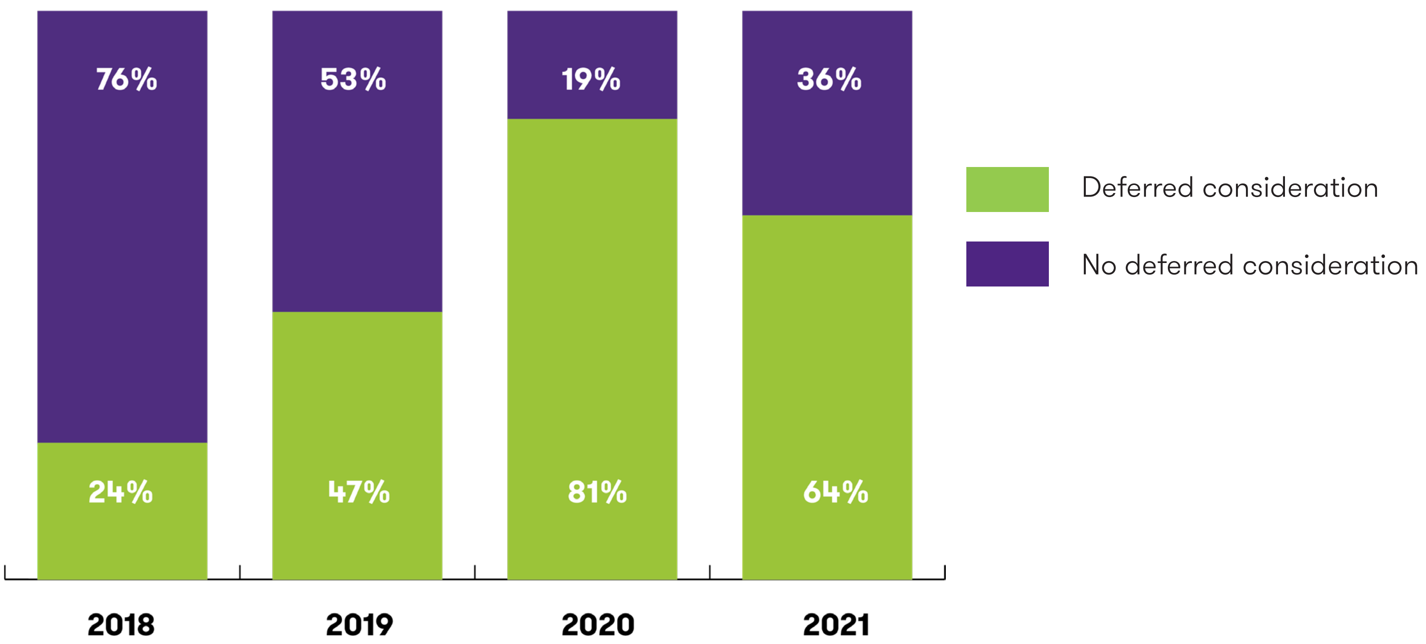
**A.** ***Polarisation of industry multiples***, which, especially in 2021, concentrated on the higher end of the range (see graph below), showing a certain market dynamism rewarding business with sound and robust indicators, despite the Covid impact.



**B.** ***Closing mechanism (Completion Accounts vs Locked box)***: before commenting on the trend described above, it is worth mentioning the main difference between the two closing mechanisms, without entering into technical details. According to the Locked Box mechanism, the economic benefits of the operation become effective between the parties from the locked box date, which is usually a date in the recent past taken as a reference to calculate the price of the transaction. On the other hand, the Completion Accounts mechanism provides for that the economic benefits of the operation become effective starting from the closing date and therefore, from the date in which the notary deed of share transfer is executed. The main advantage of the Locked Box mechanism is that the price, net of possible ticking fees, besides the normal clauses provided in the SPA, is known to the parties beforehand and does not undergo subsequent changes (as instead possible with the Completion Account mechanism). In the last four years there has been an increasing application of the Locked Box mechanism for the reasons above, with a slight decrease in 2021, probably attributable to the parties' will not to fix a price in advance, given the uncertainties in the macro-economic scenario, but rather to consider the actual performances of the companies involved in the potential transaction.



**C. *Deferred Purchase Price mechanisms***: the objective uncertainty characterising the last 24 months physiologically led to the application of deferred prices (contrarily to the past, i.e. a higher number of cases in which prices were granted as a lump sum at closing) related to the actual performances of the companies. This mechanism, which application has recorded a marked increase in 2020, as shown in the graph below, has been widely applied also in 2021.



## Current scenario and expected trends for 2022

Although the dynamism seen so far in the M&A market seems to characterise also 2022, the macro-economic context is showing a strong uneven outlook compared to the recent past.

Some of the factors which, in our opinion, are having or will have an impact on the transactons (and whose effects are scarcely predictable to date) are:

- the Russia-Ukraine war: in a global market, the strains of the war are impacting the performances of businesses, both in terms of revenues (in case they have a significant portion of turnover generated in the conflicting countries) and in terms of cost base, as better detailed below;
- increased price of raw materials and utilities: the steady increase in prices has caused a delay in leadtimes and led, in many cases, a sharp drop (already experienced or expected) in margins due to the inability to charge the increases on final consumers, at least in the short term;
- impact of the lockdowns in China due to its zero Covid strategy, which impacted not only on consumptions, but also on the sourcing of products from the areas subject to strict restrictions;
- increase in the cost of money and of debt, linked to globally redefined monetary policies to face the inflation target dynamics.

Business must therefore deal with a 2022 budget which could reflect expected margins significantly different from historical ones.

In the light of the above and considering that the last three-year period (a historical period usually taken as reference to identify/normalise the performances of a company) - even more so 2020 and Q1 2022 - has been significantly impacted by the pandemic and by the peculiar macro-economic context, will there be an impact on the trends characterising M&A operations?

In conclusion, we are confident that the Italian M&A market is bound to grow organically in the next few years, but we will probably see short-term adjustments in the next months, aimed at taking into account the uncertainties described above.

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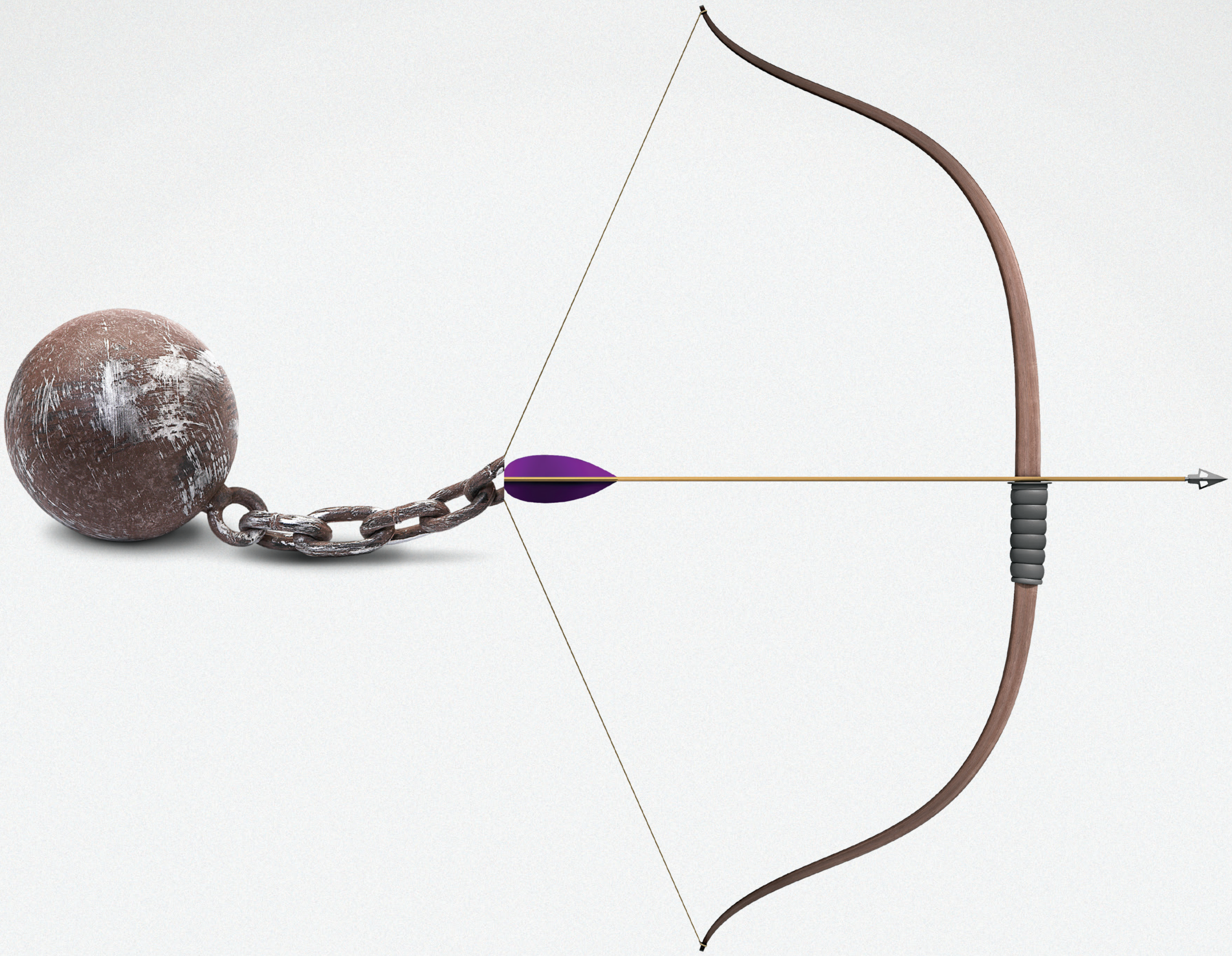

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