

# Due Diligence in M&A transactions

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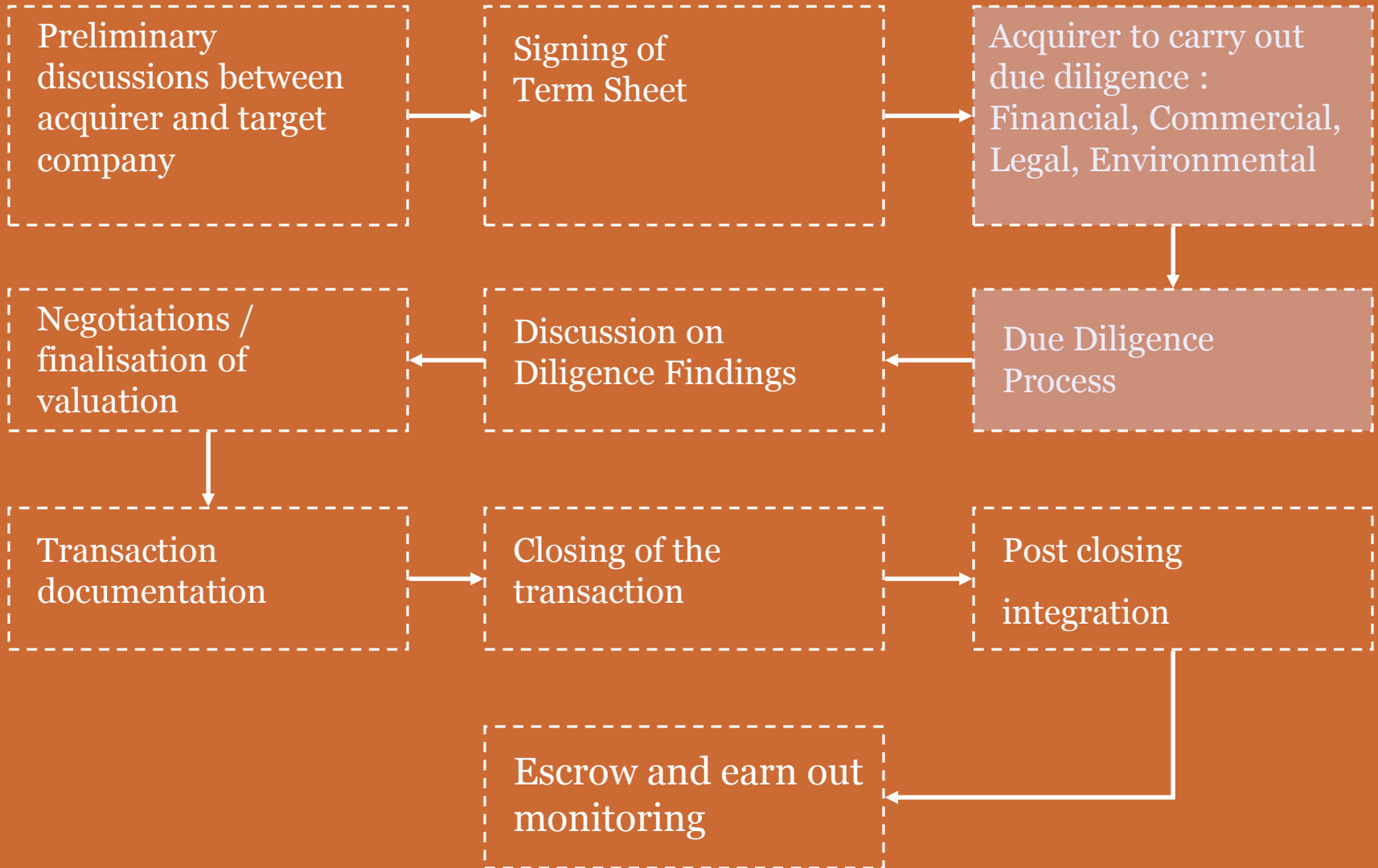
# Agenda

- Part I : Deal Process
- Part II : Due Diligence Process
- Part III : Due Diligence : User's perspective

Part I

Deal Process

# Deal Process



# Why Diligence ?

- Diligence is instinctive while venturing into 'uncharted territory'
- Devil lies in detail
- Independent external view
- Negotiation tool for the client

Part II

Due Diligence Process

# Process of Due Diligence : An overview

- Acquirer typically appoints due diligence expert once term sheet is signed
- Physical data room / virtual data room set up by Target : All required information is made available to DD expert
- Processing information and analyses
- Management discussions
- Due Diligence Report
- Assistance in finalising transaction documents

# Approach to Due Diligence

- Approach distinct from audit / assurance, tax advisory or research
  - Focus on analyses and not on mere verification
  - Checklist approach to be avoided
- Deal focus : Impact of observations
  - Anything and everything that impacts the deal is relevant and material
- Multi-faceted
  - Commercial understanding, awareness of regulatory developments, knowledge of other functional areas like IT, HR, marketing etc.



# Due Diligence : Getting Started

- Understand the rationale of the deal and strategic objectives
- Expectations from the Target Company
- Term sheet
- Valuation parameters
- Areas of focus / concern

# Examples of Term Sheet (1)

## Transaction structure

ABC Inc (Client) will acquire the food and beverages business of the Target Company. Accordingly, the business of Food and Beverages Division will be transferred into a new company in which ABC Inc will acquire 51% equity shares.

The Target Company should clearly identify assets and liabilities of the Foods and Beverages business as well as present carved out financial statements of the Food and Beverages segment. ABC Inc will carry out a financial and tax due diligence on the carved out financial statements of Food and Beverages segment.

## Examples of Term Sheet (2)

### Valuation

Our preliminary non-binding bid for 24% equity stake in the JV is as follows:

- INR [] million payable in cash on signing of SPA (subject to Retention Amount) on debt-free, cash free basis subject to JV retaining an appropriate level of cash for normal working capital
- Additional earnout payments based on incremental EBT performance of the business at the end of 3<sup>rd</sup> financial year

## Examples of Term Sheet (3)

### Retention

We would envisage that 10% of the consideration would be retained to provide us with protection against any claims that may arise in future on account of exposures existing at the closing date for which an impact cannot be quantified. The said amount will be retained upto 1 year from the date of SPA.

### Valuation

The valuation will be 4 times EBITDA for FYXX

The agreed valuation is 4 times EBIT normalized for non – operating and one-off items

# Due Diligence : What the client expects ?

- Detailed and in depth analyses of business and financial parameters
- Adjustments to valuation parameters
- Way forward solutions to 'deal issues' and protection mechanism to the client / acquirer

# Adjustments to valuation parameters

- Earnings / profitability adjustment
- Debt adjustments
- Go forward concerns
- Capex plan
- Projections
- Tax Exposures

# Adjustments to Valuation Parameters : Earnings / Profitability Adjustment

INR '000

## **Examples of accounting adjustment**

Incorrect valuation of inventory	(222)
Inadequate provisioning for doubtful receivables	(105)
Non provision of sales commission	(103)
Non provision of leave encashment, gratuity, employee liabilities	NQ
Cost of ESOP granted to senior management	NQ
Marked to market loss on forward contracts	(323)

## **Examples of normalisation adjustments**

Gross margins from discontinued products	(333)
Gross margins from non repetitive / exceptional orders	(790)

# Adjustments to Valuation Parameters : Earnings / Profitability Adjustment

Rs in '000

## Examples of go forward costs

Allocation of common costs by group company	NQ
Remuneration to senior management, not charged at present	NQ
Payments to related party to be made at market rates	NQ
Expenses towards significant outstanding litigations	NQ
Proposed capex and opex on IT and other support functions	NQ
Cost of hedging forex risk	NQ
Harmonisation of salary structures	NQ

**NQ : Not quantifiable at present**

**Client should therefore independently assess the impact of these go forward costs**



# Adjustments to Valuation Parameters : Earnings / Profitability Adjustment

Particulars	INR in mn
Reported EBITDA	365
Accounting adjustments (A)	(23)
Normalisation adjustments (B)	(11)
Go-forward costs (C)	(16)
Adjustments (A+B+C)	(50)
Adjusted EBITDA	315

Assuming the valuation parameter is 4 times EBITDA,

The initial valuation of INR million is reduced to INR 39 million

Strong negotiation point for client in finalising the valuation

# Adjustments to valuation parameters : Tax Exposures

- Exposure risk should be categorised as High / Medium / Low
- Exposure should be quantified to the extent possible
- Materiality critical

Part III

Reporting and other aspects

# Reporting Due Diligence Issues / Findings

- Issue / observation centric report
- Supported by numbers / analyses / charts / diagrams
- Include a summary of key concerns
- Set out valuation adjustments
- Way forward

# Due diligence observations – classification

	<b>Valuation</b>	<b>Business plan</b>	<b>Transaction documentation</b>	<b>Commercial implication</b>
Observation 1	✓			
Observation 2		✓		
Observation 3	✓			✓
Observation 4				
Observation 5		✓	✓	✓

# Reporting Due Diligence Issues

## Example 1

<b>Issue / observation</b>	<b>Why should the client be concerned</b>	<b>Way forward</b>	<b>How will the client cover the risk</b>
Significant dependence on select customers... most contracts due for renewal in next 3 months	Non renewal of contracts will adversely impact business plans .... Similarly, any adverse terms will also have to be factored	Client to gain more visibility on renewal of these contracts from management	Client may insist on meetings with Target's customers...or postpone the closing till key contracts are renewed

# Reporting Due Diligence Issues

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# Reporting Due Diligence Issues

## Example 2

<b>Issue / observation</b>	<b>Why should the client be concerned</b>	<b>Way forward</b>	<b>How will the client cover the risk</b>
Significant sales from unregistered brands	Key brands may be exposed to competition from unorganised players	Client to consult the legal advisors on how the IPRs can be protected	Client may insist that Target applies for registration prior to transaction closing...Any litigation costs on IPR disputes to be paid out of escrow



# Reporting Due Diligence Issues

## Example 3

<b>Issue / observation</b>	<b>Why should the client be concerned</b>	<b>Way forward</b>	<b>How will the client cover the risk</b>
Significant delays in recovery of receivables ... unreconciled / disputed balances with customers / suppliers	May result in bad debts post closing	Client to set aside certain part of consideration in an escrow	Escrow mechanism OR Representations and warranties in SPA OR Upfront adjustment in valuation

# Reporting Due Diligence Issues

## Example 4

<b>Issue / observation</b>	<b>Why should the client be concerned</b>	<b>Way forward</b>	<b>How will the client cover the risk</b>
Significant related party transactions ... costs well below market rates	Post transaction, related parties will charge market-linked rates... to impact profitability and cash outflow	Client to factor additional costs	Client will insist upon formal agreements with all related parties ... will factor additional costs in valuation

# Due Diligence : Dos and Don't's

## **DOs**

- **Agree upon a defined scope of work**
- **Set out areas not covered by due diligence**
- **Report only issues and key observations**
- **Ensure that findings are conclusive**
- **Always suggest way forward**
- **State limitations in carrying out diligence**

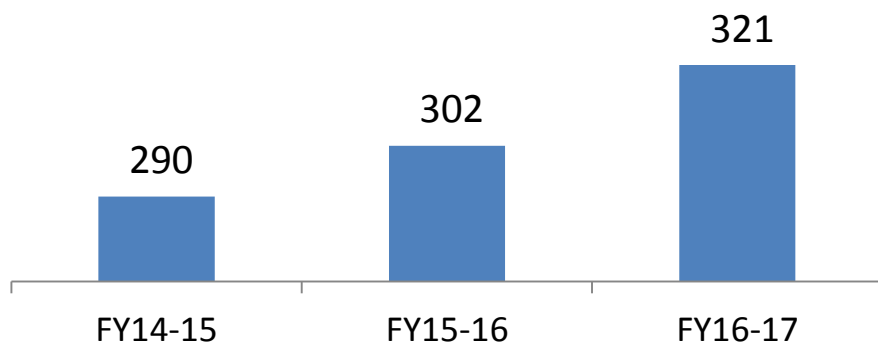
## **DON'T's**

- **Never recommend whether the client should invest or not**
- **Never include attestation / assurance work as a part of diligence**
- **Never over-analyse or analyse areas which may not be relevant from deal point of view**
- **Never charge 'success-linked' fee**

**Still interested?**

**Visually powerful due diligence  
observations: Examples**

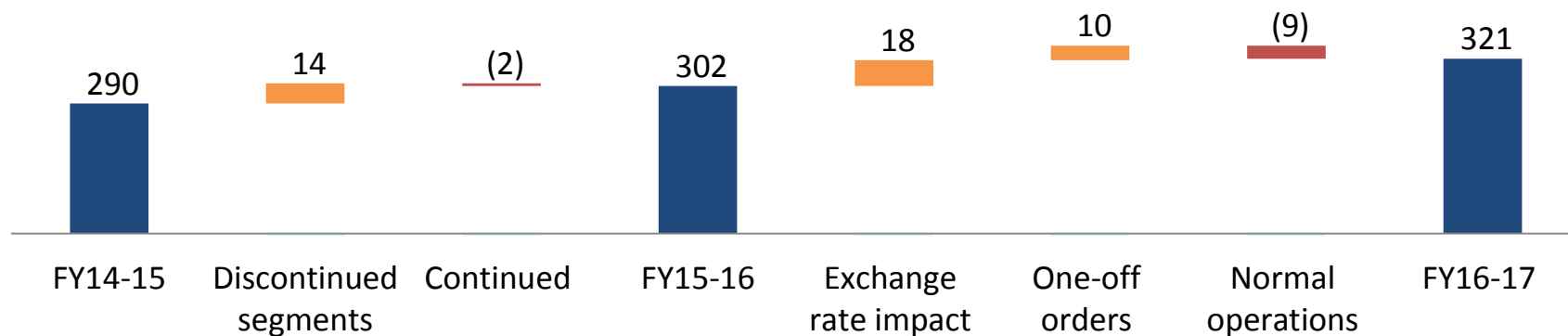
# EBITDA growth: What lies beneath



Hypothesis: Consistent growth in profitability

*Really ?*

## EBITDA Bridge



# Dissecting sales and profitability growth

