Due Diligence – Overview

**Underlying Premise**: Buyer’s accounting and legal due diligence efforts parallel the lender’s credit risk analysis
Due Diligence – Overview

The objective:

**Business Valuations**: Typically a multiple of cash flows (i.e., how deals are priced)

**Legal and Accounting Due Diligence**: Evaluating the risk that past and current cash flows will repeat in the future
Due Diligence – Overview

Lending Analysis:
(a) Cash flows to service the borrowing will be available for repayment; AND
(b) Collateral for the loan will be available (title and value) if necessary for recovery
Legal and Accounting Due Diligence: Not independent, mutually exclusive or redundant, but are an inter-related analysis (a holistic approach) to verify value, title and consistency of anticipated business performance.
Due diligence is a process by which all the relevant information to making a decision on a particular transaction comes to light.

- Financial due diligence
- Legal due diligence
- IT due diligence
- Environmental due diligence
- HR due diligence
- Operational due diligence
Objectives and Responsibilities

Objectives

- Forecast the future performance
- Analyze the potential risks and threats
- To discover deal-breakers
- Ascertain the purchase price
- Compliance with relevant laws

Responsible Departments

- Financial
- Accounting and Legal
- All

Financial and Accounting

Legal and tax
Due Diligence

Caveat:

This is an **overview**; actual DD practice must be “right sized” (cost versus benefit) and designed for the specific nature of the business (type of business (retail, manufacturing); industry; life stage (start-up, mature, etc.)); & business size
Who Benefits

Buyer
• Limits surprises post transaction
• Allows a buyer to “hit the ground running”
• Improvements are identified

Seller
• Allows closing to go smoother
• Limits post-closing issues that can lead to litigation
• Allows for optimal tax and deal structure
Other Stakeholders

• Employees, customers and vendors included feel more secure

• Investors and lenders understand repayment
Accounting Due Diligence Process

1. Define scope
2. Analyze preliminary information
   - Identifying key transaction drivers
3. Identify key benchmarking data
4. Research the Industry
   - Analyze historic financial information
5. Discuss findings with management
6. Analyze implications of Findings
7. Issue a final report
History is Important

- Last three years performance common
- Liabilities
- Sales and margin (product, geography, channel, etc.)
- Loss of customers
- Terms with key customers
- Concentrations
- Costing for manufacturers
- Employee trends
- Impairments or reserves
To Predict the Future

• Validity of the Company’s projections
• Backlog
• Budgets
• Working capital trends
• Capital expenditures and other investment needs.
Key Components of a Financial Due Diligence Report

- Company Background
- Names of key management team and accounting personnel
- Discussion on key deal issues
- Quality of Earnings Report
- Working Capital analysis
- Other identified Risks / Opportunities
Quality of Earnings

Reconcile net income to EBITDA (reported EBITDA), then make adjustments based on discussions with management, review of auditor work papers (if any), financial records (financial statements, trial balances, agings, etc.) and judgment.
Quality of Earnings

Normalizing Expenses

- Normalize excess owner compensation
- Discretionary owner expenses, benefits and charitable contributions
- Exclude nonrecurring and one-time expenses
- Normalize bad debt expense fluctuations
- Exclude gains and losses on sales of assets
- Normalize or adjust periods for when transaction arose
- Normalize significant changes in reserves
- Exclude management fees and board of directors’ expenses
- Eliminate other one-time costs, such as severance, moving costs, transaction fees, etc.
- Reallocate refunds or bad debt recoveries received
- Adjust noncash compensation, like stock options
- Normalize bonuses, professional fees, etc.

Additional Accounting Adj.

- Inventory methods
- Changes in accounting policies
- Impairment charges
- Adjust for missing accruals or for GAAP compliance
- Related party adjustments
- Lost earnings form lost customer
- Recent price changes
- Normalized staffing costs
# Quality of Earnings

<table>
<thead>
<tr>
<th>$ in USD 000's</th>
<th>2014</th>
<th>2015</th>
<th>TTM February 29, 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Sales</td>
<td>9,518</td>
<td>10,582</td>
<td>10,951</td>
</tr>
<tr>
<td>Freight Income</td>
<td>587</td>
<td>670</td>
<td>685</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>10,105</td>
<td>11,252</td>
<td>11,636</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>(6,885)</td>
<td>(7,334)</td>
<td>(7,539)</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>3,220</td>
<td>3,918</td>
<td>4,097 35%</td>
</tr>
<tr>
<td>SG&amp;A</td>
<td>(2,883)</td>
<td>(3,520)</td>
<td>(3,560) -31%</td>
</tr>
<tr>
<td>Net Income</td>
<td>337</td>
<td>398</td>
<td>537 5%</td>
</tr>
<tr>
<td>EBITDA:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Income</td>
<td>337</td>
<td>398</td>
<td>537</td>
</tr>
<tr>
<td>Depreciation</td>
<td>102</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>EBITDA</td>
<td>439</td>
<td>408</td>
<td>547 5%</td>
</tr>
</tbody>
</table>

**Normalizing adjustments for on-going operations**

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2015</th>
<th>TTM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner salary normalized</td>
<td>206</td>
<td>207</td>
<td>207</td>
</tr>
<tr>
<td>Normalized Rents</td>
<td>100</td>
<td>150</td>
<td>125</td>
</tr>
<tr>
<td>Lost customer</td>
<td>-</td>
<td>-</td>
<td>(200)</td>
</tr>
<tr>
<td>Officer life insurance</td>
<td>10</td>
<td>12</td>
<td>12</td>
</tr>
<tr>
<td>Interest income</td>
<td>(3)</td>
<td>(7)</td>
<td>(8)</td>
</tr>
<tr>
<td>Dividends</td>
<td>(2)</td>
<td>(1)</td>
<td>(1)</td>
</tr>
<tr>
<td>Legal expense related to gifting</td>
<td>4</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Gain on sale of assets</td>
<td>(50)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Additional accounting assistance</td>
<td>(50)</td>
<td>(50)</td>
<td>(50)</td>
</tr>
<tr>
<td>Commission bonus accrual</td>
<td>(18)</td>
<td>(13)</td>
<td>(12)</td>
</tr>
<tr>
<td>Normalizing adjustments</td>
<td>197</td>
<td>303</td>
<td>79</td>
</tr>
<tr>
<td>Adjusted EBITDA</td>
<td>636</td>
<td>711</td>
<td>626</td>
</tr>
</tbody>
</table>
## Working Capital

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash</strong></td>
<td>438</td>
<td>1,390</td>
<td>1,365</td>
</tr>
<tr>
<td><strong>Investment Cash</strong></td>
<td>125</td>
<td>120</td>
<td>119</td>
</tr>
<tr>
<td><strong>Accounts Receivables</strong></td>
<td>1,701</td>
<td>780</td>
<td>994</td>
</tr>
<tr>
<td><strong>Inventory 263A Cost</strong></td>
<td>899</td>
<td>1,019</td>
<td>1,316</td>
</tr>
<tr>
<td><strong>Prepaid Insurance</strong></td>
<td>15</td>
<td>18</td>
<td>30</td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>3,176</td>
<td>3,325</td>
<td>3,822</td>
</tr>
<tr>
<td><strong>Accounts Payable</strong></td>
<td>445</td>
<td>326</td>
<td>566</td>
</tr>
<tr>
<td><strong>Accrued Expenses</strong></td>
<td>102</td>
<td>136</td>
<td>55</td>
</tr>
<tr>
<td><strong>Unearned Revenue</strong></td>
<td>156</td>
<td>114</td>
<td>242</td>
</tr>
<tr>
<td><strong>Current liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>704</td>
<td>579</td>
<td>862</td>
</tr>
<tr>
<td><strong>Working capital</strong></td>
<td>2,472</td>
<td>2,746</td>
<td>2,960</td>
</tr>
<tr>
<td><strong>Adjustments:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Cash</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>438</td>
<td>1,390</td>
<td>1,365</td>
</tr>
<tr>
<td><strong>Working capital as defined</strong></td>
<td>2,910</td>
<td>4,136</td>
<td>4,325</td>
</tr>
<tr>
<td><strong>Account adjustments:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commission Accrual</td>
<td>(47)</td>
<td>(26)</td>
<td>(33)</td>
</tr>
<tr>
<td>Commission bonus accrual</td>
<td>(24)</td>
<td>(36)</td>
<td>(13)</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>48</td>
<td>48</td>
<td>48</td>
</tr>
<tr>
<td>Vacation accrual</td>
<td>(59)</td>
<td>(59)</td>
<td>(59)</td>
</tr>
<tr>
<td><strong>Total account adjustments</strong></td>
<td>(82)</td>
<td>(73)</td>
<td>(57)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2,828</td>
<td>4,063</td>
<td>4,268</td>
</tr>
</tbody>
</table>

6 mo. average: **3,720**
Findings

**Deal Breakers** – Issues which would impede the transaction going forward

**Negotiation points** – Issues which would be necessary to consider in the valuation of the business.

**Risks** – Issues or items which are knowingly taken over as a calculated decision

**Issues for agreements** – Issues which would warrant indemnities or other narrative in a purchase agreement
Traditional Hands-on Approach - Formal Checklist:

Organizational Records
General Business Records
Legal/Financial *(notes to financial statements)*
Tangible Property
Management/Employees
Due Diligence: A Legal Perspective

(continued) Traditional Hands-on Approach - Formal Checklist:

- Litigation
- Intangible Property
- Legal – Regulations & Filings
- Miscellaneous/Situational
Due Diligence: A Legal Perspective

The Purchase Agreement as a Due Diligence Tool
Components of an APA:
1) What is being purchased
2) Price
3) Closing procedures
4) Indemnities
5) REPRESENTATIONS AND WARRANTIES
Representations & Warranties – their function

1) Obtain information from Seller **before** signing the contract
2) Provide the basis for terminating the transaction
3) Provide the basis for indemnification of the Buyer
Due Diligence: A Legal Perspective

REPRESENTATIONS AND WARRANTIES

Definition: A promise or assurance; a truth statement upon which a contracting party is entitled to rely upon as being accurate
Due Diligence: A Legal Perspective

Functions of Representations and Warranties

1) **Historical Accuracy** (financial results and financial condition)
2) **Collateral quality/title**
3) **Revenue and expense assumptions**
4) **Potential disruptions** (legal disputes, etc.)
5) **Validity of the Contract**
Example:

4.4 No Litigation or Adverse Events. Except as disclosed on Schedule 3.3, there are no outstanding orders, judgments, injunctions, awards or decrees of any court, arbitrator, or governmental or regulatory body involving Seller. No suit, action or legal, administrative, arbitration or other proceeding or reasonable basis therefor, or, to Seller's knowledge, no investigation by any governmental agency, pertaining to Seller or the Purchased Assets is pending or, to Seller's knowledge, has been threatened against Seller that could adversely affect any of the Purchased Assets or materially adversely affect the ability of Seller to consummate the transactions contemplated by this Agreement.
R&Ws: Historical Accuracy (financial results and financial condition)

Books & Records
Financial Statements
Taxes
No Material Adverse Changes
Due Diligence: A Legal Perspective

**R&Ws: Collateral quality/title**

- Title to Assets; Encumbrances
- Description of Real Property
- Description of Leased Property
- Inventory(ies)
- Contracts (defaults)
- Environmental Matters
- Intellectual Property
Due Diligence: A Legal Perspective

**R&Ws: Revenue and expense assumptions**

- Sufficiency of Assets
- Condition of Facilities
- Accounts Receivable
- Employee Benefits
- Absence of certain Changes or Events
- Employees; Labor Disputes & Compliance
- Related Party Transactions
Due Diligence: A Legal Perspective

R&Ws: Validity of the Contract
Organization and Good Standing
Enforceability; Authority; No Conflict
Due Diligence: A Legal Perspective

**R&Ws: Potential disruptions (legal disputes, etc.)**

- No Undisclosed Liabilities
- Legal Proceedings
- Insurance
- Virtual assets; security, licensing infringement
Relying on the Reps and Warranties – Limitations & Analysis

1) Data versus information
2) Actual versus theoretical risks
3) Quantifying the exposure
4) “Process” controlling result/goals
Due Diligence – Overview

Anecdotes and Observations (includes Q&A)