



IAPA Deals & Opportunity Forum

11.15pm-12.30pm

Rio de Janeiro 1

Co-chaired by:



Jan van Wijngaarden
JM Corporate Finance
The Netherlands



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Due diligence and valuation

Programme Content Due Diligence:

Many of our clients regularly raise the following questions from a buyers or sellers perspective: “What is the scope of a due diligence?” and “How should we prepare for this investigation?”

As trusted (IAPA) business advisers, we should be able to answer these questions in the right way and manage this process. During the Deals & Opportunity Forum we will trigger the roundtable discussions by first showing one short movie. Subsequently the roundtable groups start discussing the case study. The case study describes the actual business performance of a trading company currently for sale.

Programme Content Valuation:

Similarly, we are asked by clients to value their businesses or some of the shares in their businesses for all kinds of different circumstances. We will use case studies to explore different valuation approaches for different circumstances and discuss where we can source evidence and comparisons to underpin the validity of the valuations we give.

The case studies for discussion purposes are below. Delegates are kindly asked to come prepared.

The objective of this Forum is that IAPA members will be able to discuss at a high level the above mentioned subjects with their clients.



Case Study 1: SHOE Ltd. (company for sale)

Introduction

The governing board of a potential **acquiring company** has drawn up an acquisition profile on the basis of its strategic analysis of the market for possible takeover candidates. On the basis of this profile, provisional discussions have already taken place with the board of Shoe Ltd and a 'letter of intent' has been signed, in which it is stated that the final purchase price is based on the intrinsic value of Shoe Ltd as per 31 December 2015, determined according to normal accounting standards, plus 5 times the standardised average net result over the years 2014-2016 (according to available annual accounts, see appendix). It has been agreed that the purchase price depends on the potential results of the due diligence. The accountant of the potential acquiring party has already briefly spoken with the accountant of the selling party and has obtained information, which includes the following, on the basis of which a due diligence will be carried out.

Shoe Ltd. has a wholesale trade in high-quality shoes, which can be distinguished as women's, men's and children's shoes under various own brands. At the beginning of this century, a reorganisation was carried out in order to make the company structurally profitable. A modest profit was made for the first time in 2004. The shoes involved are bought in, since 2003, from its production facility (100% participation), which is situated in South Korea. Previously production took place in the Netherlands. The management of the company is considering, besides the sale of men's socks (started in 2008), starting to sell pantyhose for women. The management has not yet taken a final decision. However, various samples have already been manufactured.

For the production of the shoes in South Korea, various "high-tech" machines were purchased and modified to the production methods developed in the company, taking into account the high Western European quality requirements. The necessary materials (leather, rubber, laces etc.) are bought in from various suppliers in the Far East, with whom contacts have already been maintained for a long time. Detailed purchasing contracts have been concluded with some of these suppliers, which only mention the numbers of materials to be purchased.

Sales take place in the Netherlands to several well-known shop chains, while abroad sales also take place via (large) mail order companies. A small part of the turnover is sold directly from the site in South Korea (for the Korean market). It is apparent from a number of market research studies that consumer spending, in a general sense, is under pressure and that the consumer will postpone buying more expensive shoes (spending on repairs is increasing). The expected fall in the average turnover in the shoe sector over 2016 amounts to 3%. In the coming season 2017, a price war is expected to occur. Shoe Ltd. has only a limited market share of 1 to 2%. Its relations with foreign companies (mainly Germany) are maintained by the General Director (aged 40) and the Head of the Commercial Division, Foreign Department (aged 58), who have built these contacts over a period of 20 years.

Case Study 1: SHOE Ltd. (company for sale)

Recently Shoe Ltd. has made provisional pricing agreements with one of its competitors in a certain region, in relation to various models of women's and men's shoes. The definite contract will contain a mutually agreed penalty condition. Long-term, detailed contracts have been concluded (price, numbers, quality, time, penalty clauses, etc) with the majority of the shop chains and mail order companies. In the sector, timely supply is regarded as one of the determining competitive factors.

The number of employees in the Netherlands is approximately 100 (permanent contract) and in South Korea approximately 80. Except for the members of the management team, mostly temporary workers are used in South Korea. In the Netherlands the quality control, sales planning, warehouse, transport, sales home/foreign, administration (including EDP) departments and the design department fall under the management board.

The purchasing, production planning, production and testing departments are located in South Korea. At the start of next year (2016) the quality control department in the Netherlands will cease to exist, and as a result this activity will be mainly concentrated in South Korea.

The hard- and software used dates back to 2008 and has been very well maintained and regularly updated over the years. The software used in South Korea was developed by a local programmer who is no longer employed by Shoe Ltd. Recently, as a result of various software problems in South Korea, the production and delivery of certain models have been delayed considerably. Backup procedures have been tightened up recently.

The accountant of Shoe Ltd. states that the administrative organisation is adequate. Recommendations have been made to have certain internal audits conducted by a separate official. No material corrections have been suggested by the accountant as a result of the 2015 audit conducted at the beginning of 2016.

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Appendix (received due diligence information)

Consolidated income statement (in mio euro's)

	Forecast 2016	2015	2014	2013
TURNOVER				
Men	15.5	15.1	16.8	12.4
Women	40.0	39.8	44.3	46.1
Children	17.0	16.1	15.3	8.8
	72.5	71.0	76.4	67.3
GROSS MARGIN				
Men	5.3	5.0	5.6	4.1
Women	12.0	11.5	13.0	13.8
Children	4.4	4.1	3.7	2.2
	21.7	20.6	22.3	20.1
GROSS MARGIN %				
Men	34.2	33.1	33.3	33.1
Women	30.0	28.9	29.3	29.9
Children	25.9	25.5	24.2	25.0
NEW ARTICLES				
Men's socks/gross margin	Break-even	(0.5)		
Pantyhose/gross margin	Break-even	-		
Sales costs	6.0	6.4	6.1	6.8
Costs of staff	10.0	10.0	9.5	8.4
General expenses	1.6	1.8	1.0	1.4
Interest	1.4	1.4	1.3	1.2
Depreciation	1.4	1.4	1.2	1.0
	20.4	21.0	19.1	18.8
EBIT	1.3	(0.9)	3.2	1.3
Corporate income tax	(0.3)	1.3	(0.6)	(0.2)
Net result	1.0	0.4	2.6	1.1

Consolidated balance sheet as at 31 December
(in mio euro's)

		2015		2014
FIXED ASSETS				
Building	5.6		5.9	
Machinery	5.5		4.8	
Other fixed assets	1.2	12.3	1.5	12.2
CURRENT ASSETS				
Inventories	8.6		8.1	
<i>Receivables</i>				
Accounts receivable	18.8		18.7	
Other receivables	3.1		2.3	
Cash at bank and in hand	1.0	31.5	2.8	31.9
TOTAL ASSETS		43.8		44.1
EQUITY				
Share capital	0.2		0.2	
General reserve	5.4	5.6	5.0	5.2
PROVISIONS				
Pension	1.8		1.4	
Warranty	0.7	2.5	0.9	2.3
LONG-TERM LIABILITIES		12.0		12.8
SHORT-TERM LIABILITIES				
Accounts payable	19.0		19.5	
Taxes	2.3		1.2	
Other liabilities	2.4	23.7	3.1	23.8
TOTAL LIABILITIES		43.8		44.1

Case: SHOE Ltd. (company for sale)

ADDITIONAL DATA

1. Buildings and sites

This relates to tangible fixed assets in the Netherlands (head office). The building in South Korea is leased for a period of 20 years. Recently, in connection with a potential new loan, the selling price of the building (including ground) was estimated at €7.5 million. The building is being written off over 40 years.

2. Machines

All machines (in South Korea) are in a good state and are being written off over 5 years linearly. In 2014, the manager sold three 'high-tech' machines (including any components present), which had already been fully written off, for €1.5 million to a local competitor. Six years ago in the Netherlands, a regional subsidy was obtained for these machines. The book profit has been justified under 'general costs'. Because of the strongly increasing turnover in 2014, the average occupancy of the machines was almost 80%. In 2015 investments were made, including those relating to the production of 'men's socks', for a total sum of € 500,000. The management in South Korea has already formally ordered a production line for 'pantyhose' from the supplier in order to prevent delay.

3. Other tangible fixed assets

The majority concerns office furniture and -equipment in the Netherlands, which is written off over a period of 10 years. The possible acquiring party writes off similar assets over 5 years.

4. Inventories

The inventories are valued at purchase price with associated costs such as freight and insurance (as a surcharge percentage), which applies to the Dutch inventories and against manufacturing price (direct and indirect costs) in respect of the inventories in South Korea. Intercompany profits in inventories have been eliminated in the consolidation. The inventories can be split up into "basic models" and "seasonal models". The seasonal models are fully written off after being in stock for a period of 1 year. The basic models are not written off. As per 31 December 2016, samples of pantyhose will be activated for a value of approximately €100,000 and the stock of men's socks will represent a value of €300,000. The number of other sample models is minimal.

Case: SHOE Ltd. (company for sale)

5. Accounts Receivable (debtors)

Because one of the employees in the Accounts Receivable department was off ill, resulting in the stagnation of regular reminders to debtors, the accounts receivable balance has risen. For a number of years it has been customary to reserve a fixed amount of €1 million to cover any accounts receivable risks. Foreign debtors are not insured via Atradius and are invoiced in foreign currency. Purchasing is done in US dollars.

6. Pension provision

This represents the backservice obligation for the staff in the Netherlands and the management in South Korea, based on actuarial calculations.

7. Guarantee provision

This concerns deferred obligations and risks with respect to products sold, based on the long-term sale contracts concluded, the various agreements made concerning compensating for certain repairs, the possible claims for damage and the discounts provided on the basis of other complaints (to be authorised by the commercial director). From detailed calculations in 2014, it was clear that this provision (as per end 2013) had been too highly reported for an amount of €200,000. This amount was released in 2014 under 'sales costs'.

8. Loans

The mortgage loan is being repaid at €800,000 per annum. The interest percentage amounts to 11%. The credit facility amounts to €5 million. Sureties have been given to the bank by means of a mortgage on immovable property, debt assignment of accounts receivable and inventories.

9. Accruals

During the audit of 2014 it appeared that for several cost invoices no reservations had been booked for a total amount of €75,000. This was the result of a lack of clarity in respect of the number of invoices in circulation. On the basis of the principle of materiality, no correction was proposed by the accountant.

One former employee has initiated legal proceedings because of unlawful dismissal. Given that the lawsuit is still in progress and the lawyer is positive about the outcome, no provision has been included for this.

Case: SHOE Ltd. (company for sale)

10. Turnover

The turnover, respectively the result will be reported upon delivery from the central warehouse. Intercompany turnovers have been eliminated. The strong increase in the turnover in 2014 was caused by an extra publicity campaign carried out in 2013 (costs € 900,000), reported as 'sales costs'. The turnover in 2015 of men's socks amounted to €1 million (cost price sales: €1.5 million). The share of turnover between the Netherlands /abroad is 50/50, with 80% of the Dutch turnover being delivered to branches of three large shop chains. Abroad a large variety of customers are supplied with products. Mail order companies occupy a significant position in this.

11. Sales costs

This concerns the costs for various publicity campaigns on TV, in newspapers and magazines and direct mail activities. Sponsor activities also take place.

12. Staff costs

Salaries increase on average by 5% per year. As a consequence of the much-increased turnover in 2014, 9 extra employees have been taken on (permanent contracts). Due to the fall in turnover in 2015, fewer temporary workers were engaged in South Korea for the production.

13. Corporation tax

The effective percentage for corporation tax is lower than the nominal percentage (30%) given that in 2013, the last part of the available 'carry-forward facility' (relating to losses from the past) was used and in recent years the majority of the profit was achieved in South Korea, where a lower tariff applies. The last corporation tax audit was conducted in 2010.

Questions:

- 1. Identify any business risks which are important for a buyer.**
- 2. What is the value of this company (rough estimate)?**
- 3. Would you buy this company? If yes/no, why?**

Case Study 2: Valuation Case Study

Introduction

Franky Limited creates and maintains websites for corporate clients. It's income is primarily on rolling 12 month agreements. Recent profit and loss account:

	Actual £ 2014	Actual £ 2015	PB Forecast x12 / 9 2016	Mgmt Acc Info £ 16 (Oct - Jun)
Turnover	2,105	1,331	1,535	1,151
Cost of sales	(388)	(213)	(171)	(128)
Gross Profit	1,717	1,118	1,364	1,023
Administrative expenses	- 1,156	- 977	- 1,121	- 840
EBITDA	561	141	243	182
Depreciation & Amortisation	(62)	(56)	(53)	(40)
Interest receivable	7	6	11	8
Interest payable	(0)	-	(1)	(1)
Dividend income	109	133	370	277
Profit on sale of investment		364		
Profit before tax	540	548	570	428
Taxation	(53)	12	12	(86)
Profit for the year	487	560	582	342

Franky Limited owns 46% of Infinity Ltd, a cloud based accounting software business. The Founder of Infinity Limited also owns 46%. Infinity Limited just undertook a crowdfunding round raising £2.1m and issued 8% of its share capital at £12 per share for 170,000 shares (equivalent to £25m pro rata). It recently rejected an offer for the whole business of £8m representing 6x revenue.

Franky also owns 30% of 4C Limited, a fast growing £4m sales, £2.7m EBITDA SAAS business growing by £0.7m EBITDA per year. It is expected to continue to grow at 10% pa. WACC 25%.

4C Limited has invested £1.15m (£150k a year ago, £1m in the last three months) in preference shares in a new website business, Pricechecker Limited that has recently started generating modest revenues from it's beta site. Full launch is expected in 2017 but it is unproven. Franky Limited owns 49% of Pricecheckers ordinary shares and 4C owns 49%.

We have been asked to value a 24% shareholding in Franky Limited and for the valuation of Franky Limited as a whole.