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TAS Fundamentals: Advanced

Lesson 1: Introduction

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Course format

- Highly interactive environment
- You are expected to participate and perform
- During this course, you will experience:
  - Realistic situations
  - Time constraints and pressure
  - Working in a team environment

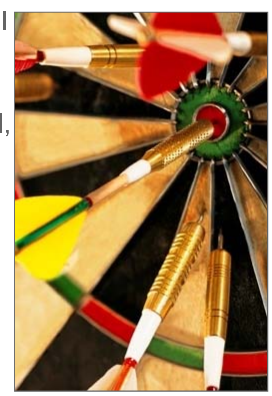
Introductions

Briefly introduce yourself:

- What is your name?
- Where are you coming from?
- What is your background?
- How long with TAS and how much experience elsewhere?
- What SSL are you most closely associated with?
- What are your expectations of the course?

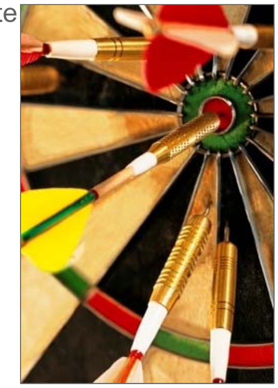
Course objectives

- Discuss Vision 2020, TAS Big Bets, Exceptional Client Service and the Capital Agenda
- Compare operational improvement, financing and strategic options to raise or optimize capital, and the advantages or disadvantages of each
- Analyze information to support the client's decision on a course of action for asset rationalization
- Prepare for a DAS engagement
- Determine the financial and operational impact of a carve-out
- Discuss what growth means, motivations for growth, possible growth strategies and associated risk factors



Course objectives (contd)

- Analyze industry, macroeconomic and corporate information to validate growth strategies
- Analyze implications of the current economic situation and the state of the capital markets on the growth strategy of a company
- Given scenarios, determine the valuation price using the appropriate method
- Demonstrate how to perform financial due diligence analyses on a target business
- Perform a 13-week cash flow forecast analysis on a distressed target company in order to provide client recommendations
- Practice communicating findings



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Course agenda

- Understanding the environment
  - What options to raise, optimize and invest capital are available?
  - How does the economic situation influence the available options?
- Understanding the options to raise, optimize and invest capital
  - What are the advantages and disadvantages of operational options?
  - What is the effect of financing options on the capital structure?
  - What is the decision process for strategic options?
- Understanding the divestment and carve-out
  - What is the process, the timeline and the most important documents?
  - What are the operational implications of a carve-out?
  - What are the financial implications of a carve-out?
- Understanding the transaction diligence process including valuation and transaction services
  - What are valuation techniques?
  - How do we do financial diligence and the what do the results mean?
  - Can one find value by investing in distressed/stressed companies?
- Communicating findings
  - How to summarize the analysis and create meaningful conclusions?

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Logistics

- Meals and breaks
- Facility locations
- Participation
- Ground rules
  - Cell phones off or set to vibrate
  - On-time starts and returns from breaks
  - Respect for each others' input
  - Computers closed when not in use

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Vision 2020

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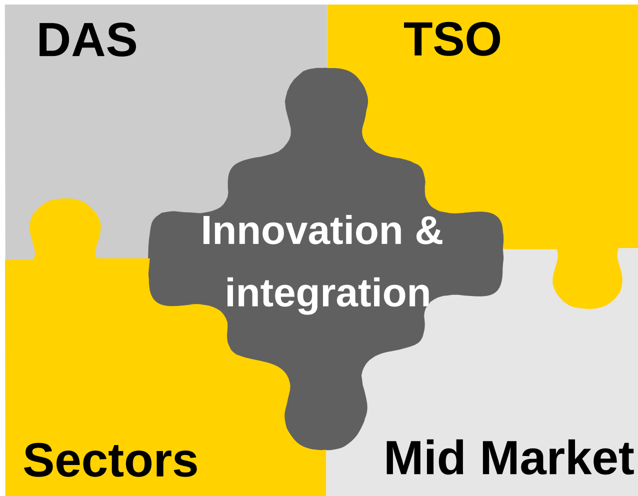
TAS "Big Bets" – driving our Vision 2020



Exceptional Client Service: Components of success (1 of 3)

Connected

- Understand the client's business agenda
- Serve the client the way they want to be served
- Use the global network and introduce our high-caliber people

Exceptional Client Service: Components of success (2 of 3)

Responsive

- Respond promptly to all client contact
- Raise our visibility with the client
- Seek — and provide — continuous feedback

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Exceptional Client Service: Components of success (3 of 3)

Insightful

- Present high-value insights proactively
- Deliver technical excellence
- Create business-oriented service offerings

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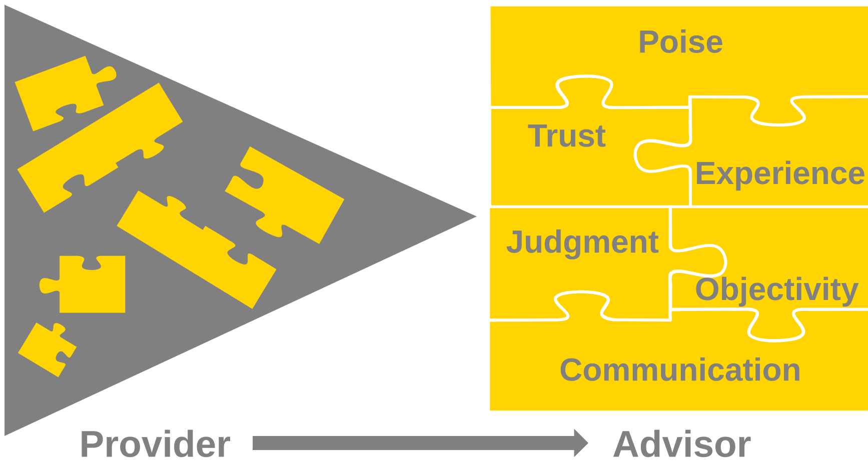
Characteristics of a business advisor



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Business advice

> **"Customers/buyers are most likely to reset buying criteria when confronted with surprising information about their business."**
> – Corporate Executive Board study

- Be relevant
  - Have something to say
  - Share market data, insights and experiences
  - Leverage firm resources
- Be aware of Firm and TAS thought leadership

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The Capital Agenda – 5-minute Exercise

Based on your pre-work, discuss amongst yourselves the key issues our client faces in each of the Capital Agenda quadrants and come up with one issue per quadrant and who in TAS would deal with this issue.

Stressed and distressed situations
- Stress and distress – e.g., liquidity issues and turnaround plans
- Preserving tax assets and minimizing costs
- Dispute resolution

Refinancing debt, equity and other obligations
- Customer and supplier analysis
- Refinancing or restructuring debt, equity and other obligations
- Dealing with stakeholder relationships and pressure

Optimizing asset portfolio and capital structure
- Delivery of synergies and effective integration

Realizing the value of investment and effective integration

Releasing cash
- Improving working capital and releasing cash
- Optimizing capital structure
- Optimizing tax and corporate structure

Planning and structuring transactions
- Acquisitions and alliances
- Planning and structuring transactions to optimize stakeholder return
- Focused due diligence to mitigate risk and drive value
- Cost- and tax-efficient structures

Asset valuations

Raising equity and debt
- Fundraising (equity and debt): IPO readiness, rights issues, PE, private placement and capital market
- Optimizing funding structure Cost- and tax-efficient structures

Divesting non-core and strategic assets
- Asset divestment
- Cost- and tax-efficient structures

Infrastructure projects

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Questions?

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Lesson 2: Understanding the options

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Options for optimizing, raising and investing capital

- What are the advantages and disadvantages of operational options?
- What is the effect of financing options on the capital structure?
- What is the decision process for strategic options?

Operational	Financial	Strategic

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Discussion: Options for optimizing, raising and investing capital

- Discuss options for GBI to optimize, raise and invest capital
- Sort your options into the following categories:
  - Operational improvement options
  - Financial options
  - Strategic options
- Use what you know about GBI from your pre-work

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Operational improvement options

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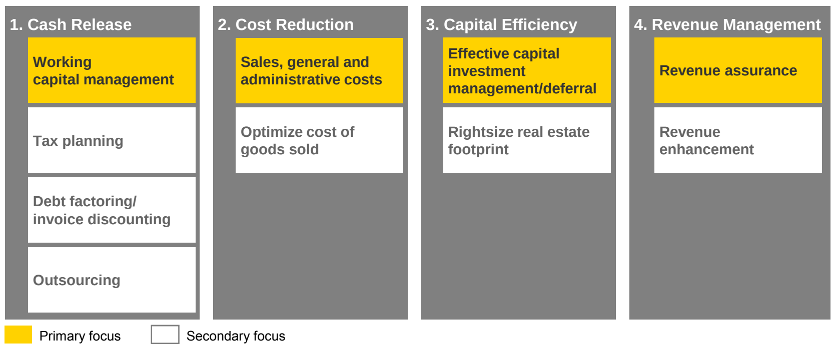
Operational improvement options

- Which options to discuss depends on a number of variables, including:
  - Resources available
  - Time constraints
  - Expected costs to achieve benefits



Working capital management

Theme	Area	Description	Typical benefits
Perform effective working capital management	Forecast to fulfil	Driving out cash savings tied up in stock and inventory across business	Typical cash release of 10% of turnover, of which 50% is realized in the first year
	Order to cash	Improving the order, logistics, invoice generation and payment collection cycle	
	Procure to pay	Maximizing procurement position, securing best deals that balance cost, value and risk	
	Cash forecasting	Accurate modeling of the business's future financial liquidity with clear understanding of cash drivers	

Cost reduction, capital efficiency and revenue management

Theme	Area	Typical benefits
Cost reduction – focus on SG&A	Program portfolio review	Savings between 8% and 30% realizable through indirect spend management; further 5% to 10% through indirect procurement practices.
	IT cost optimization	Wholesale transformation of IT can deliver savings of >30% on IT operating spend.
	Sales force effectiveness	Reorganization of sales and customer service can reduce overhead cost by >30%.
	Support function effectiveness	Wholesale transformation of support functions can deliver >40% savings on G&A costs.
Capital efficiency – investment management	Program portfolio review	Range of interventions can typically deliver 10% saving to original forecast and a 20% saving to overall cost by eliminating non-productive spend and minimizing overruns that commonly occur. Greater short-term savings can be achieved through investment deferral.
	Capital program management	
Revenue management	Revenue leakage and revenue optimization	Helps close the typical gap of up to 10% between potential and collected revenues.
	Revenue assurance function	
	Revenue assurance performance	

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Exercise: Operational improvement (working capital benchmarking)

- Objective: Identify working capital improvement options
- Time: 15 minutes
- Directions:
  - Use S&P Capital IQ to identify:
    - Comparable companies to GBI — focus on food and beverage
    - Current ratio and DSO of comparable companies
  - Compare results to GBI
    - Current ratio: 0.91
    - DSO: 86
  - Discuss with your table group what EY and TAS can do to assist in bringing GBI results in line with the comparable companies
  - Capture your observations electronically or on a flip chart and be prepared to present

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Financing options

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Financing options to raise and optimize capital

Optimize existing debt

- Renegotiate terms
- Refinance
- Restructure
- Debt to equity swap

Raise capital — new debt

- Banks
- Bonds
- Leasing
- Securitization
- Other, e.g., mezz. debt

Raise capital — equity

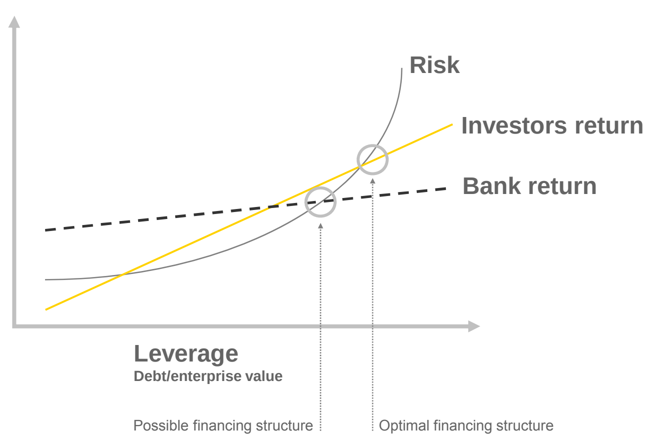
- Shares
- Warrants
- Convertibles
- Cutting the dividend

Impact on leverage: *increase* *no change* *decrease*

Difference between debt and equity

- Debt providers are creditors
  - Lend on the basis of minimal business risk
- Equity providers are partners
  - Invest on the basis of the upside
- Debt/equity choice is not mutually exclusive
  - A mix of both may be the answer

Choosing the right capital structure



Exercise: Financing options (debt capacity benchmarking)

- Objective: Identify financing improvement options
- Time: 15 minutes
- Directions:
  - Using the same list of comparable companies identify:
    - Interest coverage ratio
    - Debt to equity ratio
  - Compare results to GBI:
    - Interest coverage ratio: 1.0
    - Debt to equity ratio: 78.4
  - Discuss with your table group what EY and TAS can do to assist in bringing GBI results in line with the comparable companies
  - Capture your observations electronically or on a flip chart and be prepared to present

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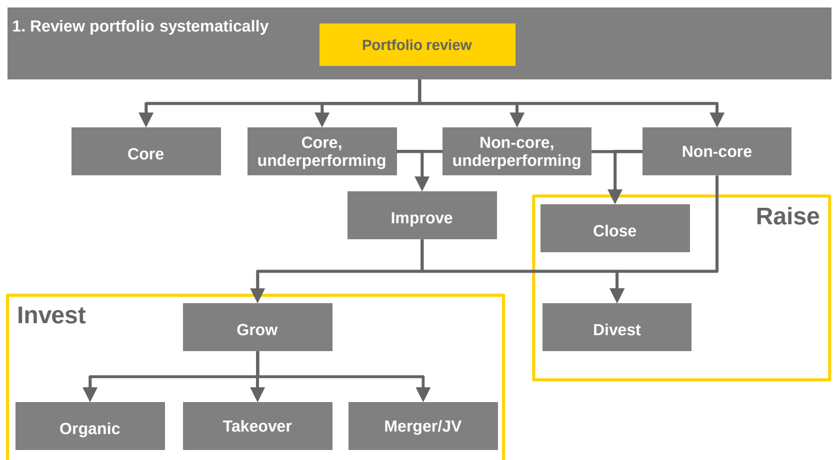
Strategic options – asset rationalization

EY

Strategic portfolio review



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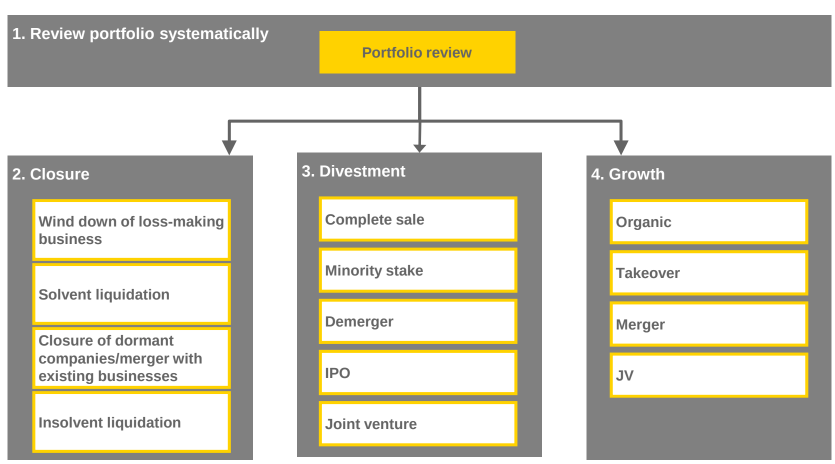
Strategic options to raise or optimize capital



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Portfolio analysis and asset rationalization decision

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Questions sellers should ask themselves

- Which business is in the best condition for a disposal to maximize value?
- What is the strategic rationale for the divestment?
- Who are the likely bidders, and what needs can we anticipate?
- What potential improvements, reflecting the timeframe and resources available, could lead to a more efficient process?
- What is the impact of the physical disentanglement on value and timeline?
- How big is the disruption of day-to-day operations?

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Exercise: Asset rationalization decision

- Objective: Determine which division GBI should consider to divest keeping in mind: transaction rationale; value; time-frame
- Time: 20 minutes
- Directions:
  - In your teams consider these facts:
    - Five percent of the Packaging division is still owned by the previous owner.
    - The Logistics business has excess capacity.
    - The Packaging division is very involved in the secret plans to develop the Drink and Food division's next product, Brand X, a product developed by the Packaging division's research and development.
    - The Logistics IT business has patents and intellectual property which have been valued by Logistics IT management as worth billions.
    - David Love's son, Albert, works for the Theme Parks division.
    - The Packaging division is currently fighting an environmental claim over a chemical spill.
  - Review EF_Consolidated accounts, GBI website and case study.
  - Be prepared to present your recommendations to the audit committee.

Exercise: Asset rationalization decision Debrief considerations

- Which division is really core to the GBI business and brand identity?
- Which division might realize the most value in the marketplace?
- Should GBI divest an underperforming business (Theme Parks) vs. a solid division (Logistics) that has strong intellectual property and other value?
- Which form of divestment is most appropriate for each division?
- Which division might be divested the quickest?

Lesson summary

- Explained the operational options to raise, optimize and invest capital
- Explained the debt and equity instruments available to companies to raise and invest capital
- Explained the different forms of closure, divestment and growth options
- Described the portfolio review options and the factors that need to be considered when conducting such review

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Lesson 3: Understanding divestment

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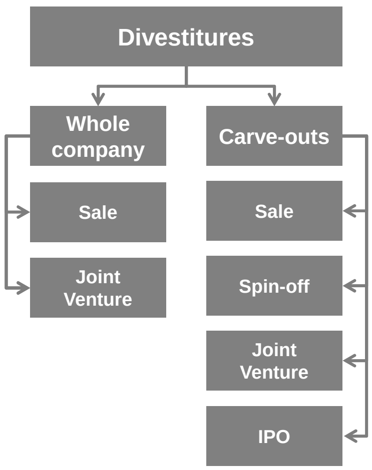
The divestment process

- Divestment options
- Timeline
- Documents
- Carve-out
  - Stand-alone costing
- Diligence preparation and support
- Impact on value

What is Divestiture Advisory Services (DAS)?



DAS is a solution to assist sellers:

*... a **flexible** combination of advice, insights and perspective*

*…which range from **early stage** diagnostics to comprehensive **transaction execution** assistance*

*… that provide the seller the support needed to **expedite** the process and enhance or preserve transaction **value***

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Sell-side transaction considerations

EY

Transaction considerations

- Exit readiness considerations
  - Strategy
  - Operational carve-out
  - Financial
  - Tax
- Drivers
- Types of buyers and sellers
- Corporate stakeholders
- Rationale
- Life cycle

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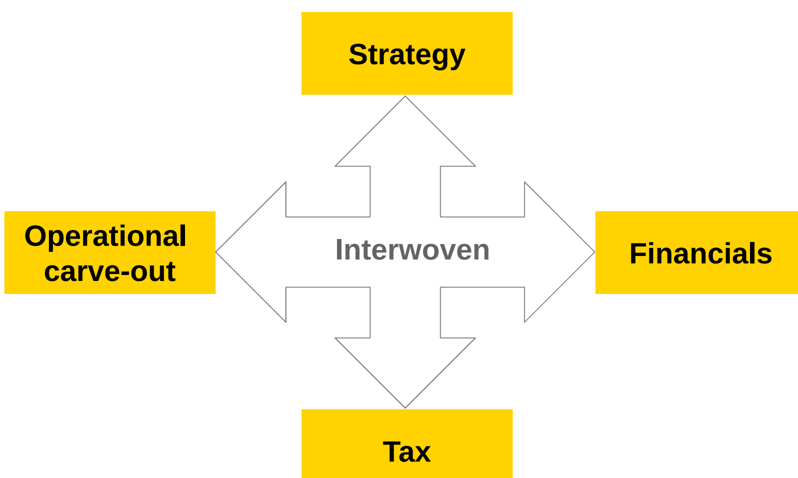
Exit readiness considerations



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Exercise: Issues surrounding exit readiness considerations

- Objective: Identify two or three general issues for each exit readiness consideration:
  - Strategy
  - Operational carve-out
  - Financials
  - Tax
- Time: 10 minutes
- Directions:
  - Working in table groups, discuss the issues of key readiness consideration assigned to your table.
  - Use a flip chart to document your findings and be prepared to discuss your findings with the class

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What is driving buyers?

- Corporate (strategic) or financial (PE) buyers?
  - What different rationale might these types of investors have for an acquisition?
  - Access to:
    - Local production facilities
    - Distribution channels
    - Products and brands
    - Local expertise/key personnel
    - Technology
  - Grow market share
  - Emerging market opportunities
  - Diversify revenue streams
  - Opportunistic M&A
  - Betting on reforms/legislation
  - Reduce competition
  - Prevent competitors from getting a strategic position
  - Participate in industry consolidation

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Financial acquirer - characteristics

- Transaction specialists
- Viewed as investors, not operators
- Minimal “in-house” resources
- Faster decision-making
- Most likely require full stand-alone capability
- Implications on our work?

Strategic acquirer - characteristics

- Operational focus
- Breadth of in-house knowledge
- Greater external scrutiny
- Implications on our work?

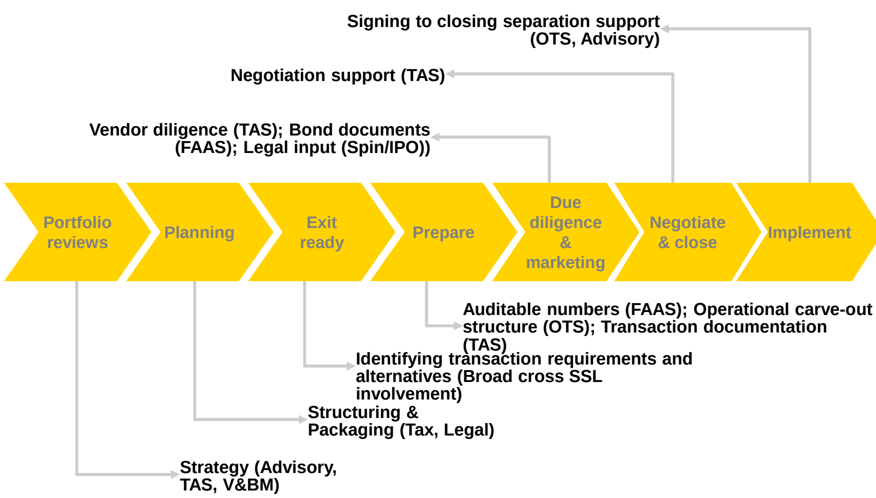
What is driving sellers?

- Liquidity needs
- Non-core assets
- Strategic exit of market, product or region
- Release shareholder value (sum of parts valuation)
- Pricing multiples are still attractive
- Regulatory (merger control or banking capital requirements)
- Future profitability issues
- Management issues

Other transaction stakeholders

- Private owners/shareholders
- Government/tax authorities
- Banks
- Senior management staff
- Non-managerial staff
- Trade unions
- Customers
- Creditors
- Local communities
- Regulators
- Employees
- Suppliers

DAS transaction life cycle



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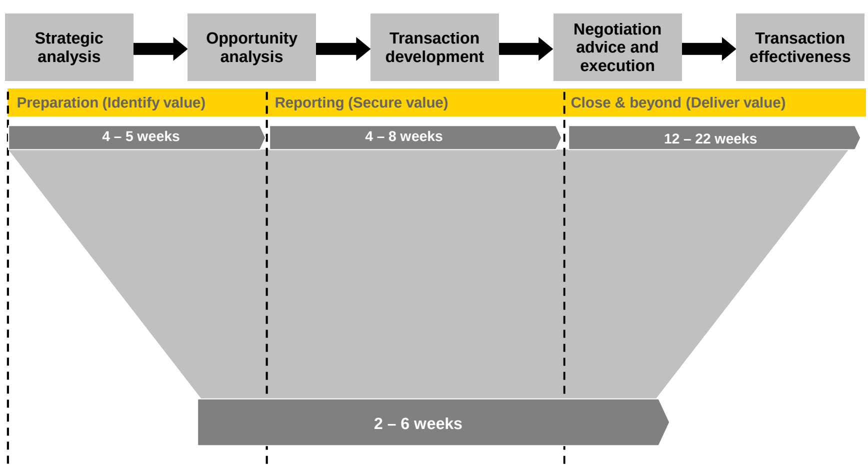
How does this timeline change for a distressed business?



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Transaction documents

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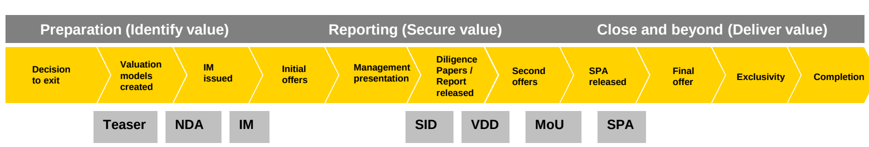
Typical documents

- Sales documents
  - Teaser, non-disclosure agreement, information memorandum
- Further information
  - Seller information document (SID), Vendor Due Diligence, dataroom, management presentations
- Contracts
  - Bid/process letters, contracts (Memorandum of Understanding, SPA, debt agreements, etc.)



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Teaser and IM

- Sales document introducing the transaction opportunity to potential buyers
- Short — 1–3 pages only
- Usually on no names basis
- Targeted at specific buyers, list to be agreed with vendor
- May be modified for specific buyer groups, e.g., private equity vs. strategic buyers
- Invitation to contact the lead advisor to discuss further
- Leads to signing of an NDA to obtain further information and join a formal sales process

- The seller's document
- Assists in telling the story of the company
- Provides detailed information to different sets of buyers to make up their minds to proceed with the purchase
- Includes:
  - Company overview, including financials
  - Industry positioning
  - Management outlook
  - Future upside potential
  - Transaction issues

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Vendor due diligence versus information memorandum

- Information memorandum
  - A sales document
  - Prepared by the seller or seller's lead advisor
  - Sent to potential buyers
  - Biased/degree of reliability
  - More common in auction situations
  - Sellers try to invite a number of potential buyers to bid
- VDD
  - Prepare a due diligence report on the target on which the ultimate buyer can rely, i.e., objective
  - Provide deal support to the ultimate buyer (e.g., supplementary due diligence, SPA advice)
  - Duty of care is to the buyers, not just the vendor/client
- When VDD is useful:
  - Auction situations where buyers' access to target needs to be controlled
  - To add credibility to complex financial history
  - Maximizes value for vendor by leveraging the process

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Exercise: Teaser — sell-side background

- Objective: As a team, write a teaser to attract the type of buyer (financial/strategic) assigned to your team
- Time: 40 minutes
- Directions:
  - Discuss what would attract your assigned buyer to the Logistics division
  - Using points from your discussion, create a teaser designed to attract your assigned buyer
  - Use EF_Teaser template to create your teaser
  - Reference EF_Logistics Management accounts
  - Be prepared to present your teaser to the class

Lesson summary

- Discussed the key readiness considerations that a client should look into prior to starting a divestment process
- Discussed the transaction drivers for buyers and sellers
- Discussed the types of players — corporate and financial
- Discussed typical transaction documents
- Created a teaser designed to attract a potential buyer

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Lesson 4: Understanding the carve-out

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Carve-out transactions

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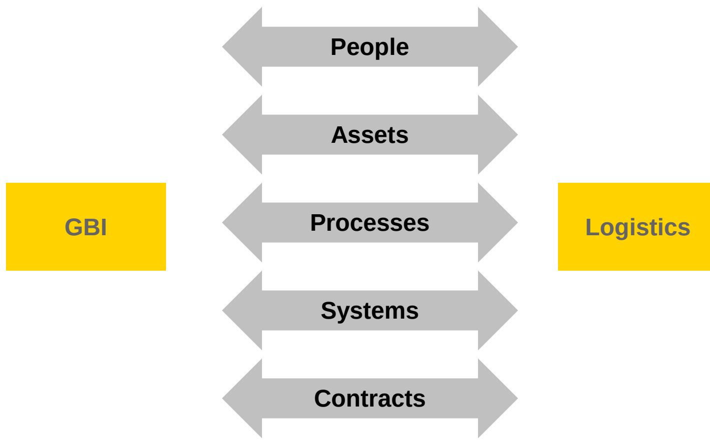
Key terms

- Stand-alone costs
- Separation costs
- Central allocations
- Transitional service arrangements (TSA)
- Synergies
- Negative synergies (dis-synergies)

Variables impacting complexity of the carve-out

- The level of dependency upon the parent
- The extent to which the unit to be carved out is entangled with other entities
- The number of geographical locations
- The level of centralization/decentralization among the different geographical locations
- The ability of the buyer to provide the services to the target operation or business post-closing

Illustration of interdependencies



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Why is it important to identify separation issues?

It helps:

- Determine the likely post-closing requirements for operational services from the seller to the target – Operating design model
- Agree on how to separate common or shared contractual relationships (e.g., corporate purchasing agreements, bundled customer contracts)
- Identify other interdependencies that must be formalized in a TSA and supply or service agreements (short-term or long-term)
- Determine stand-alone costing
- Prepare a high-level separation plan by function

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Transitional Service Agreements (TSA)

- Why is it important?
- When is it used?
- What can a typical TSA include?

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Exercise: Carve-Out

- Objective: Identify the variables that affect the carve-out and which functions require TSAs
- Time: 20 minutes
- Directions:
  - Using HO 4.1: (Logistics IM), review and briefly analyze information about the Logistics business.
  - Discuss potential carve-out issues based on your analysis.
  - List the issues identified using EF_TSA Template.
  - Identify which functions of the Logistics business might require TSAs.
  - Be prepared to share your lists and rationale with the class.

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Stand-alone cost analysis

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Stand-alone costs

- What are stand-alone costs?
  - Costs required to operate the business as an independent entity
  - Future operating cost structure
- Why are they important to identify?
  - Impacts valuation
  - Quantifies and reduces transaction risk
  - Identifies shared services entanglements
- How do we identify them?

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Creating the stand-alone model

1. Request detail data from client
2. Determine best model structure for data
3. Establish baseline cost structure
4. Determine allocations made by RemainCo
5. Define direct costs associated with NewCo
6. Calculate the total benefits burden
7. Determine full-time equivalent employees
8. Identify new personnel costs
9. Establish and compare with cost benchmarks
10. Finalize stand-alone model

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Illustrative cost model for IT

		FY 2010	FY 2010			Standalone - CIM			
	Notes	Allocated	People	Systems	Re-classified	People	Non-people	Subtotal	Headcount
($ in 000s)									
Information technology & systems - detail									
Network infrastructure									
Communications infrastructure and support	(1)						x	x	
MPLS and other WAN connectivity	(1)						x	x	
WAN data circuit expense	(1)						x	x	
WAN & LAN maintenance	(2)						x	x	
Voice systems maintenance	(3)						x	x	
Direct people support						x	x	x	x
Subtotal		x	x	x	x	x	x	x	x
PC Infrastructure and corporate shared services									
PC & peripheral infrastructure	(4)	x	x	x	x	x	x	x	x
Email & blackberry connectivity	(5)						x	x	
Remote Access	(6)						x	x	
Corporate applications	(7)						x	x	
EDI	(8)						x	x	
Other	(9)						x	x	
Direct people support						x	x	x	x
Subtotal		**x**			**x**	**x**	**x**	**x**	**x**

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Exercise: Stand-alone costing review

- Objective: Analyze the historic direct and indirect costs and Logistics management estimates about the stand-alone costs
- Time:
  - 40 minutes preparation
  - 15 minutes meeting with Logistics management
- Directions:
  - Working in teams review the following resources:
    - EF_Management stand-alone cost schedule
    - HO 4.1. Logistics IM
    - EF_Benchmark Files.zip
  - Generate a list of questions to ask the Logistics Division management about the items found on their stand-alone cost schedule and their corporate allocations
  - Conduct a 15 minute interview the Logistics management

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Pro forma P&L

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Why is it important to investors?

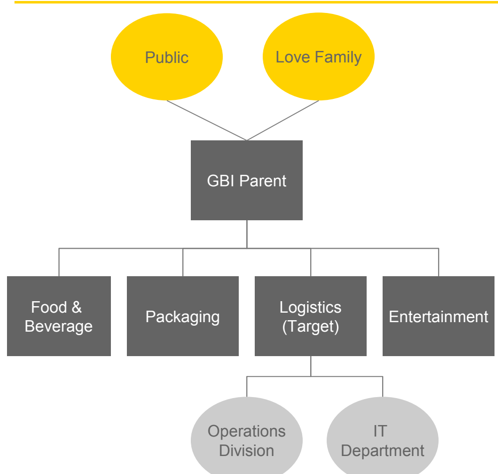
- Companies that report a pro forma P&L usually do so because the events being excluded were unusual so the financial reports required by law are misleading to investors
- Investors are interested in historical growth, which is often indicative of future growth potential
- Historical or future earnings are often used for valuation purposes
- Simply comparing the reported P&L from one year to the next may not show the “real” growth in the business — other factors may need to be considered
- Excluding certain items may enable a more granular understanding of the growth in the business

Transaction Tax

Transaction tax: key terms

- Stock/equity basis
- Inside/Outside Tax basis
- Tax attributes
- Sale of equity
- Sale of assets
- Other taxes: Value Added Tax (VAT), State and Local Tax (SALT)
- Unincorporated divisions
- Common tax issues: transfer of tax losses, step up of tax values, equity sales treated as asset sale, specific tax exceptions and exemptions

The facts



* Simplified structure for illustrative purposes.

Facts:

- GBI acquired the stock of Target (a corporation) in 1985 for CU 100 million.
- GBI's current tax basis in Target is CU 200 million.
- The total net enterprise value of Target is CU 500 million.
- Target has net tax basis in its assets of CU 40 million, made up as follows:
  1. Operations' net tax basis is CU 20 million, and its FMV is CU 300 million
  2. IT Departments' net tax basis is CU 20 million, and its FMV is CU 200 million.
- Logistics has approximately CU 100 million of tax loss carryforwards.
- GBI's and Logistics' tax rates are 25%.

Exercise: Assessing tax implications of alternative tax structures

- Objective: Determine the tax impact of alternative tax structures for the carve-out transaction.
- Time: 20 minutes
- Directions:
  - Complete this exercise in your teams.
  - Analyze the potential tax implications based on the facts and alternative structures laid out in PM 4.1.
  - Be prepared to share your analysis with the class.

Lesson summary

- Discussed key terms regarding carve-outs
- Outlined the variables impacting the complexity of a carve-out transaction
- Determined when to use a Transitional Service Agreement (TSA)
- Performed a stand-alone cost analysis
- Conducted an interview to determine management's expectations on future state of stand-alone costs
- Determined the tax impact of alternative tax structures for the carve-out transaction

Questions?

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Lesson 5: Growth strategies

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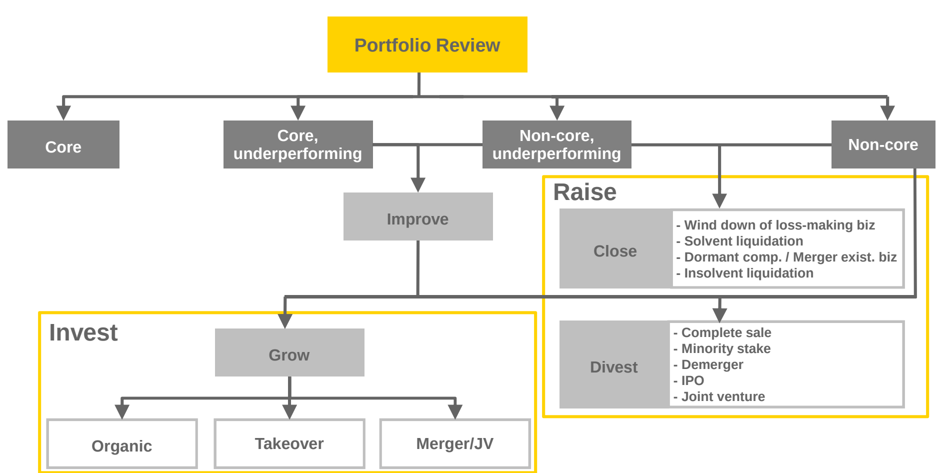
Why do companies grow and what are the risks? — strategic options



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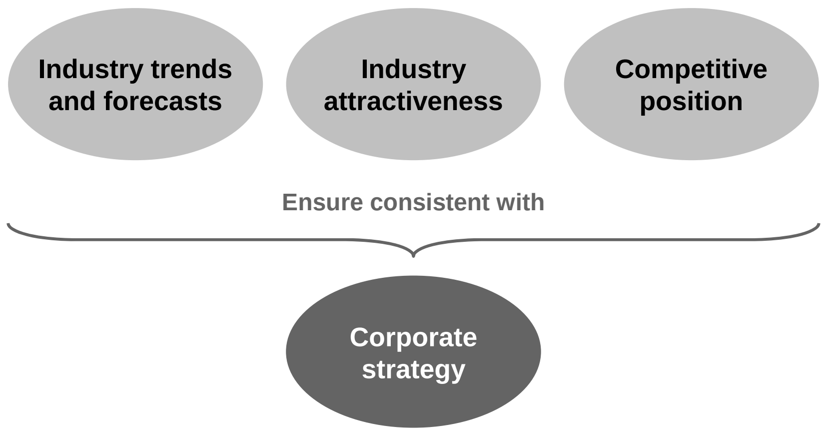
Macroeconomic and industry considerations to growth

EY

Current state of the economy and capital markets

- Economic drivers:
  - Macroeconomics
  - Equity capital markets
  - Debt capital markets
  - Currencies

Analysis of industry: external environment — key aspects



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Review of industry: industry trends and forecasts

- What has happened to the industry?
- What is likely to happen to the industry?
- Consider:
  - Market size
  - Growth
  - Market profitability
  - Segmentation of industry into different markets
  - Degree of concentration
  - Local/global
  - Commoditization
  - Government/industry regulation and impact of consolidation

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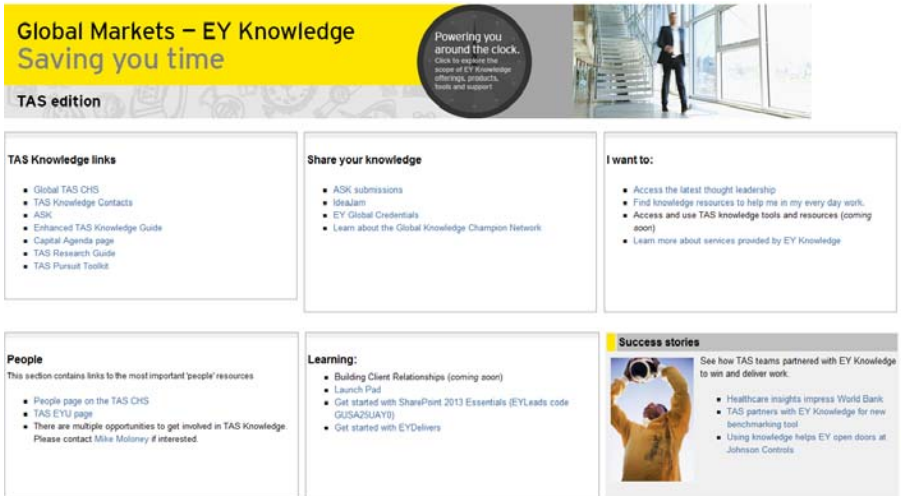
Review of industry: sources of market information



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Exercise: GBI evaluates growth strategies

- Objective: Determine how current industry and economic trends affect a GBI's growth strategy
- Preparation time: 40 minutes
- Directions:
  - Use the TAS Executive briefing and the output of your prework on macroeconomic and industry outlook to complete industry and economic research.
  - Based on your research, provide observations to communicate to GBI your recommendations for their consideration regarding expansion in the beverage sector or related sector.
  - How do these economic drivers affect GBI's plan to expand?
    - Industry consolidation
    - Product expansion

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Prospective target

EY

Why do we read the IM?

- Understand the deal or transaction:
  - What is the target company and what does it do?
- Assist in planning the engagement:
  - How complex is it, and are special resources or know-how needed?
    - Other sub-service lines
    - Industry knowledge
  - What resources might be needed?
  - Where will work be performed? How much traveling is involved?
  - Which EY offices might need to help?
  - How long might the due diligence take?

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Why do we read the IM? (contd)

- Assist scoping the engagement:
  - What should be considered in scope discussions with the client?
  - Key transaction issues to discuss with the client
  - What are the business drivers that we might be asked to analyze
  - Influences on fee estimate
- Get a head start with the analysis and Databook
- Have a rough estimate of the valuation of the target
- However, we need to consider it is not an independent document, and therefore has a strong seller's bias

Exercise: Scoping the work to analyze a target

- Objective: Practice scoping the work to analyze a target
- Prep time: 30 minutes
- Directions:
  - Use PM 5.1 Scope of Work and the PM 5.2 Big Fizz Information Memorandum and create
    - A document request list asking for any additional data/information that would be needed to perform the analysis.
    - Consider about what sub-service lines need to be involved when analyzing the target and in what areas.
  - Upload your information request list on EYDelivers
  - Be prepared to present your findings

Lesson summary

- Discussed the meaning of growth and how companies can grow
- Discussed a company's motivation for growth and the associated risk factors
- Demonstrated how to identify potential growth areas for a client scenario
- Determined how current industry and economic trends affect a client scenario
- Discussed why we read an information memorandum and what types of data are included in an information memorandum
- Identified the TAS sub-service lines that should be involved when analyzing a target company and the additional data needed to analyze the target

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Lesson 6: Business valuation

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What do you consider when purchasing a car?

- Audi R8
- Top speed: 301 km/hr or 187 mph
  - 4.4 seconds
- Engine: V8
- Power: 420 PS (309 kW/414 bhp) at 7,800 rpm)
- Purchased in March 2007

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How would you advise Julia?

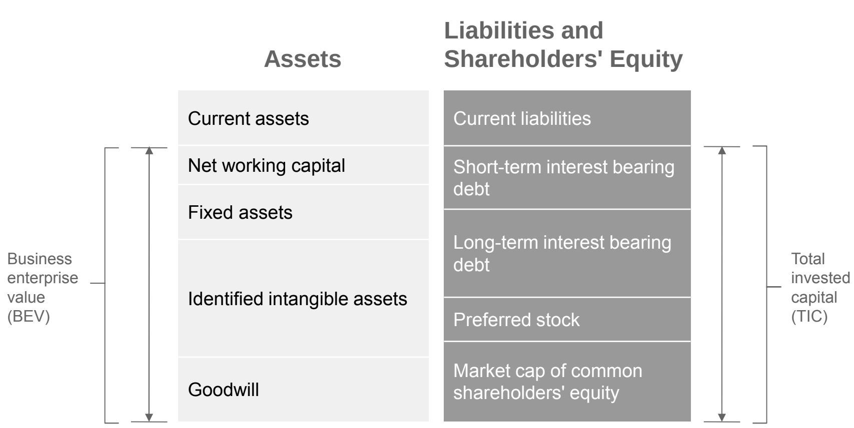
- Current market value of 80,000MU
- The current balance of the loan is 20,000MU
- 100 worth of coins in the car
- The fuel tank is half full, need an additional 10 units to fill the tank at 2MU per unit
- Current market value of golf equipment in the car is 1,200MU
- Cost of missed service is 1,000MU

Solution

Car example		Real transaction	
Market value	80,000	Enterprise value	XXX
Loan value	(20,000)	Debt	XXX
Cash left in car	100	Cash	XXX
Golf equipment	1,200	Non-operating asset	XXX
Deferred service	(1,000)	Deferred capex	XXX
Fuel	(20)	Working capital	XXX
Amount to be paid to Justin	60,280	Equity value	XXX

Business valuation

Enterprise and equity value



How our work impacts the purchase price consideration formula

Enterprise value	► Are reported earnings acceptable to use in arriving at enterprise value (quality of earnings analysis)? ► Any non-recurring items? ► Any out-of-period items? ► Any under-accruals? ► Is there evidence to support forecast earnings growth and planned cost savings? ► What are the risks to forecast EBITDA?
Cash/debt	► Which balance sheet and off-balance sheet items should be included in definition of cash or debt?
Working capital	► What are the trailing 12 months (TTM) average and minimum levels of normalized working capital?
Capex	► What is the amount of any deferred/postponed capex?
Non-operating assets and liabilities	► Appropriately classified? ► Are any overstated/understated? ► Any unrecorded significant commitments or contingencies?

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Enterprise value: Alternative valuation methods

There are three different major valuation approaches.

Market approach	Income approach	Cost approach
Quoted share price (if quoted)	Discounted cash flow (DCF) method	Adjusted net asset method
Similar/direct transaction approach “comparable transactions”	Option methods	Reproduction or Replacement cost method
Guideline company approach (i.e., earnings multiples) “comparable companies”		

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Example of approaches

Market approach

e.g., EBITDA x market multiple

EBITDA	X
x market multiple	X

Income approach

e.g., projected cash flows, discounted at a market rate

After tax operating income	X	X	X
+/-Changes in working capital	(X)	(X)	(X)
+ Depreciation	(X)	(X)	(X)
- Capital expenditure	(X)	(X)	(X)
+/- other non cash items	(X)	(X)	(X)
Debt Free cash flows	X	X	X
discounted at market rate	X%		

Cost approach

e.g., replacement cost to build a replacement asset

Market prices	X

Enterprise value	X
Less target net debt acquired	(X)
Equity value	X

Alternative approaches

Market approach

e.g., EBITDA x market multiple

EBITDA	X
x market multiple	X

Income approach

e.g., projected cash flows, discounted at a market rate

EBITDA	X	X	X
Movement in working capital	(X)	(X)	(X)
Other movements/one-offs	(X)	(X)	(X)
Capital expenditure	(X)	(X)	(X)
Tax on operations	(X)	(X)	(X)
Pre-financing cash flows	X	X	X
discounted at market rate	X%		

Cost approach

e.g., replacement cost to build a replacement asset

Market prices	X

Enterprise value	X
Less target net debt acquired	(X)
Equity value	X

Target information

Market information

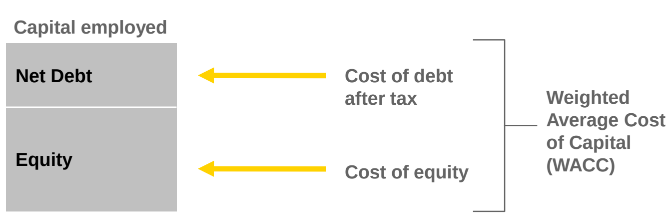
Valuation methods (cont.): Free cash flows

The DCF approach (enterprise value), free cash flows are defined as follows for both the explicit forecast period and terminal value:

Free cash flow enterprise approach	
+	EBIT
-	Tax (based on EBIT)
=	Net operating profit after tax
+	Depreciation and amortization
-	Capex
+/-	Change in net working capital
=	Debt free cash flow (enterprise)

Valuation methods (cont'd): Weighted average cost of capital (WACC)

- The appropriate rate of return to use to discount future free cash flows is the WACC
- Both of these elements (debt and equity) typically are obtained from analyses of comparable companies in the industry
- The WACC measures a company's cost of capital based on:
  - Its after-tax cost of equity and debt
  - The respective proportion of equity and debt in its financial structure



DCF advantages

- Focuses on cash flows, thereby avoiding accounting distortions
- Includes investments in fixed assets and working capital
- Incorporates a long-term horizon which discourages managing for short-term results
- Reflects risk, the time value of money and capital structure
- Compares the relative attractiveness of dissimilar companies
- Measures the effect of management decisions on value in the same manner as investors do

DCF disadvantages

- Robust cash flow projections are needed
- Cash flow projections have to be sufficiently far into the future
  (at least three to five years)
- A normalized perpetual cash flow has to be derived considering past, present and projected cash flows
- A substantial percentage of value is dependent upon the last year of explicit cash flow forecast and view on long-term growth

Exercise: Business valuation

- Objective: Determine the value of a target on a stand-alone basis
- Prep time: 60 minutes
- Directions:
  - Use PM 6.1: Business valuation, page 14 of PM 5.2, EF_Statement of Operations in TAS Fundamentals EY*Delivers* site to estimate the enterprise value of the target on a stand-alone basis
  - Use EF_DCF template in EYD
  - Build a sensitivity table with discount rate and long-term growth as variables and calculate the first projected period implied revenue and EBITDA multiples based on the value derived by the DCF

Lesson summary

- Given a scenario, determined the market price and the assumptions used
- Given a scenario, determined the valuation approach that is most appropriate for a client situation
- Discussed the advantages and disadvantages of the discount cash flow (DCF) valuation method
- Determined the value of a target company on a stand-alone basis

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Lesson 7: Analyzing a target company

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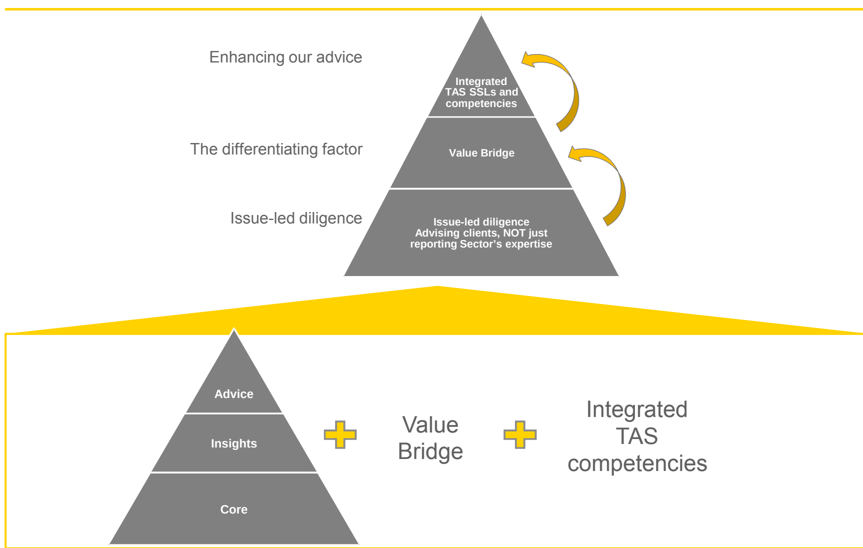
Building a better working world

Transaction Diligence



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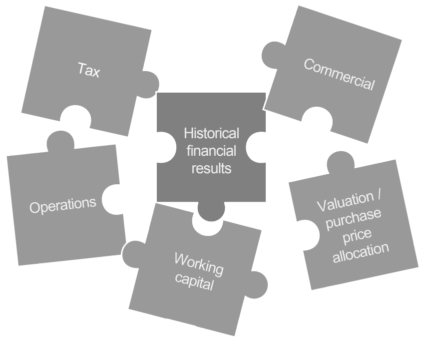
Transaction Diligence approach

Traditional diligence – Often focuses on historical financial results and functional areas



May not, on its own, support your valuation and help you avoid negative surprises

Transaction Diligence – Issues-based, around value drivers

Pinpoints key transaction drivers to help you gain rapid insight, realize value and avoid surprises

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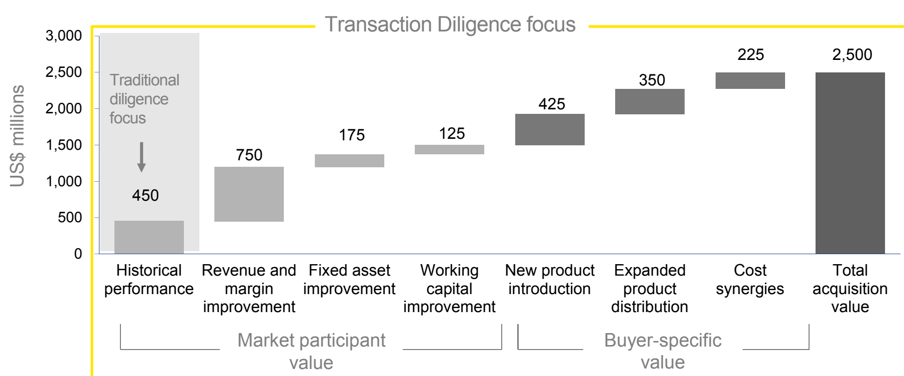
The differentiating factor: The Value Bridge

Sample value bridge analysis – summary of transaction value drivers customizable by client valuation assumptions



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Simplified purchase price formula

EBITDA, reported

+/- Adjustments

= EBITDA, (pro-forma) adjusted

X Multiple

= Enterprise Value

-/+ Net debt or cash

+/- Working Capital adjustment

- Capex adjustment

+ Non-operating assets

= Purchase price

Focus of financial diligence
Quality of earnings

Focus of financial due diligence

- Analyzing quality of earnings/cash flow
  - Historical and projected earnings
  - Run-rate matters affecting the model
  - Capital expenditures (deferred maintenance capital, growth capital expenditures)
- Understanding of key business drivers
  - Historical trends, drivers, and relationships to help develop and validate model assumptions
  - Very company/deal specific
- Net working capital
  - Purchase price adjustment mechanism
  - Operating cash flow trends (seasonality and growth) for financing
- Debt-like items
  - Non-operating or one-time cash commitments and contingencies
  - Earn-outs, restructuring liabilities, outstanding litigation or claims
  - Negotiate as debt or debt-like items in purchase and sale agreement
  - Impact to purchase price and financial model

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What is adjusted EBITDA?

- Adjusted EBITDA is an amount having:
  - The benefit of hindsight
  - The ability to normalize various non-recurring or non-operating transactions/activities
  - The ability to present a view on judgmental matters that may differ from management and company auditors
- Basis of purchase price negotiation
  - Adjusted EBITDA highlights those areas that may need to be considered/adjusted for financial modeling/forecast purposes
- Basis for negotiating financing terms and amount of leverage
  - EBITDA is a proxy for cash flow available to service debt principle and interest payments

Note: Adjusted EBITDA quantified in diligence may differ from the SEC's definition of "Pro Forma" treatment under SEC regulation S-X

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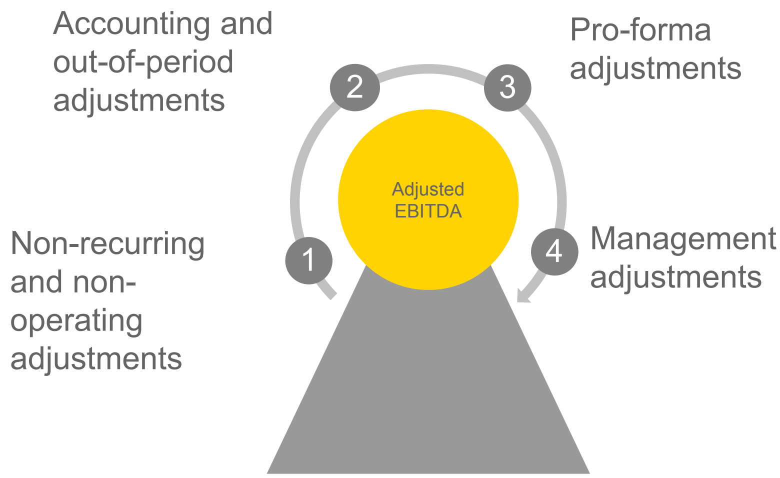
Typical EBITDA adjustment categories



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Non-recurring transactions

Non-recurring transactions may include:

- Professional fees and other
- Restructuring charges
- Legal settlements
- Transaction-related costs
- System implementation costs
- Loss of a significant customer
- Significant change in terms of a supplier contracts

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Accounting and out-of-period

Accounting and out-of-period adjustments may include the following:

- Timing of revenue recognition
- Bad debt expense/recoveries
- Warranty expense
- Bonus expense
- Returns and allowances
- Improper cut-off
- Year-end and interim "true-up" adjustments
- Waived and posted audit adjustments

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Pro forma adjustments

Pro-forma adjustments to give the effect of historical or expected future transactions may include the following:

- Acquisitions or divestitures occurring during the period under examination (pro forma annualized results pre-acquisition)
- Stand-alone costs and TSA arrangements (when target is being "carved out" from a larger corporation)
- Prospective changes,
- Migrating accounting policies to be consistent with buyer if a portfolio add-on (e.g., conforming to US GAAP)
- Synergies (or dis-synergies) resulting from the proposed transaction

Note: The adjustments presented in calculating pro forma EBITDA for due diligence purposes likely will not qualify for pro-forma treatment under SEC Regulation S-X

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Management adjustments

- Adjustment made by management for reporting or transaction purposes
- Common management adjustments include:
  - Private company expenses and personal expenses of owner
  - Eliminating what management considers to be “one-time” expenses (severance, write-off of customer receivable, etc.)
- Considerations:
  - Presented in IM, often the first view of EBITDA anyone sees and taken as fact when in reality this number typically changes
  - They present the management’s view, not necessarily impartial
  - Often adjustments are one-sided and focused solely on eliminating costs with little or no consideration for replacement cost/run-rate
  - Adjustments often ignore go-forward implications of eliminating costs

Exercise: Adjusted EBITDA analysis

- Objective: Explain adjustments to earnings, which is generally used in computation of enterprise value for purchase price computation
- Time: 40 minutes
- Directions:
  - Use the following documents:
    - EF_Project Bigfizz Databook (located in EYDelivers)
    - PM 7.1: EBITDA scenario adjustments
  - Formulate your thoughts on each of the scenarios in PM 7.1 and use the EBITDA template in your Databook to create an adjusted EBITDA table for Bigfizz.

Focus of financial diligence
Net working capital

EY

Overview of net working capital (NWC)

- What is NWC?
  - Generally, it is current assets, less current liabilities, excluding cash, indebtedness and income taxes
- Why Is NWC important?
  - Valuation importance
  - NWC shortfalls post-transaction could require a buyer to provide additional cash to fund operations.
  - Modeling importance
  - Financing importance
- NWC and the SPA
  - Adjustment between a predetermined target NWC and closing NWC
  - Makes Buyer whole, for any shortfall in delivered NWC vs. “normal” level of NWC (contemplated in EV of Target)

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What do we mean by net working capital?

Typically included

- Trade receivable
- Inventory
- Prepaid insurance
- Trade accounts payable
- Accrued wages
- Accrued vacation
- Accrued medical insurance

Typically excluded

- Cash
- Interest receivable
- Shareholder receivable
- LIFO reserve
- Fixed assets
- Deposits (asset)
- Goodwill
- Investment in subsidiary
- Deferred income taxes (asset or liability)
- Short-term investments
- Past-due accounts payable
- Accrued interest
- Line of credit
- Current portion of LTD
- Long-term debt
- Interco Accts (in carve out transactions)
- Restructuring reserves

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Key considerations when analyzing net working capital

- Seasonality
- Acquired businesses ("Add-ons")
- Extended A/R terms
- Growth versus mature businesses
- Past practices of managing working capital vs. current or go-forward practices (e.g., stretching payables and accelerating collection of receivables, adjusting reserves, etc.)
- Interim versus year-end accounting (true-up of bonuses, reserves, etc.)
- Existence of non-operating (e.g., restructuring reserves) or intercompany/affiliate assets and liabilities
- Inter-period (month) NWC swings
  - Cash receipts cycles
  - Cash disbursement cycles
- Definition of net working capital

Never accept a Target/Peg without understanding its elements and the basis for the peg

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Exercise: Working capital analysis

- Objective: Analyze the working capital of Bigfizz
- Time: 20 minutes
- Directions:
  - Use EF_Project Bigfizz Databook (located in EYDelivers) and look at the following tabs to analyze BigFizz's WC:
    - Working capital analysis
    - Monthly balance sheets,
    - Monthly net sales and CoGS
    - Income tax balances
  - In teams, analyze annual or monthly WC as assigned by the facilitator and be prepared to discuss your thoughts, the answers to the questions on the next slide and additional questions you may have to Management

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Exercise: Working capital analysis (cont'd)

Annual WC:

- What is the most appropriate WC to be used as a reference in a purchase price adjustment (trade, net or adjusted)? Why?
- Should tax balances and balances regarding the dispute with the supplier be excluded from the WC?
- Are there other short-term balances that are not included? Why?
- Do you think prepayments and accrued income should be included in the WC?

Monthly WC:

- What do you think is the most appropriate WC to be used as a reference in a purchase price adjustment (max, min, average or forecast)?
- Is the business seasonal? If so, what are the implications on WC?
- If we consider a level of WC as the appropriate, what would it mean in terms of cash (release or drain) to be below that level? Why?

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Focus of financial diligence
Net debt and debt-like items

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Net debt concepts
Due diligence issues

- Sale and Purchase agreements typically include a definition of indebtedness
- Certain liabilities (debt like items) may be preferred to be treated as debt
- Working capital considerations
- Deferred revenue/customer deposits

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Some debt-like item examples

- Unpaid bonuses
- Stretched payables
- Vacation payable over one year
- Capital leases
- Earn-out liabilities and other deferred consideration
- Liabilities related to discontinued operations (e.g., severance or unpaid royalties related to discontinued products)
- Litigation reserves
- Deferred revenue, to the extent not captured within the working capital or separate mechanism
- Income tax liabilities
- Certain off balance sheet liabilities
- Deferred capex
- Large and unusual self insurance liabilities
- Pension liabilities (other than 401k)
- Bank overdraft in accounts payable, to the extent not included in working capital
- Gift card liabilities in excess of one year of operations
- Employee, shareholders' loans payable
- Deferred tax liabilities
- Hedging obligations

Debt-like items due diligence considerations

- Liabilities not defined as part of working capital should be treated as debt-like items
- Debt definition should be looked at concurrently with definition of working capital
- **There is no right or wrong answer – only a negotiated outcome**

Exercise: Net debt analysis

- Objective: To identify and calculate net debt of a target to support the client in their purchase price considerations
- Time: 25 minutes
- Directions:
  - In teams, discuss the potential debt, debt-like and off-balance sheet items for the client to consider when developing the purchase price
  - Individually complete the net debt analysis for Big Fizz, including items for client consideration for the adjustment to enterprise value
  - Access the following schedules from the Big Fizz Databook in the TAS Fundamentals EY*Delivers* site:
    - Lead balance sheet
    - Actuary provisions
    - Trade creditors aging
    - Net debt template

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Purchase price formula

Review the purchase price consideration formula and the impact our work has had

Enterprise value	► Are reported earnings acceptable to use in arriving at enterprise value (quality of earnings analysis)? ► Any non-recurring items? ► Any out-of-period items? ► Any under-accruals? ► Is there evidence to support forecast earnings growth and planned cost savings? ► What are the risks to forecast EBITDA?
Cash/debt	► Which balance sheet and off-balance sheet items should be included in definition of cash or debt?
Working capital	► What are the trailing 12 months (TTM) average and minimum levels of normalized working capital?
Capex	► What is the amount of any deferred/postponed capex?
Non-operating assets and liabilities	► Appropriately classified? ► Are any overstated/understated? ► Any unrecorded significant commitments or contingencies?

Exercise: Purchase price adjustment

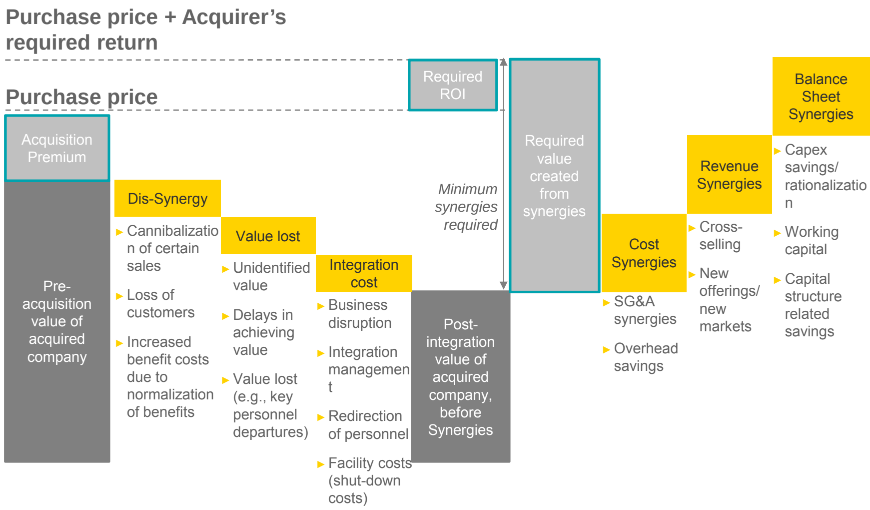
- Objective: Explain the impact of working capital adjustment on the purchase price adjustment
- Time: 10 minutes
- Directions:
  - Use PM 7.2 for specific directions

Analyzing the impact of synergies and dis-synergies

Considerations

- How certain/realizable are the synergies?
- What one-off/non-recurring/upfront payments are needed?
- Timing of synergies — how long will it take for the costs to be offset by the synergy savings?
- Does the buyer want to pay the target the full value of synergies if they bear the risk of realizing them?
- What about negative synergies?

Achieving transaction value



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Synergies: a holistic view

		Definition	Examples
Value creation	Revenue synergies	• Revenue enhancement due to new capabilities, markets and/or products of combined companies	• Cross selling of products • Market expansion
	Cost synergies	• Recurring cost savings impacting expense line items	• Consolidation of manufacturing facilities • Headcount reduction • Reduction in overlapping R&D
	Reduction in invested capital	• Reduction in capital spend due to leverage of combined assets, capabilities and external relationships	• CAPEX avoidance • Working capital improvements
Value reduction	Negative synergies	• Incremental recurring costs as a result of integration	• Product cannibalization • Customer loss • Employee churn
	One-time costs	• One-time costs required for business transition, or integration	• Rebranding costs • Employee severance
	Increased CAPEX	• Capital expenditure required for business transition, separation or integration	• Equipment relocation • Capitalized IT integration costs • Write offs of equipment

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Exercise: Synergy analysis

- Objective: Analyze synergies if GBI acquires Bigfizz and determine their impact in the acquisition
- Time: 20 minutes
- Directions:
  - In teams, use EF_Synergies analysis - facilitator to assign tables and answer the following questions:
    - Headcount
      - What are the risks when removing overlaps in joint management and other redundant non-production labor?
    - Production
      - Why do you think offshoring the production from GBI plants to Bigfizz plants in India is interesting?
    - Address the risks associated with attaining planned synergy's (either headcount or production)?
  - Be prepared to present your findings as a team.

Exercise: Impact to value with synergy analysis

- Objective: Analyze the identified synergies and their impact on the value if GBI acquires Bigfizz.
- Time: 20 minutes
- Directions:
  - Use the outcomes of EF_Synergies analysis to update your DCF model.
  - Prepare a Value bridge and present your findings as a team.

Accretion and dilution

EY

Concept

- Accretion/dilution analysis is often seen as a proxy for whether a contemplated deal creates or destroys value for a listed corporation
- The company is primarily concerned with “pro forma” earnings per share
- The level of accretion/dilution affects affordability to potential acquirers
- Think about earnings impact in terms of its components
  - Acquirer’s and target’s net income
  - Transaction adjustment (after tax effect)
  - Less financing costs for acquirer
  - Pro forma net income is then divided by pro forma number of shares

Lesson summary

- Performed financial due diligence analyses to determine EBITDA adjustments
- Determined the EBITDA adjustment for working capital
- Practiced identifying and calculating the net debt of a target business
- Practiced completing a purchase price adjustment for a target
- Practiced analyzing synergies between a client and target business
- Discussed the purpose of an accretion/dilution analysis

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Lesson 8: Analyzing a distressed company

EY
Building a better working world

Distressed investing

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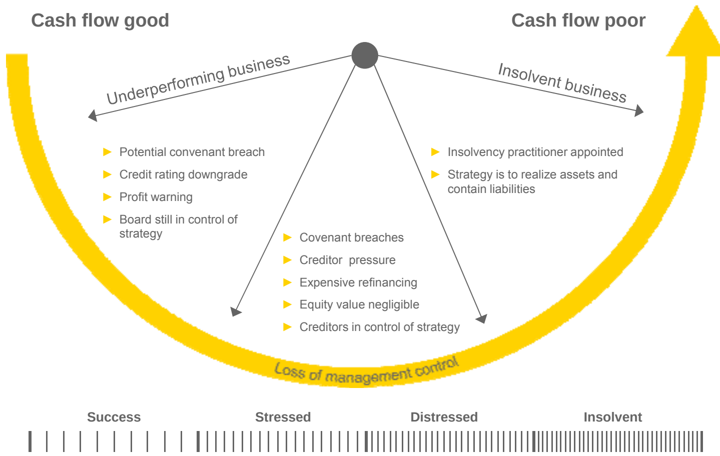
Who has control of a business?



Potential opportunities of buying distressed assets

- Deeply discounted assets
- Increase market share
- Expand geographical/product range
- Significant levels of embedded debt financing
- Defensive measure — prevents asset from falling into competitors' hands.
- Motivated "rescued" employees

Potential challenges of buying distressed assets

- Acquirer may overpay
- Integration issue can lead to costly delays or chronic underperformance
- Could falsely take on array of off-balance sheet liabilities
- Adjust valuation to reflect the nuance of distressed asset market condition
- Underestimation of cost and effort of turnaround can reduce return on investment

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The distressed investing equation

- Price
- Complexity
- Imperfect information
- Speed
- Leverage
- Operational fix
- Exit/integration

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Exercise: Identify the pros and cons of investing in a distressed company

- Objective: Prepare a summary for the account team outlining your perspective of the pros and cons of investing in a distressed company as well as any issues and questions that arise
- Time: 20 minutes
- Directions:
  - Working in groups, use PM 8.1: Indian Fizz teaser and discuss the pros and cons of investing in Indian Fizz.
  - Additionally, outline any additional information that is missing that you would need to complete the diligence.
  - Be prepared to present your findings to the class.

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Short-term cash flow analysis

EY

Short-term cash flow forecast analysis

- Why do this?
  - Crisis stabilization
- What is the short term?
  - Four weeks/13 weeks
- Can the business meet its liabilities?
  - Where does cash come from?

Short-term cash

- What is included?
  - Opening position
  - Receipts
  - Payments
  - Closing position
- What cash/funding is available?

STCF methodology

- Three key principles:
  - What you know ***has*** already happened
  - What you know ***will*** happen
  - What you ***think*** might happen
- Based on a rolling 13-week cash flow

The building blocks of a short-term forecast

- Unwind of opening balance sheet trade debtors and creditors
- Underlying regular payments, e.g., rent, payroll
- Receipts and payments arising from forecast sales and purchases
- One-off irregular payments, e.g., capex, loan repayments, redundancy costs
- Opening bank position per bank statements
- Headroom analysis — comparison to facilities

Short-term cash flow analysis: receipts

- Normal cash collections/terms/retentions
- Overdue and disputed debt collections
- Collection history
- Trading items vs. asset realizations
- Inventory sales

Payments

- Essential suppliers and legal actions
- Government creditors
- Wages and salaries
- Letters of credit
- Trade insurers
- Any deals to be done and creditor pressure

Exercise: 13-week cash flow forecast

- Objective: Analyze a company's short-term cash flow in order to advise its management of possible options
- Time: 30 minutes
  - Directions: Working in teams:
    - Access Indian Fizz Limited Profit and Loss for Quarter 1 of 20XY and Indian Fizz Limited Short-Term Cash Flow from TAS Fundamentals EY*Delivers* site
    - Reference PM 3.2: Indian Fizz Teaser
    - Identify:
      - Potential issues/areas of concern you want to raise with management
      - What explanations management may provide when you raise the issues
      - What analyses to perform and further information to gather when you go on-site
    - Be prepared to present your findings to the class

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Lesson summary

- Discussed the opportunities, challenges and factors to consider when buying a distressed asset
- Practiced analyzing a 13-week cash flow forecast analysis on a distressed target company in order to provide client recommendations

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Lesson 9: Storyboarding and communicating

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Building a better
working world

Hot review: what are the benefits?

Refocus analysis and prioritize approach

Identify the key issues from the analysis of information

Form views earlier

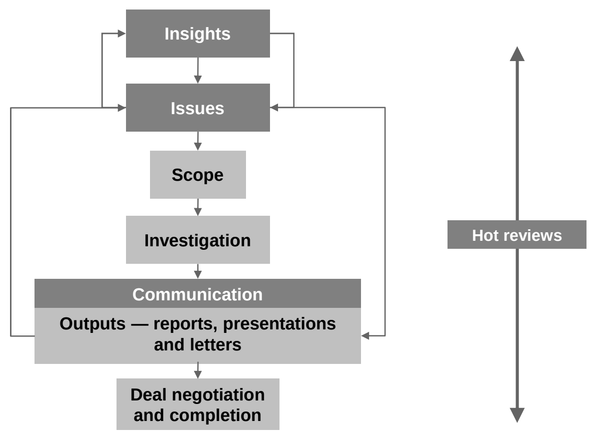
Encourage partner involvement at early stages

Get things right the first time

Promote team discussion

Manage our risk and raise the quality of what we do

Hot review: when does it happen?



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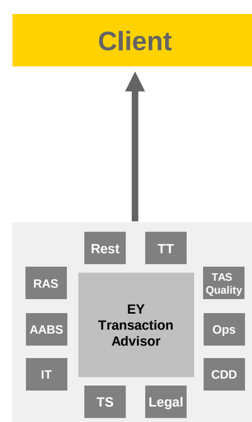
Communication with client and team

- Client:
  - Focus on what is important
  - Know client's key questions
  - No surprises
- Team:
  - Consistency of messages within written report
  - Prevents duplication
  - Integrated reporting



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Benefits of storyboarding

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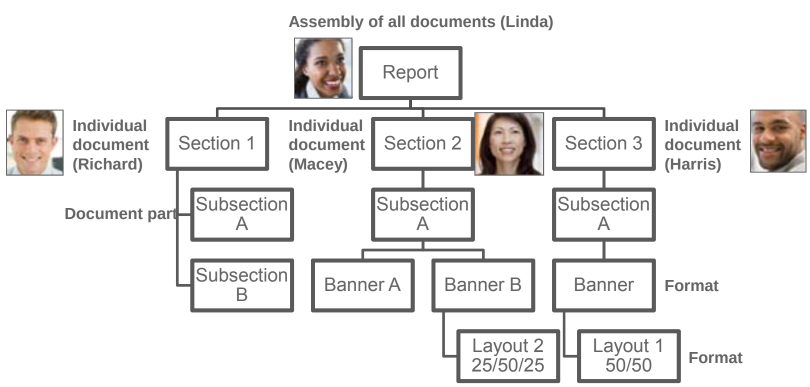
Storyboarding report components



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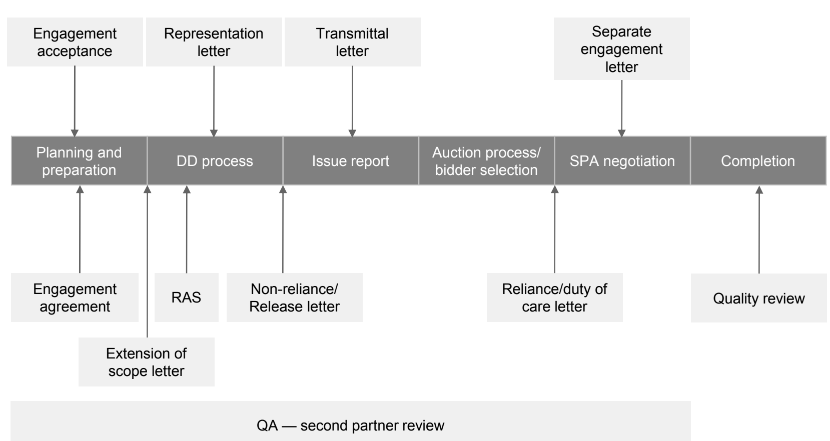
Exercise: Storyboarding and communicating

- Objective: Create a presentation for an internal storyboarding meeting
- Time: 60 minutes
- Directions:
  - Working in teams, create an internal presentation on your assigned topic.
    - GBI is a new account target. Use the Capital Agenda to identify issues, SSLs/competencies and services to convince EY office to pursue GBI as a client.
    - What are GBI's options to raise cash?
    - What are GBI's options to grow?
    - Provide tasks taken and key findings regarding the transaction diligence performed on Big Fizz.
    - Provide tasks taken and key findings regarding the process you would recommend to GBI regarding the carve out of Logistics.
    - Provide tasks taken and key findings regarding investing in a distressed company.
  - Use appropriate sections of the pdf Takeaway guide as well as the work you have already done during the course when creating your presentations.

Risk awareness: timeline of a typical engagement



Lesson summary

- Discussed hot reviews and the benefits of performing hot reviews
- Discussed storyboarding and the benefits of storyboarding
- Created a presentation for an internal storyboarding meeting
- Discussed risk management concerns when communicating our findings

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Lesson 10: Conclusion

EY
Building a better working world

Course objectives

- Discuss Vision 2020, TAS Big Bets, Exceptional Client Service and the Capital Agenda
- Compare operational improvement, financing and strategic options to raise or optimize capital, and the advantages or disadvantages of each
- Analyze information to support the client's decision on a course of action for asset rationalization
- Prepare for a DAS engagement
- Determine the financial and operational impact of a carve-out
- Discuss what growth means, motivations for growth, possible growth strategies and associated risk factors

Course objectives (contd)

- Analyze industry, macroeconomic and corporate information to validate growth strategies
- Given scenarios, determine the valuation price using the appropriate method
- Demonstrate how to perform financial due diligence analyses on a target business
- Perform a 13-week cash flow forecast analysis on a distressed target company in order to provide client recommendations
- Practice communicating findings

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Core expectations of our TAS professionals

- Build EY's brand
- Develop robust and enduring client and stakeholder relationships
- Develop personal brand
- Strive to be a trusted business advisor
- Build and deploy high performing teams
- Provide exceptional client service
- Deliver world class service and effective risk management
- Deliver profitable growth

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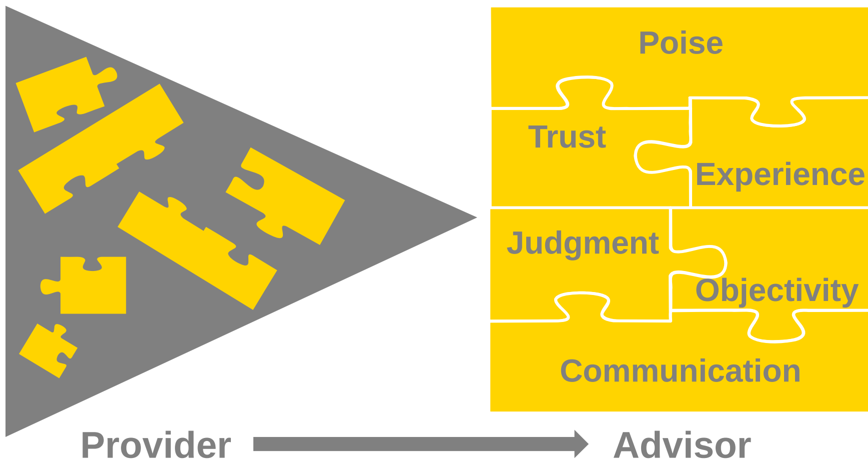
Characteristics of a Business Advisor



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Business advice

> **"Customers/buyers are most likely to reset buying criteria when confronted with surprising information about their business."**
> – Corporate Executive Board study

- Be relevant
  - Have something to say
  - Share market data, insights and experiences
  - Leverage firm resources
- Be aware of Firm and TAS thought leadership

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Questions?

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