

# From Concepts to Closing – Mergers & Acquisitions Essentials

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# Agenda for the event

1. Rationale for M&A
2. Introduction to M&A Lifecycle
3. Selected case studies from Deloitte
4. Introduction to financial due diligence
5. Fair value considerations
6. Tax Due Diligence: Overview & key technical aspects
7. Legal perspective including understanding Sales and Purchase agreements

# Rationale for M&A



# What drives M&A Decision?

## Global snapshot of M&A Activity



- Global M&A value increased Y-o-Y by 13% to US\$2,081B but deal volume declined by 22% to 34,018 transactions.
- China’s economic growth is slowing down impacting its ability to sustain high levels of M&A activity. Buyers are focusing on India and Japan driven by the favorable business environment and regulatory reforms.

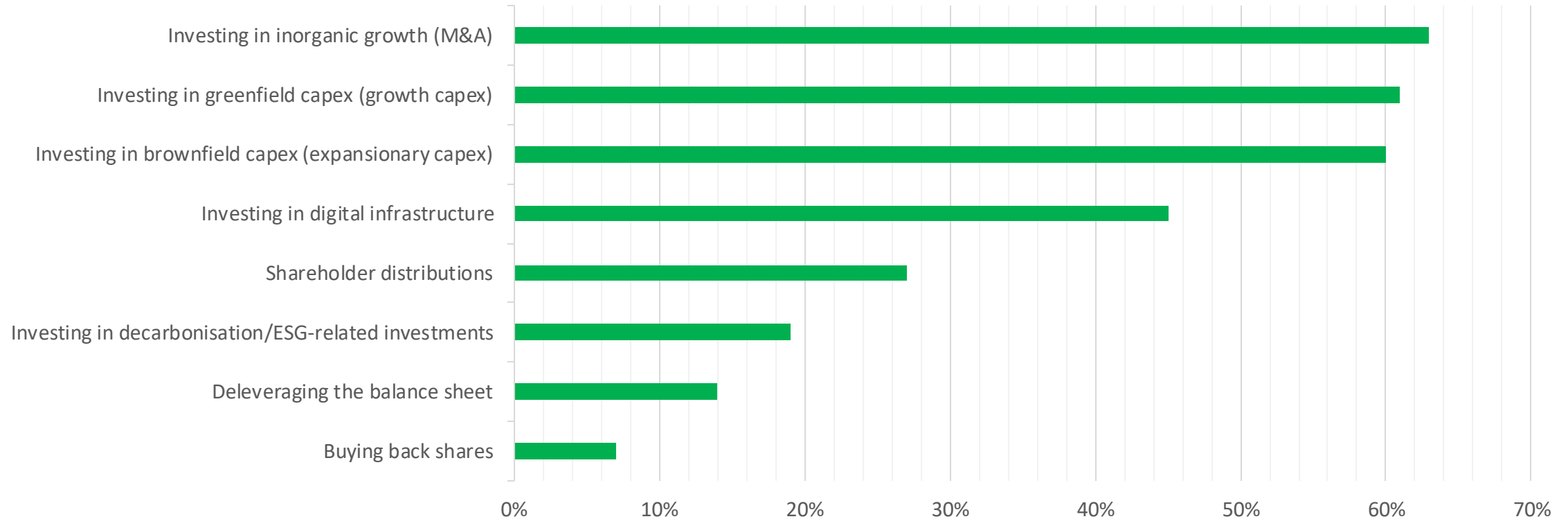
Source: Deloitte analysis based on data from Refinitiv

# What drives M&A Decision?

Top capital allocation priorities to drive shareholder value growth in the next 12 months

Heads of M&A Survey by Deloitte Australia covering 130 firms

## Capital Allocation Priorities



## What drives M&A Decision?

“A primary goal of acquisitions is the purchase of new capabilities”.

View from the Australian Heads  
of M&A Survey

**66%**

See technology disruption as a  
medium to high risk  
influencing the drivers of  
M&A.

Consumer business

Expedite synergy capture

Fill Gaps in core portfolio

Maintain parity with competition

### Goals of acquisition

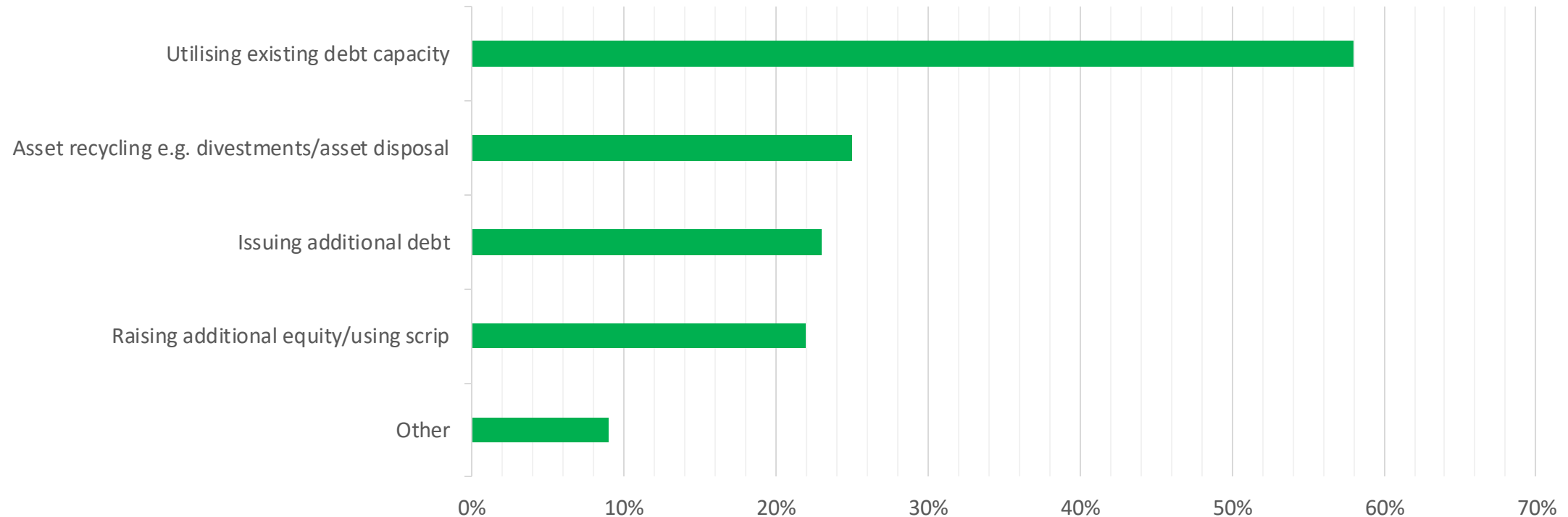
- ✓ Acquisition of new capabilities
- ✓ Growing the company and scaling effects
- ✓ Product/service portfolio diversification
- ✓ New markets/ customer groups
- ✓ Increased market share

## What drives M&A Decision?

Top capital allocation priorities to drive shareholder value growth in the next 12 months

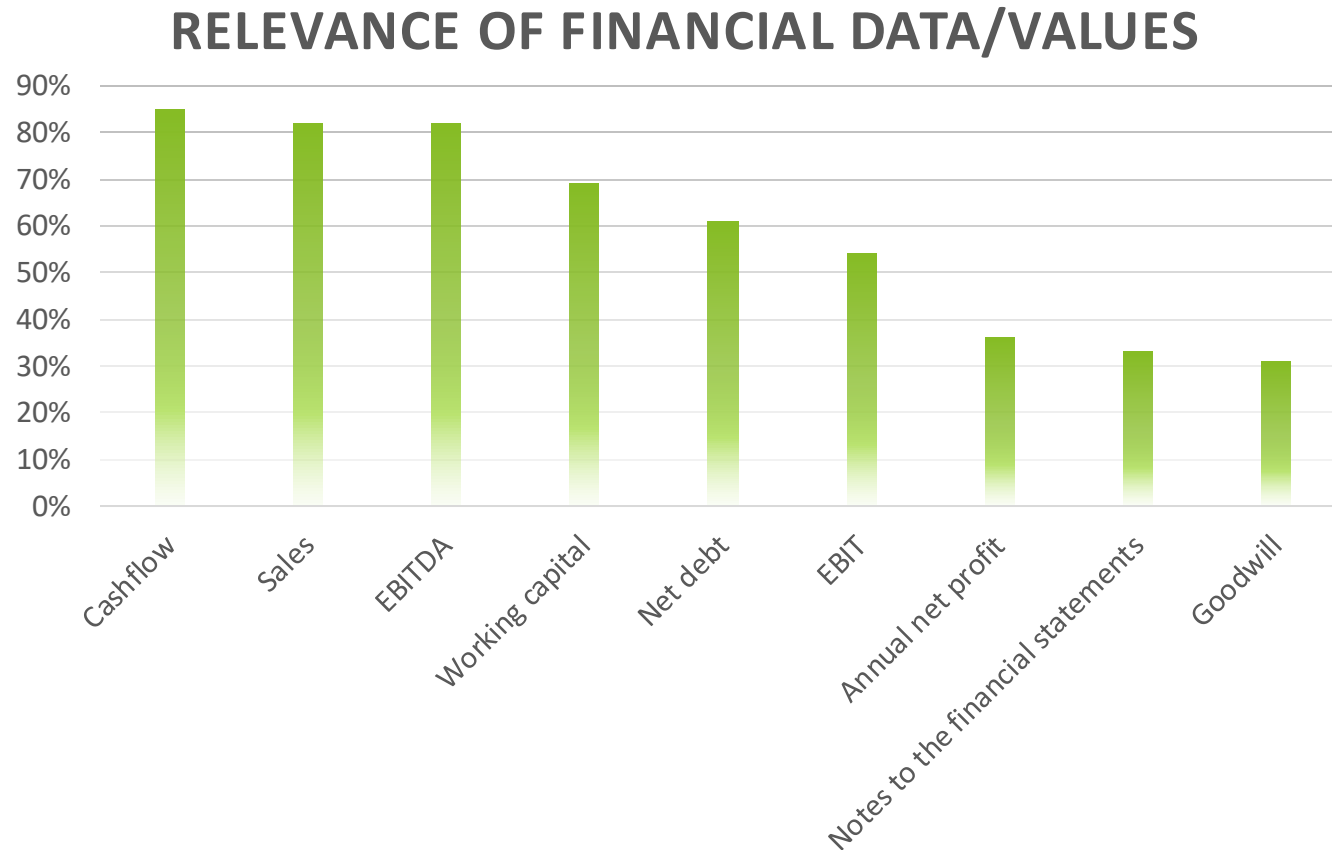
Heads of M&A Survey by Deloitte Australia covering 130 firms

How do you intend to fund your capital allocation priorities over the next 12 months?



## What drives M&A Decision?

M&A heads must raise their awareness of the importance of accounting standards since they influence parameters that determine purchase price.” Egon Sachsalber, Partner, M&A Transaction Services, Deloitte



### Key aspects of financial statement analysis

- Financial statements and management reports are key sources of data for an informed probe and analysis of potential targets.
- They provide initial clues to help determine whether a target is financially attractive and the price is reasonable.
- They provide a link to the business valuation conducted with future performance and multiples-based valuation.

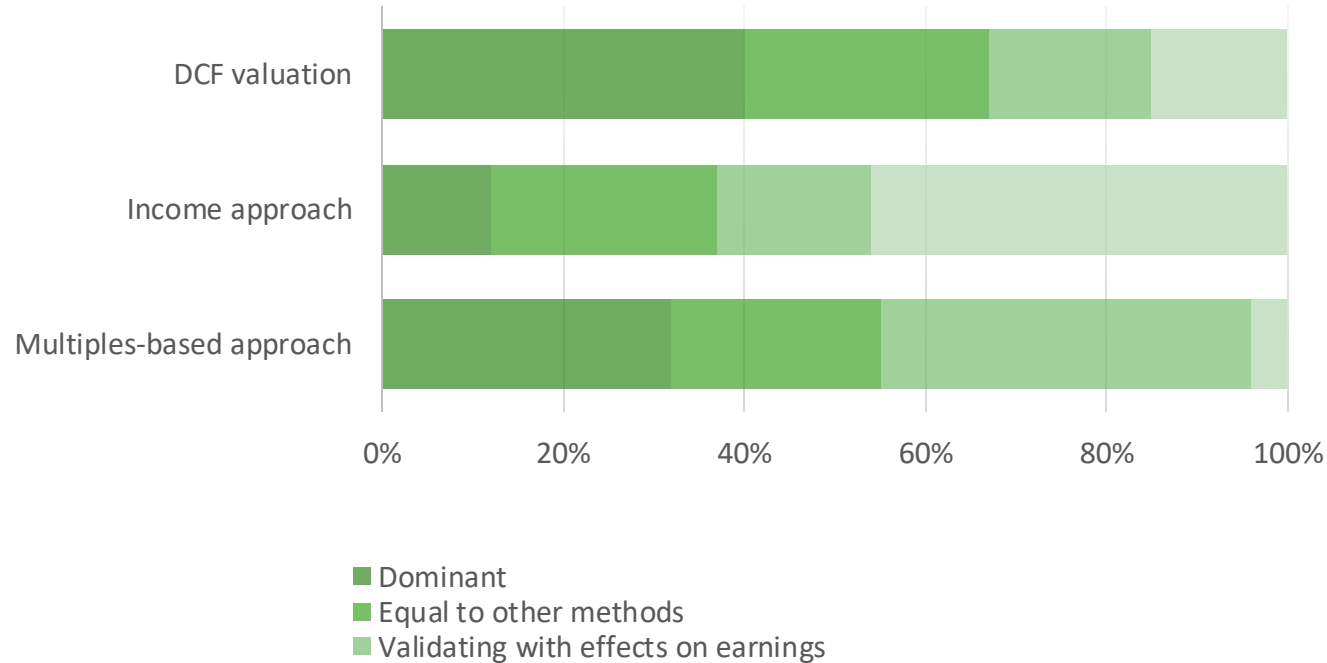
Survey conducted by Deloitte Germany in the second half of 2022.



# What drives M&A Decision?

## Preferred methods of business valuation

### RANKING OF THE VALUATION METHODS



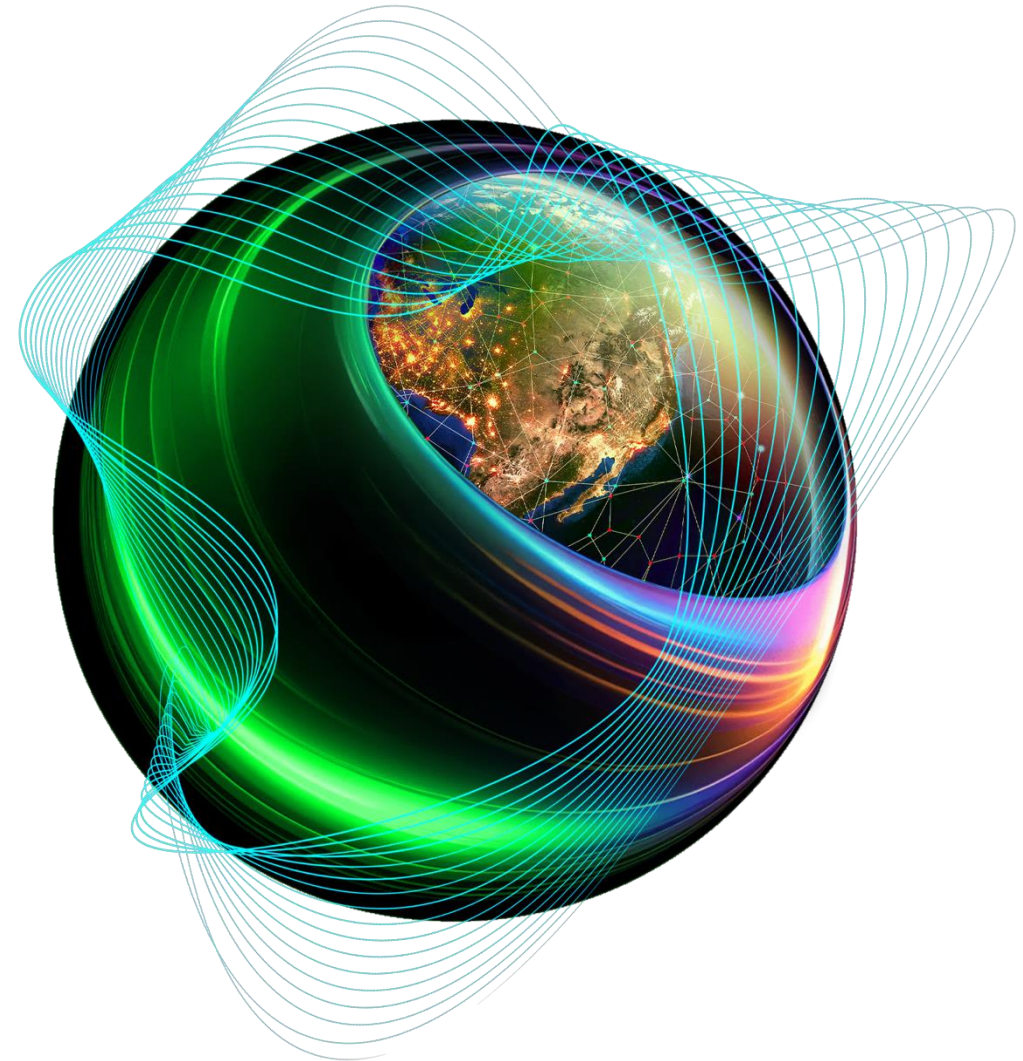
- The main purpose of business valuation in M&A transactions is to determine a price range to negotiate.
- DCF valuation plays a central role within business valuation.
- Most use two or more methods for business valuation.
- Most carry out a past-performance analysis of up to three years and extend it to a forecast period over five years.

Survey conducted by Deloitte Germany in the second half of 2022.

# What drives M&A Decision?

## Reasons for termination of a Transaction

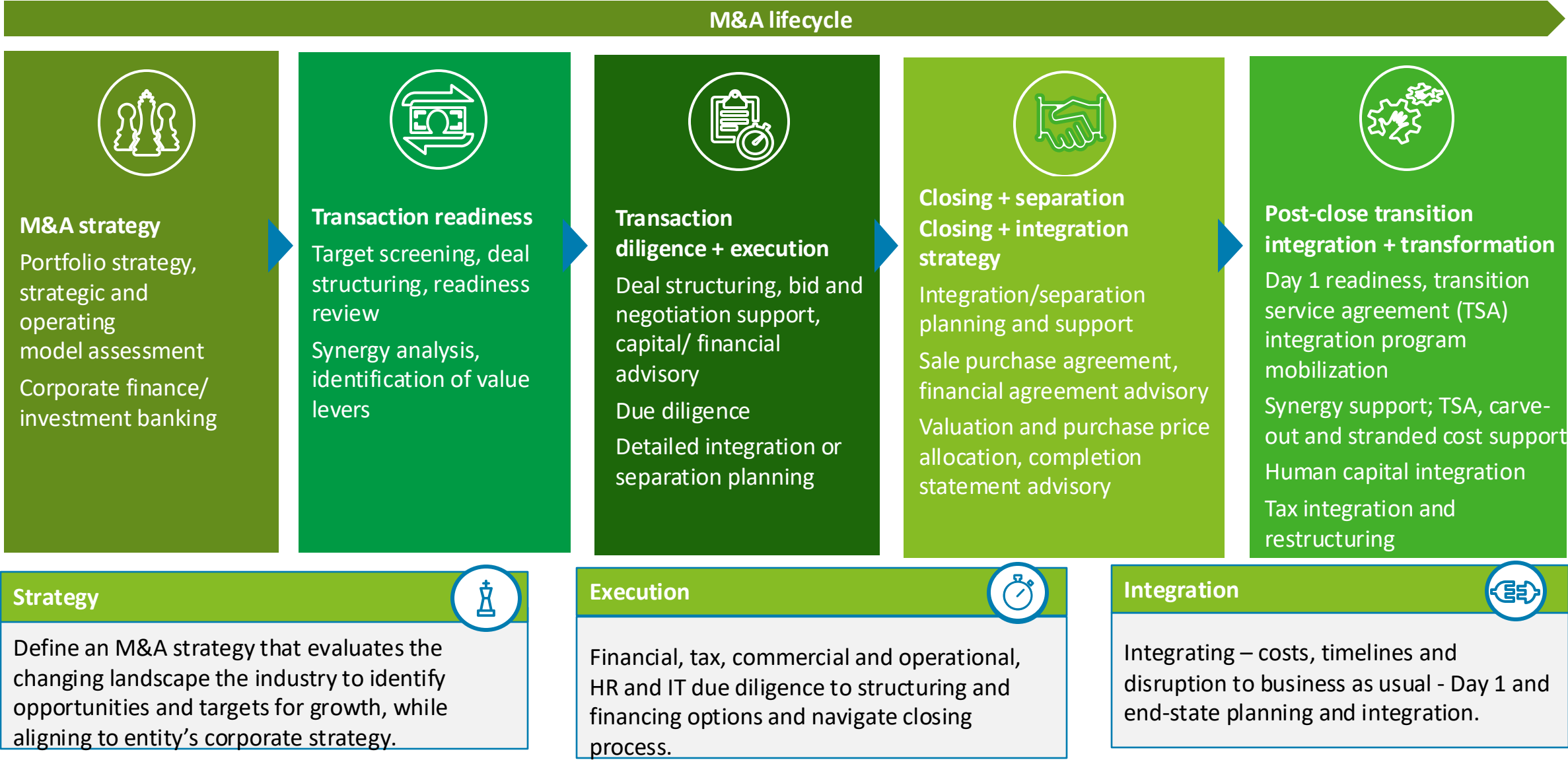
- Purchase price
- Results of due diligences
- No strategic fit
- Lack of synergies
- Quality of management



# Introduction to M&A lifecycle



# Introduction to M&A lifecycle



# Introduction to M&A lifecycle

5

- Day 1 stabilization of organization and functional capabilities
- Execution and management of integration plans
- Organization design and implementation
- Infrastructure rationalization
- Execution of synergy opportunities
- Management and tracking against synergy targets
- Customer retention, product and growth strategy
- Supply chain, manufacturing and R&D optimization
- Regulatory, tax planning and compliance matters
- 100-day plan (Private Equity buy-out)
- Change management and stakeholder communications

4

- Sale and purchase agreement (SPA)
- Fixed asset management
- Purchase price disputes
- Synergy and one-off cost alignment
- Purchase price allocation
- Organizational design and selection
- Completion statement/audit
- Transaction execution
- Mobilization of integration program
- Establishment of Day 1 requirements, playbooks and work plans
- Design and development of integration structure for finance, controls, risk management, tax systems, processes, people, sales and marketing
- Harmonization of accounting methods
- Definition of workforce transition, culture, communications and change management program
- Operational forecasting

1

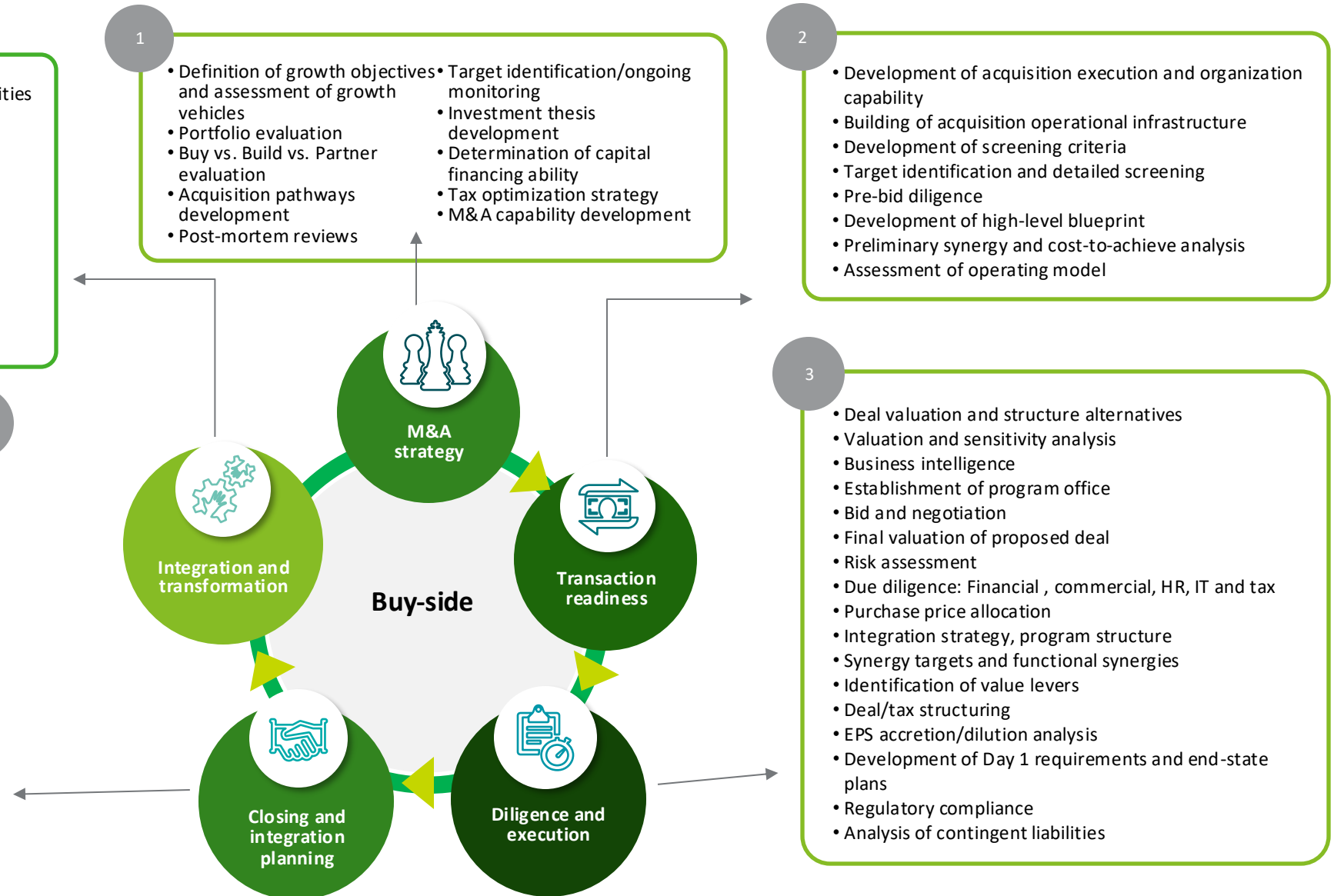
- Definition of growth objectives
- Target identification/ongoing monitoring
- Investment thesis development
- Portfolio evaluation
- Buy vs. Build vs. Partner evaluation
- Determination of capital financing ability
- Acquisition pathways development
- Tax optimization strategy
- Post-mortem reviews
- M&A capability development

2

- Development of acquisition execution and organization capability
- Building of acquisition operational infrastructure
- Development of screening criteria
- Target identification and detailed screening
- Pre-bid diligence
- Development of high-level blueprint
- Preliminary synergy and cost-to-achieve analysis
- Assessment of operating model

3

- Deal valuation and structure alternatives
- Valuation and sensitivity analysis
- Business intelligence
- Establishment of program office
- Bid and negotiation
- Final valuation of proposed deal
- Risk assessment
- Due diligence: Financial, commercial, HR, IT and tax
- Purchase price allocation
- Integration strategy, program structure
- Synergy targets and functional synergies
- Identification of value levers
- Deal/tax structuring
- EPS accretion/dilution analysis
- Development of Day 1 requirements and end-state plans
- Regulatory compliance
- Analysis of contingent liabilities





# Introduction to Financial Due Diligence



# Introduction to financial due diligence

## Types of investors



### Financial/PE clients

#### **Financial/ PE clients primarily look for:**

- Valuation, exit strategy, internal rate of return
- Quality of earnings (e.g. EBITDA)
- Forecast profitability and cash flow
- Quality of assets/liabilities
- Tax impacts
- *Reports are provided to investment committees and financing banks*



### Strategic clients

Objectives are similar to those of financial investors

#### **Plus, for example:**

- The quality of the business / operations
- The growth strategy (e.g. geographical expansion, new line of products, new distribution channel, technological development)
- Post-acquisition synergies
- Revenue, Net income, EPS
- Effective tax rates
- *Reports are generally provided to investment committees*

# Introduction to financial due diligence

## Difference between due diligence and audit

| Area        | Due Diligence  | Audit   |
|-------------|--|---|
| Who         | M&A advisors   | Independent auditor   |
| Objective   | <ul style="list-style-type: none"><li>- Quality of earning and assets assessment</li><li>- Historical working capital needs</li><li>- Assessment of debt and debt like items</li><li>- Sales and operating expense trends</li><li>- Assessment of assumptions used in management forecast</li><li>- Assessment on key policies and system</li><li>- Identification of deal breaker</li></ul> | Provide opinion on whether the financial statements have been according to Sri Lanka Accounting Standards |
| Deliverable | FDD report   | Audit opinion   |
| Users       | Buyers, Sellers and other investors  | Wide range of stakeholders including investors, Banks, suppliers and customers                            |



## Introduction to financial due diligence

Financial due diligence is conducted to tell the investors about the Target given the transaction context

### **The process by which information is gathered about:**

- a target company;
- its business; and
- its environment/markets whilst,
- considering the structure of the envisaged transaction.

### **It is not just:**

- Checking the facts
- Reformulating them
- Accounting

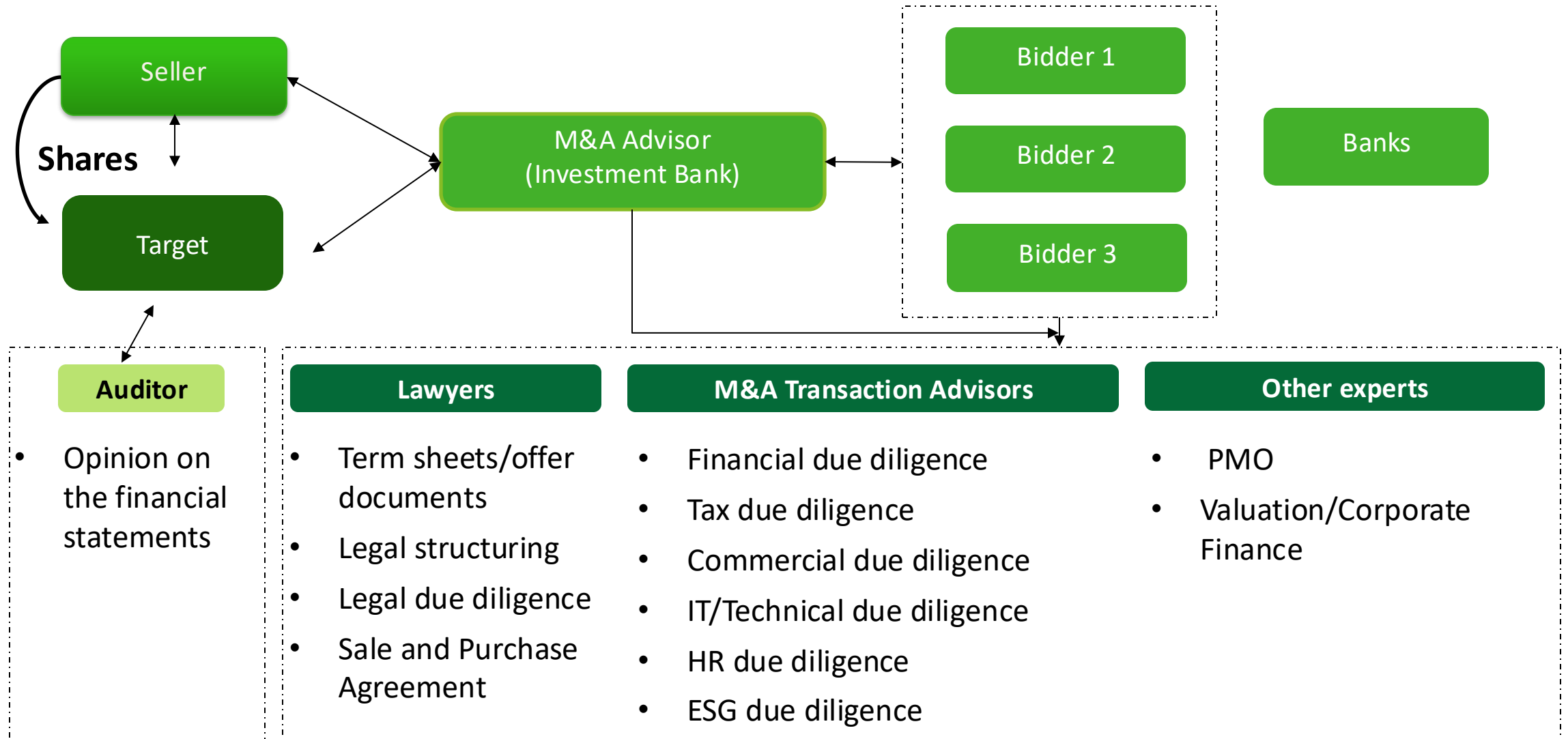
### **It is about**

- Analysis/evaluation
- Interpretation
- Communication

*“Financial due diligence is a process by which information is gathered about a company, its business and its environment to ensure that prospective investors (and sellers) make an informed investment decision.”*

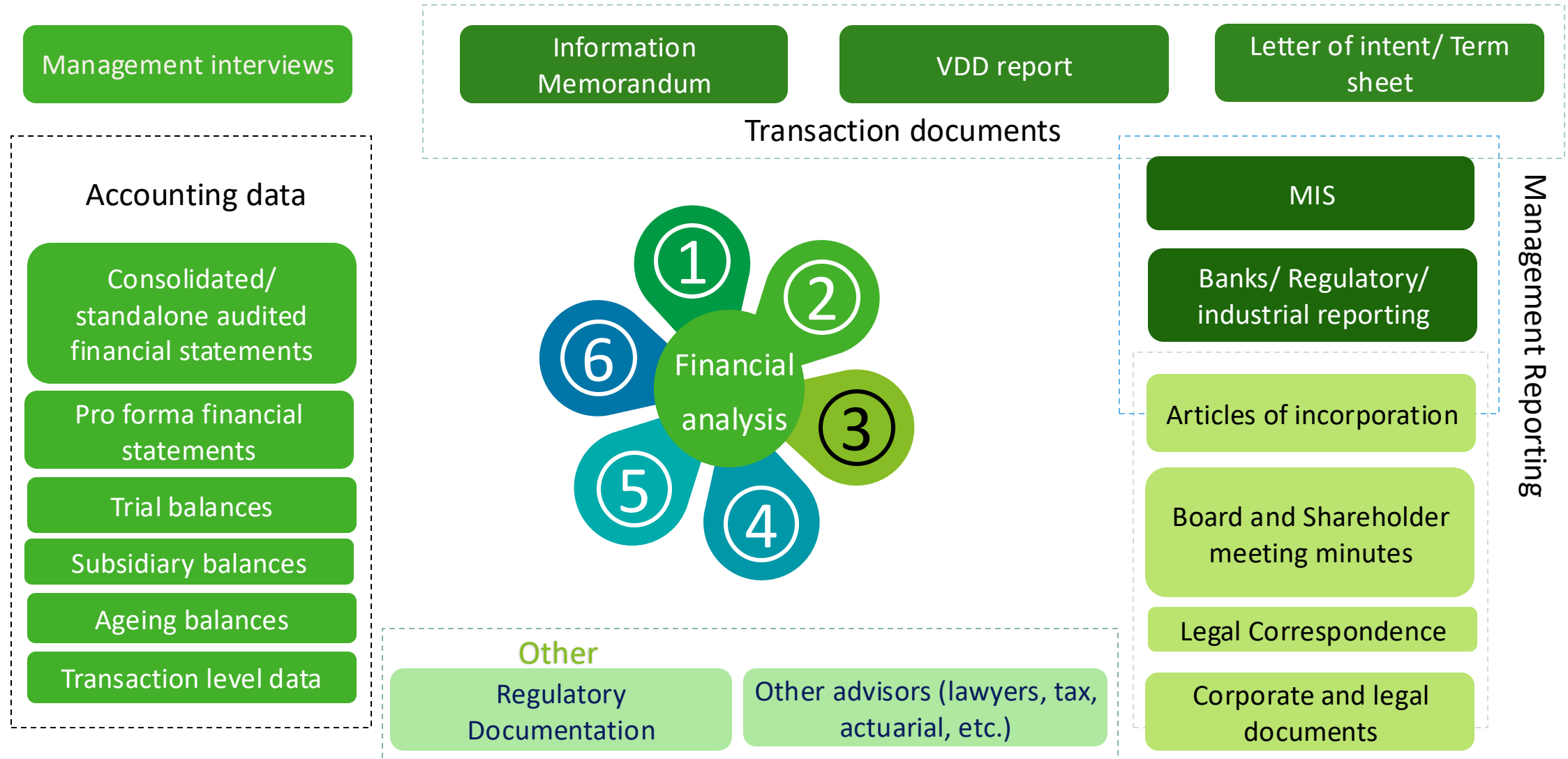
# Introduction to financial due diligence

## Parties to a transaction (typical acquisition / disposal)



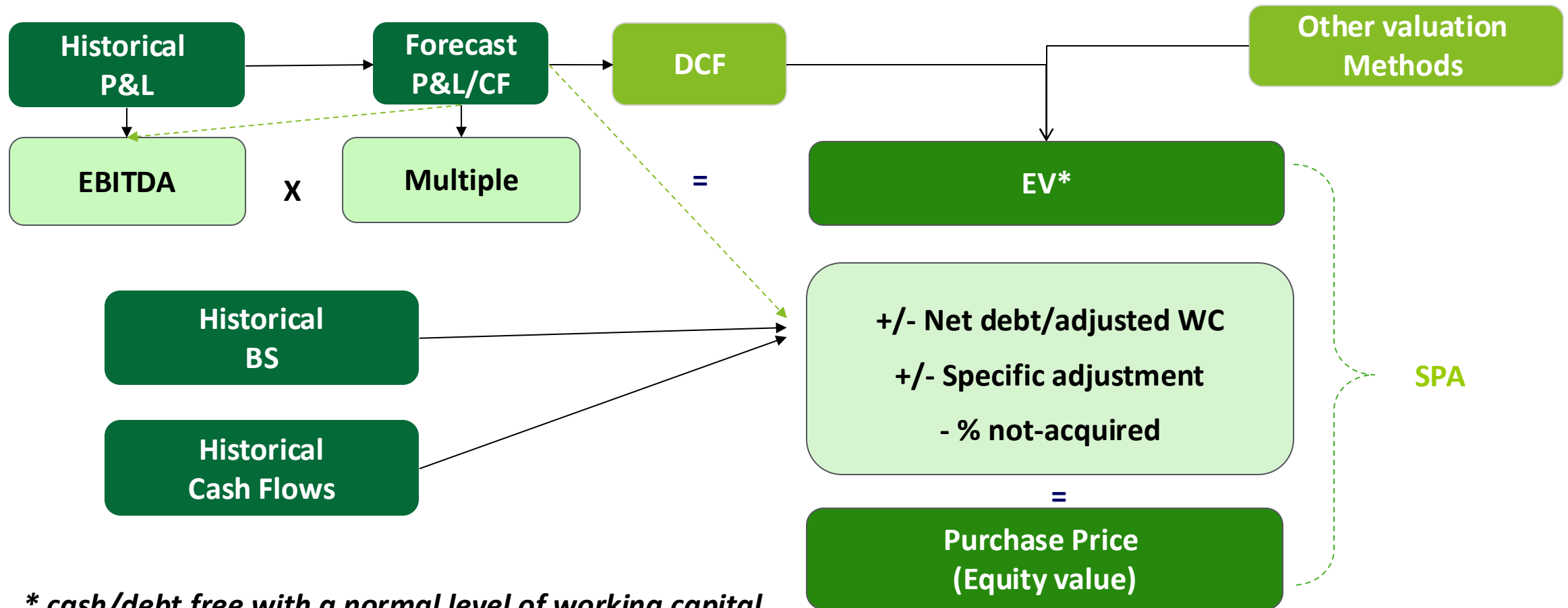
# Introduction to financial due diligence

## Sources of information



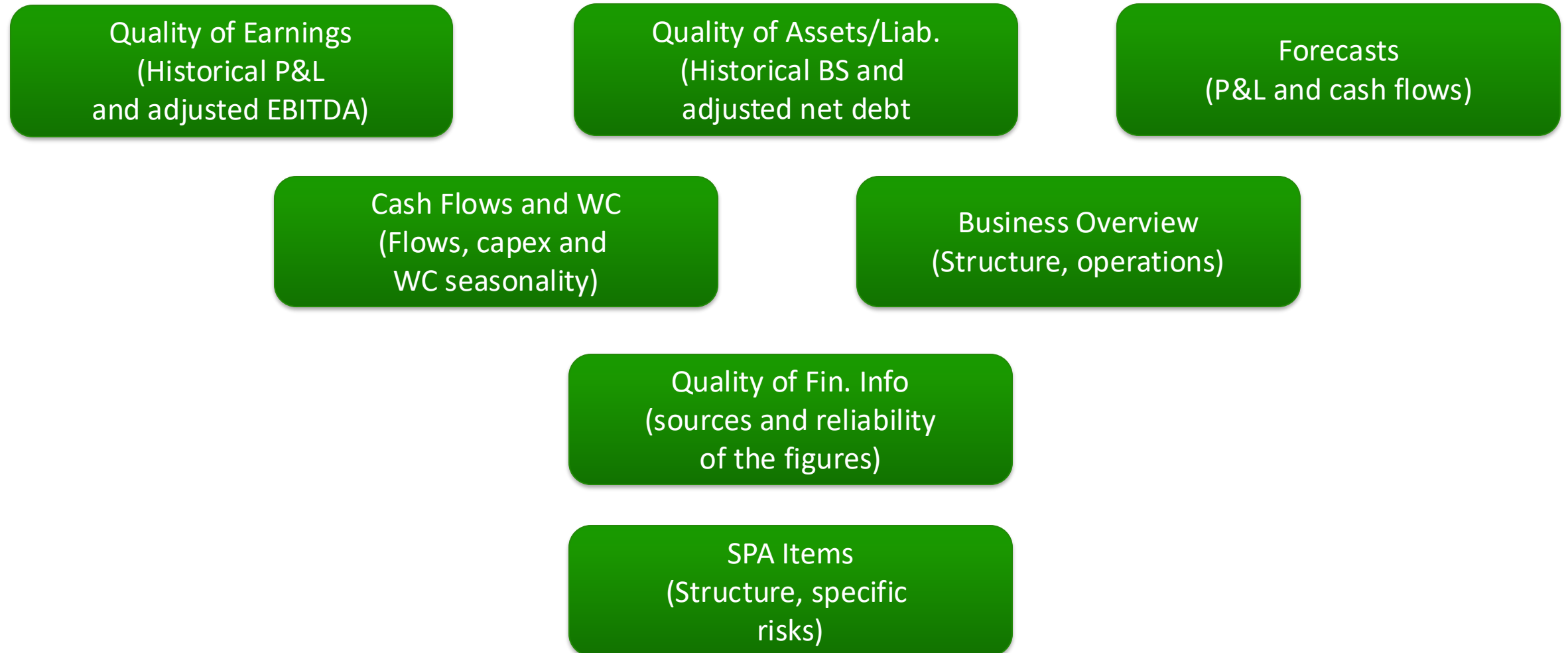
# Introduction to financial due diligence

## Principles of financial analysis – Enterprise Value (EV) Model



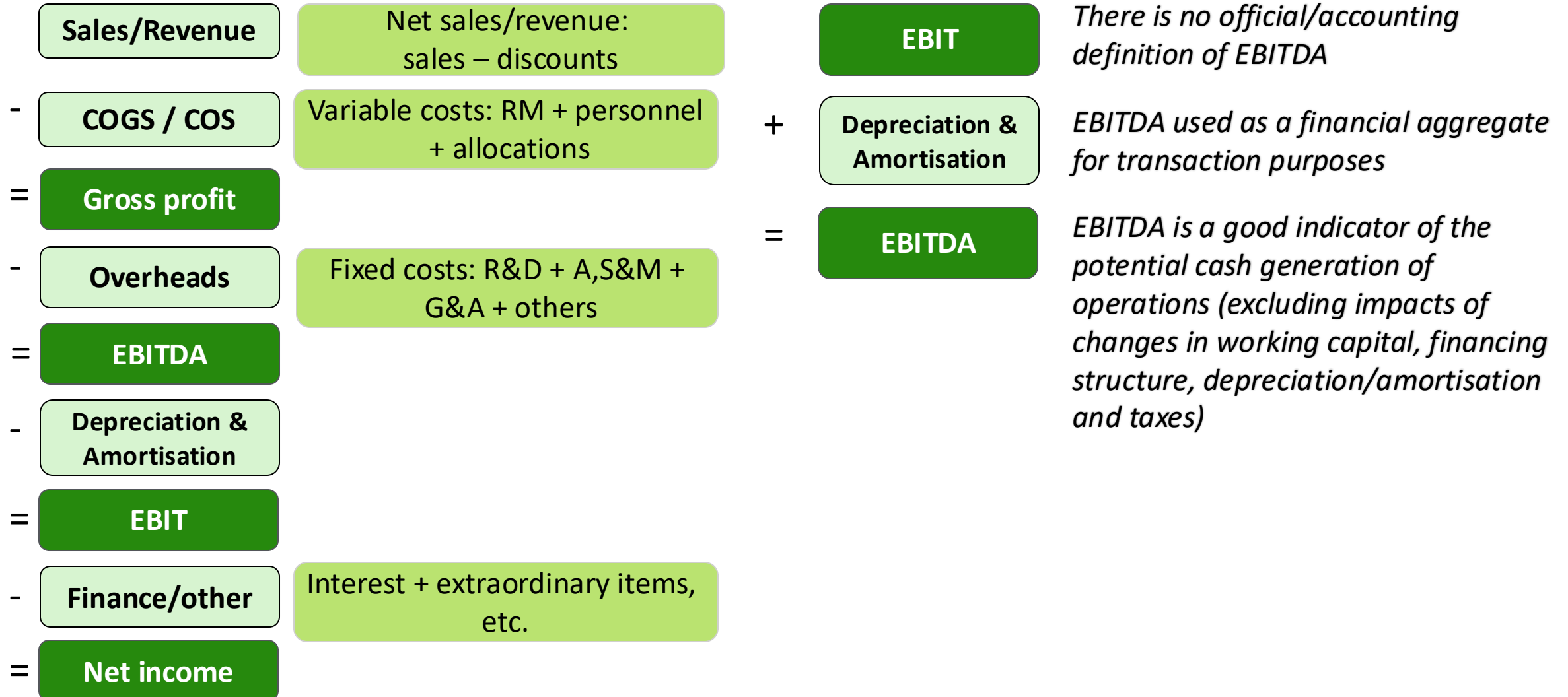
# Introduction to financial due diligence

## Principles of financial analysis – Organising analysis



# Introduction to financial due diligence

## Principles of financial analysis – Components of the Profit and Loss account



# Introduction to financial due diligence

## Analyzing Sales/Revenue

### A) Breakdown and growth of sales:

- By activity, by channel
- By product/service,
- By client, by geographical zone, etc.
- Price-volume

### C) Organic vs. external growth:

- Performance of the existing business vs. acquired business
- Pro forma analysis

### B) Seasonality and LTM:

- Impact on forecasts/outturn
- Correlation with working capital

### D) Risks/opportunities/adjustment:

- Concentrations (clients, geography etc.)
- Revenue recognition
- Product/service life cycles and investments (fixed assets, marketing) – gain/loss of contracts/clients
- Order book/backlog

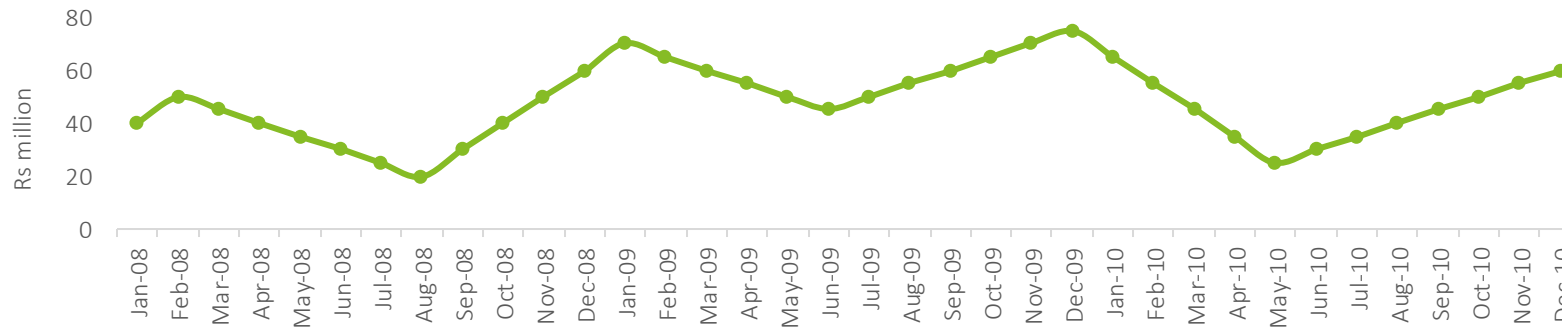
Revenue as per Accounting Standards don't always equal to sales. Specific Issues may include

- ✓ Principle vs Agent relationships
- ✓ Multiple Performance Obligations in single sales contract
- ✓ Point of time vs period of time revenue
- ✓ Trade vs settlement discounts and commissions
- ✓ Deferred and Unearned revenue

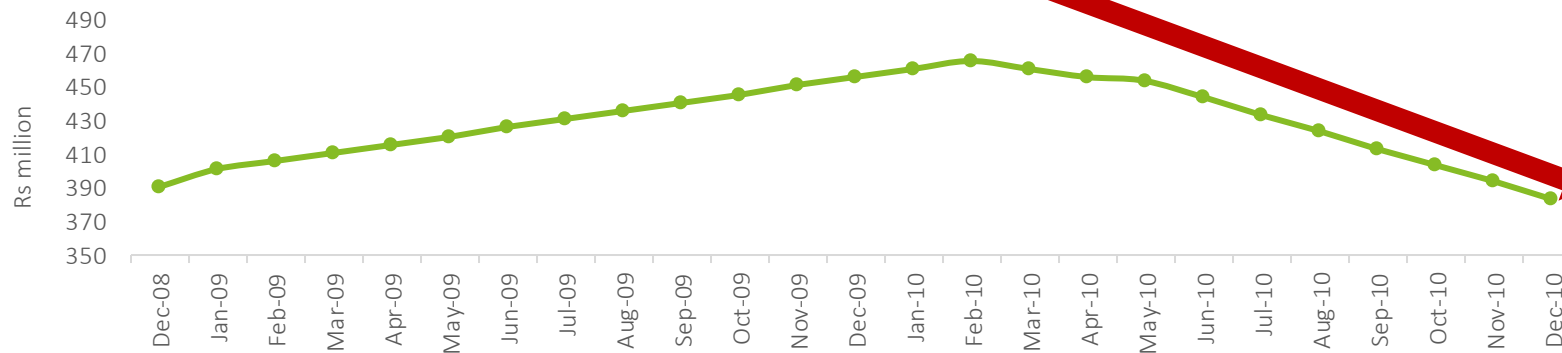
# Introduction to financial due diligence

## Analyzing Sales/Revenue Trend

Monthly sales



LTM sales



## Last Twelve Months (LTM)

Continuous LTM analysis strips out underlying seasonality and shows the true trend, because each LTM point has 12 months of data.

Industry specific KPIs should be considered when analyzing data.

- Leisure sector – Occupancy/Average Daily Rate
- Airline Industry – Revenue Passenger KMs/Available Seat KMs/Load Factor
- Banking and Finance – Net Interest Margin/Cost to Income Ratio
- Insurance – Laps ratio

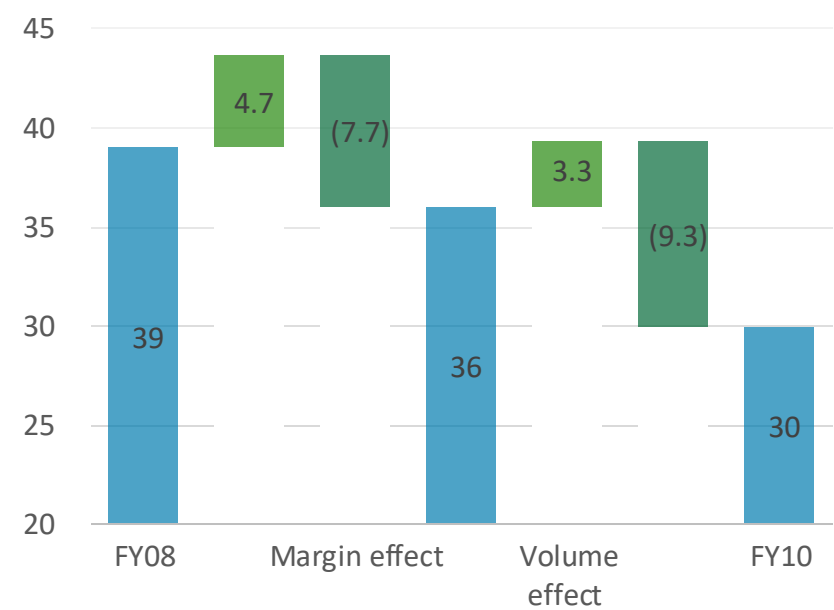


# Introduction to financial due diligence

## Analyzing EBITDA Trends

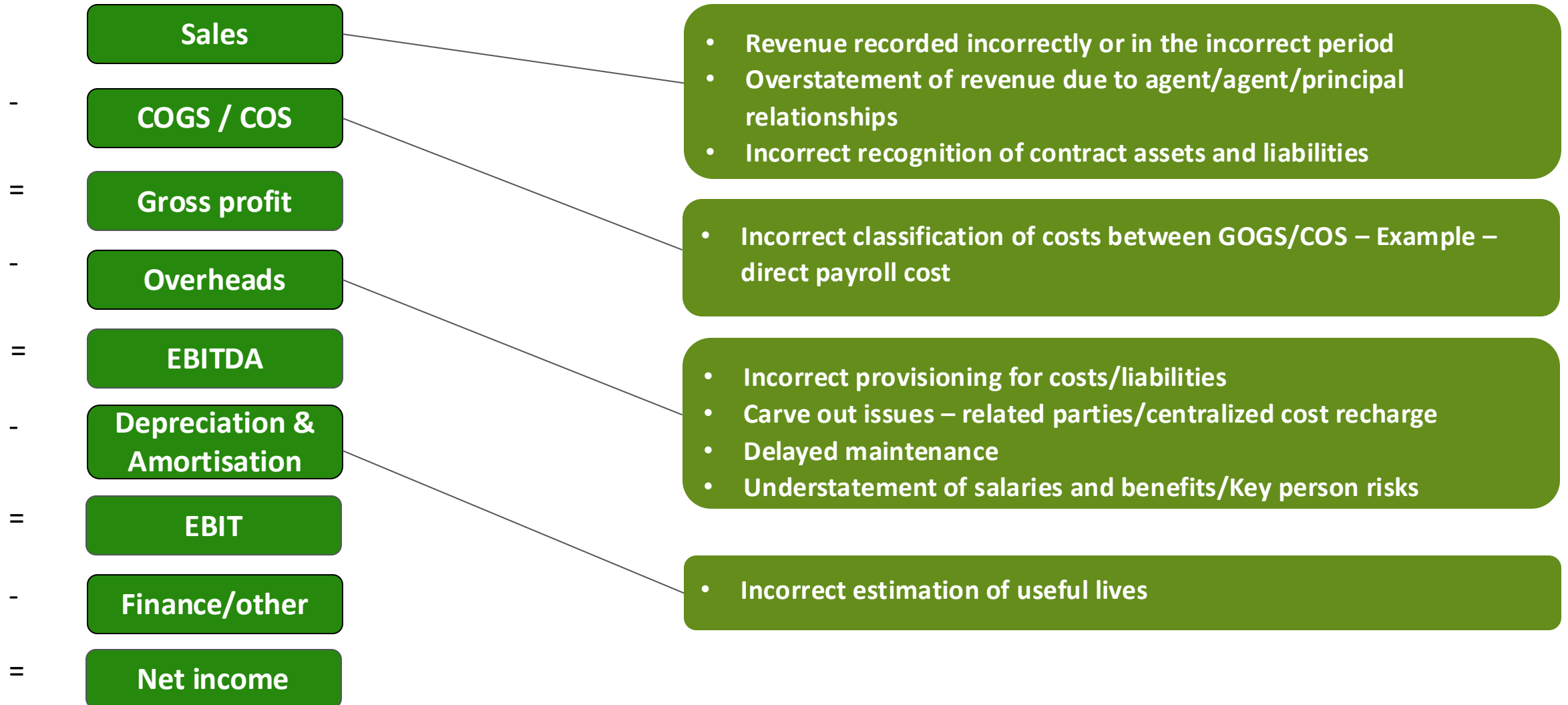
|   |  |
|---|--|
| <p><b>A) Breakdown and growth of EBITDA (in value and in %):</b></p> <ul style="list-style-type: none"><li>- by activity, by channel</li><li>- by product/service, zone etc.</li></ul> <p><i>Note: such analysis requires relevant allocations of overheads</i></p> | <p><b>B) Analysis of overhead costs:</b></p> <ul style="list-style-type: none"><li>- variation in value/in %</li><li>- growth as a % of sales</li><li>- ability to control costs (fixed vs. quasi-variable)</li><li>- impact on sales (marketing, R&amp;D)</li></ul> |
| <p><b>C) Bridge:</b></p> <ul style="list-style-type: none"><li>- by activity/entity/product etc.</li><li>- sales impact (price/volume) vs. costs</li><li>- by significant item</li></ul>  | <p><b>D) Risks/opportunities/adjustments:</b></p> <ul style="list-style-type: none"><li>- growth and significant impacts</li><li>- quality of earnings (see hereafter)</li></ul>   |

EBITDA BRIDGE



# Introduction to financial due diligence

## Typical issues in the income statement



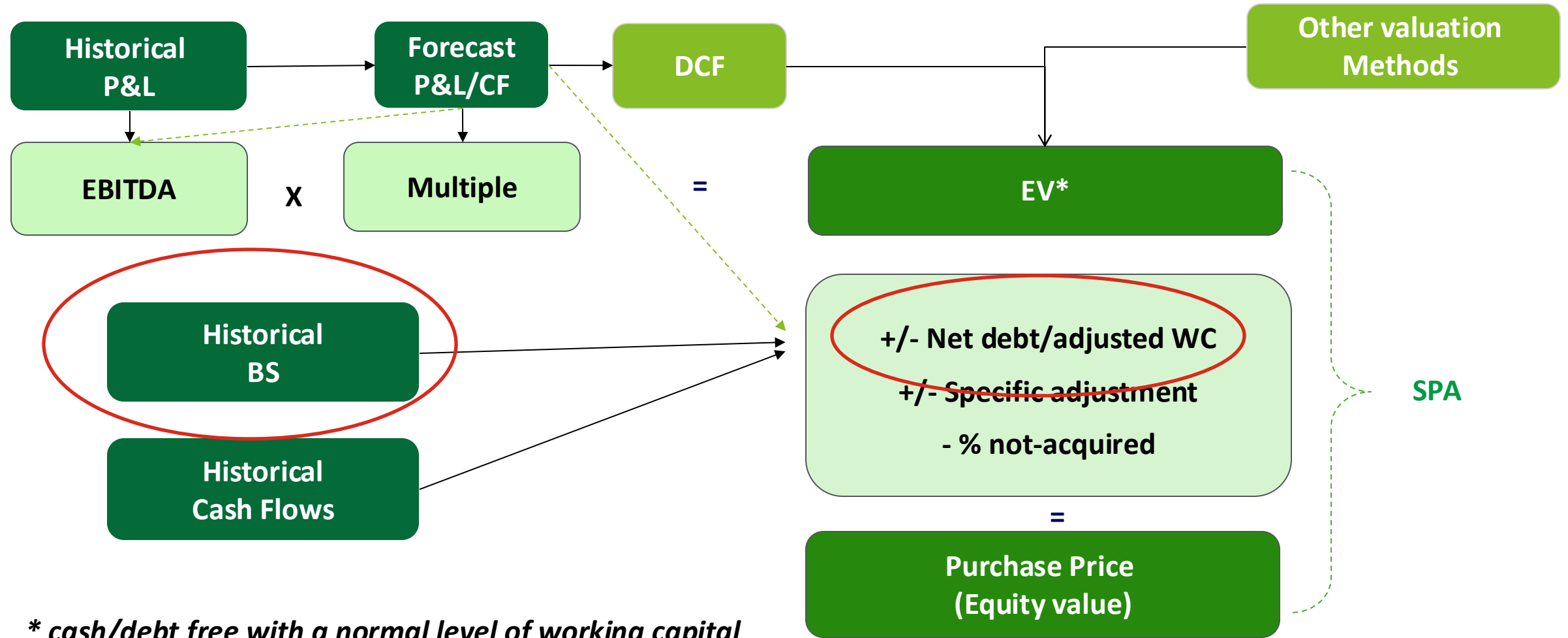
## Introduction to financial due diligence

### Quality of earnings (Type of adjustments)

| Type                     | Definitions  | Examples  |
|--------------------------|--|---|
| Pro forma/run-rate items | Harmonisation of the historical and forecast scope   | 1) Acquisitions/disposals<br>2) Minority Interests and unconsolidated<br>3) Ramp-up/full-year effect  |
| Accounting items         | Classification issues<br>Non-cash accounting impacts<br>Changes of method and calculation/cut-off errors | 1) Reclassification of items above/below EBITDA<br>2) Over/under capitalisation<br>3) Over/under-provisioning and provision releases<br>4) Revenue/cost cut-off |
| One-off items            | Items occurring in one period due to a specific, inhabitual event  | 1) Exceptional costs/profits incurred or not-incurred   |
| Non-recurring items      | Present historically but not recurring going forward   | 1) Costs not-incurred post-transaction/synergies<br>2) Trading impacted by the transaction  |

# Introduction to financial due diligence

## Principles of financial analysis – Enterprise Value (EV) Model



# Introduction to financial due diligence

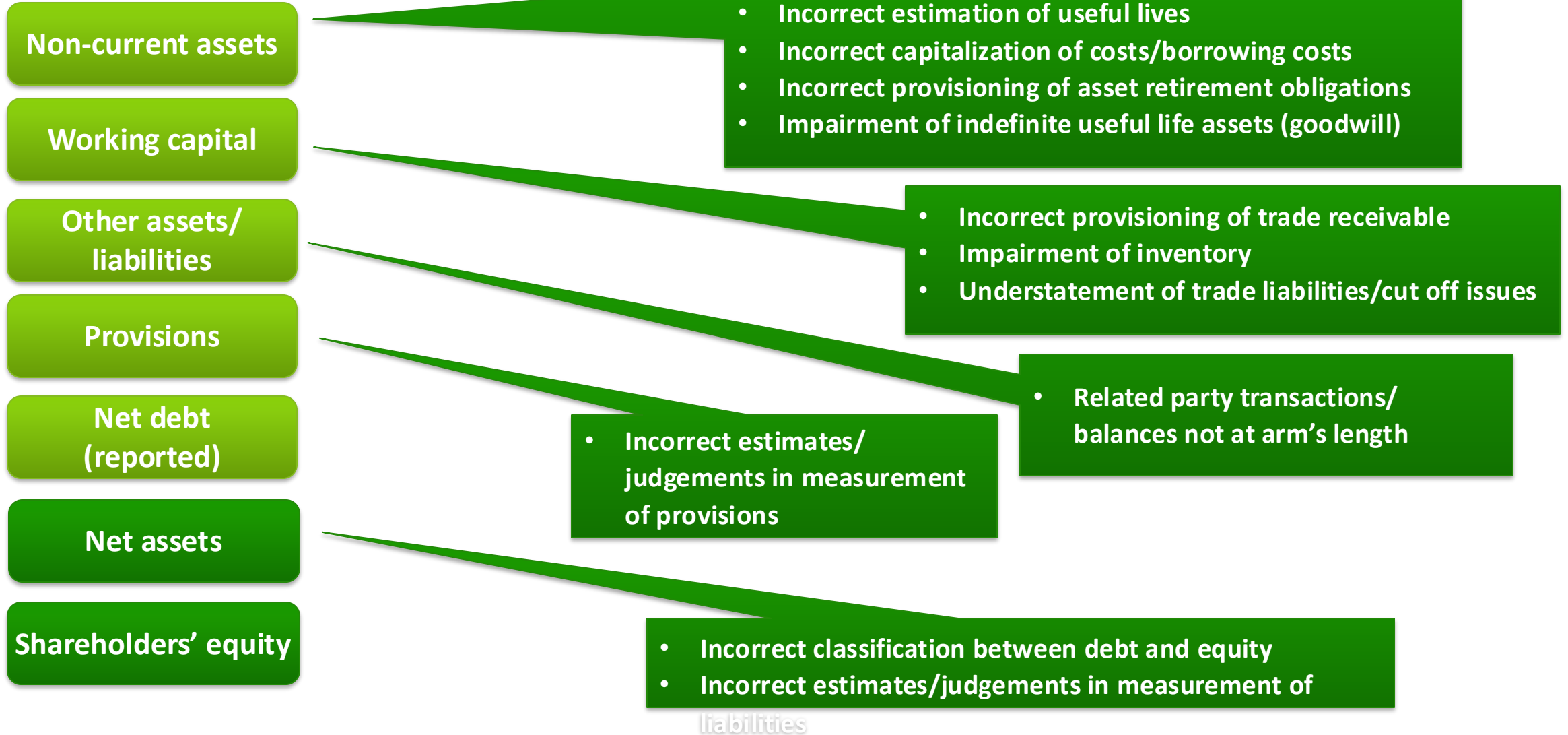
## Balance sheet analysis

|                              |  |
|------------------------------|--|
| Non-current assets           | Fixed, intangible, financial   |
| Working capital              | Trade and other  |
| Other assets/<br>liabilities | Deferred taxes, other items  |
| Provisions                   | Pensions, litigation, other  |
| Net debt<br>(reported)       | Cash and equivalents, financial<br>debt, finance leases, bonds,<br>shareholder loans |
| Net assets                   |  |
| Shareholders' equity         |  |

- Sort/reclassify the balance sheet in order to separate it into its different financial components
- Identify/analyse long term assets (fixed, intangible, financial)
- Identify/analyse the components of trade and other working capital (what items to include/exclude from the definition and potential adjustments)
- Identify/analyse provisions and similar items which may be debt-like or require specific SPA treatment
- Identify/analyse other assets and liabilities (e.g. deferred taxes)
- Identify/analyse the components of reported net debt (what items to include/exclude from the definition and potential adjustments)
- Analyse shareholders' equity (e.g. variations, distributable reserves)
- Identify/analyse off balance sheet items (e.g. contingent liabilities, pensions)

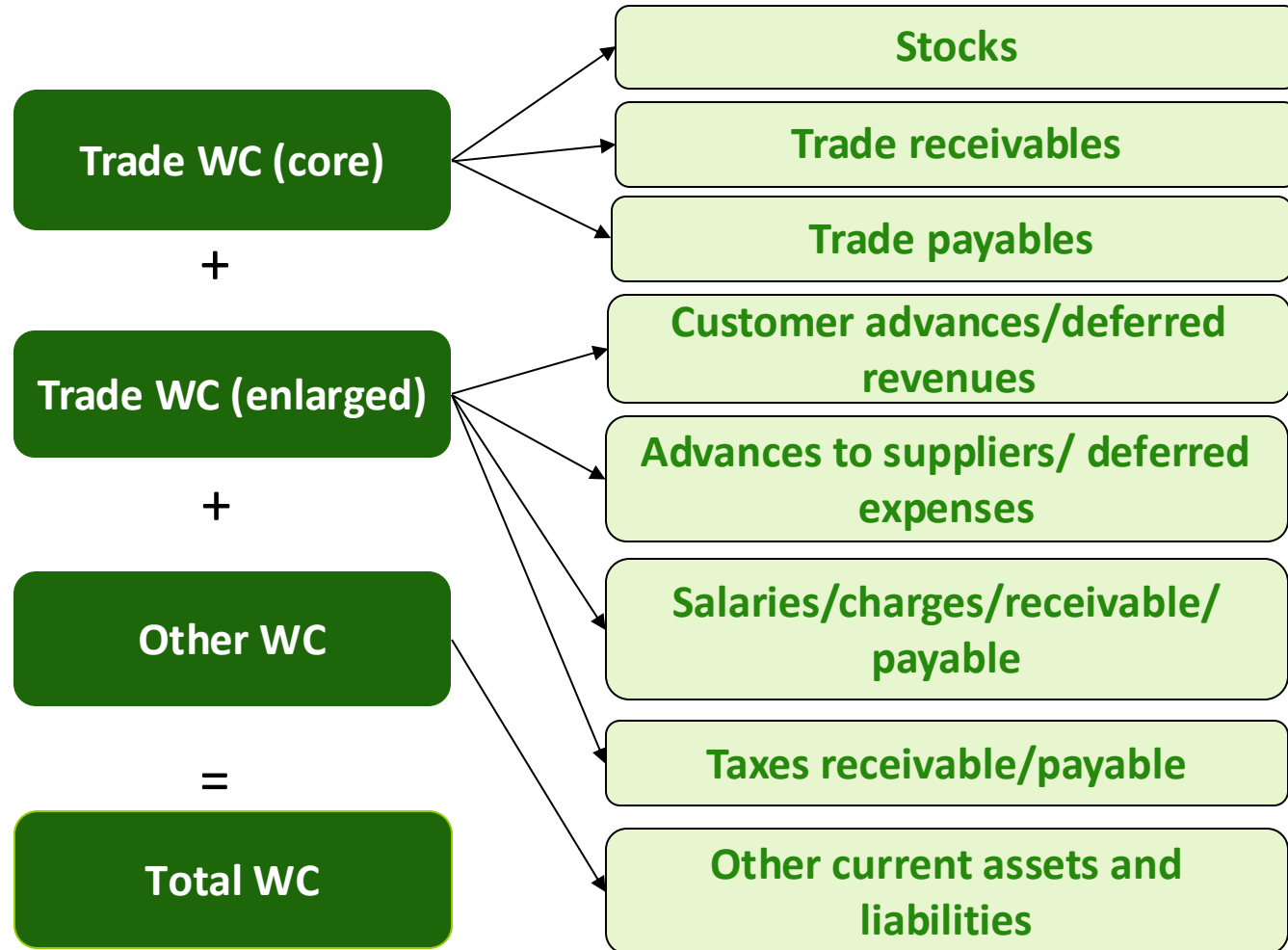
# Introduction to financial due diligence

## Typical issues in the balance sheet



# Introduction to financial due diligence

## Working capital analysis



- ✓ Working capital represents the short-term assets and liabilities necessary to maintain current business operations.
- ✓ Working capital varies based on the level of business activity.
- ✓ The counterparty to working capital is cash.
- ✓ Typically, a working capital adjustment is necessary to correct the level of cash at closing to reflect an average working capital level.
- ✓ Cash is a net debt component, so the adjustment is included therein

*There is no standard definition of working capital – each entity is different.*

# Introduction to financial due diligence

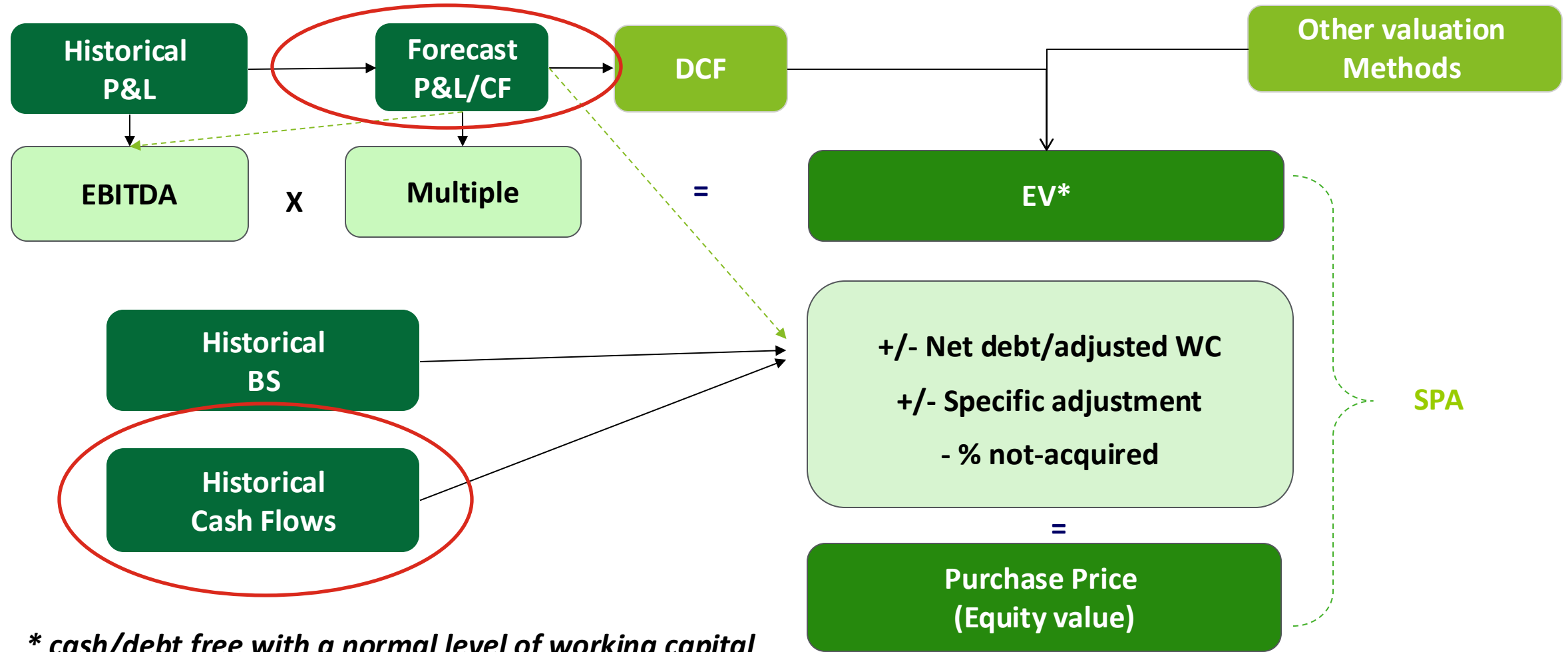
## Working capital analysis

| Trade WC (core)                        | Trade WC (enlarged)                                 | Other WC             |
|--|---|----------------------|
| Stocks (RM, WIP, FG)                   | Deferred revenue/expense                            | Other ST receivables |
| Trade/accrued receivables              | Personnel payables                                  | Other ST payables    |
| Trade/accrued payables                 | Social benefits receivables/payables                |                      |
|  | Tax receivables/payables                            |                      |
|  | Prepaid expenses                                    |                      |
|  | Advances and prepayments                            |                      |
| Excluded from WC                       |   |                      |
| Deferred taxes                         | Short term financial debt<br>(< 1 year)             |                      |
| Accrued interest                       |   |                      |
| Cash in transit receivable/<br>payable | Receivables/payables from<br>disposals/acquisitions |                      |
| Payables for fixed assets              |   |                      |



# Introduction to financial due diligence

## Principles of financial analysis – Enterprise Value (EV) Model



# Introduction to financial due diligence

## Cash flow analysis

- A) Analyse the ability of the business to generate recurring cash flow (general analytics/cash flow overview)
- B) Analyse capex levels
- C) Analyse the average working capital level
  - *Analyse conversion of EBITDA to cash and the correlation between trading performance and cash levels*
  - *Identify potential EBITDA/net debt adjustments*

### **Analyze** monthly (or quarterly) balance sheets and:

- Analyse the consistency of monthly working capital components with the latest balance sheet/retained working capital definition. Make normalization adjustment if necessary
- Analyse the working capital trend in absolute value (e.g. seasonality/cyclicality, minimum, maximum)
- Analyse the working capital trend on LTM basis (eliminates seasonality)
- Analyse the WC trend compared to activity (in days of sales/purchases)
- Determine the level of average/normal working capital

# Introduction to financial due diligence

## Cash flow analysis

|                               | Y         | Y+1       |
|-------------------------------|-----------|-----------|
| <b>EBITDA</b>                 | <b>11</b> | <b>15</b> |
| +/- Non cash items in EBITDA  | 1         | (1)       |
| +/- Change in working capital | 2         | (6)       |
| - Capex, net                  | (3)       | (5)       |
| <b>Free cash flow</b>         | <b>10</b> | <b>3</b>  |
| +/- Investments, net          | 0         | 1         |
| +/- Financing cash flows      | 0         | 4         |
| +/- Tax cash flows            | (1)       | (3)       |
| <b>Net cash flow</b>          | <b>9</b>  | <b>5</b>  |

**EBITDA**

**+/- Non-cash items**  
*(e.g. provisions variations)*

**+/- Working capital variation**  
*(i.e. cash movements with no P&L impact)*

**+/- Capex**

**= Free Cash Flow**

**+/- Investments**  
**+/- Financing items**  
**+/- Income taxes**

**= Net Cash Flow**

- It is important to analyze the historical capex to identify growth capex and maintenance capex.
- Any shortfall in maintenance capex would require an adjustment.

# Introduction to financial due diligence

## Comparison of accounting cash flow and free cash flow analysis

### Accounting presentation

Net income  
(Operating cash flows or the indirect method)

Non-cash operating items  
(e.g. WC and provisions variations)

Investment items  
(Investments, acqu./disp., int./div. received)

Financing items  
(Loans, dividends paid, capital variations)

Beginning cash

Net cash flows

Ending cash

### Free cash flow presentation

EBITDA

+/- Non-cash items  
(e.g. provisions variations)

+/- Working capital variation  
(i.e. cash movements with no P&L impact)

+/- Capex

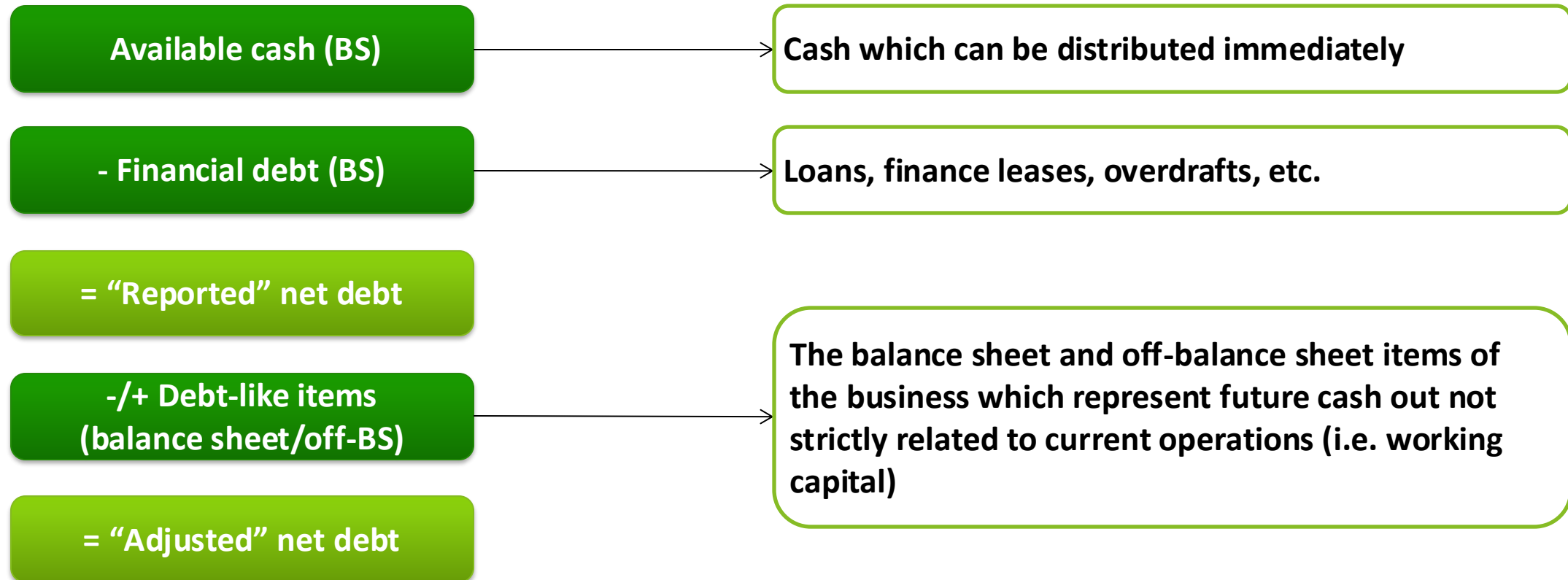
= Free Cash Flow

+/- Investments  
+/- Financing items  
+/- Income taxes

= Net Cash Flow

# Introduction to financial due diligence

## Net debt analysis



# Introduction to financial due diligence

## Net debt analysis

### Indications:

1. Is reported net debt consistent with the transaction scope?
2. Does a particular item have debt-like characteristics (interest, net present value, etc.)?
3. Does the item impact cash?
4. Will the item exceptionally reduce the ability to distribute cash to shareholders?

### Examples:

Unconsolidated entities  
Minority interests

Finance leases, pensions, options

WC variation, trapped cash, provisions

Indemnities, litigation/ tax risks, operational risks

# Introduction to financial due diligence

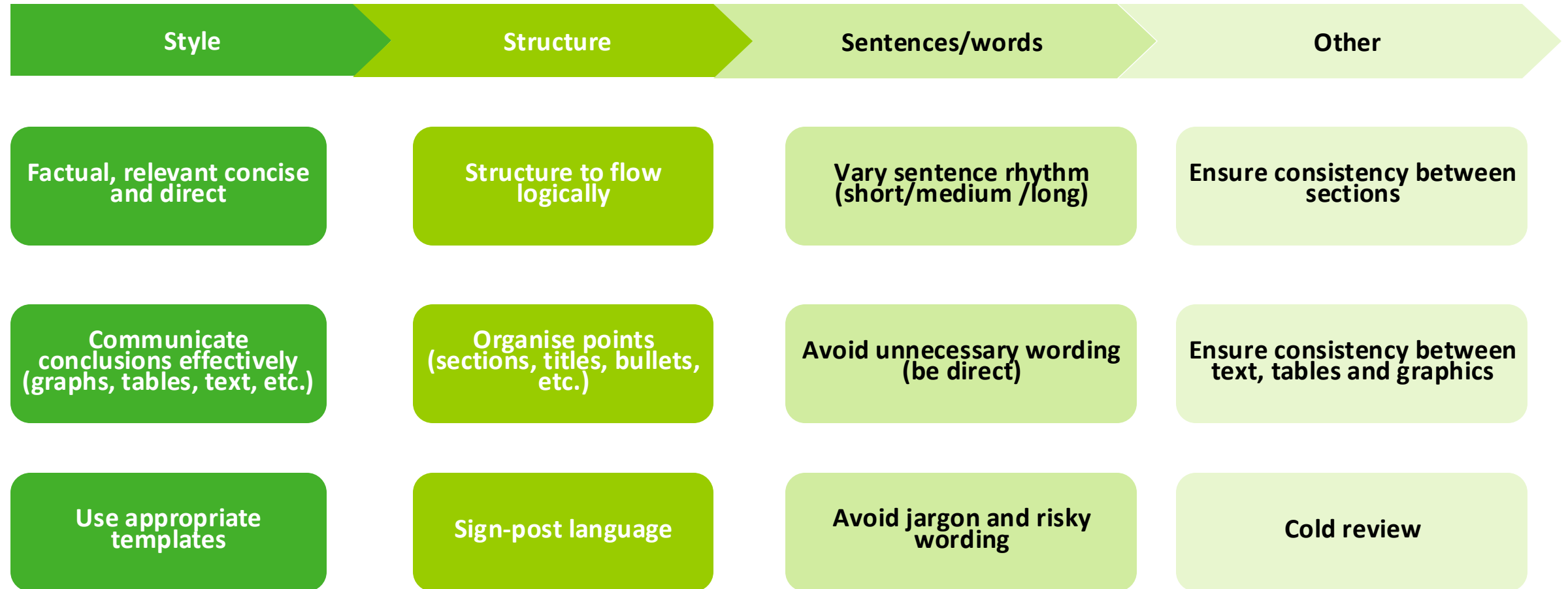
## Net debt analysis – Typical adjustments

| Adjusted Net Debt                                   | FY2X        |
|---|-------------|
| Bank borrowings                                     | xxxx        |
| Shareholder borrowings                              | xxxx        |
| <b>Total borrowings</b>                             | <b>xxxx</b> |
| Cash at bank  | (xxxx)      |
| Cash equivalent                                     | (xxxx)      |
| <b>Net debt reported</b>                            | <b>xxxx</b> |
| <b>Normalizing adjustments</b>                      |             |
| Deferred tax liability                              | xxxx        |
| Retirement benefit obligations                      | xxxx        |
| Lease obligations                                   | xxxx        |
| Disclosed contingent liabilities (legal/guarantees) | xxxx        |
| Preference shares                                   | xxxx        |
| <b>Due diligence adjustments</b>                    |             |
| Presale customer advances                           | xxxx        |
| Understatement of Asset Retirement Obligation       | xxxx        |
| Income tax disputes                                 | xxxx        |
| Delayed Capex                                       | xxxx        |
| Working Capital Adjustment                          | xxxx        |
| <b>Adjusted Net Debt</b>                            | <b>xxxx</b> |

- Robust adjusted net indebtedness analysis has a direct impact on transaction price
- Reported cash and debt balances should be analysed in detail
- Net debt adjustments are highly subjective and depend upon the target's profile and the transaction context

# Introduction to financial due diligence

## Financial Due Diligence Report





# Fair value considerations



# Fair Value Consideration

## Requirements of IFRS (SLFRS) 3 – Business Combinations

- An acquirer of a business **recognizes the assets acquired and liabilities assumed at their acquisition date.**
- The IFRS establishes principles for recognizing and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree.
- Each identifiable asset and liability is measured at its **acquisition-date fair value.**
- The **consideration transferred** in a business combination (including any contingent consideration) is **measured at fair value.**
- Fair value is defined as “**the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date**”.
- The acquirer should identify any difference between:
  - a) the aggregate of the consideration transferred, any non-controlling interest in the acquiree and,
  - b) the net identifiable assets acquired.
- **The difference will be recognized as goodwill.** If the acquirer has made a gain from a **bargain purchase** that gain is recognized in profit or loss.

## Fair Value Consideration

### Possible intangible assets and contingent liabilities for considerations

- Purchase price allocation – IFRS 3 provides a 12 months window to finalize the fair valuation and goodwill
- To qualify for recognition as part of applying the acquisition method, an item acquired should:
  - meet the definition of an asset or a liability at the acquisition date; and
  - be part of the business acquired (the acquiree) rather than the result of a separate transaction.
- Assets and liabilities that are to be considered
  - Customer/Depositor relationships
  - Trademarks/Licence/Patents
  - Internet domain names
  - Technical knowhow/manuals
  - Contingent liabilities relating to litigation
  - Performance bonds and guarantees



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