BUY-SIDE

FINANCIAL DUE DILIGENCE SERVICES

AVS CAPITAL SOLUTIONS
An Affiliate of Axiom Valuation

Why Financial Due Diligence?

During a Merger and Acquisition (M&A) process, seller tends to present the target company in the best way possible to increase value. As the baseline for negotiation, target company's enterprise value is often estimated based on a multiple of either Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) or revenue. Seller may adjust EBITDA by excluding certain expenses or convert the revenue recognition method from accrual to cash to increase EBITDA or revenue, hence, increase target company's enterprise value estimate.

The purpose of the financial due diligence process is to discover those unusual adjustments and to determine a normalized EBITDA and revenue, therefore, to help buyer start the negotiation with a fair EBITDA and revenue basis.

The financial audit process focuses on the presentation of earnings, expenses, assets, and liabilities under generally accepted accounting principles ("GAAP"), while the financial due diligence process focuses on the quality of both the earnings and the cash flows from a valuation perspective. The audit may accept certain adjustments, such as non-operational gains/losses, but some of those adjustments may distort the future earnings ability of the target company, hence, its value estimate. In addition, the projections presented by the seller may be aggressive and not consistent with target company's historical trends, as well as the industry trends.

Financial due diligence process helps bridge the gap among target company's historical results, its projected performance, and the industry trends.

Why Financial Due Diligence? (Continued)

Certain significant issues, risks, and opportunities that financial due diligence process can help to identify are listed below:

- Revenue and Earnings Concentration with respect to Geography, Customer, Product line, etc.
- Non-operational Income/Expense
- Supplier/Vendor Reliance
- Related Party Agreement
- Potential Synergy
- Debt-like Item
- Working Capital Requirement
- Change of Control Issue

Financial Due Diligence - Purchase Price Impact

Financial Concept	*Estimation Method*	*Diligence Analysis*
M&A Purchase Price		
= Enterprise Value	Multiple of EBITDA or Revenue; Discounted Cash Flow; etc.	Quality of a) Earnings, and b) Cash Flows Investigation
- Debt	Buyer Assumed Liabilities as These Debt-like Items could be a Reduction of the Purchase Price	Debt-like Items Analysis
+/- Surplus/Deficit in Working Capital	Adjustments between the Actual Closing Working Capital and the Prior Agreed upon Target Working Capital	Working Capital Assessment

Quality of Earnings and Cash Flows Investigation

Quality of Earnings and Cash Flows Investigation focuses on normalizing EBITDA to assist clients in establishing the enterprise value of the target company.

• *Investigations*	❑ *Reconcile EBITDA to audited income statements and interim results* ❑ *Identify items impacting valuation:* ❖ *Accrual versus Cash Timing* ❖ *Non-cash Transactions* ❖ *Non-recurring Income/Expenses* ❑ *Understand and evaluate appropriateness of the adjustments to EBITDA from a valuation perspective*
• *Outcomes*	❑ *Identify historical trend for the normalized EBITDA* ❑ *Establish baseline EBITDA for valuing the target company*

Debt-like Items Analysis

Debt-like Items Analysis identifies potential reductions to the enterprise value of the target company.

• *Analyses*	❑ *Assess future non-operation related cash outflow* ❑ *Plan for the reported debt as shown on the balance sheet* ❑ *Estimate the timing of future cash commitments*
• *Outcomes*	❑ *Provide negotiation leverage* ❑ *Incorporate the concept of debt-like items in addition to the traditionally defined indebtedness in drafting the purchase agreement*

Working Capital Assessment

Working Capital Assessment helps recognize historical trend and a normal level of target company's working capital and provides the basis for the target working capital negotiation.

- *Assessments*
  - *Remove non-operation related items within the current assets and current liabilities*
    - *Excess cash*
    - *Dividends*
    - *Non-operation Related Taxes*
    - *Debt-like Items*
  - *Identify historical working capital patterns*
  - *Benchmark against normalized working capital level*

- *Outcomes*
  - *Establish a target working capital amount in drafting the purchase agreement*
  - *Understand the potential areas for resulting working capital surpluses or deficits compared to the target amount*

Summary

Our team has the experience and knowledge to identify and understand the critical factors that drive valuation which can assist you in your negotiation process.

Our procedures are tailored to each project and consider risks for both the company and the industry. We look beyond the historical data to provide you with insights into trends that affect future performance.

Call us for a confidential discussion.

AVS CAPITAL SOLUTIONS
An Affiliate of Axiom Valuation

Company Quality of Earnings Example

Preliminary Adjusted EBITDA Summary

$ in Thousands	Reference	Fiscal Year (FY) 2018	FY 2019	Trailing Twelve Month (TTM) Jun 2020	Commentary
Net Income		**3,510**	**3,775**	**4,025**	Audited 2018 and 2019 financial statements
Depreciation and Amortization		123	132	141	
Interest Expenses		200	210	220	
Income Taxes		1,170	1,259	1,341	
EBITDA, as Reported		**5,003**	**5,376**	**5,727**	
Management Adjustments (MA)					
One-time, Nonrecurring Items	**MA-1**	75	40	10	Litigation, resolved in May 2020
Market Value of Owner Compensation	**MA-2**	100	110	110	Revised to reflect market compensation
Adjust Related-party Transactions to Fair Market Value (FMV)	**MA-3**	15	15	10	Tax motivated transactions
Total Management Adjustments		190	165	130	
Management Adjusted EBITDA		**5,193**	**5,541**	**5,857**	
Potential Due Diligence Adjustments (DD)					
Inventory Obsolescence	**DD-1**	-	(20)	(10)	Slow moving and discontinued items
Revenue Recognition	**DD-2**	(10)	(20)	(5)	Multiple recognition elements
Reserve for Doubtful Collections	**DD-3**	(22)	40	(18)	Modify reserve methodology
Restatement for Lease	**DD-4**	-	-	20	Effective Jan 1, 2020
Total Potential Due Diligence Adjustments		(32)	-	(13)	
Preliminary Adjusted EBITDA		**5,161**	**5,541**	**5,844**	
Potential Pro Forma Adjustments (PF)					
Rental Increase Effective Jan 2020	**PF-1**	(20)	(20)	(12)	Restate prior periods for lease increase
Restructuring Effective Dec 31, 2019	**PF-2**	26	28	-	Reduction in Selling, General & Administrative Expenses (SG&A) headcount
Lost Customers	**PF-3**	(250)	(180)	-	Back out revenue from customers
Total Potential Pro Forma Adjustments		(244)	(172)	(12)	
Pro Forma Adjusted EBITDA		**4,917**	**5,369**	**5,832**	