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Financial Due Diligence: Analysis of a key phase in M&A operations

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Abstract

The aim of this professional master thesis is to explain all the details regarding my internship in the M&A Transaction Service department at Deloitte, providing my personal point of view on this experience, which is giving me the opportunity of expanding my knowledge in the field of M&A operations, in an environment always evolving and changing.

I begin with a general introduction on Deloitte and on its main divisions, with the objective of presenting the reality I am working in, with a detailed structure, composition, and presence in the Italian market.

Then, I present my internship position, why I chosen this role, how I have been welcomed, and what are the tasks and the projects in which I have been involved since I began my period in the company. To conclude the first chapter, I define some challenges encountered, the connection with my study cycle, skills gained, and current plans for the future.

In the second chapter I am deepening my analysis around the concepts of due diligence and financial due diligence. I will provide all the necessary definitions and categorizations to understand those processes, as well as some specifics regarding adjustments made during the analysis, underlying the key relevance of the process in the world of M&A operations.

Finally, I conclude my dissertation with a sum up of my experience, providing once more my personal perspective, and presenting some relevant aspects related to my studies and previous experiences, all beneficial to what is coming next.

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1

Company description

1.1 Introduction

In this first chapter of my dissertation, I present Deloitte, the company I am working for, starting with a brief history of the firm, followed by an analysis of the division in which I am involved. After that, I will provide an overview of my job position, outlining the main aspects of the work, the people and tools involved, and a typical day working on a project. I will conclude this chapter by providing my point of view, explaining my impressions, my reflections, and my ideas for the future and for the continuation of my career in this field.

1.2 Company presentation

1.2.1 Company history and mission

Deloitte Touche Tohmatsu, or simply "Deloitte", is the largest multinational professional services network. It provides a wide range of services and activities to clients, mainly audit, tax, consulting, risk, and financial advisory services.

The company was founded by William Welch Deloitte in 1845 in London. Deloitte was immediately recognized for his expertise in the financial and accounting field, and was nominated as independent auditor for a public company for the first time in history. In the late 1800s, he expanded the offering of its services branching out to New York City, where he opened an office in 1880, moving to Wall Street 10 years later. During the 1900s, the global network was established and continued to grow. Several member firms were established across different countries, creating the foundation for a global presence that continues in the modern days. In the last years

of the 1990s, Deloitte became one of the first companies to introduce a dedicated consulting practice, and simultaneously to adopt, within its range of services, the risk management and enterprise risk, to cover for new business challenges. In 2003 the name "Deloitte" was adopted, to improve its identity and brand recognition.

Recently, Deloitte has been focusing on digital transformation and innovation, with the aim of addressing the needs of its clients and keep the pace with the evolving business landscape. Currently, Deloitte is recognized as one of the "Big Four" accounting firms, along with PwC, EY, and KPMG. The company operates in more than 150 countries, relying on an international network of professionals and employees (more than 350,000), linked with the strong knowledge of the local territory. These are the key aspects that allow Deloitte to help each client reach its business goals and targets.

Deloitte's mission is reflected in its main statement, which is "Make an impact that matters". This is present in every decision and action taken, delivering where and when the client needs it the most. Moreover, Deloitte is guided by five main principles, that everyone within the company must follow and use as a guideline towards reaching its goals and objectives:

1. *Lead the Way.* Deloitte do not want to lead only on the professional side, but also for a better and more sustainable future.
2. *Serve with integrity.* Deloitte and all its people act ethically and with integrity. In a sector like this, earning the trust of clients, institutions and of the public is the key to the success, since reputation is one of the aspects that allow Deloitte to be industry leaders.
3. *Take Care of Each Other.* People in the company are treated like a family. Well being is prioritized, as well as respect, fairness, and development.
4. *Foster Inclusion.* Deloitte fosters an inclusive culture, embracing diversity and the different perspectives that comprise its international workforce.
5. *Collaborate for a Measurable Impact.* Team is a key word in the day-to-day at Deloitte. The mindset is towards a collaborative environment, across different people, territories and business tasks.

1.2.2 Financial Advisory

As I previously said, Deloitte offers a wide range of financial services, covering many areas and topics within the financial industry. Personally, I am involved in the Financial Advisory department, that is composed of the following five subcategories, that I am now briefly analyzing.

Deloitte Forensic. This Deloitte's division provides assistance to senior management, external counsels, courts, arbitrators, and prosecutors in three main areas: a) the analysis of data to uncover specific insights, such as investigating possible financial frauds, irregularities, misconduct, or regulation compliance of their clients, b) support clients when there is a resolution of dispute, by offering financial analysis, testimony, and damage quantification, and c) help clients implement internal controls and preventive measures to avoid possible future risks and not face irregularities in the business process.

Restructuring Services. Deloitte's restructuring and turnaround division assists major banks, helping institutions and companies to reorganize services to restore the financial equilibrium of their operations. The main activities carried out by this area are financial restructuring, to implement business strategies to improve the performance of the company; operational improvement, to identify critical areas, such as cost-saving measures and efficiency enhancements; bankruptcy and insolvency, to assist companies in distressed situations, often related to liquidity, debt servicing or security.

Valuation Services. The valuation services division provides a strong experience in assessing accurately and reliably the value of a business, assets, or financial instruments. This covers real estate, fixed assets, and financial assets, to understand their real value and market position. The list of activities carried out involves financial reporting valuation, transaction valuations, tax valuations, and litigation support, that comprise all the stages of a transaction, and the possible support in case something doesn't go as expected.

Capital Markets Advisory. This division follows clients in accessing capital markets, by providing several services such as debt and equity raising, through both public offerings and private sources or placements, capital structure optimization, which seeks to balance debt and equity raisings, to optimize the business continuation of the company, and risk management, which involves identifying and preventing all the financial risks that could arise, such as interest rate, currency, or commodity risks.

Mergers & Acquisitions. Deloitte works side to side with corporate buyers, sellers, and private equity investors to follow them through the entire cycle of an M&A deal. The services offered by Deloitte's professionals consist in due diligence, valuation, integration support, and transaction advisory. These activities are tailor made to the specific needs of the clients, to deliver the best and most accurate solution, from the planning to the execution and completion of the operation.

The financial advisory department, with its divisions, serves different industries. Among these, the most important are consumer goods, financial services, government & public services, technology, media & telecommunications, life sciences &

health care, and energy, resources & industrial. During my internship, I have been working across different sectors. In the proceeding sections I offer my perspective on my work experience in this department.

1.2.3 M&A Transaction Services

The M&A Transaction Services is a section of the Financial Advisory department, and it is comprised of a wide range of advisory services aimed at supporting clients and business during transactions, such as acquisitions, mergers, divestitures, joint ventures, or other activities between companies. Over the years, the department of Transaction Services has become a point of reference for both strategic and private equity clients, both in Italy and abroad, by offering expertise in an always increasing number of sectors. The importance of these services is crucial, since they play a key role in identifying and minimizing risks, maximizing value, and making sure that the transaction turns out successfully for all the parties involved.

This department offers three main services:

1. Deal Origination - this is the starting point of any M&A operation. In this phase the objectives that the transaction is expected to achieve are defined, the sector in which the target entity operates is analyzed to look for opportunities available on the market, and a list of possible counter-parties is prepared, as well as presenting the plan of the operation and the feasibility of the same.
2. Due Diligence – this involves an extensive analysis and examination of the financial, operational and legal side of the transaction. This stage, as I further explain in chapter 2, includes identifying possible risks and problems that could threaten the continuation of the deal, as well as areas for improvements and opportunities.
3. Valuation – this offers an assessment of the value of entire businesses, rather than specific assets or detailed financial instruments owned by companies. Deloitte’s experts use specific methodologies, such as modeling or techniques of scenario analysis, and instruments to deliver the best results that allow clients to make informed decisions and financial reporting.
4. Integration and Separation – these activities represent the last part of an M&A deal. In order to exploit the benefit identified in the previous stages, Deloitte works alongside the companies to make sure that the execution of the post-transaction activities is carried out correctly, and the new entities operate effectively.

There are, besides the ones just mentioned, several aspects that make this division so interesting and effective in its operations. The first aspect is reputation: Deloitte has a strong experience in M&A operations over the years, in different sectors and areas, and is well-known globally for its standard of excellence and the precision of its work. Moreover, in order to improve its due diligence and valuation services, Deloitte utilizes new advanced technologies, such as artificial intelligence and other ways to analyze data, to improve efficiency and accuracy of results. In addition, due to the wide global presence, Deloitte offers client the opportunity of obtaining the most dedicated service thanks to the solid local and territorial knowledge, and offers employees the opportunities of working on international deals, alongside with people with different knowledge and backgrounds.

1.2.4 Deloitte in Milan

Deloitte is one of the most important societies offering financial services to companies and institutions in Italy, and has been present in this country for more than 100 years. Deloitte employs around 11,000 people in Italy, with offices based in 23 different cities, reaching an incredible number of clients with all its services.

Within its industry, and between the market of services that it offers, Deloitte in Italy ranks at one of the highest position among its competitors. Financial advisory is one of the main area of expertise in Italy and in particular in Milan, which represent the most important financial hub of the country. The services offered by Deloitte in Italy target different categories of customers, from multinational corporations, large private equity funds, to small and medium-sized enterprises (SMEs), which represent the heart of the industry in Italy. Deloitte has a detailed and tailored approach to understand in every situation the goals and needs of its clients, delivering the best solution for each.

One key aspect of Deloitte that allows the company to benefit in the financial landscape is its composition. In fact, Deloitte is not built like a traditional company, with branches opened all over the world, but is organized as a network. This means that it is composed of a collective of member organizations that operate under the brand of Deloitte, but in reality those are individual, independent and legally separated entities. The benefit from this structure is the solid collaboration between the different members, to provide a cohesive solution to clients, shared resources, strong brand and reputation, and global presence. For example, my team worked on a project with Deloitte Denmark, involving both an Italian and a Danish company (I will give more details below in the section related).

1.3 Job position and tasks

In this section, I present my position as an intern at Deloitte, starting from a more motivational part, in which I highlight why I chose this position in this company, moving on to a section in which I explain how Deloitte includes in its operations the new employees. Following this, I will present some examples of tasks by describing how a project is structured, and which could be my duties. Lastly, I will give an overview of the project I have worked on, describing the variety and different challenges that we have to face constantly in this industry.

1.3.1 Why this role?

I had thought for a long period about what I truly wanted to do after the completion of my study cycle, and the reasons that led me to apply to this positions were many. First, I thought about an internship like this as the most coherent continuation of my personal interests and the studies I have carried out: I am extremely interested to the M&A world in particular, and having the opportunity of dealing in first person with some of the most important deals within the Italian market is something that is making me enthusiast of the work that I am doing. Linked to this, I also wanted to dive immediately in real projects to gain tangible work experience, which I was sure to find in this position, especially in this department. Second, the courses I followed both in the Bachelor's and in the Master's served perfectly for this position, an aspect which I will further analyze later in the paper. Third, since I am at the beginning of my career, my first goals and objectives consist in gaining knowledge and experience and developing a set of hard and soft skills to be prepared for what will come next. I was convinced that working for a team at Deloitte would have been the perfect environment where to begin and to learn everything as much as possible, from the skills needed for the job, to the relationship and interpersonal capabilities. I believe that an environment like the one I am in now is the best "training ground". In addition, the organization of Deloitte, divided in specific divisions with a lot of autonomy, and the single projects handled by a small group of people, places individuals in a position of high responsibility from the beginning, and I personally find this very stimulating. Another reason is related to the main values rated by the company, such as hard-work, collaboration, and integrity. Lastly, I was lucky to have some direct experience from people working for the company, and after having gathered the relevant information, applying for this role felt like the ideal and most natural option.

1.3.2 Deloitte's welcome policy

Deloitte, as a well-established international network, is used to welcoming interns and new hires among its teams, and it has some dedicated activities for them to integrate properly within the environment, the values and the mission of the company, in order to prepare them to operate as a member since the beginning of your experience with them. As an intern without a strong history of past and previous experiences in environments like that, for me at the beginning everything has been new and to understand.

During your first day, you are given the necessary equipment for the role, such as a computer and a phone, and you are welcomed by a more experienced colleague (in my case, an associate came to greet me). Immediately, you get to know both the workspace, the colleagues and everything regarding the work environment. A trainer then helps you set up your devices and your work place, following some specific procedures. After that, Deloitte starts your training regarding the company and the job to familiarize new joiners with the company's values, its mission, and its responsibilities.

The training in Deloitte comprises two types of activities: the first ones consist in a series of online video courses that are mandatory for every employees, that involve topics as Deloitte's main values, brand identity, integrity, privacy, security, company presentation and company activities. Other courses are related to key aspects for the profession, such as safety on-the-job, non-disclosure policies, or other general measures for ensuring the perfect prevention for any accidents or problem. The second type of activities are on-site courses, called "Deloitte Experience", organized by the company for the new hires from the whole country. I attended a week of formation in Milan, where we had to participate in several activities that prepared us for the job, from theoretical courses to more practical ones, involving the use of the most-used instruments on the job, such as Microsoft Excel and Microsoft PowerPoint. I think that the on-site activities were particularly useful, mainly from the relationship point of view, as you experience for the first time how to interact with experts, colleagues, and professionals.

The last element that is mandatory to start working for the company is to attend a medical examination from the company's doctor, who verifies your fitness and health.

The aspect that I instantly noticed was the positive welcome received by the colleagues: since we are in a quite competitive and constantly evolving industry, I was not expecting such a warm welcome and inclusion since the first day, and that was something I was pleased to encounter.

1.3.3 Project organization

The position I applied for at Deloitte was as an M&A Transaction Services Intern, but let's dive deeper in what my tasks and my role directly involve.

The Transaction Services division is in charge of performing activities of financial due diligence, i.e., the analyses performed by businesses, investors, or professionals to assess the health and opportunities associated with a target company in the context of a business transaction (this topic will be further explained in chapter 2). This definition is necessary to explain that all the activities in which I have been involved are related to this type of process: in just a few words, me and my team perform an analysis of the company or business and produce a detailed report to be delivered to the client. I will now outline the main operations and characteristics pertaining to my job.

Project length. Each project presents its own peculiarities: target company, type of activity required, industry and market in which the company operates etc. However, due diligence is a phase of the deal that must be completed quite rapidly. Consequently, the length of a project is between three to four weeks and a maximum of a couple of months (some exceptions with more complicated deals can arise).

Team composition. In approaching a new project the first step towards is to define a specific team that is assigned to that. Usually, teams' composition is between four and six people, each with a different seniority. One intern, one associate, one manager, one senior manager, and one director is the usual structure: this is great for an intern, as you constantly deal with people with different level of experience, and you get to know the most from everyone. In addition, a peculiar aspect of the Transaction Services office of Milan is the close relationship with those in Bari (Italy) and in Tirana (Albania). Thanks to these relationships, every project welcomes someone from the Bari office and the Tirana office, allowing you to experience a different approach and knowledge from a different country.

Start of the work. Each project follows a specific timeline, but the general procedure is similar for every situation. The first step is necessarily the data gathering: Deloitte gets in touch with the target company as to receive all the necessary data to kick off the project. This means providing the client with the so-called "Information Request List", or IRL, which is a file containing all the documents that the team needs to properly complete the job. This document gets continuously updated during the continuation of the work, as soon as the company provides the data, or the team adds requests to perform a more detailed analysis regarding some specific issue that may arise. Thanks to this list, the target company is able to provide us with the necessary and precise documents.

Project continuation. Following the IRL, Deloitte receives a first tranche of

documents, including the financial statements, so the team can start to elaborate the information. With a series of internal meetings, the tasks are divided between the members, and everyone proceed with organizing the received documents. At this point a workbook is created: this is a shared Excel file within the team containing the different sections of the analysis. In this way, every person involved in the project is always up to date with the analysis, and is able to modify and add new progress.

Workbook composition. The workbook is the reference document for the whole project. It is the file that contains all the analyses and elements considered. To deal with its inherent complexity, the workbook is divided in sections, to facilitate tracking of the single parts of the analysis.

1. *Overview.* The overview contains the company's structure and presentation, as well as a general analysis of the Board of Directors, the main customers and main suppliers of the company. This is the introduction of the workbook, and gives an overview of the perimeter of the transaction, making it possible for the team to understand the position of the company and its composition.
2. *Quality of Earnings.* This is the most relevant. This section is dedicated to the analysis of the earnings of the company, after making some relevant adjustments that will have an impact for the transaction (this is further explained in chapter 2).
3. *Profit & Loss (P&L).* Here the deep analysis on the profit & loss of the company is performed, starting from an overview based on the company's financial provided, moving to a detailed focus on the single elements contained in this first statement. Here, every voice of the P&L is evaluated, and the IRL is updated if clarifications are needed.
4. *Balance Sheet (BS).* After the P&L, the balance sheet is similarly analyzed. The procedure is similar, we begin with an overview, and then consider the single accounts with the related amounts. As just said, the analysis take care of any detail contained in the balance sheet.
5. *Cash Flow (CF).* The analysis of the three financial statements is completed with the cash flow. Here, a cash flow statement is prepared by using the P&L and the balance sheet that were organized in the previous stages, in order to have an overview of the profitability of the company as a whole.

Client relationship. One important aspect for the success of a project is to keep a close relationship with clients, as to remain updated on the progresses and

be in touch in case of new developments. Usually, periodic calls or meetings with clients are organized to discuss any updates and to define the next steps. During these meetings, a brief recap of the current state is presented, followed by the request by the team of the missing data to pursue some specific and more in-depth pieces of the analysis.

Report composition. When the majority of the data have been worked out and elaborated for the analysis, the second stage of the project begins. At this point, when the workbook contains some information, it is time to start preparing the final deliverable for the client. This report takes the form of a PowerPoint presentation, that contains the data and the necessary insights that will allow the client to understand the situation of the target company. The report is written based on the elements contained in the workbook, and it follows, in most cases, the same identical structure (overview, quality of earnings, P&L, balance sheet, cash flow, appendix). In order to have the relevant information to complete the report, the team needs to have some meetings with the target company, to understand the main issues, for example all the clarifications from the data in the workbook, its business plan, or the strategy for the future years if the transaction were to occur successfully.

Conclusion of the project. The last few days before the deadline are dedicated to the conclusion of the project, when the team reviews both the workbook (which may not be delivered to the client), and the final report. The review is a key part of the project to ensure excellence is delivered. The report needs to follow some internal standards, both on the aesthetic side and on the content side: the choice of the colors, of the shapes and of the positioning of text and graphs needs to be correct, as well as the choice of the wording, the way of explaining detailed concepts and projections. For these reasons, the report is to be checked carefully by everyone, to be finally delivered to the client once the team has the certainty of the excellence of the work.

1.3.4 Tasks and duties

As an intern, I do not have precise tasks and duties, but I span the entirety of the project as I work on the activities that are most needed at every moment. Since every project is different, but with some commonalities, there are no specific tasks always assigned to me. An example of the tasks I have been assigned involves conducting market research of the company and its position on the market, and prepare the company and organizational structure, which are, respectively:

- Company structure – this represents the ownership of the company and the eventual presence of subsidiaries, in order to understand who owns the stakes

of the company and whether the company has branches or other division, for which percentages and where.

- Organizational structure – this represents the governance of the company: with this graph, we represent the main roles in the board, the CEO, the most important directors and the relevant roles, with the associated persons inside the corporation.

When we receive the documents regarding the financial statements of the company we are analyzing, one of the first tasks to be completed is to prepare a general presentation of the statements, so the P&L and the balance sheet. This aims to depict the situation of the company, highlighting all the adjustments that might be required. After that, the work is divided, and we start preparing all the so-called "details", which consist in considering a single macro-voice, and subdivide it in smaller and more precise components, in order to understand the trends and movement of the single accounts over the years.

Another example of a task that I am often assigned to is to prepare the specific illustrations to be attached to the final report. In particular, we prepare some specific charts to provide a graphical representation of the most important and relevant data, such as: EBITDA¹ bridge, which represents the different components of the EBITDA, and Revenue bridge, which represents which products, locations or typologies have a stronger impact on the total revenues. Moreover, we usually represent the sales and revenues organized by products or by location by means of pie charts or stacked columns charts, as well as the revenues divided by the quarters of the year, in order to have an insight regarding seasonality and cyclic nature² of the business.

Overall, I won't say that my tasks are repetitive or always the same, but the job requires me to adapt to the situation, depending on the specific deal, on the specific company, on the document you have available for the analysis. In order to provide an even better explanation, I will now give a brief overview of the projects I worked on during these first months of my internship at Deloitte.

1.3.5 Projects examples

As I previously explained, every project is different and needs to be faced with a fresh perspective. Since I started my internship on the 3rd of April 2023, I had the opportunity of working on three different projects, all with different characteristics and aspects, in particular:

¹EBITDA stands for Earnings Before Interests, Tax, Depreciation and Amortization.

²Seasonality and cyclicality of the business consists in a period of the year in which the sales are consistently higher than the rest of the year.

- A carve-out for a brewery, carried out between an Italian and a Danish company.
- Acquisition due diligence for a company operating in the food industry, between two Italian companies.
- Refinancing due diligence for a company operating in the consumer goods and healthcare sector.

Carve-out project. The first project consisted in a sale of a portion of a business to another company in the same industry. This project involved the selling of a facility of the target company, which was then incorporated by the acquiring entity. This project entailed a greater challenge than a traditional M&A transaction, for the following reasons: first, in an usual operation, the whole company or business is bought or sold, facilitating the valuation and due diligence since you consider the company in its entirety. Moreover, in a carve-out, you need to distinguish the part of the company that is being sold, and the part that is remaining under the control of the original company, thus requiring a double analysis (one for the whole and one for the segment). In addition, this distinction needs to be done for every aspect of the company, from personnel to inventory, and involves a lot of estimation and hypothesis. This project has been challenging, but in the end, we managed to satisfy the needs of the client, reaching our objective.

Acquisition due diligence. The second project consisted in a traditional operation, an acquisition due diligence from a strategic buyer³, who wants to acquire the company to benefit from its strong performance. However, also this had its challenges that we had to overcome: firstly, the business had a remarkable performance during and slightly after the Covid-19 pandemic, making it harder for us to understand the true profitability during normal times, since during the pandemic period they operated in some sense like a monopoly⁴. Secondly, since the core business was the trading of sea products, like fishes, lobsters, and prawns, the analysis of the inventory and of the warehouse was really peculiar, and we had to pay a strong attention to the conclusions that we derived. However, since Deloitte had a long-lasting relationship with the client, the job was carried out smoothly despite those difficulties.

Refinancing due diligence. The third project is still in progress, and will probably be completed during the month of September. This project is characterized by the unique feature that, being a refinancing deal, it involves only one company,

³A strategic buyer, as we will see in chapter 2, is a buyer that pursue the operation in order to benefit from synergies.

⁴With monopoly in this case I mean that they had power similar to a situation in which the business is the only player in the market.

the client, and not two of them as is normally the case. Despite this peculiarity, the approach to the deal was similar to the process previously outlined: gathering the information and analyzing it. Even this job presented some challenges, mainly due to the organization of the target company. In fact, this company operates both in Europe and in Asia, forcing to distinguish between the two segments, with two different structure, two business plans, strategies, and also currencies. After having reported everything in a comparable way, we could start our analysis of the "divided" business. Luckily, the management team of the target turned out to be very proactive and collaborative, and we are rapidly moving towards the closing of the deal, but there are still some aspects to be clarified and better explained.

Overall, I am appreciating the opportunity of working in such diverse projects and deals, as this is giving me the opportunity of growing and gaining every day more experience in the field.

1.4 Impressions and future

In this last section of the first chapter, I provide a recap on my impressions on the internship, describing the connection and coherence between the position and my study cycle, explaining the most important skills gained, the challenges that I had to face, in particular at the beginning, and my future plans and ideas for the continuation of my career.

1.4.1 Internship's first perception

I began the internship on the 3rd of April 2023. After nearly 5 months, I realise that what I was expecting does not coincide with the reality. The element that surprised me the most are the people: since my first day, everyone has been amazing with me. I was immediately included in the office group, everyone is willing to help in case I experience problems or I struggle with any aspect regarding the company, the job, or anything else. I was expecting a competitive environment, in which is hard to find someone nice to you, but in reality everyone is. From the first project, where I was disoriented by the new environment, new people, new tasks, each one of my colleagues and team mates have spent time with me, explaining our objectives and how to reach them. If the social aspect was the biggest surprise, the more technical and practical aspects were also positive since the start: once I was involved in the projects (this was one of the few initial struggle, as explained in the "Challenges" section below), the pace, flexibility and organization of work were really favourable, and I immediately managed to understand how the work at Deloitte is structured.

However, not everything was positive and interesting since the beginning, but

nothing that could not be resolved with a dose of patience and hard work.

1.4.2 Challenges

Besides all the positive aspects related to this experience, it is important to consider the challenges that I faced during these 5 months of internship. The first one, as I was expecting before starting, was understanding the job, the tasks I was assigned to, the instruments employed, and how I had to cope with the difficulties of the job. This has been surely one of the hardest obstacles, since I had no experience within a similar role, and everything that I had to deliver was new to me. Second, and strictly linked to the first one, was the fast paced environment: at Deloitte you need to be at the same time very precise and very fast in providing the analysis required to complete the tasks and the project you are working on, and at the beginning I struggled to understand the correct pace and standards. However, I knew it was a matter of time before I would have overcome these difficulties. After the initial period, I understood both the aspects of the job in which I was involved, and the time and manner to be respected. Third, the most problematic challenge was that when I entered in Deloitte, the amount of projects currently in progress, and the ones about to begin, was scarce. This is because in the first quarter of the year the M&A operations' environment suffered from a slight slowdown, that translated to a reduced workload. Due to this, at the beginning I struggled to be involved directly, to strengthen my relationship with the colleagues, and to start-off my experience at best.

To sum up, these challenges, despite in some cases being hard to overcome, did not turn out to be a severe threat to my internship and to my experience, and did not create an issue to bring the job home. They made me grow, in particular from the personal side, as I managed to deal with complicated situations by acting in the correct way, besides the obvious and solid growth on the professional aspects of the job.

1.4.3 Interconnection with the study cycle

As I stated at the beginning of this discussion, the internship in M&A Transaction Services at Deloitte has been the perfect continuation of my study cycle. In particular, the courses attended during my Bachelor's degree at Ca' Foscari University of Venice in Economics, Markets and Finance, such as "Corporate Finance", or "Accounting and Business Administration", provided me with the knowledge and capabilities to face the majority of the topics and tasks that I had to deal with every day at my job. Moreover, the courses completed both during the first year of Master at Ca' Foscari, and during this second year at Université Paris Dauphine,

allowed me to master the concepts and knowledge gained previously, and expand my horizon and perspective in the financial environment. To be more specific, the course "Financial Reporting and Advanced Corporate Finance" and the "Financial Economics" courses in Venice, gave me a really strong confidence in the topics of accounting and corporate finance, as well as further deepening my knowledge of M&A processes and operations. This was also expanded during my last year in Paris, where Professor Reinoso's "Business Simulation" and Professor Gannage's "Corporate Strategy" bestowed me with important practical skills, most importantly Excel skills which I apply every day at the office. Lastly, even though not directly related with the practical aspects of the job, the "Leadership in Finance" course, taught by Professor Reinoso, gave me the possibility of working on some key soft skills to be applied not only during my internship, but also in the everyday life (more details about this will be provided in the following section). To sum up, all the steps that I have completed prepared me perfectly for this internship, and all the exams, courses, and professor have left me something for the future, from skills to hard knowledge, that I am already applying and I will continue to do so.

1.4.4 Hard and soft skills

One important aspect to highlight regarding my period of internship consists in the hard and soft skills that I gained during the period.

Regarding the hard skills, they are divided in two main categories: accounting side, and technical side. On the accounting side, I had the opportunity of mastering my knowledge of accounting principles, and in addition to what I studied during my bachelor and master, I gained the ability to navigate with confidence a company's financial statements. In particular, since this is the most relevant aspect of my job, I learned to differentiate the single voices and accounts of both the balance sheet and the P&L statements, in order to reclassify them and use for the analysis required. This allowed me to understand the relationship between the accounts, how they are interconnected, and what is the impact of each managerial decision, both from a material point of view, and from a strategic point of view. More than that, during the internship, on the technical side, I have been specializing in the use of some programs, in particular Microsoft Excel and Microsoft PowerPoint. In the course of my studies, mainly at Université Paris Dauphine, I already had the chance of improving my ability in these fields, but here at Deloitte, these two instruments have become my best friends. In order to complete the analysis required, we manage our data and the documents provided only with the help of Excel, performing data organization, data analysis, and modelling. After that, we need to prepare our final deliverable, which is fully done with the interaction between Excel and PowerPoint.

This helped me a lot in becoming confident and faster when dealing with these programs.

On the other hand, focusing on soft skills, this internship is giving me the opportunity to grow also from a personal point of view. The most important skills that are required for this position are organization, precision, attention to details and a strong work ethic. Precision and attention to details have always been two of my strengths, and having the possibility of improving on these fascinates me. Organizational skills are key, since you have to deliver your tasks in a short time frame, and to complete everything, keeping the high standards of excellence, you need to be perfectly organized to cope with the workload. In addition, I developed a strong sense of adaptability since I had to get used to changing teams, change projects and adapt to new tasks within a couple of days, making me capable of working with several people with different backgrounds and ideas, and different ways of setting up the work stream. Finally, two aspects on which I improved substantially are multitasking and proactiveness: multitasking refers to working on multiple projects at the same time, rapidly switching your mind and thoughts from one to the other. Besides that, I developed proactiveness in the situations where I had to perform specific tasks for which I had not been trained or prepared, so I had to understand by myself what was the specific request and how to solve it correctly.

Summing up, I am having the opportunity of gaining key skills and capabilities, that will not only be useful at this stage of my career and my life, but I will apply them in every aspect of my life, both personally (soft skills), and professionally (soft and hard ones), in every chapter of my journey.

1.4.5 Future plans and opportunities

To conclude the analysis of my internship at Deloitte, I present my future plans, outlining the opportunities I will have, even though I have not yet decided which track to pursue.

This internship is giving me the opportunity of dealing with an aspect of finance that has always interested me: the world of M&A operations and deals, aspects that could influence the financial market and shape the economy of a particular country or territory. Considering the future, I would like to make two different points: opportunities and future ideas. On the opportunity side, the feedback I received so far by my colleagues, managers, and people I worked has been very positive, and I believe there is the possibility for me to be offered a full time role after the termination of my internship, in October 2023. Deloitte is certainly one of the most interesting and appealing realities for this role and position, but I do not personally want to bind myself to one possible path. Looking ahead to my future

endeavours, then, I am considering three different options. First, if there is mutual satisfaction between me and Deloitte, is to remain in the M&A Transaction Services department, with a full time offer, in order to gain a stronger knowledge of this role, of the company, and of the operations that are carried out in the market. Second, working for a different company, remaining in the field of corporate finance, but changing either the company, or trying a different experience in a new city, in a new country, in a totally new environment, maintaining only the field of interest. The third path that I am considering is to try a whole different adventure, from the job position to the environment, in order to get the most different set of experiences. This third path could include a new experience abroad, which I am very interested in pursuing, rather than an experience in a completely different field than my current one. Each path has its own benefits and challenges, from the first one, that involves an environment in which I am fitting very well, to the third one, which provides the opportunity of trying something new, which intrigues me, given that I am still at the beginning of my career. All in all, I have not taken a decision yet, and I cannot wait for what the next weeks and months have in store for me, with the consciousness that this current experience will be crucial for whatever route I will decide to take.

2

Academic Research

2.1 Introduction

As an intern in Deloitte in the M&A and Transaction Services department, in the division of Financial Advisory, I have the opportunity of dealing in first person with different M&A deals and operations. In particular, my division operates in the stage of the deal relative to financial due diligence, and I am facing different processes, with their relative characteristics and peculiarities.

The objective of this second chapter is to define clearly the concept of "Due Diligence", providing the relative definitions, the typologies, the stage in the operation, and all the people and institutions that are involved in the process. After that, I will narrow my analysis around the scope of "Financial Due Diligence", defining this process, the key characteristics, and when the process provides benefit to the transaction. The third section is dedicated to a focus to the most common adjustments that are made in order to provide the clients with the best information to reach a decision, such as EBITDA, Net Financial Position, and Working Capital. Lastly, I describe some risks and challenges that may arise following this process, necessary to the closing of each deal.

The aim of the chapter is to find a proper answer to the following questions, besides providing the best possible overview to the topic just mentioned: what are the most relevant reasons that drive the realization of a financial due diligence, and, in addition, why do many operations collapse due to a poor due diligence, which risks do we need to mitigate with the process?

The choice of this precise topic is based on my experience as an intern at Deloitte, where with my team I need to carry out this activity for different types of projects and operations (as I highlighted in the previous chapter), following the precise steps

in order to deliver the best solution to our clients.

2.2 The concept of Due Diligence

This first section has the objective of generally defining the concept of "Due Diligence". Starting from a general definition, I am then providing all the details necessary to have the clearest possible idea on the topic: different typologies of due diligence, at which stage of the deal the process is carried out and by who. This section is beneficial for the following ones, where I am going deeper in this process, which I perform daily during my internship.

2.2.1 What is due diligence?

Due diligence is one of the most important processes when executing an M&A transaction. This is, in a few words, the "investigation by an investor or its advisors of the accurate and complete character of the target company's business"¹. It involves all the activities carried out in order to reach a valuation of a company, which should include also a valuation of the potential of the operation.

The first time in history in which it is heard about due diligence was during the conclusion of the nineteenth century, when was employed as a method of assessing the conduct of the State and of people with regards to foreigners. This had not many aspects in common with the current meaning of the term, but even then was a practice to determine whether the parties were operating correctly according to the law. Around 50 years later, in 1933, it is encountered the first use of due diligence as related to transactions, according to "section 11b3 of the U.S. Securities Act of 1933, stating that sellers of securities have to give investors enough information to make an informed decision before buying"². Due diligence, since then, began to be used to different areas in mergers and acquisition, becoming a standard practice around the 1950s. As of today, the concept has evolved in practices and coverage, but the foundations were laid down around 90 years ago.

Taking a step-back, why do investors and companies perform M&A operations? These kind of operations are performed according to several reasons:

1. Strategic growth and expansion – meaning that companies may want to enter in a new market, diversify their business or expand the product or service offering through an operation.

¹Rosenbloom, A. H. (2010). Due diligence for global deal making: The definitive guide to cross-border mergers and acquisitions, joint ventures, financings, and strategic alliances. Bloomberg Press.

²Marker, A. (2019, March 14). Due diligence types, roles, and Processes. Smartsheet. <https://www.smartsheet.com/due-diligence-guide>.

2. Synergies and costs savings – create economies of scale by improving the efficiency of the production, either in terms of revenue growth, or in terms of costs savings.
3. Competitive advantage – companies want to increase their market share and client reach, in order to be less sensitive to the actions taken by competitors, or staying ahead for what regards new trends in the industry.
4. Talent acquisition – this is less frequent, but it can arise in very technical businesses with a strong employment specialization, in order to "stole" the expertise from the competitors.
5. Financial objectives – meaning either restructure the financial situation of the company in case of distress, rather than increase the profitability of the company at the eyes of the investors.
6. Risk mitigation – reducing the impact of a period of crisis in a single industry, rather than fighting supply chain shortages or strong dependency on customers and suppliers.

Following this reasoning, one question immediately arise: if there are such valid and strong reasons to perform these kind of operations, why most of the deals, from 70 to 90% according to the Harvard Business Review³, fail? Moreover, according to an internal research of Deloitte, around 30% of the deals do not achieve their expected value. These aspects are due to two main reasons: firstly, there is lack of capabilities when performing the integration phase of the deal, and secondly, and most importantly, due diligence is performed poorly. Within the following sections I try to navigate the aspects of due diligence, underlying its importance in deal making, and stating some elements and factors that we carefully analyze at Deloitte.

2.2.2 Types of due diligence

As said before, due diligence must cover all the features for what regards the completion of an operation, from the initial business plan to the strategy of integration of the acquiring company. In order to carefully analyze all the involved factors, due diligence is divided in different types of analysis, each performed by a different team, with different peculiarities. It has to be said that there is not a precise categorization, since every advisor has its own subdivision. Personally, I refer to Deloitte's categories, due to the fact that are in some sense simplified and easy to understand, as well as they cover all the aspects of the transaction.

³Don't make this common M&A mistake. Harvard Business Review. (2020, March 17).

- **Commercial due diligence.** As the name says, it provides a deep analysis on the commercial aspects and operations of the company, such as revenues and future expectations, historical performance of sales and costs, position on the industry and its trends, customer typologies, and brand perception.
- **Financial due diligence.** This provides a picture of the financial position of the company, going deeply on some key areas and performance indicators, as well as highlighting the main risks of the deal (I am explaining more on this in the following section).
- **Human Resources due diligence.** This evaluation focuses on the composition of the target company, mainly on the organizational structure, and all the aspects related to the Board of Directors and the employees, such as compensation structure, HR policies, turnover analysis, and other internal agreements and policies.
- **IT due diligence.** The IT valuation goes into deep details of the target information technology department, in particular all the systems, processes, applications, and, most importantly, security and cyber security, in order to clearly state the possible risks, threats, but also synergies in this area.
- **Operational due diligence.** The operational analysis is limited to considering past and current operational performance, the division and organization of costs, preparing a map of potential synergies for what regards the integration of the target with the buyer.
- **Tax, Labor, and Social Security due diligence.** This is often called tax and legal due diligence, and is one of the most important along with the financial one. It has the objective of identifying the most relevant tax issues, such as compliance, tax credits or incentives, as well as the legal aspects, for example pending litigations, regulations compliance and contracts, in order to mitigate potential risks and threats.

All the categories have been taken from "Deloitte, Introduction to due diligence."⁴. Remember, these are not universal, so there could be some classifications with a slightly different name allocation. However, it is important to clarify that some aspects of the analysis are present in different types of due diligence, as a way of double check the job done by the different team.

⁴Kennedy, V. (2021a, January 22). Introduction to due diligence. Deloitte. <https://www2.deloitte.com/br/en/pages/strategy-operations/articles/fusoes-aquisicoes-introducao-due-diligence.html>

2.2.3 When is done? Who is involved?

As I said in chapter 1, the process of due diligence can last from three to four weeks, until usually a two to three months time-span. But during an operation, at which stage is due diligence performed?

A transaction, usually, is composed of five main stages, involving all the necessary steps and relative documentation. In particular consider:

1. Phase 1 is the so-called "**M&A Strategy**", where the objectives of the deal are identified, and the decision of pursuing a transaction is made.
2. Phase 2 is the "**Target Screening**", also known as deal origination, where potential targets or buyers are identified and contacted, and potential synergies are evaluated. During this stage, a letter of intent is signed. A letter of intent (LOI) is a document establishing some basic terms between the parties entering into an agreement.
3. Phase 3, which is the one we are interested in, is the "**Due Diligence**" step, in which the teams are organized, protocols, methodologies and timelines are set, and the different types of analysis are performed and commented; if the due diligence is successful for both the parties involved, they sign a purchase agreement, stating the terms and conditions of the transaction. The purchase agreement includes aspects such as purchase price, payment structure and time, any precedent conditions and provisions. This document can be wither a Share Purchase Agreement (SPA), for a stock-based acquisition, or an Asset Purchase Agreement (APA), for an asset-based operation.
4. Phase 4, which is the "**Transaction Execution**", can begin only once the previous documents are signed. In this stage, the deal structure is developed, the official offer is made and the final terms of the deal are set. Similarly, the integration is planned, in order to define the final steps of the transaction as well as the closing.
5. Phase 5. Finally, even though is not the proper conclusion, phase 5 consist in the "**Integration**", where the integration plan is presented and applied, and every aspect of the involved businesses is integrated, such as organizations, workforce, operations, facilities, customers and products. I said that this is not a proper conclusion due to the fact that the integration phase lasts for a longer period, since the parties need to see whether the companies are able to maximise the value with the operation and reach the synergies or other benefits that were planned in the earlier stages of the transaction.

For what regards the people participating in a due diligence project, the number involved varies depending on the type of analysis, but is usually a stage that comprises a wide number of professionals from different sectors. The cast usually ranges from the company's employees, company's traditional professional advisors, and the specific advisors hired for their expertise in determined areas, such as legal, tax, financial, and operations in the target's home country (Deloitte falls under this category). Let's see more in details this last group mentioned⁵.

Legal professionals. Since law and regulation are two aspects at the same time really important and really detailed, more or less all the deals at these days involves a team of specialized professionals in fields such as corporate law, tax, real estate, employee contracts, or insurance. This is because businesses need to follow strictly the regulations from the local country or from the European Union (if they operate in this area), rather than the United States, and for these reasons we need experts in those fields to come up with their analysis and conclusions.

Financial professionals. For what regards the accounting and financial aspects, the companies involved rely on their internal experts, such as the CFOs and controllers, with the help of outside experts, such as from consulting firms, or other auditors. If we have a situation of a cross-border deal, often different firms are implicated, in order to have a different perspective and point of view of the operation, as well as investment banks or commercial banks chosen by the parties involved.

Operational professionals. Every single aspect of the target's business needs to be evaluated, from the production, to the sales, to the properties, marketing, human resources and all the operational issues involved. For an investor, valuing these aspects is hard in particular whether this operation is the first in the industry, and lacks of a strong knowledge of the sector. Due to this, and due to the fact that the analysis needs to be precise and detailed, outside advisors take care of the process and perform all the necessary valuations.

2.3 Financial Due Diligence

Having completed the overview regarding due diligence, it is time to dive deeper into the aspect with which I deal everyday during my internship at Deloitte: "Financial Due Diligence". This is one of the analysis mentioned before, and involves on the target company's side the internal accountants and the CFO, and on the external side a specialized team usually from a consulting firm or from a bank. Let's see in details what is, what are its objectives and why it is so important.

⁵Rosenbloom, A. H. (2010). Due diligence for global deal making: The definitive guide to cross-border mergers and acquisitions, joint ventures, financings, and strategic alliances. Bloomberg Press.

2.3.1 Definition, scope and importance

Financial due diligence is defined as the process in an M&A transaction that ”analyzes the company’s performance, in order to explain its economic-financial evolution, it identifies possible risks and opportunities and substantiates the valuation criteria previously agreed upon by the seller and the buyer”⁶. Due diligence is carried out not only for the acquiring company, but also for all the parties directly or indirectly involved in the operation, such as lenders or debt providers.

Generally, financial due diligence can be of either two different categories:

1. **Buy-side due diligence.** Here, the analysis is performed by a potential buyer or an acquirer who wants to purchase the target company rather than part of it with the transaction. The buyer could be a strategic buyer, which is a buyer that is generating synergies from the transaction, or a private equity firm, a venture capitalist or an investment bank, looking for a profit from the operation. This type of due diligence focuses on assessing the financial health of the target company by analyzing the financial statements, debt and credit position, profitability, and growth perspectives. The optimal situation for a buyer is to find a company with a strong financial health, a solid position in the market with a forecasted growth, stable and constant.
2. **Sell-side due diligence.** On the contrary, this analysis is performed by the owner of a business who is interested in selling its activity, becoming the vendor or seller. Differently from an acquisition due diligence, the process here is more towards identifying the areas of interest for a potential acquirer, in order to simplify both the stage of finding potential buyers and the subsequent progress of the whole operation. The amount and quality of work necessary for a sell-side due diligence are the same as the ones required for a buy-side one, the only difference is the perspective and the approach towards the target company.⁷

It is important to note that the scope and objectives of a financial due diligence depend on several aspects: in particular, they could vary on the typology of operation, on the way through which the operation is carried out, on the industry in which the company operates, on the business’ scale, and on the size of the companies involved. However, there are some areas of analysis which are common to all the typologies or businesses. These areas are:

- Profitability of the company – since the due diligence is always structured on a period of interest (that usually includes a period of three years), the analysis gives you the amount of profit over the period considered.

⁶Marchetti, S. (2022). The importance of Due Diligence. TopHic - Dig Deeper.

⁷Chettri, Y. (2023, May 23). Everything you need to know about financial due diligence in 2022. SignalX AI. <https://signalx.ai/blog/everything-about-financial-due-diligence/>

- Debt level – how much the company is indebted is a necessary question to be answered, as well as the repayment plans and structure of the payments.
- Growth strategy – it is key for the potential acquirer to understand which are the plans for the company in the future. Both for the short-term and for the long-term, whether the growth is expected to be constant or to increase steadily and then stabilize.
- Financial health – as mentioned before, the current situation of health of the company is one of the starting points of the whole analysis. If the target is not "safe" from this point of view, there is no reason to keep the deal alive.
- Working capital requirements – this is going to be explained better later: the analysis of the working capital is one of the most important part of the whole process. Here is also done with a future perspective, to give the buyer an idea of the requirements after the acquisition.
- Revenue generation – an important aspect to consider is how the company generates revenues and profits. This considers several factors, such as customer breakdown, types of products, areas of operations, and others. The result of this is the adjusted EBITDA metric.

2.3.2 Asset purchase vs. Stock purchase

In an acquisition, the form and structure of the transaction strongly affects also how the due diligence is performed. The three main structures that are commonly implied for an M&A operation are an asset sale or purchase, a stock sale or purchase, or a mixed form within the two. Here, I consider the different approach that is applied between the all-asset and the all-stock transaction. The differences are not only on the way in which due diligence is organized, but also in the risks assumed, since when a stock purchase is considered, the acquirer takes on the entirety of the risks.

Asset purchase. In the situation of an asset purchase operation, the relevant information to be considered are certainly assets acquired and assumptions on liabilities. The analysis is limited to the just mentioned elements, and for many reasons it is simpler than considering an all-stock transaction. The assessment should then take the following elements under consideration, depending on the typologies of assets and liabilities that are being acquired: firstly, it is important to clearly identify which assets of the company are brought in, along with the liabilities assumed, in order to have the precise perimeter of the due diligence. Secondly, the team should verify the accuracy of the information on assets, following different steps: physical counts and observations of assets, review of documents or other files to check for the

presence of either other assets (bank statements or shipping documents for example), or assets held by another party, check the work of external accountants or other professionals on assets, analysis of current regulation to verify for the main issues to be addressed, and check for the approval of the target of investments and purchases related to assets. Thirdly, a similar assessment needs to be done for liabilities, which has some bullet points to be followed as the asset side: be sure about the amount of outstanding payable, look for eventual unrecorded liabilities or accruals, check for the reports of the board of directors in case of approvals of commitments to purchases or other issues (even on the legal side). Similarly as for the asset, control for the work of the external accountants (check for litigation existing or threatened), and, lastly, verify the income tax and the and eventual communications from the regulatory agencies. The fourth and last element to be done is an evaluation of the result of the processes, with an investigation on any potential issues to be solved.

Stock purchase. In case of a stock purchase, the situation is more complicated. In fact, the process of due diligence involves not only all the procedures already analyzed in the previous paragraph, but also some additional ones: work on the financial reports of the company, as well as gather every analysis made internally regarding trends and summaries. Then, with all the information, prepare some details, focusing the attention on the consistency of the data (a change in one account should make the professionals consider why it happened and how is reflected in the other statements), then there should be communication between both the financial and the tax and legal teams of due diligence, to verify if the correct filings were made. Be in contact with both the lawyer of the target company and the other professionals involved in order to check if any claim exists or whether anything has failed to be recorded in the documents provided by the target company. If employees are represented by specific unions, check for the contracts to see if they need to be renewed or they have additional cost accruals, and, lastly, contact the management to have a view of stock options or eventual ramifications. The amount of work required to carry out all these activities can vary a lot depending on the operation, the timing of the transaction, and on which priorities are set in every situation. Often, due to lack of time in these processes, some areas are considered as non-material and are not analyzed at all⁸.

2.3.3 Benefits of the process

Since now, I have talked about the processes of due diligence and financial due diligence, how they are structured and which are the main differences. However, the

⁸Rosenbloom, A. H. (2010). *Due diligence for global deal making: The definitive guide to cross-border mergers and acquisitions, joint ventures, financings, and strategic alliances*. Bloomberg Press.

main focus is always on why the process is carried out and what are the main benefits that they could bring to the transaction. As said in the beginning of the chapter, due diligence is a stage in the process that can either confirm what previously stated, place the operation under a serious threat, or even make the deal collapse. For these reasons each benefit that brings is very important and has a precise value. The most relevant of those are:

- Understand the viability of the acquisition – by performing financial due diligence, the investor gets to know for sure if the transaction is feasible and helps him or her to make an informed decision.
- Identifying risks – it is possible to understand whether some risks can come up during or after the operation. A risk that could seem negligible at first could then turn in a serious problematic in the future, so it is better and important to identify all the risks at the initial stages and address them to avoid future issues.
- Know the true value of the target company – with the due diligence carried out, it is verified whether a true value in the target has been assigned. This is key in order to make the right decision from the investor’s point of view.
- Uncover and find any issues before making a final decision – if the target presents some criticisms, these are pointed out during the process, and there is still time to address them before any binding decision is made, or any agreement is signed.
- Reduce acquisition costs and legal costs – if the due diligence is carried out properly, all the costs related to the transaction are reduced, as well as the probability of incurring in high legal fees in the future. This could save the investor from having to pay a lot of money.
- Avoid post-acquisition dangers – as the sentence says, after the conclusion of the operation many things can happen, this could be due to an overestimation of the value of the company, rather than to an analysis not performed correctly. Due diligence therefore helps avoiding surprises and risks, and helps securing the success of the entire operation.⁹

⁹Shaji, A. M. (2022, December 21). Carrying out financial due diligence: Process, scope & limitations. Enterslice. https://enterslice.com/learning/carrying-out-financial-due-diligence-process-scope-limitations/Why_is_Financial_Due_Diligence_crucial

2.4 Most common adjustments: Quality of Earnings

Financial due diligence, as was just presented, is a very complicated process with a key importance and details. In particular, the process involves carrying out several adjustments to reach the specific goals and objectives. Those adjustments, as any other step just mentioned, can vary depending on the type of transaction, on the target company, on the type of business and sector, and also on the amount and quality of data that is to be received by the advisors from the target company.

The first and one of the most important adjustment that is made is the Quality of Earnings assessment. As the "Introduction to Financial Due Diligence" document published by Deloitte says: "a quality of earnings assessment seeks to understand the nature, trends, and sustainability of results"¹⁰. This adjustment is strictly correlated with the EBITDA adjustment that I am considering below, as it provides an evaluation of revenues, gross profit and the same EBITDA, in order to find a representation of earnings that includes only those relative for the transaction, excluding the non-recurring, non-operational and one-time (see more details in the next section).

In this part I am focusing on the most important analysis that should never be missing in a due diligence report:

- Analysis of the EBITDA Adjusted
- Analysis of the Net Financial Position or Net Debt Adjusted
- Analysis of the Working Capital Adjusted

Remember that, as was previously said, the analysis is not limited to these three factors, but these give the investor the possibility to have a clearer idea on whether the investment that he or she is about to make is really worth or not.

2.4.1 EBITDA Adjusted

As I defined in the chapter above, EBITDA stands for Earnings Before Interests, Tax, Depreciation, and Amortization. It gives us a good idea of a company's profitability, and it is at the same time a good metric for the free cash flow, because it will allow the investor to determine how much cash is available from operations to pay interests, capital expenditures, and other investments. Basically, it is computed

¹⁰Xavier, R. (2022, April 10). Financial due diligence. Deloitte. <https://www2.deloitte.com/br/en/pages/strategy-operations/articles/fusoes-aquisicoes-due-diligence-financial.html>

in the income statement, by taking all the revenue of a company, and subtracting all the expenses (except for depreciation and amortization), which are considered as non-cash expenses. EBITDA is strongly used during the valuation process, but its importance is not limited to that. During the process of financial due diligence, EBITDA is computed with the aim of assessing the value of a company, in order to understand whether the amount of sales that the target is able to generate is not excessively covered by the expenses necessary to reach those levels. Besides that, we need to introduce a new metric, this is called "Adjusted EBITDA", and is computed on the basis of traditional EBITDA, but adjusted in order to consider or not operations discretionary, one-off, non-recurring and non-operating that might have distorted the real calculation and the operations reported in the balance sheet¹¹.

It does not exist a "unique and standard" measure to compute adjusted EBITDA, it is in fact obtained by subjective calculations whose objective is to transform the economic indicator of the company in a value that can be useful to explain the economic efficiency of the society. It is important to always present the adjustments made, in order to make possible for the investor to understand why you have done it in such a way. The most important adjustments can be summarized in the followings:

- Addition of non-operating revenue, for example the sale of asset non core for the business.
- Elimination of non-operating expenses, for example research and development for projects that have not started yet.
- Elimination of non-recurring expenses, for example renovation or restructuring, legal expenses.
- Elimination of property costs, for example rent of buildings and maintenance costs.
- Addition of the costs related to stock options.
- Adjustments for goodwill impairment, if any.
- Gains or losses on foreign exchange, if any.
- Adjustments coming from periods precedent to the one considered for the analysis, and eventual impact of activities that were ceased.

It is important to notice that, for public companies, usually non-adjusted EBITDA is the metric which is reported in the financial statements, while adjusted EBITDA,

¹¹DHH - Dominion Hosting Holding S.p.A. (n.d.). Consolidated Pro-Forma * as at 31.12 - DHH. <https://www.dhh.international/wp-content/uploads/2018/04/020-Ebitda-Adjusted-31.12.2017-DEF.pdf>

even though it provides a more accurate financial metric in case of an M&A operation, it is not a generally accepted accounting principles (GAAP)-line¹² in the income statement of the company, and for this reason needs to be manually computed by the advisors.

2.4.2 Net Financial Position Adjusted

The Net Financial Position, or Net Debt, is one of the most used indicators in order to value solvency and performance of a company. Generally, it allows us to determine three main aspects: first, the total level of indebtedness of the whole company, both at a short and at a medium or long time period, second, the ability of repayment of the debt, when is related to the sales, revenues, or EBITDA, and, third, when comparing it to the net equity, it is obtained a measure of the soundness of the capital structure of the company.

In order to compute the net financial position, only financial assets and liabilities are to be included in the computation. In addition, a particular attention must be dedicated to some specific voices and accounts which are not always appearing in the financial statement of the company, which are:

- Financial leasing – this depends on how is accounted, for example, if IAS principles (which are the Italian principles of accounting) are used for the analysis, the residual amount to be paid towards the leasing entity should be included into the calculation of the net financial position.
- The staff leaving indemnity – this has not a clear position, since some of the accountants believe that it should be included in the NFP, while another group believes it is only a negative liability and therefore not to be considered.
- Commercial debt overdue – commercial debt represent an operating liability, but after they expire, they become a financial liability, and therefore needs to be carefully considered when we are dealing with the net financial position.
- Credit advances – some companies already register the closing of the credit as well as the parallel increase in liquidity, but in some cases they need to make some adjustments in case the movement does not figure out in the accounts¹³.

After having considered carefully the voices just mentioned, it is possible to compute the net financial position. This is generally obtained by taking all the liquid funds

¹²U.S. Securities and Exchange Commission. “Non-GAAP Financial Measures, <https://www.sec.gov/corpfin/non-gaap-financial-measures>

¹³Longa, V. (n.d.). Posizione Finanziaria Netta: Facciamo chiarezza. Caravati Pagani - Dottori Commercialisti Associati. <https://www.caravatipagani.it/news/posizione-finanziaria-netta/>

(cash & cash equivalents, deposits, or other), add the short-term financial receivables, subtract the short-term financial payable, which include debts for factoring, leasing or controlled entities at short-term. The result is the short-term net financial position. After that, the medium and long-term financial receivables are added, and medium and long-term financial payable removed, which consist in debt towards banks, other financing debt and financial liabilities towards controlled entities.

Once all the calculations have been performed, it is important to say that if the sign at the end is positive (+), this means that the company has an excess in liquid or financial funds with respect to indebtedness, while with a negative sign (−), there is a lack of liquidity to cover up for financial debt, meaning that the company is not able to repay its debt providers.

During due diligence, similarly as for the EBITDA and the EBITDA adjusted, some corrections are made to the original form of the net financial position, in order to make it more accurate and precise for the investor's decision. After the adjustments, the new metric is called "Net Financial Position Adjusted". The most important adjustments made are the following:

- Addition or elimination of credits and debits non operating, for example those towards administrators or shareholders.
- Addition or elimination of liquidity and investments, for example deposits, stocks, or securities.
- Addition or elimination of financial debt, for example loans and obligations.
- Gains or losses on foreign exchange, if any.
- Other items if impact cash over financial liabilities.

This metric, in financial due diligence, offers the advisors and the investors the opportunity to identify whether the company is under or over levered, or if it is possible for the same company to contract additional debt to finance its operations. In addition, it is also used in the valuation phase to compute enterprise value, that is used to compute the expected price to be paid for the transaction. Lastly, notice that, as well as for the EBITDA, there is not a standard methodology to compute the net financial position and the NFP adjusted, so it is necessary to state the process of calculation clearly to facilitate the interpretation of the results.

2.4.3 Working Capital Adjusted

The third and last important metric that I am considering is Working Capital. Generally, working capital is the difference between the company's current assets,

such as accounts receivables and inventories of raw materials or unfinished goods, and current liabilities, such as accounts payable and debts (remember, cash is usually excluded for the calculation of working capital)¹⁴. Working capital, or net working capital, is computed simply by taking the difference of the voices just mentioned; it is important to notice that both for assets and liabilities are included in the computation the current ones, which means all the accounts that the investor is capable of liquidating within a year.

Working capital tells about the ability of the company of repaying its short-term obligations. If it is positive, it means that the assets are higher than the liabilities, and that the company has the resources to pay its short-term debts and pay off its creditors. On the other hand, if working capital is negative, it means at first sight that the company is not able to repay its obligations (sign of liquidity shortage), and this can lead to serious problems, such as bankruptcy. This is a measure that tells whether the company is financially sound and healthy. Note that, having a positive working capital is not always a sign of positive situation: if the result is too high, it means that the company has either too much inventory, or it is not investing its excess cash, or again it is not capitalizing on debt opportunities at low expense. At the same time, having a negative working capital is not always a negative sign: this depends strongly on the type of business: for example, let's consider all the subscription-based businesses or those with long-term contracts, they are subject on having high deferred revenues, and therefore a negative working capital. Another situation is the case of retail or restaurants, as well as all businesses in which customers pay upfront, which frequently have negative values of working capital¹⁵.

Net working capital is strongly used in financial due diligence, but the calculation is slightly different and takes the name of Net Working Capital Adjusted. This is the working capital that is left for the firm after the elimination of all the non-operating elements. This is computed as the sum of accounts receivables plus inventory, to which are subtracted accounts payable plus operating liabilities. This metric has the objective of valuing how a firm manages its capital. Moreover, it is used also to gather some insights on seasonality and peaks and falls during the operating period. In particular, seasonality focuses on:

- Impact on historical performance.
- Improvement on the prevision of cash flows.

¹⁴Marshall, D. H., McManus, W. W., & Viele, D. F. (2023). Accounting what the numbers mean. McGraw Hill Education.

¹⁵Zangarini, G. (2022, August 10). Come Si Calcola il capitale circolante netto?. QuiFinanza. https://quifinanza.it/economia/capitale-circolante-netto-cose-cosa-serve/660535/#CCN_positivo_o_negativo_cosa_significa

- Determination of credit lines necessary to cover the payments.
- Variability between the different months.

On the other hand, the so-called "peak-through analysis" considers when the working capital reaches its maximum and minimum value over a period, and relates it to the financing situation in order to be sure to have enough funds to be prepared when the working capital turns to be low.

2.5 Challenges to success

At the eyes of investors, due diligence may seem a part of the deal which does not carry that much importance, and is certainly less "attractive" than other stages of the deal, like the valuation or the execution phase. However, this is where the full profit (or risks as well) are located. To conclude the analysis, I would like to present the risks and challenges that accompany due diligence, with a final snapshot on the possibility of making a deal to collapse due to a poorly executed due diligence process, rather than a lack of attention of the investor.

As the study on the impact of due diligence carried out by Steve McGrady¹⁶ says, due diligence often fails to identify any statistically significant factor that could predict successor failure. At the same time, the study produced some interesting results:

- A higher purchase premium paid does not produce a more probability of success.
- The size of the acquirer compared to the target does not matter in terms of result of the transaction.
- There is no difference demonstrated between vertical and horizontal mergers.

In the study, in addition some elements that were present as common factors in all the successful deals are presented:

- A common vision for the future of the company shared by both the seller and the buyer.
- A detailed plan for eventual change that could be made after the transaction.
- An organization for the new entity which is based on the strengths of the two companies, with the objective of maximizing value.

¹⁶McGrady, S. (2005). Extending due diligence to improve mergers and acquisitions. *Bank accounting and finance*, 18(4), 17.

- The choice of the leadership team, done quickly.
- A plan realized to focus on cultural issues.

This study is just a demonstration of how the quality of the due diligence can affect the success of the deal. However, the risks and challenges are not confined to the ones presented above, but there may be many, often related to the missing experience either on the target company side, or to the advisory side. The most common challenges that are frequently encountered, which I can confirm due to my recent experience, are:

- Not knowing which questions to address – it happens again and again that the team assigned to the due diligence is not prepared to address in advance the key issues, and this may result in a longer process, or in a process in which crucial analysis are left behind.
- Execution of the process slow – if the target is not ready with the documentation, or the team is slow in completing the analysis, this could result in a postponement of the closing, that can in some extreme cases either erode some of the value.
- Lack of communication – a lot of sellers does not care that much about the process of due diligence. For this reason, they may not be interested in responding rapidly and correctly, leading to a poor communication and impatience by the other parties.
- Lack of expertise – this happens more on the advisory side, where the team assigned to perform the analysis does not show enough capabilities or expertise to carry out the job.
- Cost problems – since the cost of due diligence has an impact on the operation, making it last longer than expected could be a serious problems, especially if the investor had a tight plan on that side¹⁷.

2.5.1 Risks and collapse of the deal

Due diligence has the objective of mitigating some risks of the transaction, such as financial, operational, legal, or reputational. Those risks are often related to the situation of the company and the market, or the industry itself, and there is not always room for eliminating them completely. History have shown several

¹⁷Due diligence process: 7 vital steps explained (complete checklist). Due Diligence Process: 7 Vital Steps Explained (Complete Checklist). (2022, December 21). <https://dealroom.net/faq/due-diligence-process>

examples in which due diligence could have saved a deal: what are the most recent of those? Two very famous cases, that were on the top line of the financial news in the recent period: Elon Musk's acquisition on Twitter, where Musk agreed a price with Twitter's board before knowing the presence of bot users in the platform, aspect that made the deal at severe risk, before being completed, even though not resulting in a positive operation, until now. The other is the operation between Binance and FTX, the two giant crypto exchanges, collapsed due to leaked documents regarding some dirty deals of FTX, which were not considered at the beginning of the relationship. At the end, FTX filed for bankruptcy on the 11th of November 2022. What is the morale of the whole story? Do your due diligence, and do it the right way.

Conclusion

To sum everything up, I will try to give once more my final perspective on the internship, firstly with an academic contribution section, in which I am presenting how my study cycle connects with the position I have at Deloitte, with tasks and also challenges. Then, I am concluding with my personal perspective, both on the internship and on my ideas for the future, how I would like to continue my career and what are the aspects that I bring from this position.

I have currently completed five out of six months planned for my internship in M&A Transaction Services at Deloitte. As I said, besides some hard time at the beginning, my period here has been great. For sure, one of the advantages that I had when I began my period in the office, was certainly my solid background and strong preparation in terms of knowledge, both from the hard and soft skills perspective, due to my study cycle and past academic activities. I immediately noticed that other interns struggled with some aspects, some of them had problems with the concepts, while others had issues with the more technical part of the job. I already talked about this in chapter 1, but let's clarify a little this aspect.

Starting from the beginning of my university cycle, with my bachelor's degree in Economics, Markets, and Finance, I had the opportunity of building a solid knowledge in the field of accounting and analysis of financial statements. In addition, during that first cycle, I had the opportunity of studying for six months at Nova School of Business and Economics in Lisbon, period in which I developed some key soft skills, such as teamwork and organization, that I apply every day at Deloitte. Moving on with my studies, during my master's degree in Economics and Finance, I had the opportunity, during the both the first year in Venice and the second one in Paris, of mastering the skills and capabilities gained during the bachelor. In the first chapter I mentioned some exams who were really important for me, here I would like to spend some words for some professors that gave me the opportunity of growing. In Venice, professor Dindo during the bachelor was really important: he pushed me towards expanding my knowledge linked to my interests, and I always followed with pleasure and passion his classes, which made me capable of knowing

how the financial market works and operates. During the first year of master, one professor that I always remember is professor Giakoumelou, who taught us "Financial Reporting and Advanced Corporate Finance". Besides finding that course particularly interesting and strongly useful for my job position in the Financial Advisory department, I loved her approach towards the industry and towards the class. She gave us important insights on how the sector is operating from the inside, advice that I found especially relevant during my first weeks in the office, where the impression you make is crucial. During the last year, when I attended the courses at Université Paris Dauphine in Paris, many professors passed me relevant knowledge or practical experience. One above all, professor Reinoso: due to its past experience in the consulting industry, he provided us a key representation of the work environment, as well as a package of soft skills which I had not honed until that time. With his two courses, "Leadership in Finance", and "Business Simulation", I had the opportunity on one side of gaining a series of soft skills, from communication and public speaking to organizational skills, which are necessary to be successful in any job environment. On the other hand, working on the business project very related to my current occupation was important to deal for the first time with this kind of work. Lastly, I would like to mention professor Beaudoin, with his course on "Investing on Financial Markets", which gave me the opportunity, besides learning meaningful concepts, to experience, with his group projects, how it is like entering in a great working environment like the one we had the chance to.

Overall, I believe that all the steps I made till now made me capable of learning, either from professors or from colleagues, and at the same time allowed me to grow and to become a better person and a better professional every day.

Lastly, I closed chapter 1 by saying that I have still not decided which path I would like to follow for my future, since this is a decision that requires a lot of time, and I have still one full month of internship to go, period in which many things can change. Since I am still at the beginning of my career, the most important element for me would certainly to be able to find an environment that stimulates me, an environment in which I feel challenged, but at the same time a place to grow and learn. I stress so hard this concept, repeated many times during this report, since I don't believe that at this point in life there is a place where you should be or a route that you should follow, but you need to be open to what the future has in mind, and sure about the previous steps you made. Personally, I feel blessed to have had the opportunities that I had, from Venice to Lisbon, to finally Paris, and now Deloitte in Milan. I am not sure about where I will be next, who I am working with and for, but I am sure about the fact that what I did, until now, is successful.

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Sitography

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Appendix

Please find attached below my internship evaluation, made by the Andrea Sferrazza, Director in the M&A Transaction Services department at Deloitte.

Conte, Tommaso

From: Sferrazza, Andrea
Sent: lunedì 28 agosto 2023 19:18
To: Conte, Tommaso
Subject: Tommaso Conte

During his internship period in the Transaction Services department, Tommaso has been involved in two major Financial Due Diligence operations. In detail:

- 1) Acquisition due diligence of a company operating in the retail sector for agribusiness. During this project, Tommaso supported the team with analysis on revenues and margins by product category, analysis of the fixed cost of the business and certain tasks on the balance sheet of the entity. Tommaso proved to be a valuable resource, providing support in technical areas and multi-tasking in managing the various activities assigned by the team leaders.
- 2) Financial due diligence in relation to a bank refinancing for a retail group based in Italy. On this project, Tommaso was part of a team composed of 6 people and contributed in the analysis of sales and margin by product category, personnel cost, analysis of trade receivable and trade payable ageing and forecast figures. Tommaso shows signs of a professional growth, confirming the positive performance on the previous project.

Overall, the performance of Tommaso was positive, highlighting a great technical background gained through school, professional behavior in the different phases of the projects and engaging effectively with the team members during the fieldwork.

Andrea Sferrazza

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