Pre-Due diligence samples for XYZBCD GmbH: RAILS SPA PAPER SPA

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Analysis by Alessandro Pasetti

Alessandro Pasetti writes about investment strategy and assets valuation for banking clients mainly based in London and Europe. Based in London, he previously worked for almost five years at Dow Jones/The Wall Street Journal carrying out M&A research for the investment banking community. Prior to that, he contributed to the launch of Loan Radar, where he worked for three years in London. He had stints in equity research at such banks as Bear Stearns in London and HVB in Munich. He did its intermarket analysis research thesis with Unicredit in Milan.

Deal: PAPER SPA

FOREWORD

This extract concerns a company operating in the paper business, by providing production equipment. To maintain anonymity for this extract, we called:

- *the company analyzed: PAPER SPA*
- *the renting company: PARTNER SA and PARTNER Italia for the italian branch*
- *locations TOWN1, TOWN2, …*
- *competitors: COMPET1, COMPET2, …*
- *people: OWNER*

We were contacted and provided some documents on december 24th, 2013, at 6pm. We were told that on january 10th, 2014, PAPER SPA would have to appear in court to discuss its bankruptcy, forcing the company to fire 188 employees. The documents that we received were sufficient to extrapolate the

economic and legal status of the company, but without the important updates of the last 2 years. Nonetheless we were able to understand many key issues that should be addressed. This pre-due diligence was delivered december 27th, 2013 at 4:17pm.

This case, obviously a distressed one, is a good example of how we understand the situation and prepare to transform it into:

- *an opportunity for the investor*
- *a sustainable operation of the company*

Stage: Pre-Due Diligence Assessment

PAPER Spa is in dire straits. Not only is it in the midst of a massive corporate restructuring but, on the verge of bankruptcy, it bears the hallmarks of an investment for which a typical private equity-like internal rate of return (IRR) of 20% would not be enough to justify the risk being taken by any potential suitor.

It certainly deserves a “look”, particularly if more disclosure on its order book and financials is granted. Another matter is whether anybody should invest in it.

Sticking Point For Investors — Cash Flow Projections

Any investor ought to be aware that the firm, currently in "concordato preventivo", according the to Italian bankruptcy law (i.e. near liquidation if a solution can't be found by January 10):

A. is deeply in trouble, with trade unions slowing negotiations and limiting any synergy (revenue/cost) upside.

B. boasts a capital structure that is completely untenable.

C. hasn't changed much operationally since its new French owners (via their Italian subsidiary, PARTNER Italia Spa) took the helm in July 2011, although a recently awarded order of EUR30 million has allowed it to re-start production — at least partially.

Yet in any restructuring deal such as PAPER's, opportunity could lie in wait. But does it? New investors should be wary.

This pre-due diligence assessment investigates whether the company — once its overstretched capital structure is sorted out (possibly via a debt-for-equity swap) — may be able to generate enough cash to operate as a going concern. We preliminary state that a conservative corporate structure comprising a large chunk of equity capital should be put in place by any acquirer. That would inevitably dilute the economic merits of the deal.

Methodology — We Go With Comps

A DCF analysis doesn't apply here since PAPER's revenue, cost base (COGS and indirect costs) and operating profitability are intrinsically too volatile to model. Any NOPAT as such derived could be highly misleading.

A SOTP analysis doesn't apply either, as disclosure of the firm's latest financial position is minimal, although one could argue that if financials are obtained during a proper due diligence process an option could be to evaluate the separation of the core business (production) from the "maintenance" unit — the latter is a more stable revenue contributor, less risky and as such with lower profitability.

It's not ideal, but further down this paper we value PAPER against two of its larger peers in the sector.

Exit Strategy — Not An Easy Way Out

Any investor with a two-to-four year exit strategy should also note that a fully-fledged break-up of the firm into two units would be against the sector's trend — vertical integration of services, that is.

Indeed, smaller and larger industrial groups both in Europe and stateside are intent on strengthening their maintenance divisions to exploit deeper relationship with clients and hedge credit/third party risks stemming from production. Typically, it takes more than six month to be paid off.

In this context, we don't foresee any particular benefit from the business cycle to the pulp and paper industry and its suppliers over the medium term. Working capital management (WCM) is a variable of paramount importance, though.

WC can be strained if credits aren't (……) risk associated with the core business.

The documentation we sighted (see "Ricorso Per Ammissione Alla Procedura Di Concordato Ex Art. 160") shows that (…… ……)

(……) a trade buyer or to sell out to a private equity house half way through the restructuring process, which should take about two years, if properly implemented.

PARTNER, which has rented the operations at an annual rate of EUR600,000 since July 2011, has not been (…… …… …… …… …… …… …… …… …… …… …… …… …… …… …… …………) and COMPET2 are for top-lines growth well above European/U.S. GDP growth into 2015, but most likely analysts factor in the likelihood of non-organic growth (M&A), at least for the Austrian company.

For the sake of argument, we now assume that (…… …………) and amortization add 40% to the value of Ebit, which means Ebitda hovers around EUR6 million in year one. Capex requirements in the sector tend to be pretty low at 2% of revenue, which means that — assuming no working capital adjustments — operating cash flow for PAPER would come in north of EUR5 million a year.

If a EUR20 million takeover of PAPER is financed via a (…… …………) scenario yields a stellar internal rate of return of 49%. Dividend payout is assumed at zero.

(On a pro-forma basis, the business at the time of the purchase would bear net leverage just above 2x. Any investor should be reminded that this sector is (…… …… …… …… …… …… …… …… …… …… ………… …… …… …… …… …… …… …… …… …… …… …… …… …… …… …… …… …… ……

…… …… …… ……) a balloon repayment so as to keep bank creditors at bay for some time. Banks still own most of the debt of the company — Unicredit has the largest exposure of all creditors. Investors must be granted a grace period (no interest, no capital repayments) of at least two years from the purchase date.

Down to earth with a more realistic scenario.

Say that trailing revenues stand at EUR20 million (which is close to the latest revenues being disclosed), with Ebit margin at a normalized rate of 5%, and Ebitda margin at 8%; operating cash flow comes in just short of EUR2 million a year (we still do not assume any adjustment from working capital swings, which will likely occur, we think).

Such a deal would need to include a larger equity tranche of up to (…… …… …… …… …… …… …… …… …… …… …… …… …… …… …… …… …… …… ……) an exit in 2016 would then yield a paltry return IRR of 4.6% (10-year US Treasury yields have just breached 3%.....). Initial net leverage, meanwhile, shoots up above 5x.

PAPER is a junk credit, so one possible structure backing any such takeover could include a significant PIK loan tranche. The cost of capital, as gauged by (…… …… …… …… …… …… …… …… …… …… …… …… …… …… …… …… …… …… ……).

Enterprise values/sales multiples of PAPER's comparable businesses range between 0.5x and (………) (on a trailing basis), while EV/Ebit multiples range between (……….) and 18x.

Under our two aforementioned scenarios, the enterprise value of PAPER would range between (…………………………..). The high end of the range is completely unrealistic, while the low end of the range is more in line with the amount that PARTNER might be willing to offer (…… …… …… …… …… ……

…… …… …… …… …… …… …… …… ………) and which represents a discount of roughly 40% to the value of PAPER's assets at liquidation.

(To get a sense for the scale of the investment being required, a company such as PAPER needs the financial muscle to be able to produce/assemble machinery whose cost varies between EUR50 million a piece to EUR350 million or more.)

It doesn't look too good unless you are in already, does it? The French are in already and are willing to finalise the acquisition if they find the funding.

Overview

The pulp and paper industry (PAPER's end-market) is in turmoil all along the value chain. Since 2007, consolidation has occurred at the top end with all the main players seeking both revenue and cost synergies. As such, they boast a more competitive cost base that can't be matched by smaller/tiny/niche players.

A fire in PAPER's HQs — which virtually halted production in early 2011 (and, by coincidence, the firm started its downfall right then) -- and theft are elements that should not be overlooked.

Also, although financial figures are sketchy and backdated, there are elements to suggest that additional asset write-offs should be pencilled in by any possible buyer under a base-case scenario.

At present, our inflation-adjusted risk/reward model doesn't (…… …… …… …… …… …… …… …… …… ………) remains unclear.

Key Questions

- What is the competitive advantage of the firm? Is it going to cut a niche for itself in the pulp and paper industry?
- Need more clarity about the order book and operating leverage.
- Geo mix: is it true that the company is fairly differentiated?
- Can we have more visibility on revenue and profitability?
- Why those creditors who represent the minority holders don't try to line up some financial backing and engineer a debt/equity swap with the support of a private equity house/distressed investor?
- Can the cost base, highly inefficient at present vs comps, be bettered?

Relevant Docs

1. Original agreement (July 2011)
2. 2 Amendment (July 2012)
3. 3 Creditors (List)

Deal: RAILS SPA

FOREWORD

This extract concerns a company operating in the technical rails business. The owner is looking to retire and is slowly looking for a potential buyer. He acts as CEO and we met him to discuss his views. To maintain anonymity for this extract, we called:

- *the company analyzed: RAILS SPA*
- *locations TOWN1, TOWN2, …*
- *competitors: COMPET1, COMPET2, …*
- *people: OWNER*

We were not provided documents, but we procured them ourselves on january 2nd, 2014 at 4:56pm and this pre-due diligence was delivered january 4th, 2014 at 1:06pm.

This case, a stable business from a 100 years old company, is a good example of non-distress situation where we:

- *understand the need of the seller and propose him a good way out (will need adjustments according to the transition work provided by OWNER)*
- *prepare to propose an independent valuation that create an opportunity for the investor*
- *prepare planning a sustainable operation of the company*

Stage: Pre-Due Diligence Assessment

RAILS SPA must become a leaner machine. If its boss, Mr. OWNER, is serious about selling out and fetching a decent valuation, he should spin off its real

estate assets from the core industrial businesses, at least on a pro-forma basis. Otherwise, investors shouldn't bother.

“Tunnel & Mining”, “Rails & Fastening Systems” and “Railway Equipment” are the three pillars for which the Milan-based company (just EUR13 million of revenue in 2012) claims a “leading position” across several markets. In 2012, the revenue split between the (improperly labelled) "commercial" and "industrial" operations was EUR6.9 million and EUR6.2 million (see page 41 (…… …… …… …… …… …… …… …… ….. ……… ….. ….. ….. ….. ……).

(…… …… …… …… …… …… …… …… …… …… ….. …… …… …… …… …… …… …… ……) does not provide any compelling evidence that:

1. It can actually compete with rivals on a larger scale (it vaguely mentions four rivals, two from Germany, one from Belgium and one from the U.K. — see Doc 3).
2. It can swiftly enlarge its geographic reach via deal-making or joint ventures.
3. It offers meaningful upside in a sector historically characterized by (…… …… …… …… …… ….. …… …… ….. ……… ….. ….. ….. ….. …… …… …… …… …… …… ……) contracts are awarded.

Its website is (…… ……… …… ….. ….. ….. ….. ….. ….. ….. ….. …… …… ….. ….. ….. ….. ….. ……)

(…… …… …… ……… …… …… …… …… …… ….. …… ….. …… …… …… …… …… ….. ….. ….. ….. ….. ….. ….. ….. ….. ….. ….. …… …… …… …… …… ……) shows poor profitability – a mid-single digit Ebit margin means peanuts in terms of net income. But profitability can improve by hammering costs.

For a company essentially run by one top executive with the backing of two senior members (37 employees in total, including the 3 senior members just mentioned, 18 workers, 15 blue-collars, and 1 part-time worker), a bloated cost base isn't necessary. Rather, it is the path to value destruction.

Among others (such as insurance, mails and (…… …… …… …… …… …… …… …… …… ………).

(…… …… …… …… …… …… …… …… …… ………) – one may wonder whether such a cost base is mainly for the benefit of the owner and his family. On top of that, the board receives a compensation of EUR142,000 a year.

RAILS SPA reported a bottom line of about EUR90,000 in 2012 — so, needless to say perhaps, these costs are out of whack with reality.

Anybody running RAILS SPA could (…… …… …… …… …… …… …… …… …… ………).

(…… …… …… …… …… …… …… …… …… ………).

Real Estate A Bargain?

It should serve as a reminder what RAILS SPA said in its financial reports in 2012:

"La difficilissima situazione (…… …… …… …… …… …… …… …… …… ………)

(…… …… …………) proprietaria accollandosi le residue rate del contratto di leasing di cui sopra."

In short:

"The incredibly tough marketplace for commercial real estates has determined the impossibility to (…… …… …… …… …… …… …… …… …… ………) in the leasing agreement."

While it is true that investors may be attracted to RAILS SPA real estate assets it also holds true the fact that the realization value for these assets may greatly differ from their book value (…… …… …………). A meaningful discount should be warranted.

This what RAILS SPA told us (see Doc. 3 — CompanyXX.doc):

- Main factory in TOWN1 (near Milano) approx. sm 13.000, free of mortgage

- Warehouse in TOWN1 (near Milano) approx. sm. 1.500, remaining mortgage EUR700.000
- Office in TOWN2 sm 120 rented, free of mortgage
- Office in TOWN3 sm 90 rented, free of mortgage,
- Office in TOWN2 sm 90 rented, remaining leasing EUR40.000
- Factory in TOWN4 rented, remaining mortgage EUR300.000
- Factory in TOWN5 remaining mortgage EUR1.2 million

Total value is EUR11 million, RAILS SPA says. Oh yeah!

Moreover, this is what RAILS SPA says on revenue generated by its real estate portfolio:

“Proventi Diversi (voce A5b) del Conto Economico) ammontano a 131,6 mila euro, e sono composti quanto a 21,2 mila euro da Sopravvenienze Attive, quanto a 72,6 mila euro da Affitti Attivi a cui si aggiungono 4,1 mila euro da Recupero Spese Condominiali, e per 12,7 mila euro da Proventi per recupero Spese Trasporto ed infine per 21,0 mila euro per Proventi vari e Ricavi diversi."

Then, the yield (excluding capital gains/losses from asset sales) on real estate assets is 1.2%.

RAILS SPA points out that it has “EUR600,000 in cash and securities free of any lien” – only 10% is in cash on hands, however, and since we do not trust book values of securities, we need to check the investment portfolio to gauge the downside risk associated with it.

Balance Sheet – Think Again

It's hard to measure the company's performance based only on financials for 2011 and 2012. Several balance sheet items, however, should catch the eye of a diligent investor.

- Gross property and plant is up 25% to EUR8.6 million (Meaningful size, high risk, how does the company justify such a spike in value in a marketplace still struggling to find buyers at certain prices?)
- Financial assets more than halved to EUR459K (high risk, and down from EUR1.2 million in 2011).

It poses the question whether management is cashing in now as it struggles to grow its core business organically. Moreover, large swings in the reading of such balance sheet items, although small on an absolute basis, may mean that management are taking their eyes off their core activities.

- Inventory is up 56% to EUR (…… …… …… …… …… …… …… …… …… ………) or does that mean diminuished sales?)
- Receivables are on their way (……), althogh RAILS SPA says in its 2012 financial report that its financial position is sound.

A Bid For RAILS SPA

On this basis, the company might initially deserve a low-ball bid which values it a fraction of (…… …… …… …… …… …… …… …… …… ……… ……

…… …… …… …… …… …… ……) million cash would do (but banks must take a haircut first).

At EUR(….) million, the take-out multiple (based on sales) would come in a tad below 2x, roughly in line with the multiple that Siemens paid for Invensys Rail (a much bigger, diversified, profitable entity, etc etc).

Questions:

- RAILS SPA says its NOPAT is going to grow significantly in the next two years — but we (……) profile maturity.
- 2012 financials show a Ebit margin in (…… …… …… …… …… …… …… …… …… ……… …… …… …… ……….. …… …… …… ……). What is the normalized figure for the last 5/10 years?
- We estimate that operating cash flow, excluding working capital adjustments (estimatesd at between (…… …… …… …… …… …… …… …… …… ………)
- Hedging strategy? EUR/exports – the P&L shows a big swing between 2011 and 2012. What do they do? Nothing? If expansion abroad is the route forward, it’s time to think proactively how to hedge the curreny risk.
- Clarify the debt maturity profile and the pricing of the debt outstanding– we pencil in 4% excluding fees to be paid to banks.

Relevant Documentation

3 Files (Visura, Financials, Doc 3)