



Sell-side Advice to a Mid-sized, Hungary-based IT Company

Capstone Project Summary

by

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Summary of the Project

The sponsor of my capstone project was a boutique financial advisory firm established by an experienced Private Equity professional in Hungary. The firm advises companies on Mergers & Acquisitions (M&A) transactions. Lately, the owners of a medium-sized, Hungary-based IT company mandated the advisory firm to set up a transaction plan and successfully sell their majority ownership stake to financial or strategic investors. To prepare the company for the sell-side M&A transaction, a thorough analysis of the company's financials between 2019 and 2021 had to be prepared to identify critical revenue and cost drivers. Besides, a four-year financial model had to be developed to forecast the company's financials between 2022 and 2025. These analyses are the basis of marketing materials that support the M&A process. The materials include the Investment teaser and the Information Memorandum.

During the project, my main tasks were to analyze the historical financials and contribute to the preparation of the forecasted financial model. As a first step, I examined the official financial statements, including the income statement and balance sheet. To develop a deeper understanding of the company's financials, I also analyzed the chart of accounts which is a more detailed breakdown of the company's financials on a monthly basis. As a next step, a rearranged structure for the income statement items was created, which grasps the characteristics of the IT industry better than the standard income statement structure. This is an important requirement by potential investors as they compare targeted companies against specific industry benchmarks, which is only possible if the income statement is in a comparable format. Rearranging the financials does not affect the company's profitability measures or the balance sheet. Instead, it is a new representation of the income statement figures. This rearrangement was not needed in the case of the balance sheet as its structure is in line with what the investors would expect. As the company did not prepare the cash flow statement, my tasks included compiling it based on the income statement and the balance sheet. As a next step, I analyzed the financials of the company's foreign entity and added up the two entity's numbers to have a picture of the group's total revenues and expenses. As a final analysis step, intercompany items were adjusted to avoid double-counting.

One can follow a top-down or a bottom-up approach to prepare the forecasted financials. A top-down approach focuses on high-level market trends and drives the company's revenues based on the estimated market share. On the contrary, the bottom-up approach emphasizes the company's

business activities and focuses more on analyzing the revenue and expense sources in more detail. In the forecasting model, we took the company's historical financials as a basis. As a next step, the most critical drivers of revenue and expenses were identified (e.g., personnel expenses) and modeled following a bottom-up approach. Less important expense items were modeled as a percentage of sales or based on another financial metric in the forecasting period.

Throughout the preparation phase, multiple meetings were organized with the company's management to validate our modeling assumptions and ask for their input to make the financial model more robust and credible. Finally, I created charts to visualize the financial data and put them in the Information Memorandum circulated among potential investors.

Key outcomes

Historical financial model

Technically, the result of the historical financial analysis is a spreadsheet with comprehensive financial data on the company, including the income statement, balance sheet, and cash flow statement for financial years 2019, 2020, and 2021 on an annual basis. For 2021, the entire financial analysis was prepared monthly to see monthly patterns, which were then used for modeling the forecasted financials. For each period, the financial model contains the following columns:

- Financials of the Hungarian entity
- Financials of the foreign entity
- Pro-forma combined financials of the Hungarian and the foreign entity
- Intercompany adjustments
- Pro-forma consolidated group financials

Forecasted financial model

The forecasted financial modeling outcome is a spreadsheet containing comprehensive financial data for the financial years 2022, 2023, 2024, and 2025 on a monthly basis. Like the historical financial analysis, this model covers all three primary financial statements, the income statement, balance sheet, and cash flow statement.

Charts used in the Information Memorandum

I prepared financial analysis spreadsheets and created charts that visualize the most critical financial data inserted in the Information Memorandum. For instance, I compiled revenue bridge and customer bridge waterfall charts which depict the key drivers of the company's revenue and the customer base every year between 2019–2021 and 2022–2025.

Lessons Learned

The Capstone project gave me a valuable learning experience. A sell-side transaction is a highly complex process with multiple stakeholders, making it possible for me to develop various skills. First, analytical thinking and confidence with numbers are vital skills in M&A transactions as a significant part of the work is analyzing numbers. During the analysis of historical financials, I had to develop a deep understanding of the company's revenue and cost items. Although most parts of the financial statements seemed to be clear at first sight, it turned out that raising clarifying questions with the management or the company's accountants is always valuable as they can uncover unseen insights that are important in the later stages of the process. Regarding the forecasted financials modeling, one must have some creativity when building the model and must put significant effort into benchmarking and validating modeling assumptions. This is essential as the forecasted financials will be a basis for financial budgets. Thus, the model must be credible, robust, and achievable for the management and potential investors. Besides analytical skills, one must have a solid attention-to-detail attitude. Throughout the analysis, we often had to request additional information, even at the invoice level, to understand the company's financials. This is needed to be 100% precise about the financials, ensuring that the entire model is robust and consistent. On the other hand, one must have the ability to see the big picture as well. Compiling a financial model in a spreadsheet is just one step of the complicated M&A process. However, it is more challenging for the management to execute the financial plans laid out in the model. Therefore, one must simultaneously look at the pure numbers and the big picture to see the more significant trends and not get lost in the details. Although most of the work I have performed relies on spreadsheets, I had to continuously consult with the project sponsor, the company's management, and sometimes the accountants to validate modeling assumptions. Politeness and professionalism in communication were essential to building trust with the stakeholders of the capstone project.

