Quality of Earnings 101

QOE Overview

What is a Quality of Earnings ("QOE")?

- Cash flow focused analysis on the quality and quantity of a company's normalized earnings, also known as Financial Due Diligence ("FDD").
- Main sections of deliverable:
    - Normalized EBITDA
    - Net Working Capital Analysis
    - Debt & Debt-like Items

What parties hire a QOE?

- Private Equity / Venture Capital
- Family Offices
- Hedge Funds
- Strategic Buyers
- Corporate Sellers
- Lenders

Types of QOE?

- Buy-side due diligence: Assess business from view of client looking to purchase target.
- Sell-side due diligence: Assess business from view of company looking to sell all or part of its business.

Type of Purchases:

- Stock deal – All assets and liabilities generally transfer with business.
- Asset deal – Buyer only buys assets it needs – avoids restructuring and unknown liabilities.

QOE Process

- Where does QOE fit in the "deal" process?
  - Phase 1: Identify deal = Letter of Intent (LOI)
  - **Phase 2: Evaluate deal = Financial Due Diligence (QOE or FDD) + other diligence to include but not limited to Insurance, IT, Customer, Operations.**
  - Phase 3: Execute deal = Structure deal/purchase agreement/close deal
  - Phase 4: Post-deal = Business integration
  - Phase 5: Monetize deal = Complete integration and deliver on synergies
- Once engaged and deal is "live," what are steps to perform a QOE?
  - Pre-field work (assess data room, create data pack, preliminary discussions with target/client)
  - Field work or conducted remote (meetings with management, detailed testing)
  - Post-field work (wrap-up testing, prepare formal report, follow-up discussions with target/client)

QOE Deliverable

- Main Sections of QOE
  1. Quality of Earnings
     - Details Management's and RedRidge’s EBITDA adjustments
  2. Net Working Capital
     - Details normalized working capital to assist client in setting working capital peg
  3. Debt & Debt-like
     - Details items that should be addressed in the purchase document to ensure the buyer and seller are in agreement on treatment of items.

+ Enterprise value
- Debt and debt-like items
= Equity value
+/- Working capital adjustments
+/- Other price adjustments
= Cash consideration

Letter of Intent (LOI)

- Purchase Price or consideration
- Asset vs. Equity Purchase or Merger
- Cash-free debt-free basis
- Working capital peg
- Other terms & conditions
- Cash Consideration Example:

$ in 000s	$
FYXX EBITDA	1,000
EBITDA Multiple	5.0x
Purchase Price	**5,000**
+/- Working Capital Adjustments	500
Less: Debt & Debt-like items	(2,500)
Cash Consideration at Close	**3,000**

Working Capital Summary:	
Target Working Capital	2,000
Working Capital at Close	2,500
Working Capital Adjustment	500

QOE – Management EBITDA Adjustments

- How do we identify adjustments?
- What are common areas of adjustments?
- Why do we make QOE adjustments?
- Example of normalized EBITDA calculation:

	$ in 000s	FY22	FY23	TTM Jul-24
	Sales	27,639	30,403	32,208
	Cost of Goods Sold	13,718	14,812	14,712
	Gross Profit, as reported	**13,921**	**15,591**	**17,495**
	Gross Margin %, as reported	*50.4%*	*51.3%*	*54.3%*
	Operating Expenses	12,456	14,326	15,560
	Other (Income)/Expense	438	509	864
	Net Income, as reported	**1,028**	**756**	**1,072**
	Interest/Taxes/Depreciation	2,244	2,590	2,780
	EBITDA, as reported	**3,272**	**3,346**	**3,852**
	EBITDA %, as reported	*11.8%*	*11.0%*	*12.0%*
	Management EBITDA Adjustments			
1	RIF Employee Salaries	506	664	504
2	Transaction Fees	-	-	143
3	Credit Card Accrual	-	73	73
4	Gain/Loss on Sales of Assets	(33)	(64)	(64)
5	Accrued Phantom Stock	27	(38)	(45)
6	Other Accruals	-	(39)	(39)
7	PPP Loan and Other Forgiveness	-	(26)	(26)
8	Unreconciled Variance	(6)	77	103
	Management EBITDA Adjustments	**494**	**648**	**649**
	EBITDA, Management Adjusted	**3,765**	**3,994**	**4,501**
	EBITDA %, Management Adjusted	*13.6%*	*13.1%*	*14.0%*

QOE – RDS EBITDA Adjustments

- How do we identify adjustments?
- What are common areas of adjustments?
- Why do we make QOE adjustments?
- Example of normalized EBITDA calculation:

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	EBITDA, Management Adjusted	**3,765**	**3,994**	**4,501**
	EBITDA %, Management Adjusted	*13.6%*	*13.1%*	*14.0%*
	RDS EBITDA Adjustments			
A	RDS Revision - RIF Employee Salaries	(18)	(20)	82
B	RDS Revision - Unreconciled Variance	6	(38)	(64)
C	Deferred Revenue Adjustment	(580)	(473)	(490)
D	Remove GT Income Taxes	28	209	267
E	Remove Foreign Exchange Gain/Loss	132	(41)	165
F	Payroll Tax Reimbursement	25	22	(97)
G	Colombia Revenue Normalization	11	13	(49)
H	Normalizing Rent Expenses	(46)	(52)	47
I	Unrecorded FY23 Review Adjustments	-	(34)	(34)
J	Payroll Reclass	(0)	(0)	(10)
K	Remove Processing Fees	0	11	5
L	Remove Miscellaneous (Income) Expense	(30)	11	4
M	Normalize Accounting Staff	(229)	57	1
N	Subcontractor Refund	-	21	(0)
O	Employee Benefits Normalization	(18)	(0)	0
P	Unreported IBNR Reserve	- NQ	- NQ	- NQ
	RDS EBITDA Adjustments	**(720)**	**(315)**	**(172)**
	EBITDA, RDS Adjusted	**3,045**	**3,679**	**4,329**
	EBITDA %, RDS Adjusted	*11.0%*	*12.1%*	*13.4%*

Net Working Capital Adjustments

- How do we identify adjustments?
- What are common adjustments?
- Why do we make NWC adjustments?
- Example of NWC adjustments:

	$ in 000s	Dec-23	Jul-24
	Current Assets	**9,038**	**10,300**
	Current Liabilities	**11,040**	**11,228**
	Net Working Capital, Reported	**(2,002)**	**(928)**
A	Cash	(809)	(913)
	Intercompany Receivable/Payable	312	(87)
	Remove Interco A/R	(323)	(388)
	Remove Interco A/P	49	6
B	Intercompany Receivable/Payable	38	(470)
C	Accrued Interest	30	16
A	Debt	5,096	4,997
	Definitional Adjustments	**4,355**	**3,630**
	NWC, Definition Adjusted	**2,353**	**2,702**
	LOI Adjustments	**(501)**	**94**
	NWC, LOI Adjusted	**1,852**	**2,796**
	RDS Diligence Adjustments		
1	Adjust Deferred Revenue	(878)	(1,120)
2	Remove Vacation Accrual	270	267
3	Remove Accrued Bonus (Accrued Phantom Stock)	82	28
4	Adjust LOI Adjustments	205	-
5	Columbia A/R Normalization	(108)	-
6	Remove Employee Receivable	0	(0)
7	Remove Outstanding Checks	154	(25)
8	Remove Prepaid and Accrued Taxes	(241)	(301)
9	Remove Prepaid Payroll	-	(458)
	Diligence Adjustments (+/- NQ)	**(517)**	**(1,610)**
	NWC, Diligence Adjusted (+/- NQ)	**1,336**	**1,186**

Net Working Capital - Adjusted

- How do we identify adjustments?
- What are common adjustments?
- Why do we make NWC adjustments?
- Example of adjusted NWC:

	Average			
$ in 000s	**TTM**	**T9M**	**T6M**	**T3M**
Current Assets				
Accounts Receivable	5,657	5,672	5,797	5,769
Inventory	2,101	2,180	2,234	2,294
Prepaid Expenses	322	313	300	289
Other Current Assets	19	20	17	18
Total Current Assets	8,099	8,186	8,348	8,371
Current Liabilities				
Accounts Payable	657	698	740	702
Payroll Liabilities	391	435	409	507
Other Current Liabilities	565	584	598	580
Accrued Taxes	74	72	69	84
Current Portion Deferred Revenue	4,751	4,829	4,976	5,104
Total Current Liabilities	6,437	6,617	6,792	6,977
Working Capital, RDS Adjusted	**1,662**	**1,568**	**1,556**	**1,393**

Recommend a Working Capital Peg

Debt and Debt-like Items

- Cash-free debt-free basis
- Common debt-like items?
- Example of Debt & Debt-like schedule:

	$ in 000s	On B/S?	Jul-24
A	Cash	Y	(939)
	Debt:		
B	Line of Credit	Y	1,881
C	Notes Payable	Y	6,181
	Net Debt		**7,123**
	Debt-Like:		
1	Long Term Deferred Revenue	N	483
2	Vacation Accrual	Y	267
3	Self-Funded Medical Plan	N	108
4	Accrued Bonus (Accrued Phantom Stock)	Y	28
5	Accrued Interest	Y	21
6	Accrued Income Taxes	N	16
7	Additional Tax Exposures	N	NQ
	Total Debt-Like		**924**
	Total Debt and Debt-Like		**8,047**

QOE Detail Testing

- Cash Proof
  - Why do we do this?
  - Why is it important?
- Revenue Cut-off Testing
  - What are we testing for?
  - What is impact on QOE?
- Disbursements Testing
  - What are we testing for?
  - What is impact on QOE?
- Owner’s Equity Rollforward
  - What are we testing for?
  - What is impact on QOE?

Amanda Roberts – Executive Vice President

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Amanda Roberts oversees business development and strategic growth efforts. Through Amanda's leadership, RedRidge has grown to cover over 150 clients internationally including lenders, investment banks, funds and corporates. Since she joined at inception in 2009, her efforts have developed RedRidge into a high-quality, reputable brand operating across nine offices in the USA and UK.

Prior to joining RDS, Amanda served as an originator at Bridge Finance Group. She also previously served in an underwriting capacity at LaSalle National Bank after completing the bank's credit training program.

Originally from Indiana, Amanda holds a Bachelor of Science in Marketing from Indiana University Kelley School of Business. She is a former president of the Secured Finance Network (f/k/a/ Commercial Finance Association) and an active member of the Association for Corporate Growth. She is also an active supporter and contributor to GRIP Outreach for Youth organization in Chicago.

David Johnson - Managing Director

David Johnson performs asset-based lending examinations on behalf of banks and other non-bank lending institutions. He also serves on deal teams engaging in quality of earnings reviews. David has performed engagements ranging in value from $1 million to $500 million for transactions involving various debt structures and sizes.

Prior to joining RedRidge, he spent seven years in the Assurance Practice at Ernst & Young, LLP (“EY”), where he was a Manager in the Financial Services. He was primarily focused on financial statement audits of public and private companies operating across the financial services sector. David also served as an intern in EY’s Fraud Investigation & Dispute Services practice.

David earned a Bachelor of Arts in Economics and Mathematics and a Master of Accounting from the University of Michigan–Ann Arbor, Ross School of Business. He is a CPA licensed in Illinois and member of the American Institute of Certified Public Accountants and Illinois CPA Society.

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Alejandro Silva provides buy and sell side financial due diligence services. He has served private equity investors, middle-market companies, and corporate clients across a variety of industries, including software, manufacturing, business services, retail, and construction.

Prior to joining RedRidge, Alejandro spent two and a half years in the audit practice at Ernst & Young LLP (EY) and a combined 5 years in the transaction service practice at KPMG and Houlihan Lokey. At EY, Alejandro performed GAAP audits for public and private entities in the real estate, manufacturing, and media & entertainment sectors. Through his experience as an auditor, he developed strong analytical and project management skills, financial statement presentation, internal controls, and regulatory compliance. Alejandro then transitioned to transaction services at KPMG and Houlihan Lokey where he assisted financial investors, lenders, corporates, and other advisors in identifying and evaluating key value drivers and risk factors impacting value. These included: Pre-LOI phase one, Stoplight analysis, Full scope buyside diligence, Due diligence for add-ons, Full scope sell-side diligence, and/or business combinations and carve-out financial statements.

Alejandro earned a Bachelor of Business Administration with an emphasis in accounting from California Polytechnic State University San Luis Obispo.

Questions?

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Thank you.