OUR APPROACH TO YOUR FINANCIAL PROJECTIONS

Purpose

A financial forecast may serve 3 purposes which in turn impact the time horizon: **(1)** short term (1-3 years) for management decision making, **(2)** medium term (5-7 years) for borrowers to determine the repayment of a loan or **(3)** long term (7-10 years) for investors to determine the valuation of a business or asset.

Forecasting cash flows

In developing financial projections we believe it is fundamental to work closely with management in order to understand their industry and business value drivers. Macroeconomic factors and industry reports should also be considered.

Furthermore, a detailed analysis of historical financials to understand growth rates, margin development, one-off items, cost reduction programs, working capital development and capital expenditure levels should also be conducted.

When developing projections, we will separate costs which are variable by nature (i.e. they are linked to activity levels) and costs which are essentially fixed (i.e. at least in the short term they are not impacted by changes in activity level). Semi-variable costs may also be considered.

Variable costs (i.e. primarily cost of goods sold) are typically projected as a percentage of sales, whereas **fixed costs** (i.e. selling, general and administrative expenses), are typically projected via a relevant growth rate (e.g. RPI, salary inflation). Operating leverage is the resulting positive impact of revenue growth on profit margins.

We also consider that even in the long run, fixed costs will be impacted by activity levels (i.e. operating leverage has its limits). Therefore, depending on your business, it may be appropriate to at least partially link fixed costs to the development of revenues.

For key drivers, we may also consider scenario or sensitivity analysis to a base case (or management) forecast. This is of particular use if you wish to determine a valuation.

Once the forecasts have been developed, a 'common sense check' can ensure that assumptions are critically assessed and an explanation of the development of key items can be provided.

1. Are the projections reasonable and not overly optimistic or pessimistic?
2. Is there sound reasoning for any unusual changes in growth rates and margins (i.e. fluctuations in ratios between years)?
3. If the business operates in a cyclical or seasonal sector, do the projections reflect the nature of the sector (i.e. continuously growing revenues and operating profits are unlikely to be realistic)?
4. Does the business undertake sufficient capex to support the projected growth? Is any expansion in asset productivity (sales / inventory / fixed assets) realistic?
5. Does the business have sufficient working capital and are there any projected improvements in working capital management (i.e. reduction in working capital days)?
6. Are your business's returns on capital and margins consistent with the overall sector?

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Forecast period

The forecast or projection period should reflect a reasonable trade-off between the ability to develop meaningfully detailed assumptions (e.g. availability of forecast data) vs. having a sufficiently long period to reach a performance level characteristic of a steady state (i.e. where growth rates and margin levels are sustainable in the long-term).

Key considerations include:

- **High or low growth** - in less mature industries, growth rates tend to be significantly above average until maturity has been reached. If the forecast is being conducted for valuation purposes, the forecast period should be long enough to allow for a gradual decline in growth rate towards a steady state and thus to capture the value of the above-average growth.
- In such a scenario a 2 stage forecast is commonly used and one-off events or fundamental changes in the cash flow profile should be included.
- **Cyclicality** - the forecast period should allow a full economic cycle before reaching a mid-cycle level at the end of the projection period.
- **Finite asset life** (both tangible & intangible) - cash flow projections are typically generated for a period capturing the entire life span of such assets.
- **Forecast period** - either period of the loan or longer if conducted for valuation purposes. Estimates beyond 7 years become increasingly unreliable and offer little incremental value due to discounting (with the exception of the terminal value).

Level of detail

The forecast or model should be sufficiently detailed to reflect **(1)** the purpose of the model and **(2)** all the key value drivers relevant to your business. We would recommend a more detailed, sophisticated and rigorous model for larger investments or acquisitions. Ultimately the model must be clear and credible with assumptions that are easily justified.

All our valuation models are prepared in **nominal terms**. This reflects the fact that **(1)** both interest rates and financial statements are quoted in nominal terms and **(2)** we consider this to be the more conservative approach due to the **lower depreciation tax shield**.

This is due to the fact that depreciation is tied to the lower historical cost of an asset. Therefore as inflation rises, firms will not deduct enough depreciation expense to replace increasingly expensive assets even though capex grows with inflation.

While depreciation is a non-tax item, the tax deduction and positive cash flow it creates is less than it would otherwise be with current cost assets due to the lower tax shield afforded by lower depreciation.

Synergies

Synergies are the value created due to a business combination where costs may be excluded (e.g. working capital improvements, efficiency programmes). Most commonly cited in M&A where the acquirer is a trade buyer, combining functions or broadening a new firm's product or market mix can result in increased revenues or lower unit costs.