

Financial Irregularities Exercise 1

LittleDrone lost its way

LittleDrone (“LD”) is a start up company manufacturing propellers and other moving parts for drones. It was founded in 2015 by two friends from university with a background in robotics and mechanical engineering, who used to play with drones as teenagers. They founded the company with less than €50K from family and friends. By 2018 the company managed to grow, with the help of some development grants, to having 70 employees.

In late 2018 a private equity venture fund agreed to inject €23m for a majority stake in LD. The investment was to help build a new production facility and R&D laboratory and help fund the growth of the company. Transaction costs were €0.1m and the rest went into the Company.

The company had a lot of interested customers as drone demand was growing rapidly and many manufacturers of drones were entering the market.

In 2019 an investment of €8m was made in a new manufacturing and R&D facility and an investment of €5m was made in a new CRM system for €1m and acquiring some technology licenses for the rest.

Following the investment, the following things became clear:

- The new plant was installed in early 2019 and was working at between 20% and 30% capacity for the whole period to mid 2021.
- The production manager, in order to make use of unused capacity, produced parts for inventory, anticipating future demand. He felt this would help to amortise the investment.
- A new CRM system was acquired but had some operational problems in tracking customer payments.
- Over half of the technology licenses acquired were never used by the Company.
- Many new people were hired for new product development, as the founders wanted to remain on the cutting edge of innovation

By the end of 2020 the company ran into cash flow problems and the Fund was obliged to advance another €1m as an emergency overdraft. By the middle of 2021 the Fund was going to have to advance another €6m to keep the company afloat and there was a lack of clarity about what could be done to solve the problem.

The financials of the Company are shown below:

in €m	2018	2019	2020	2021 (6M)
INCOME STATEMENT				
Sales	2.0	10.0	15.0	9.0
COGS	1.9	5.0	8.0	4.0
Gross Margin	0.1	5.0	7.0	5.0
SGA Costs	1.5	2.5	4.5	3.0
EBITDA	(1.4)	2.5	2.5	2.0
Depreciation	1.0	2.0	2.0	1.0
Amortisation		1.0	1.0	0.5
EBIT	(2.4)	(0.5)	(0.5)	0.5
Interest				
PBT	(2.4)	(0.5)	(0.5)	0.5
Tax @25%	0.0	0.0	0.0	0.0
PAT	(2.4)	(0.5)	(0.5)	0.5
BALANCE SHEET				
Cash	20.5	3.5	0.0	0.0
Accounts Receivable	1.0	7.0	12.0	18.0
Inventory	0.5	3.0	6.0	9.0
Intangible Assets, Net	0.0	4.0	3.0	2.5
Fixed Assets, Net	2.0	8.0	6.0	5.0
	24.0	25.5	27.0	34.5
Overdraft	0.0	0.0	1.0	7.0
Accounts Payable	2.0	4.0	5.0	6.0
Share Capital	24.4	24.4	24.4	24.4
Retained Earnings	(2.4)	(2.9)	(3.4)	(2.9)
	24.0	25.5	27.0	34.5

In addition, we have the following supplementary information:

SUPPLEMENTAL INFORMATION	2018	2019	2020	2021 (6M)
SGA Costs	1.5	2.5	4.5	3.0
Of which salary costs	0.7	2.0	3.5	2.5
Total employees	70.0	130.0	160.0	200.0

You are the analyst at the Fund and have been asked to prepare an analysis about what has happened and what could be done to turn this problem around.

In order to perform your analysis, you should do the following:

1. Figure out how the €23m was spent on over which periods. To do this, you need to produce cash flow statements for 2019 to mid 2021.
2. See where are the areas where the Company has gone wrong. To do this, use ratios analysis on the financial statements, as well as making use of the supplemental information given. You should focus especially on margin ratios and working capital ratios.