THE STRATEGIC CFO

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WINTER 2014

CASH MANAGEMENT

Plus

CRITICAL ISSUES

in Acquisitions

This is the first of three articles that follow on from the Leadenhall presentation by Simon Dalgarno at the recent CFO Symposium in Sydney. The articles will highlight the pitfalls that often befall the unwary buyer in M&A transactions and how to avoid them. They pass on practical tips from lessons learned the hard way while providing thirty years of valuation and transaction advice in Australia.

Why buy?

We all know there are plenty of potential acquisitions out there in the market – big and small. Many significant private companies are owned by baby boomers with succession issues, or they need capital for expansion, or it makes sense to consolidate and rationalise. Owners who retreated from the market in the wake of the GFC now sense that activity is picking up again and although the prices are not what they were in 2007, they are probably returning to trend. These businesses are potential targets for larger organisations pursuing growth strategies.

The strategic acquirer knows that the best acquisitions result from a pro-active search rather than opportunism.

The plan and the purpose must be clear – new products, complementary technology, new geographic areas or amalgamation with a competitor. Information about potential opportunities is boundless but implementing the search, making contact, pricing a business, undertaking due diligence, sorting the tax, accounting, legal and IT issues, structuring a deal, incentivising staff, post-acquisition and integrating the new business into your culture are all complex areas in which the CFO will participate, directly or indirectly.

The magic word is 'synergy'. Whatever the stand-alone value of a business, if you have the missing piece of a bigger puzzle you can add value through synergies.

But what you must avoid is paying for your own upside i.e. don't give away value (or at least, too much) during the price negotiation if is part of the value-add that you, the strategic acquirer, are bringing to the deal.

Price

We say the most important thing about price is that it's only part of the deal. Seasoned M&A professionals will tell you that if they can set the terms and conditions, you can set the price.

A further caution is that many of the 'rules of thumb' that are popular for valuing businesses just don't stand up to scrutiny where almost every business is different.

There are similar technical issues when relying on earnings multiples to price. The use of raw multiples (taking 'earnings' at a point in time and applying a 'market multiple') and rules of thumb, often lead to bad deals. Acquisitions are far more complicated than that and need significant research, thought and due diligence. At best, multiples are a short-hand way to estimate value and are only suited to stable, mature, predictable businesses. Imagine buying a business on a five-times multiple of last year's EBIT and then discovering a need for significant capex a couple of years down the track! The valuation methodology needs to capture the future, not the past.

Consider alternatives to cash. Scrip acquisitions or 'earn-outs' where a proportion of the consideration is deferred and paid against the achievement of profit goals may be appropriate to align the interests of the buyer and seller. Don't pay the ferry-man until he gets you to the other side!

Critical Issues in Acquisitions – Article 2

In our previous article we talked about the potential benefits of acquisitions and the accompanying pitfalls if an appropriate strategy and process is not in place. We also discussed pricing and how short cuts like using rules of thumb and multiples can lead to bad deals. This time we address two of the basic process issues – valuation and due diligence.

Valuation

The main objection to the use of multiples is that it is point-of-time, often historic, analysis whereas the strategic acquirer wants to know how much cash the business is likely to generate in the future. That simple objective should

also shape the agenda for due diligence.

Modelling future net revenue generation poses its own problems but it is not as reckless as relying on historic, static analysis which might be arithmetically satisfying but does little to identify the drivers of value in the business. Professional valuers rely on Discounted Cash Flow (DCF) for this purpose, usually applying a standard post tax Weighted Average Cost of Capital (WACC) to pre-interest, post-tax cash flows to estimate Enterprise Value (cash free, debt free). Enterprise Value is then adjusted to determine the entity value or the value of goodwill. There is a role for the CFO directly or indirectly in assisting with these technical inputs to the model but the value of the target business should not be influenced by its capital structure.

The value range from the DCF analysis sets the parameters for a price negotiation. A price once agreed is often expressed as a set of values for the component assets: goodwill and intangibles, tangible assets and working capital (adjusted to the date of Completion, to prevent vendors from 'gaming' working capital).

Due Diligence

This is a critical process that may be staged and include redacted documents to preserve confidentiality as the negotiation continues over time.

DD should not follow a 'check-list' approach but should focus on the:

- go/no go issues
- value drivers of the business; and
- structuring (e.g. sale of shares or assets)

'Tick and flick' issues are important but it is most important to understand the business and what (and who) drives it.

The people in the business are critical. Make sure you understand their contracts, any changes needed (e.g. non-compete clauses) and what will incentivise them going forward. Change can create uncertainty and destabilise the key assets of the business, the people!

Good change management strategies with clear communication and appropriate retention strategies are essential.

Above all, focus on the future profitability of the business and ask questions about those factors!

Critical Issues in Acquisitions – Article 3

In our previous articles we have discussed acquisition strategy, valuation, pricing and due diligence. This time our focus is on synergies and post-acquisition issues including Purchase Price Allocations (PPAs) and Impairment.

Synergy

Why do mergers and acquisitions so often fail? The potential value from a strategic acquisition is often justified by identifying and quantifying 'synergies' between the acquirer's and the vendor's businesses. However, these synergies often don't materialise because the buyer:

- over-pays; or
- over-estimates the synergies; or
- pays for the synergies in the purchase price ('pays for his own up-side').

Alternatively, the due diligence has concentrated on 'tick and flick' and failed to pick up the really important factors including irreconcilable cultural differences between the two organisations.

The answer is to be very particular about the synergies to be realised, their value and who is going to be responsible for delivering them. Then make those people accountable for delivery. Develop a 100 day integration plan and monitor progress closely. Avoid the typical outcome of 'half the forecast synergies at double the cost.'

Some synergies are low risk:

"We have customers in common, we can use one delivery truck."

Others are high risk and contain fundamental misjudgements:

"We supply beer to restaurants, they should buy wine from us."

Acquisition Model

Many companies have or develop a model to value targets (including the synergies that are expected to accompany the transaction). Make sure that your model is appropriate. Who built it? Who understands it? Make sure that you plan an outline of the desired functionality before you get down to details. Separate the inputs, assumptions, calculations and outputs. Include cross-checks, a commentary and sensitivity analysis.

Avoid:

- over-complicating the architecture
- long, complex formulas
- hard-coded assumptions within formulas

PPAs and Amortisation

It is impossible to declare an acquisition is EPS accretive unless you first undertake a PPA and value the intangibles. Market data indicates 75% of purchase consideration relates to intangibles of which 20% are amortisable intangibles, generally with a life of less than 5 years. In the USA, undertaking a pro forma PPA prior to an acquisition is common practice. In Australia, the penny is yet to drop.

Impairment

Impairment is a dirty word when you are undertaking an acquisition.

However, under the accounting standards you will be required to test for impairment in twelve months, probably using a 5 year cash flow. Why not develop that 5 year cash flow during the due diligence process and have it signed off? A year later, when testing for impairment and if the forecasts have changed significantly, it will not be a matter of shooting the messenger (the CFO!) but drilling into reasons why the line managers have not delivered what was expected.

Remember also that the discount rate to be used to test impairment will relate to the risks associated with the acquired business which is unlikely to be the same as the WACC of the acquirer.

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