

Mergers and Acquisitions: Trends, the value proposition and guidelines for engaging advisors

Prepared by Temple: Capital Investment Specialists

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Summary

The M&A game is changing and smart acquirers will focus on three things

The next five years will provide good opportunities in M&A but the game will be very different to what it has been in the past. This paper outlines several important trends in M&A and argues that acquirers should be doing three things to ensure they capture value in acquisitions:

- Identifying the value creation proposition and linking it to strategy
- Anchoring the transaction activity to unlocking that value
- Managing deal implementation to realise value post settlement

Introduction

The next few years will see a growth in the number of businesses for sale

The ANZ National Business Barometer (2007 and 2008) provides good insight into the longer term drivers of M&A activity amongst the SME market in New Zealand [1, 2]. These studies show that much of the wealth is tied up by the baby boomers and that many of them wish to exit either capital or time over the next few years. What this means is New Zealand can expect to see an increase in changes of ownership over the coming decade. In fact, if age density (i.e. number of people per age group) is assumed the only driver we can expect the number of business exits in 2016 to be 30-40% higher than in 2006. To provide some sense of scale we estimate New Zealand will see on average 2,000-2,500 businesses (of more than 6 full time staff) change hands every year between 2009 and 2014 (Figure 1). [3]

This growth in activity will be complicated by two factors: firstly the cohort of 35-49 year olds is much smaller and secondly they're much poorer.

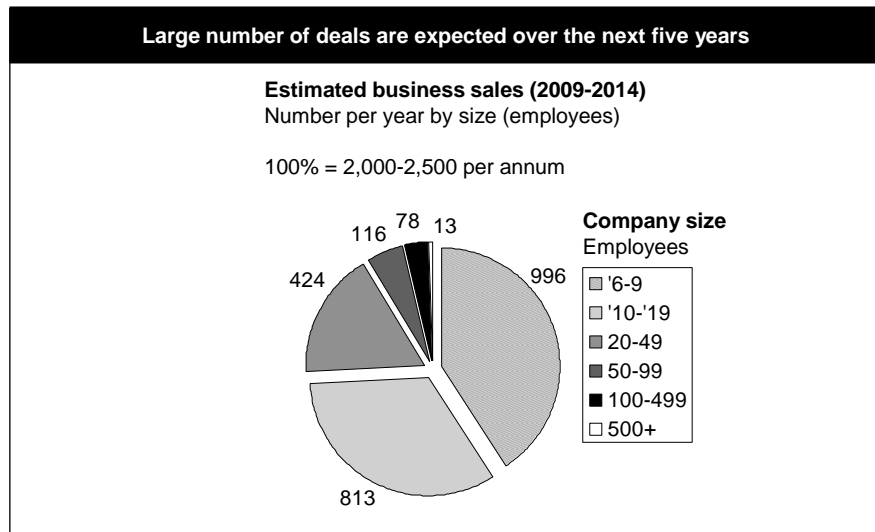
In 1996 there were 1.6 younger potential new owners for every 50-64 year old owner.[4] In 2016 there will only be one. So the pool of potential buyers will be smaller.

What's more, the younger talent pool is poorer and will be coming into this game at a time when debt is an ugly word. [5]

What this means is New Zealand will need to see growing demand for M&A activity, increased consolidation, the mergers part of M&A, and the requirement creative funding structures to transfer wealth between generations.

Figure 1: An estimate of the number of exits per year to 2014

AN AGING BUSINESS OWNER COHORT WILL SEE SEVERAL THOUSAND BUSINESSES CHANGE HANDS (2009-2014)



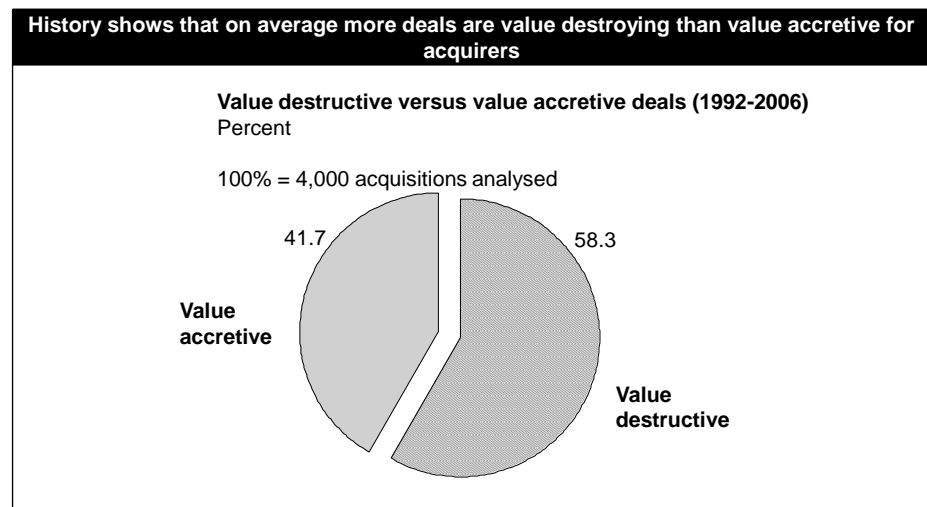
Source: ANZ National, New Zealand Ministry of Economic Development, Temple

History shows us acquirers usually lose out

Unfortunately history shows us that acquirers get it wrong more often than they get it right. Many studies over the past two decades indicate that the winner's curse is alive and well. A recent study by The Boston Consulting Group examined 4,000 acquisitions over the period 1992-2006 and showed that almost 60% of deals are value destructive for acquirers (Figure 2). [6] Furthermore this research doesn't really tell the whole story. Of the ~40% that were value accretive a large number are only marginally so [7]. M&A transactions that add only 1% to acquirer may be mathematically positive but it is not immediately obvious that this warrants the effort and risk that invariably went into creating it. These studies are from outside New Zealand and for public businesses but we believe they represent a useful proxy for returns from M&A in New Zealand and that any variation is likely to be on the downside.

**Figure 2:
Winners and
losers in M&A**

HISTORY SHOWS THAT ON AVERAGE WE GET IT WRONG MORE THAN WE GET IT RIGHT



Source: The Boston Consulting Group 2007

In summary there will be significant demand for and opportunity in M&A activity over the next five years but in the past many investors have not proven to be effective acquirers. To avoid the pitfalls in the remainder of this paper we will argue that there are three things acquirers should focus on in M&A activity in New Zealand:

- Identifying the value creation proposition and linking it to strategy
- Anchoring the transaction activity to unlocking that value
- Deal implementation to realise value post settlement

Identifying the value creation proposition and linking to strategy

M&A activity needs to tie in explicitly with a strategy – M&A is a tool not a strategy

Firstly, research shows that companies that do well first define and agree on a strategy and then seek organic and M&A opportunities to achieve that strategy. [8] For the purpose of the paper we define strategy as:

“the handful of decisions, that largely drive most of the subsequent decisions and actions of a business, are not easily changed, and have the greatest impact on whether the objectives of the business will be achieved”

One US business that has created significant value in M&A required not only a solid business case for the acquisition from management but also a formal and documented link to the agreed company strategy. This simple prerequisite is very powerful as it forces two things: firstly the agreement to the strategy and secondly a clear link to that strategy. Conversely companies that do less well often see M&A as a strategy in and of itself and may capture some synergies but quickly find a need for further growth. One recent New Zealand example saw several small businesses within one industry acquired at high multiples with no clear view on the value creation strategy beyond the concept of ‘cost reduction’. This business is now under significant cashflow pressure.

Acquirers should explicitly and quantitatively understand the value creation opportunity and associated risks

Acquirers should be explicit and quantitative about value creation. What is value creation? Acquirers should be aware of one simple rule in M&A activity: one plus one equals more than two – this is where value, Deal Value Add, is created. Figure 3 shows an example of deal value add for a retail due diligence engagement Temple led.

Shareholders should not accept qualitative answers like *“it’s strategically important”* or *“it will allow us to increase sales”* without a *clear and quantified* understanding of how these benefits will increase returns to shareholders. There is often resistance to this quantification however, to borrow a quote of Galileo’s, investors should seek to :

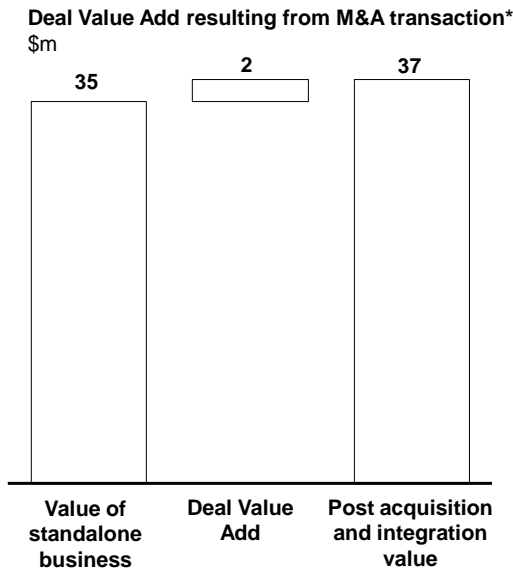
“Measure what is measurable, and make measurable what is not so.”

Surely this is always done? In our experience many acquirers undertake significant analysis on financial and legal dimensions while failing to identify and prioritise the value creation and value destruction levers that may occur following the transaction. Investors should not confuse a complex spreadsheet model with a simple, explicit and quantitative assessment and communication of opportunities and risks¹.

¹ Some exposure, for example prison time for health and safety liability, can reasonably left from quantification

Figure 3: A simple example of Deal Value Add

ACQUIRERS SHOULD EXPLICITLY AND QUANTITATIVELY UNDERSTAND THE DEAL VALUE ADD



* Disguised retail sector analysis

One way to estimate Deal Value Add for the acquirer is to use a simple value / probability framework for the potential value creation and value destruction that will occur as a result of the transaction. This framework considers all of the components of total deal value, both risk and opportunities, and allocates an estimate of the size of the opportunities or risks, each with a probability of occurrence.

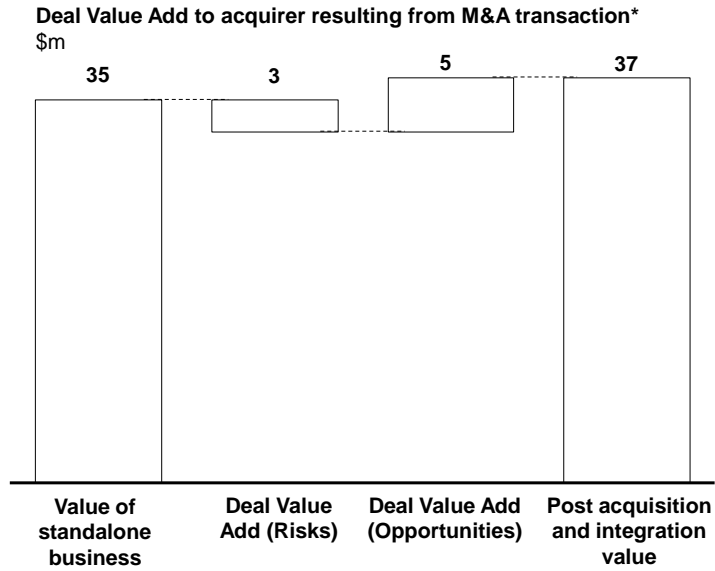
Firstly the Deal Value Add should be separated into risks and opportunities that will increase or decrease Deal Value Add.

In a commercial due diligence engagement of a retail target we undertook for a US private equity fund we looked at total deal value from the acquisition – the sum of potential upside and downside. Figure 4 illustrates four of the elements that made up total deal value add.

The estimates of upside and downside impact were contributed to by the financial team, lawyers and our team who provided support on the estimation of value and probability. For each element we assessed both the impact on the deal, measured here by EBITDA, and the probability of occurrence. These estimates were then included in the model to form a view on the total Deal Value Add to the acquirer. Examples of this engagement are shown in Figure 5 and 6

Figure 4: Deal Value Add for the acquirer

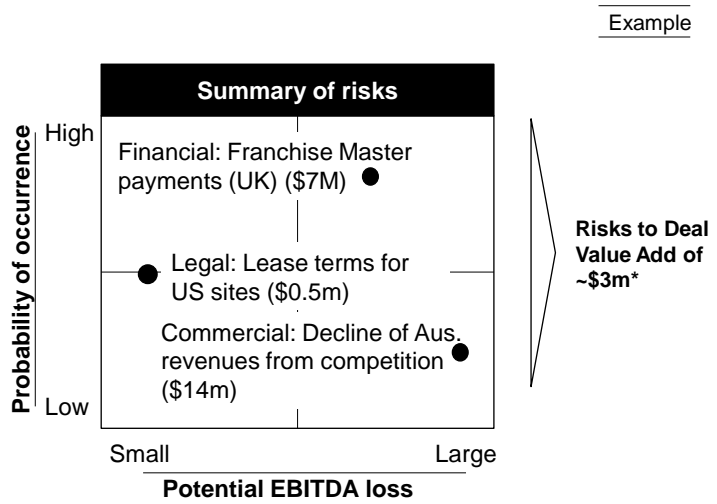
ACQUIRERS SHOULD ESTIMATE BOTH UPSIDE AND DOWNSIDE



* Disguised retail sector analysis

Figure 5: Example of risks to deal value

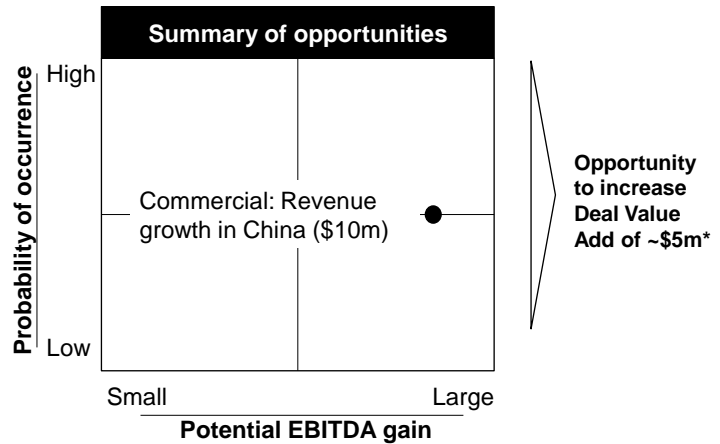
SUMMARY OF VALUE CREATION OPPORTUNITIES THROUGH M&A: RETAIL EXAMPLE



* Nonlinear function of EBITDA, working not shown

Figure 6:
Example of
opportunities to
increase deal
value

SUMMARY OF VALUE CREATION OPPORTUNITIES THROUGH M&A: RETAIL EXAMPLE



Example

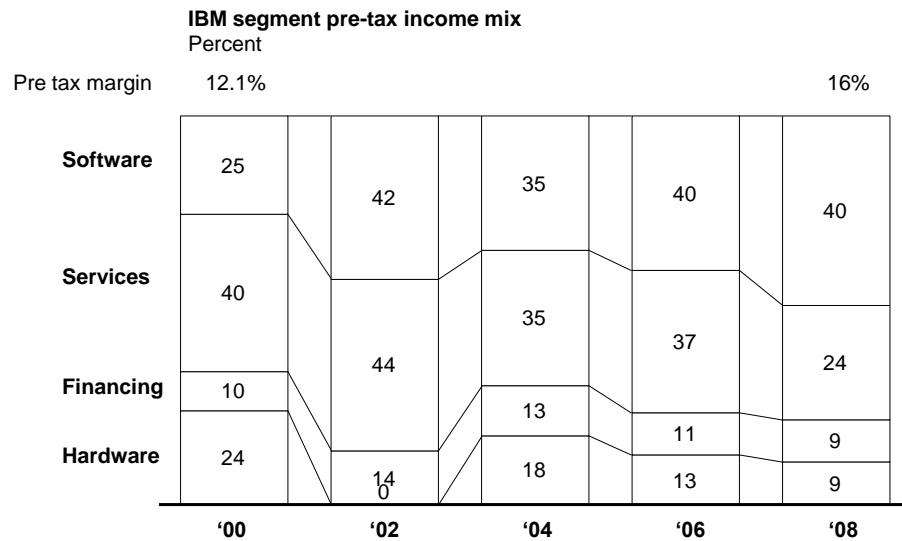
* Nonlinear function of EBITDA, working not shown

IBM is a
postcard
example of what
successful
MD&A looks like

In the first part of this decade IBM recognised increases in global integration and the emergence of a new computing paradigm. [9] In response IBM made major investments in capabilities in emerging markets around the world and accelerated integration. At the same time IBM embarked on a structure M&A programme aligned with their new strategy by exiting commoditizing businesses like PCs and hard disk drives, and making more than 100 strategic acquisitions this decade. The result, shown in Figure 7, is impressive.

Figure 7: IBM's
impressive M&A
outcomes

IBM'S HAS SEEN A SIGNIFICANT CHANGE IN PRODUCT MIX AND INCREASE IN MARGINS WITH A STRUCTURED M&A ENABLED STRATEGY



Source: IBM Annual Report 2008

Anchoring the transaction activity to unlocking that value

Anchoring transaction activity

Based on our experience in supporting buy-side transaction decisions we see three frequent problems with transaction activity today, namely:

- There is often significant advisor activity and therefore fees around a transaction however there is rarely an explicit link between activity and value created
- Poor engagement and alignment between buy-side advisors dilutes potential client value
- The current fee structure promotes deal closure at the expense of deal value

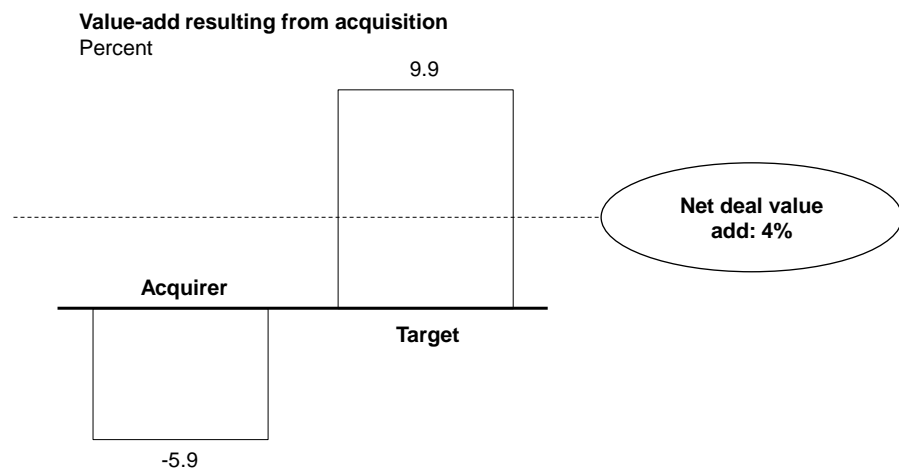
Advisory fees can be the difference between value creation and destruction

Our research shows that on the buy-side alone the total advisor fees can easily exceed 10-15% or more for lawyers, investment bankers, accountants and other specialists who may be needed for a deal. In fact, our market assessment suggests that M&A fees on the buy-side alone will be worth \$200-400m per annum. Advising is big business.

Against this backdrop we look at the average value created in a deal. Recent research suggests that while on average Total Deal Value is positive (4%), this is because of a large gain to the target (9.9%) and a smaller loss to the acquirer (-5.9%) as shown in Figure 8 [9]. These fees therefore represent a significant proportion of the deal value-add. In fact – these advisory fees may be the difference between creating and destroying shareholder value.

Figure 8: Average target and acquirer deal value

AVERAGE DEAL VALUE IS SMALL AND FAVOURS THE SELLER



Source: McKinsey & Co

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Align advisors

Poor engagement between buy-side advisors dilutes the potential value that these

and develop a collaborative advisor model

external activities could provide their clients. Clients should assemble a group of M&A professionals across investment strategy, legal and accounting who will work collaboratively as a team to identify risks and opportunities from conception to closure.

This team will work together under an agreed and transparent operating model to answer two questions:

1. Is this deal value-creating for the client?
2. If yes what is the best deal story and structure for the client?

Use the value and risk assessments to prioritise advisor activity

To ensure the value add in a deal is not swamped by advisor activity, acquirers should use the value / probability matrix discussed in Figure 5 and 6 and ensure all internal and external activity is aligned around the things that will drive value. Each advisor should be responsible for quantitatively justifying why their activities will lock in value add or mitigate value destruction.

- Be explicit around the where value is created why team effort should be allocated to it e.g.
“We will focus on the cost savings from head office integration as this represents \$3m of EBITDA” – internal commercial due diligence team
- Be explicit around the risk to that value-add e.g.
“I will review these contracts in detail as they represent a high chance of default and this would lead to \$5m of EBITDA downside” - lawyer

They should equally be explicit around the any activities they will not be undertaking. These two measures drive should drive every activity undertaken by your team or your advisors.

Ensure the fee structure is appropriate for the current stage

There are three fee structures most commonly used for buy-side advisors:

- Fees per time
- Fixed fees for workload
- Success fees, sometimes with a retainer

Fixed fees may be a useful substitute for per time fees in allowing the acquirer to adequately budget for a transaction. Acquirers should remain conscious that in fixing the fee they will invariably be taking on a fee premium to cover the advisors exposure. In many cases a good faith renegotiation clause is included should there be significant changes to scope, timing or time commitment

In general buy-side advisors should not be paid a success fee. Often the buy-side advisor is a respected bank or firm and in practice, and because the acquirer is almost by definition less experienced, these participants in the team exert significant influence.

Paying them to close a deal before a definitive decision that a deal is value creating introduces a large asymmetry into the decision making process. Note this is quite different to sellside advisors where a 'success fee' of some form clearly aligns advisor and client objectives.

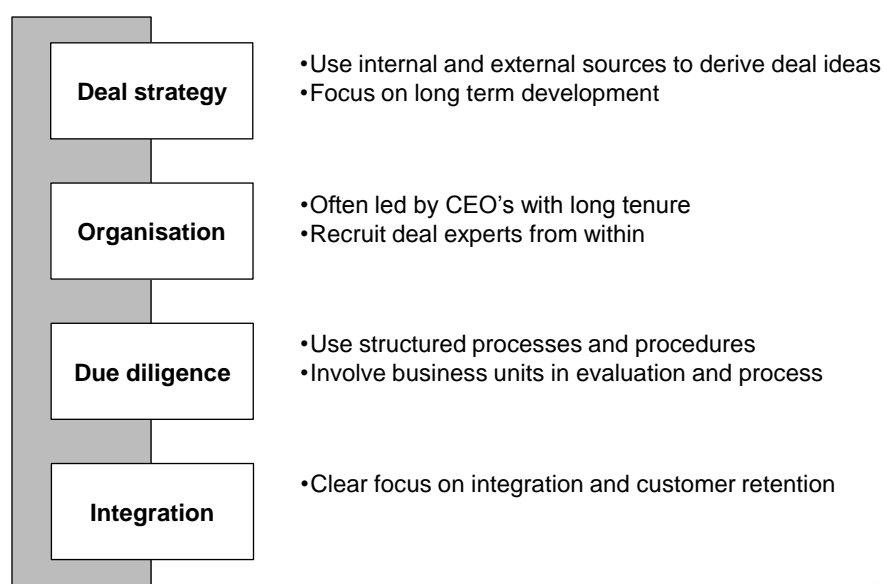
Irrespective of the fee model acquirers should ensure that the fee magnitude is aligned with the value being created in the deal. This should ideally be related to required activity. A guide for setting the fee is some percentage, measured for example by Net Present Value (NPV) of estimated deal value-add, rather than the size of deal.

Deal implementation to realise value post-settlement

Successful acquirers differentiate themselves from their poorer performing peers on four dimensions: Their approach to deal strategy, their organisation approach to the deal, their due diligence approach and their integration focus. [7]

- **Deal strategy:** Use of both internal and specialist external advisors to assist in the identification and origination of deals. Irrespective of the deal source the mindset of successful acquirers is longer term development rather than short term metrics.
- **Organisation:** Successful acquirers often have teams as talented as their less successful peers however the team members tend to be longer tenured members within the acquirer. This is also the case for the CEO of the acquirer.
- **Due diligence:** Successful acquirers differentiate themselves by using a structured and documented approach to due diligence. We often encounter 'industry experts' who have deep knowledge on a current sector however do not have the skills to analyse, synthesise and communicate findings in an objective manner.
- **Integration:** Successful acquirers recognise the challenges of integration and explicitly prioritise activities to successfully achieve this while retaining customers of both the target and the acquirer.

LESSONS FROM SUCCESSFUL ACQUIRERS FOR HIGHER SHAREHOLDER RETURNS



Source: The Granularity of Growth, Patrick Viguerie et al. 2008

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