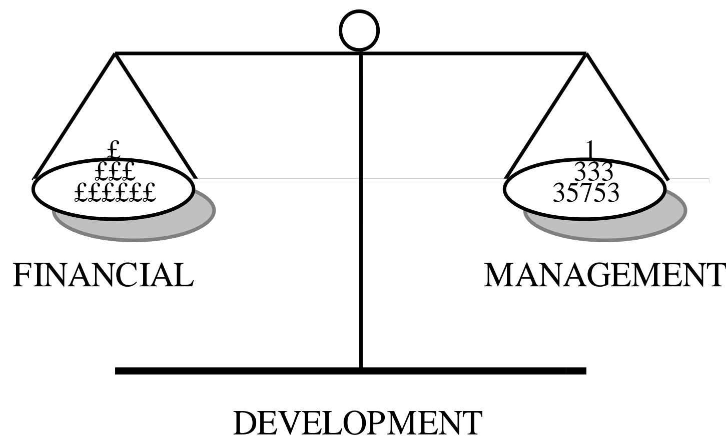
FINANCIAL MANAGEMENT DEVELOPMENT

Financial Accounting

Acquisitions

NO 155

THE FUNDING OF AN ACQUISITION



ONE OF A SERIES OF GUIDES FOR

FINANCIAL MANAGEMENT DEVELOPMENT

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

THE FUNDING OF AN ACQUISITION

Overview

The easiest way to fund an acquisition is to use cash. This also avoids the problems of trying to cope with two negotiations at once. The true cost is the opportunity cost of the "lost interest" or next most attractive use for the cash. In practice most acquisitions are not for cash because the acquirer has not got enough or has better things to do with it.

The alternatives are many and this paper sets out the issues surrounding five of the most common:

1. Share Exchange
2. Share Issue
3. Borrowing
4. Mezzanine Finance
5. Deferred Purchase

Share Exchange

This is a fairly frequent method of avoiding the need to involve bank finance with its consequent effect on gearing and interest cover. The key issue is the relative value of the shares being offered. Since share values change, problems often arise when independent factors affect one of the companies - but not the other. One particular danger is when both parties believe their own shares are worthless but that the other party's shares have value. Consecutive acquisitions at ever higher share prices to buy valueless companies is similar to pyramid selling.

This has considerable merit in locking owners of the acquired company in to ensure they have reason to assist in ensuring the continued health of the enlarged group. This is only true if they are debarred from selling their new shares for a reasonable period.

The problem from a financial viewpoint is the loss of distributability of reserves. In a few case this can be overcome by adopting Merger Accounting, but FRS 6 (amended 2009) only allows this is specific cases. There may also be technical solutions whereby reserves can be distributed prior to acquisition, but the main problem is that from a commercial viewpoint, the vendor may want cash.

Share Issue

A company without cash may issue new shares (probably via a Rights Issue to existing shareholders) which then provides the cash to fund the acquisition. The two transactions can be timed to occur together and provided the issue is underwritten the risk of the finance not being available is reduced. The financial problem is that unless the price earnings ratio of the acquisition is better than that of the acquirer, there will be a dilution of earnings. Even if they are the same the acquisition costs may cause Return on Capital to fall if they are written off against profits. Perversely if the acquisition cost is written off against reserves it will reduce the apparent capital employed in the Balance Sheet, leading to an improved ratio.

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Many analysts add back Goodwill written off in past years to identify true Capital Employed. Others use Stock Market Value - hence the recent move towards calculating Shareholder Value not just ROCE.

Borrowing

Provided the return from the acquired company exceeds the interest cost of the funds to acquire it, profits will be enhanced. However, the Gearing Ratio of the acquirer will suffer and it will therefore be perceived as more risky with a consequent increase in the price earnings ratio required by the shareholders. The nature and the timescale of the borrowing needs to be considered. Ideally it should be designed to match the income stream from the acquisition. Unfortunately bankers may want to see some return of capital before infinity. Borrowing short term to finance a long term investment is not normally advisable.

Mezzanine Finance

If a share issue is one alternative and borrowing outright is another, mezzanine finance is effectively anything in between. It is not easily defined but normally consists of some form of debt with a higher than normal interest rate and a right or potential right to participate in profits. To compensate for the higher return it is normally subordinate to more senior debts in terms of its security. A very wide definition would treat everything except Ordinary Shares at one end of the spectrum and Secured Loans at the other as "mezzanine" with a variety of rights and orders of subordination in terms of payment of "interest/dividends" and return of capital.

Convertible Bonds are probably the most common form of mezzanine finance. Depending upon their conditions they can help reduce the risk of outright borrowing without loss of control. They are therefore common in Management Buyouts and Leveraged Buyouts. However, care needs to be taken that the "rocket scientists" in the merchant banks do not make the whole deal so complicated that no one knows what is going on. This was the primary cause of the financial crisis which surfaced in 2008, but was started in the 1980's with interest rate swaps, financial futures, etc.

Deferred Purchase

"Why pay cash when you can have credit?" In smaller acquisitions it is common for there to be some form of deferred payment or earnout based on the performance of the acquired company after acquisition. These lock in the vendors and are a form of protection against any unforeseen problems not identified during the due diligence process. As with Mezzanine Finance they reduce the risk but a sensible vendor will merely price the risk back in.

In summary, there is a necessary balance between risk and reward and in a perfect market there would be an ideal combination for every eventuality. In reality the buyer needs to consider not only the short term costs and risks but also the longer term implications before committing to either the purchase or the raising of finance.

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website: **FinancialManagementDevelopment.com** including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).

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