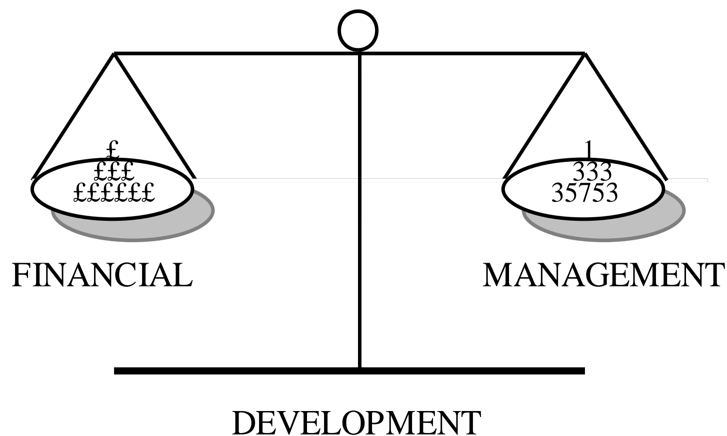
FINANCIAL MANAGEMENT DEVELOPMENT

Financial Accounting

Acquisitions

NO 151

ACQUISITIONS



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.

ACQUISITIONS

This paper sets out some of the considerations underlying the process of acquiring in the commercial sense. It is not designed as a technical paper for accountants but as a general guide to management who are considering making a corporate acquisition and who need to understand the whole picture before taking action. It is a basis for thought not a blueprint for action.

The Paper is in four parts:
WHAT IS AN ACQUISITION
WHY ACQUIRE ANOTHER COMPANY
ALTERNATIVES TO ACQUISITIONS
VALUATION OF ACQUISITIONS

WHAT IS AN ACQUISITION

An acquisition takes place when one business entity acquires control of the business of another entity. In most cases Company A acquires the whole business of Company B by way of a payment of cash, or cash equivalent, to Company B's shareholders in return for their shares. As a result of the transaction the shareholders of Company A now have a new asset, namely the shares in B, although they have comensurately less cash. The former shareholders of B, having received their cash now have no further part to play as shareholders, although they frequently remain on the scene in other roles.

The Directors of A, who exercise power on behalf of the Shareholders of A, now control B's assets and are responsible for its liabilities. The Directors of B remain in place because, like other assets, employees, trade relationships etc. owned by B, they continue as before unless the new owners decide otherwise.

In summary, an acquisition is where the Directors of the acquiring company gain control over all the assets, liabilities, rights and duties of the business they have paid for. The main difference between this and any other form of gaining ownership (Asset purchase, recruitment etc.) is that the business is acquired as a Going Concern. The business therefore has an additional, intangible asset, which is not shown in the books, called Goodwill. This exists because the various assets together are capable of producing a profit which is greater than they could produce separately. It is the valuation of this Goodwill and its preservation after the act of acquisition which are the vital components of the process.

There are various ways of structuring an acquisition. The most common is to satisfy the payment with shares rather than cash. However in many cases the objective is to acquire a particular feature of Company B and alternative methods of so doing are considered later. Variations on the payment method are not considered here as they are rightly an accounting/legal/fiscal consideration. The role of general management is to concentrate on how much is paid, not how it is paid.

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WHY ACQUIRE ANOTHER COMPANY?

A cynic might observe that many acquisitions are made to satisfy the ambitions of the Directors of the acquiring company. A pragmatist might believe that it is easier to acquire another company than it is to grow one. An accountant might observe that being easier, does not make it cheaper. Conventional wisdom suggests that there are at least eighteen reasons for an acquisition which can be related to commercial factors.

Market Driven

1. To expand in existing markets by buying a competitor
2. To expand on existing markets by buying a distributor
3. To expand into a complementary product range by buying a fellow supplier to existing customers
4. To expand geographically by buying an outlet in a new territory
5. To gain new customers by buying a supplier in a new product area (diversification)

Production Based

6. To protect raw material sources by buying a supplier
7. To enhance the existing production methods by buying know-how
8. To improve production (including management, administration and sales) skills by buying key employees or experience in a similar organisation
9. To acquire specific assets or rights owned by another company

Financial/Strategic

10. To guard against poor trading results by buying a company with counter-cyclical earnings (e.g. an umbrella manufacturer buying a deck chair manufacturer)
11. To increase the financial strength of the enterprise by buying additional sales turnover irrespective of their products or markets (conglomeration)
12. To improve the corporate return on investment by buying another company cheaply and selling it (trading in companies)
13. To improve the corporate return on investment by buying another company cheaply and running it down
14. To improve the corporate return on investment by buying another company cheaply and selling off the various assets (asset stripping)
15. To gain synergy by sharing overheads, premises, production or sales facilities
16. To remove a competitor

And

17. To prevent a competitor from doing any of the above
18. To gain publicity

Any combination of the above may be used to justify an acquisition, but before opening negotiations, let alone the company chequebook it is worth considering the alternative methods of achieving the same ends. This is frequently worthwhile as an aid to valuation. The maximum price to pay is the value of the desired benefit.

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ALTERNATIVES TO ACQUISITIONS

Once specific benefits have been identified, it is important that all concerned in the acquisition process are aware of them (subject of course to sensible commercial confidentiality). It is common in negotiations to buy things you do not want as part of the package. It is important to avoid, despite the thrill of the chase, omitting to buy what you originally wanted or buying it in such a way that you cannot achieve your objective. It may be easier to structure a more straightforward commercial deal which minimises the diversion of management time which is a feature of all acquisitions.

Do it Yourself

Whatever the objective it is nearly always possible to achieve it another way. Costing this alternative can often be the first practical step in the valuation process.

Independent Purchase

Most things and many people can be bought. The purchase of shares brings duties as well as rights and these can cause problems. It may be easier and therefore cheaper to buy the asset, the know-how, the people (recruitment fees, transfer fees or golden hellos) or the rights. Certainly it is easier to negotiate. Because a company continues trading, the subject matter, and thus the price, of a full acquisition alters every day.

Contractual agreement

Sources of supply, markets, know-how, distribution channels etc. can be protected by relatively simple, open agreements. If the only objective is to secure a particular source of supply then most suppliers will be happy to enter into some form of long term supply arrangement. The cost may be high but it is unlikely to be any higher than the cost of the whole company and if it is, then it probably means that the acquirer is in for a surprise from some unexpected liability which reduces the net value being obtained. In any event the legal and contractual costs of such an agreement are likely to be considerably lower than the acquisition cost, unless the acquirer believes the current owner is unaware of the value of the right being sought. This places a high value on the current owner not finding out, so confidentiality and speed become vital.

Joint Venture

A joint venture shares the risks and the rewards. It may well be possible to structure a deal whereby both parties retain their independence. This may be worth a lot and can be priced in. Joint ventures are particularly common where there are overseas activities and where it is therefore important to retain local goodwill and knowledge. Successful multinational operations often have such arrangements in order to avoid xenophobic sentiment.

Partial Acquisition

It is perfectly possible to buy less than 100% of the share capital of a company and yet acquire control. This is recognised by legislation which requires Groups to consolidate the figures for all entities where they own more than 50% of the shares. There are also extra disclosure

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requirements if the ownership is below 50% but above 20%. However it is still a common form of gaining the desired objective without paying the full amount. It depends on the objectives of the current owners, some of whom will retain their interest in the acquired company's fortunes. This can be of benefit to the acquirer, who may wish to lock in the existing owners to ensure a smooth transition and protect future trading. It should be less expensive and easier to negotiate since there will be a continuing relationship and thus both sides have more reason to be reasonable.

VALUATION OF ACQUISITIONS

There are many ways of valuing an acquisition. To take two extremes: there is the value to the current owner and the value to the potential owner. If these were the same there would be little point in wasting the cost of the acquisition process. It is therefore reasonable to suppose that the value to the buyer should normally exceed the value to the seller by something more than the acquisition cost. There are two methods of valuing a company: break-up value or going concern, and many ways of arriving at these figures. The key issue is to keep testing the underlying assumptions. Sometimes the arithmetic is wrong, but there is normally someone to sue after the event if that is the case. Nearly all acquisitions fail to reach their objectives and the primary reason is that the original objectives get lost in the negotiation process. It is therefore vital to have a clear valuation at the start against which any changes in circumstances or assumptions can be tested to see if the value is reduced or enhanced.

Both valuation methods are valid for the buyer and the seller but they will undoubtedly come to different results. It may be that neither is wrong, it is just that they are each faced with different alternatives. Both sides probably believe that they have information which the other party does not, both will have a different funding cost and both will have different views of the future. In the final analysis it is a matter of opinion and the final agreed price is as likely to depend on emotion as on rational calculation.

Break-up Value

This is the value of the net tangible assets. It represents the lowest a seller is likely to accept and the fall back position for the buyer if the acquisition takes place but no good comes of it. The two figures will probably be similar but there are likely to be tax and logistical reasons why they will be different. For the buyer the value will normally be lower since he will have wasted the acquisition costs. However it is very common that some part of the acquired company is not required and the disposal proceeds will thus represent a speedy return of part of the purchase price.

Arriving at this value is theoretically easy but often difficult in practice. It involves considering each separate asset, including those not in the Balance Sheet (Brand names patents, supplier contracts etc.) and estimating what they could be sold for net of selling costs. From these are deducted the amounts required to pay any liabilities, including those not in the Balance Sheet (Redundancy, site clearance, pension obligations, etc.). The net figure remaining is the break-up value. In some cases it may be negative. The net liabilities may exceed the assets. This does not mean the company is worthless it merely means that it becomes worthless if it stops trading.

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It is sensible to establish this figure even if the intention is to continue trading because it represents the worst case. The risk of it happening needs to be considered and acquisition history is littered with organisations who failed to consider potential adverse consequences. Timing of the cash flows is important. Even if there is no other use for funds tied up, the opportunity cost of earning interest on the funds instead of having them tied up in assets is a true cost of the deal.

Going Concern

The value of a going concern depends on what the current or future owners intend to do with the company. These assumptions must be realistic. Any price can be justified by putting in unrealistic assumptions. Most acquisitions have a range of values, each under different assumptions of key factors such as market share, competitor reaction, interest rates, foreign exchange rates or tax rates. Once the assumptions are agreed the mechanics of the valuation are easy.

The key is cashflow. An acquisition represents a cash outflow. Once the acquisition is made there should be future cash inflows. These will consist of the profits adjusted for any changes in fixed or working capital. They may include disposal proceeds or the cost of expansion. All changes in cashflow as a consequence of the acquisition need to be included. Thus synergy between existing and acquired units will give rise to changes in cashflow compared to the situation without the acquisition. It is perfectly possible to buy a company which makes losses and be better off. Ford bought Jaguar because they did not want anyone else to. Funding losses in the early years was merely part of the acquisition price. This is of course risky. Lloyds bought Halifax Bank of Scotland (did the Government tell them to?) with unfortunate results.

Once the cashflows and their timing is known it is relatively easy to carry out a Discounted Cash Flow analysis to reduce all cashflows to present day terms to come up with a precise price. To do this requires an appropriate discount rate which is normally the cost of borrowing plus an amount to compensate for risk.

The analysis will depend on numerous assumptions but is the best method to value a company. If done properly it forces all concerned to consider the options and state their assumptions. The review process includes testing the assumptions to ensure that they are feasible and not self contradictory. It is also important to test the validity of assumptions concerning alternatives and the savings by avoiding them. It is too easy to justify a course of action by proposing an artificially expensive alternative and then claiming a saving against it.

In many cases it is difficult to establish precise cash flows. If so it is common to find Earnings (Profit after tax) used instead. The purchase price is calculated as a multiple of Earnings. This is effectively the P/E Ratio which is widely quoted in the financial press. It is common to use this as a valuation method. Unquoted companies are normally valued on a lower multiple than Quoted companies, but the methodology is the same. If Earnings are £1 million and a typical Price/Earnings Ratio for the industrial sector is 15, a reasonable valuation is £15 million. This is a crude measure but often provides a start point from which both buyer and seller can negotiate.

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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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