DEAL

MANAGING TRANSACTION PROCESSES SUCCESSFULLY

Stern Stewart & Co.

DEAL

MANAGING TRANSACTION PROCESSES SUCCESSFULLY

Stern Stewart Research // Volume 62
Gerhard Nenning, Dr. Wulf Rendtorff, Ralph Hesse

Management Summary

Acquiring a company can generate or destroy a lot of value for an enterprise within a short period of time. That is why, in order to accomplish value-adding growth with the purchase, the transaction has to be strategically and specifically prepared, expertly executed and include extensive integration measures, so that all of the intended effects on earnings can be realized. It is important that the company's organizational structure is not overtaxed by the deal, and that sufficient resources are made available. The management has to concentrate fully on the negotiations during the transaction, and the decisions relating to it. So a project team is required that is always in control of the situation and that monitors all the process steps and involved parties.

The following phases are generally involved in a transaction process, in order to accomplish its pre-defined corporate goals, and not to subsequently have to adjust the corporate goals to fit the transaction:

FOUR PHASES

1. Identifying value and growth potential: In which parts of the company can value be generated through growth? 2. Prioritizing the investment opportunities: Which opportunities for growth can and should be realized? 3. Conducting the transaction: What steps have to be taken into account when executing the transaction? 4. Post-merger integration: How can the success of the transaction be ensured in the implementation phase?

---

1. Identifying value and growth potential: How is value created through growth?

Only seldom is a company able to distinguish how attractive given areas of growth and investment are on the basis of holistic, dynamic portfolio management. And that although a tool of this kind is an important instrument of control that makes investment opportunities transparent and comparable, enabling fast and good executive decisions.

Example (leasing industry): *By building up a dynamic portfolio model that autonomously feeds in the data gathered by independent market experts, the market prospects of investments can be precisely analyzed. And this applies not only with a view to the attractiveness of the assets in the market cycle, but also with regard to the lessee's risk costs. In this way, the company can compare the attractiveness of the various investments' market prospects with each other and with the portfolio, and quickly sell assets that tie-up capital and reallocate the proceeds to new investments.*

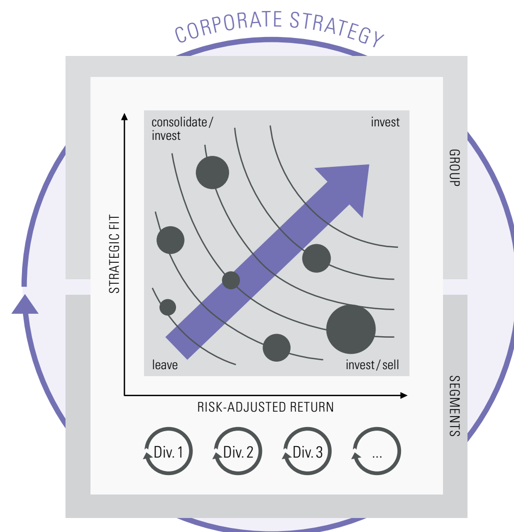


FIG. 1: HOLISTIC PORTFOLIO MANAGEMENT IN THE COMPANY

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

Experience shows, however, that only companies in narrowly defined industries or niche markets have such prerequisites, although the possibilities for developing such management tools are by no means limited to such segments. A specific market and competition analysis is a good way to hone a corporate strategy and find new growth segments. Here, a good collaboration between the company's own market experts and external specialists creates the conditions that are needed to identify market opportunities and make the investments that fit the corporate strategy.

Example (oil and gas industry): *In preparation for forward-looking investments, the market segments are redefined and the investment potential of these segments evaluated against the background of segment-specific market developments. On the basis of these segments, new products can then be defined, upon which the company's investment activities are concentrated. The non-industry-specific expertise of external specialists can be a key aid to the management and internal market experts here, enabling them to identify innovative options in changing market situations.*

2. Prioritizing the investment options: Which growth opportunities should be realized?

Based on the defined growth areas, market prospects can then be identified and compared, and not merely with the goal of filtering out the opportunities with the best risk/return profile. The analysis should be much broader than that, i.e. at company level, and include in particular the company's restrictions with regard to financing capability, balance sheet structure and rating aspects. In addition, potential financing structures are matched to the various investment fields and examined as to their value contributions for the company. Experience has shown that it is already at this point that it becomes apparent that the company's debt capacity will not suffice for all the desired transactions.

Example (energy industry): *The inclusion of the growth strategy in the business plan leads to the exposure of critical implications in the net debt ratio and rating. The remaining financing scope is not enough to cover all growth segments while also making necessary replacement investments. An analysis of the intrinsic value of the investment potential, against the background of the readily available financing options, provides transparency on which projects are to be given priority and prevents the uncoordinated consumption of funding. Combined with the structured build-up of al-*

 © 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

ternative financing structures for realizing positive balance sheet and rating aspects, this process is an important element for securing future corporate growth.

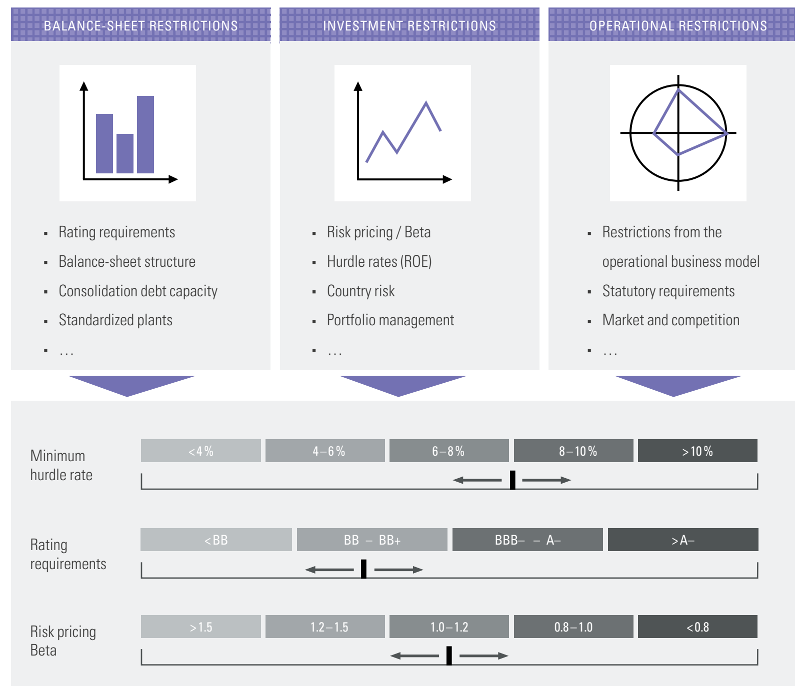
In order to prevent inciting internal competition for company or external project financing resources, and to instead ensure strong growth with the greatest possible value contribution for the company, the best possible investment and financing structures should be mapped to the individual growth segments at this stage, and these should in particular take into account key balance-sheet figures and rating aspects of the company.

Example (real estate sector): *To improve the balance-sheet and rating ratios, alternative financing structures are developed, so as not to have to keep realizing all development projects and takeovers with traditional means. Refinancing property through European investors using only funding based on equity (e.g. participation rights) ensures, on the basis of the current capital market status, at least the same returns on yield, and thus has a positive effect on the rating.*

Experience shows that not only future projects are restructured as a result of this process. Indeed, it usually pays to also refinance existing projects, or even to completely restructure the debt side of the equation before making (or being able to make) new investments on this optimized basis.

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

FIG. 2: ANALYSIS OF RESTRICTIONS IN THE FUTURE CAPITAL ALLOCATION



3. Conducting the transaction: What transaction steps have to be observed?

Once a value-growth target has been identified on the basis of the growth strategy, an interactive transaction process begins that contains the following steps:

- Due diligence and strategic evaluation of the target,
- Structuring the investment and optimum financing,
- Negotiating the transaction and ensuring the contractual documentation.

As a rule, these three steps take place simultaneously.

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

Due diligence und strategic evaluation of the target

The due diligence study is not only about gaining a precise understanding of the target; the experts have to critically scrutinize the business plan, with all its growth assumptions, and validate it on the basis of the buyer's own experiences. The old adage "The money is made in the buying" applies here. A due diligence study and the valuation of the property for purchase that builds on it is not only the sum of the individual plans from the consultant teams and company divisions involved. The valuation has to take important aspects of the company's corporate and financing strategies into account. This applies all the more when the future value of the target is largely derived from the realizing of synergies. If this is the case, not only the target plan requires validation, the sales and cost plans of the acquiring company also have to be revised in detail.

Example (media industry): *Portfolio companies are acquired in various segments, in order to create a broader base of revenue contributors for the transformation process in the digital business, and at the same time to fully exploit the own experience with the consolidating of print media. The valuation is based primarily on the validation of the planned sales targets, the sustainability of which has to be analyzed precisely against the background of consolidating markets. Planned sales volumes will also affect the existing business. Just as important is the amount of synergies that can be achieved. Their scope and the time at which they will be realized are essential for planning earnings and the financing concept that is based on them.*

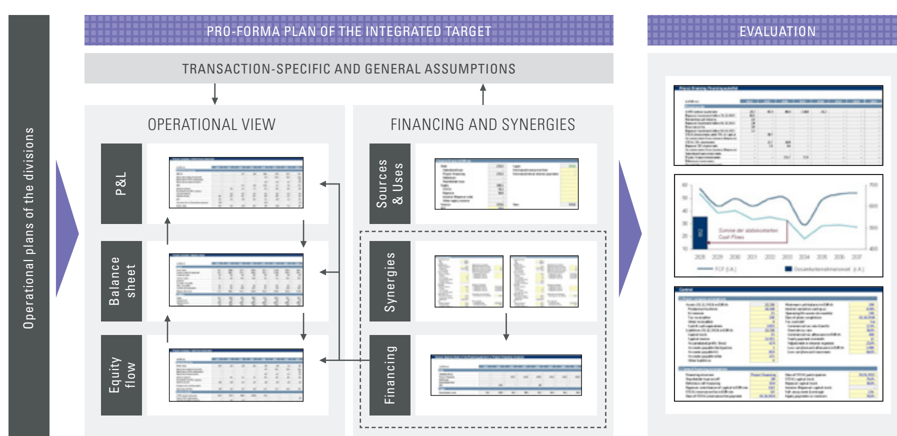


FIG. 3: PRO-FORMA VALUATION OF AN ACQUISITION, TAKING SYNERGIES INTO ACCOUNT

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

Alongside the detailed validation and quantification of the synergies, it is also important to determine the scope and implementation steps for realizing the synergies in question and gaining the corresponding management commitment. Only if the management sees the plan at the end of this process as an in-house product and is completely behind it can the subsequent realization be successful. Without extensive coordination by the transaction team, challenges of this kind are difficult to master, as the senior management has to concentrate fully on the negotiations, especially in this phase.

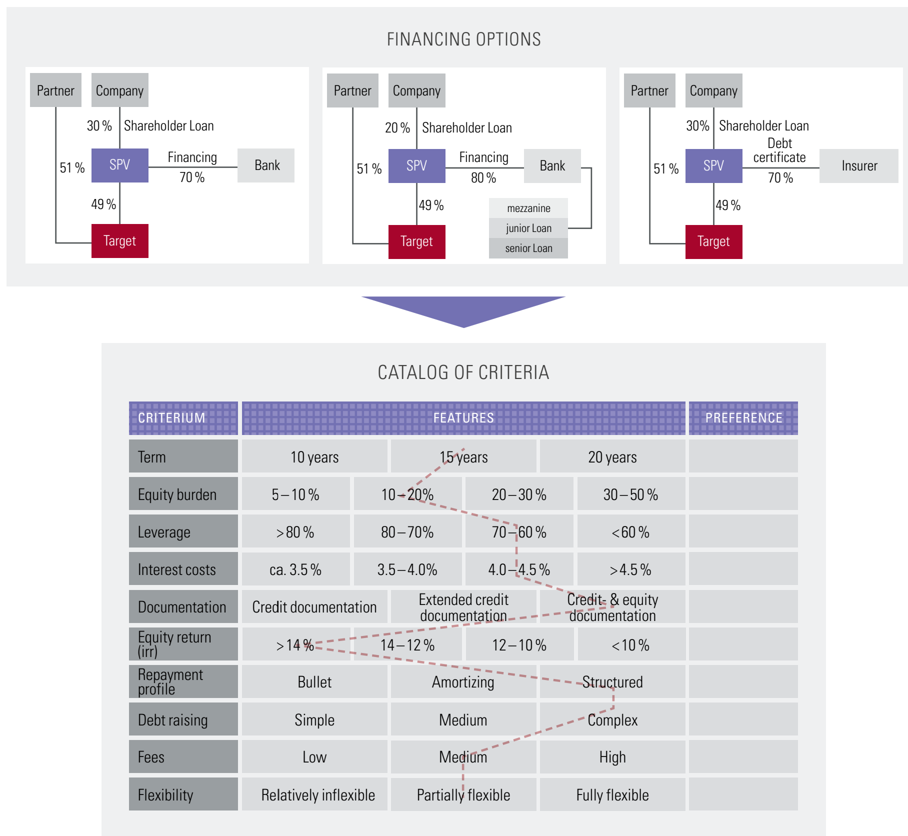
Structuring the investment and optimum financing

Parallel to the valuation, the investment structure and financing concept have to be optimized constantly. This process step is not only about financing the individual corporate acquisition; the future burden on and flexibility of the acquiring company are materially influenced at this point, which in turn can have considerable consequences for the future corporate strategy.

An ideal acquisition financing structure must therefore not only take liquidity aspects from interest and repayment servicing into account, it also has to keep an eye on the other provisions of the financing agreement and the effects of the covenants. The negotiation of the financing agreement here means much more than simply negotiating the interest margins with the lending banks. If not all aspects of the current target and future company growth are accounted for in this structuring process, it doesn't take long before company decisions start colliding with the provisions of the financing agreement. The result are protracted and expensive waiver processes, which generally lead to complex renegotiation or even a restructuring of the financing.

Example (automotive supplier industry): *When taking over a company, acquisition funding with high leverage is achieved, with the purpose of sparing the company's equity. In a second transaction, a new joint venture is set up that binds large amounts of the company's equity. The business plan of the first acquisition is not achieved, which leads to the covenants of the acquisition financing not being fulfilled. The immediate result is waiver processes, followed by the restructuring of the financing, and this affects the further investment strategy of the company and the joint venture.*

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.



CRITERIUM	FEATURES				PREFERENCE
Term	10 years	15 years		20 years	
Equity burden	5 – 10 %	10 – 20%	20 – 30 %	30 – 50 %	
Leverage	> 80 %	80 – 70%	70 – 60 %	< 60 %	
Interest costs	ca. 3.5 %	3.5 – 4.0%	4.0 – 4.5 %	> 4.5 %	
Documentation	Credit documentation	Extended credit documentation		Credit- & equity documentation	
Equity return (irr)	> 14 %	14 – 12 %	12 – 10 %	< 10 %	
Repayment profile	Bullet	Amortizing		Structured	
Debt raising	Simple	Medium		Complex	
Fees	Low	Medium		High	
Flexibility	Relatively inflexible	Partially flexible		Fully flexible	

FIG. 4: SIGNIFICANCE OF THE COVENANT GRID WHEN STRUCTURING ACQUISITION FINANCING

Costs arising like this can be avoided if all of the relevant aspects are accounted for in the transaction phase and enough room is left for changes. Also, possible collisions with other instruments of corporate financing have to be taken into account (e.g. shareholder financing, leveraged-buy-out financing and corporate financing tools existing at group level).

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

Example (capital goods companies): *After the takeover of the company by a private equity fund using a leveraged buy-out financing, the growth has to be accelerated non-organically. The complex covenant grid complicates these investments. The result is ultimately a restructuring of the financing agreement by means of a capital increase.*

Experience tells us that the constitution of the required equity plays a key role here. Alongside the provision of real equity via shareholder financing, this can also be achieved by other means in a third-party loan. This enables not only tax structure models to be considered, but also future asset sales, refinancing from uninvolved assets and subordinate vendor loans.

Example (IT industry): *When financing the acquisition of a target, using own funds can provide significant headroom and generate positive effects on the interest margin. The process for the sale (and leasing) of the property to international investors that is initiated by the company management in parallel generates the required capital amount. By preparing the takeover of the target with a special view to opportunities that increase equity, the company can make a success of both processes.*

Negotiating the transaction and ensuring the contractual documents

The contracts for the sale and financing have to mesh transparently. This applies not only to the object of the purchase and financing, but also to all guarantees that secure the company's future success.

All issues critical for the transaction have to be gathered, their effects on the valuation of the target analyzed, the treatment monitored in the sale and financing agreements, and the representation in the context of the overall transaction ensured.

Only a central transaction team with members from all company departments and involved consultants who fully understand all facets of the transaction and support the negotiations with comprehensive transaction management can assume this task. This is not merely project management. The success of the transaction is decided here, and the realization of the subsequent integration into the company prepared.

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

4. Post-merger integration: How is the success of the transaction ensured in the implementation phase?

It goes without saying that an organization first has to take a few deep breaths after closing a transaction. An asset or company acquisition means more work for everyone involved. Plans and budgets are often overstepped, and then first have to be reviewed and processed. This frequently leads to a standstill, which also results from the fact that external resources leave the company again, and tasks are returned back to the line. The organization itself is then busy with daily business, however, or has insufficient resources or experience with implementation to integrate companies into the group, or even to realize synergies.
Therefore, the concept for integrating the new company into the group should be prepared, with all the required measures, during the period between signing and closing. From experience, the takeover of a company causes a degree of insecurity among the company's management, which should be counteracted with specific implementation measures. The new employees have to be taken on board, as they are the gatekeepers for the realization of the integration measures.

Example (pharma industry): *In a short acquisition process, the company is taken over and initially continues to be managed as an independent subsidiary. Immediately after the signing, contracts are closed with the management of the acquired enterprise and a new incentive system established in the company. These measures also help minimize the risk of valuable managers being headhunted by other companies.*

However, if there is initially a standstill in the integration of the new company, it may be possible to compensate for it in the short term, but the longer it lasts, the more it endangers the success of the transaction, as the assumptions for the implementation and the time schedule for realizing synergies are based on the corresponding measures and processes. Furthermore, it should always be taken into account that structuring process landscapes, merging business units and taking any necessary staff-related measures not only requires time-consuming preparation and implementation measures, these measures can only be successfully realized after a certain period of time, which has to be accounted for in the business plan and when executing the implementation.

Example (building materials industry): *In the case of a leveraged buy-out of a rival company, extensive synergies are planned for when the companies are merged. However, the company launches the activities too late after the closing, and they are realized after a delay and only incom-*

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

pletely. This leads to cost and earnings goals not being achieved, which in turn means that the financing of the company acquisition has to be restructured to some degree.

Executing integration and savings measures is a big challenge for any management team. Expert advisors not only help in this phase with their experience and additional resources, which maintain the implementation speed and dynamic even after an energy-sapping transaction, they also ensure the management a certain neutrality in the process, which often demands a number of unpleasant decisions.

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

Stern Stewart & Co.

Stern Stewart & Co. is an independent strategy consulting boutique. Our advisory focus is on the core issues of management. These include strategy, corporate finance, organization and performance management. We see company managers as strategic investors in the business, and support them to increase the value of their company.

The authors

Gerhard Nenning, gnenning@sternstewart.com
Dr. Wulf Rendtorff, wrendtorff@sternstewart.com
Ralph Hesse, rhesse@sternstewart.com

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

Stern Stewart & Co.

München
Salvatorplatz 4
D-80333 München
T +49.89.242071.0
F +49.89.242071.11

Dubai
Emirates Towers, L 41
Sheikh Zayed Road
PO Box 31303, Dubai
United Arab Emirates
T +971.4.319.9963
F +971.4.319.9964

Kopenhagen
Ryesgade 3A
DK-2200 Kopenhagen N
Denmark
T +45 33 17 00 00

London
2nd Floor,
Berkeley Square House
Berkeley Square
London W1J 6BD
United Kingdom
T +44.20.7887.6265
F +44.20.7887.6001

New York
1330 Avenue of the Americas
23rd Floor
New York City NY 10019
United States
T +1.212.653.0636
F +1.212.653.0635

Schanghai
Office 1206, 12/F Shui On Plaza
333 Huai Hai Zhong Road
Lu Wan District
Shanghai 200021
P. R. China
T +86.21.5116.0564
F +86.21.5116.0555

I www.sternstewart.com
E info@sternstewart.com