

# Merger & Acquisition Focus



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storm clouds?

A look at what's on the M&A horizon

*Price management*

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Ask the Advisor

# Sunny days or storm clouds?

## A LOOK AT WHAT'S ON THE M&A HORIZON

**A**fter two record-breaking years in 2006 and 2007, analyst predictions that M&A activity would slow in 2008 have proved accurate. During the first quarter, tighter credit markets reduced the availability of relatively cheap financing that has buoyed M&As in recent years.

This has spelled bad news for leveraged buyout firms that rely on low interest rates to finance their transactions. Other mergers — particularly the kind of mega-deals that drove M&A volume in 2007 — have been stymied by general economic weakness. What might buyers and sellers expect going forward? Here's a snapshot.

### Moving to the middle

Big deals have been hardest hit by the recent credit crunch. Most transactions, therefore, have been smaller this year. The size of the average deal fell 37% during the first quarter of 2008, and 993 deals during that period were valued at less than \$100 million — 48 more than during the same period last year, according to financial consulting firm Dealogic.

The trend toward smaller, easier-to-finance deals is likely to continue. Domestic middle market M&A activity is expected to remain steady through the rest of the year. A worsening economic scenario and expanding holding periods by private-equity investors due to credit-crunch-related illiquidity, however, could negatively affect this segment of the market.

Although private-equity firms are doing fewer deals these days, they're aiming for larger targets.

In January 2008, three private-equity firms — Thomas H. Lee Partners, Blackstone Group LP and Bain Capital Partners — collectively spent \$3.38 billion on three U.S. companies.

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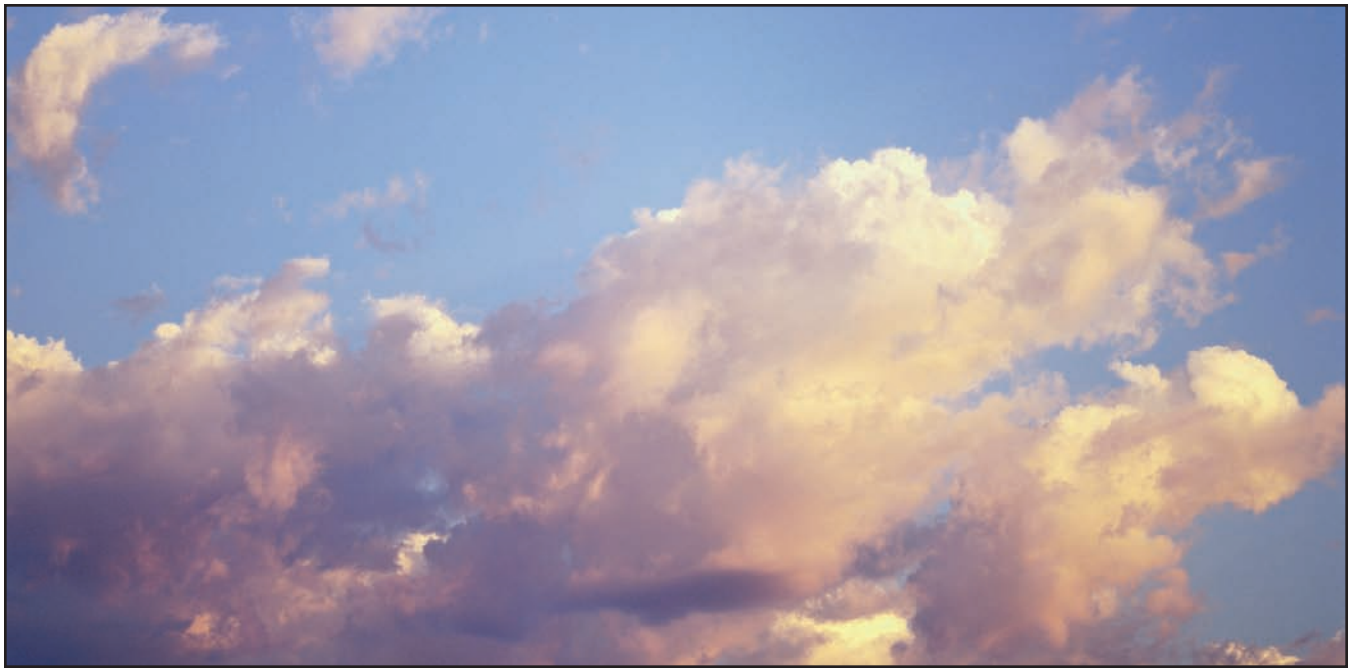
With private-equity investors less of a competitive threat, corporate buyers, which are more likely to make strategic than financial acquisitions, will likely step in. Acquisitions, in fact, remain one of the best options for growing a company. And because these buyers generally don't rely as heavily on debt to fund acquisitions, they may be less affected by the credit crisis in the near term. Earlier this year, for example, Oracle Corp. announced a \$7.85 billion agreement to buy its competitor, BEA Systems Inc.

### Foreign forecast

Even as mixed results are expected domestically, global M&A activity will likely remain robust through 2008. Relatively stable economies in Europe and high growth in emerging markets make these regions the most active.

U.S. mega-funds that continue to raise record amounts of capital are expected to put money to work offshore. Although these funds aren't pursuing the size of transactions they have in the recent past, many seek opportunities in emerging markets to participate in the higher growth rates in Asia, South America and Eastern Europe. Foreign buyers are expected to play an increasing role in overseas and U.S. mergers, as both sovereign funds and large foreign companies seek to take advantage of the weak dollar to expand their global capabilities.





The combined value of completed global M&As in January 2008 was down 32% to \$182 billion, but announced deals have been strong so far this year. According to Dealogic's research, the number of announced deals was up 8% to 2,381 globally that month, making it the second best January of the past six years.

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### Driving forces

Indeed, the health of the U.S. economy will be the pivotal factor for increased or reduced M&A activity for the rest of the year. If you're planning to buy or sell a company, keep an eye on:

- ❖ The possible recovery or further deterioration of the subprime market,
- ❖ Whether the Federal Reserve further cuts rates to avoid recession or halts increases to address inflationary concerns,
- ❖ Consumer spending,
- ❖ Corporate earnings and their impact on public and closely held company valuations,
- ❖ Employment levels, and
- ❖ Presidential election results.

A weaker economy makes U.S. goods and services more competitive, so companies that intend to sell

in the future may be able to boost their bottom lines now by increasing their focus on overseas sales. In addition, lower interest rates could raise the value of stocks, making it easier for companies to issue more shares or borrow funds to finance additional investments.

Buyers, depending on the industry, may be able to find reasonably priced acquisitions. Potentially fertile hunting grounds include food producers, pharmaceutical companies, hospitals, utilities, laboratories, and safety- and ergonomics-related businesses. The subprime lending meltdown, on the other hand, has made it difficult for buyers with less than stellar credit profiles to secure acquisition funding.

Other factors, however, may counteract the credit crunch. Large pools of uninvested private equity capital, significant corporate cash holdings, and increasing foreign participation in the U.S. market due to a weak dollar mean there's plenty of money out there looking for the right investments.

### A brighter-than-expected outlook

Although the U.S. economy appears to be in a trough at the moment, increasingly diversified markets, the relative health of many larger corporations and the place in the private-equity buy-and-sell cycle should prevent the kind of M&A drop-off experienced in 2002 and 2003. Indeed, 2008 may turn out to be a relatively healthy year for both buyers and sellers. ■



## PRICE MANAGEMENT

# Addressing an overlooked aspect of integration

To realize the value of an acquisition in the long term, it's essential to effectively integrate the two companies as soon as the deal closes. You've likely thought about such issues as integrating workforces, facilities and IT and accounting systems, but have you made a plan to integrate price management of your expanded line of products or services?

Buyers sometimes focus their efforts too narrowly on finding cost reduction efficiencies and pay little attention to revenue-generating activities such as price management. But according to Deloitte Consulting, focusing on a newly merged company's pricing can help improve gross margins by 10% or more.

### What and why?

Price management is the process of optimizing, communicating and enforcing prices for products and services. The process enables you to determine the most appropriate pricing for each customer based on the net amount after applying discounts, rebates and other charges and deductions. Even the smallest price change can dramatically affect profits. In some cases, a price increase that may barely be detectable in the marketplace can transform a company's bottom line.

Still, some businesses don't work to improve their pricing because, among other reasons, they lack access to current price and discount structures, have a limited understanding of the market's perceived value of their products and services, or don't have the in-house analytical capabilities to calculate the benefits. Other companies shy away from any price management initiative because they think it means increasing prices across the board and fear they'll lose customers.

### Improvement opportunities

Most pricing benefits are realized within the first 12 months after a deal closes, according to Deloitte. The return on investment of a pricing project typically exceeds 300 — providing high-impact returns early for relatively little effort.

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So it's important to start planning early. Take advantage of the period before the deal process begins and assemble a "clean team" of representatives from both companies. You may be able to request and analyze pricing data and identify pricing opportunities for existing products and customers. The data may also help you envision how you'll manage customer retention, discount realignment and compensation incentives.

Once the deal is complete, change your discount and promotion policies and processes to help eliminate inconsistencies between the merging companies. If you've prepared stakeholders well in advance, your sales team may be more receptive to product focus and territory shifts. And customers may be more understanding of changes to products, pricing and discount structures. In fact, they may even welcome different pricing structures if they're accompanied by higher quality products, services or guarantees.



## Know your products

Pricing management requires you to have a complete understanding of your product's or service's supply-and-demand variables and market factors. Determining these factors can be as simple as collecting information about the market. Or you may need to analyze more complex factors, such as population demographics or the growth rate of businesses of a certain size or type. Your research may conclude, for example, that your customers are more amenable to promotional offers than you'd previously considered.

You can also glean information from case studies, expert forecasts, customer research and internal data, such as enterprise resource planning (ERP) and accounting systems. Also consider price management applications and analytical software. The best tools provide an integrated view of customers, past purchases, benchmarked pricing by segment and size of purchase, relationship data, and comparison of trends over time.

## Retaining customers

Every company has its own discount pricing policy for favored customers. But maintaining separate discount structures following an acquisition can undermine some of the potential value expected from the transaction. List prices can be deceiving; be sure to calculate the sales yield after discounts, rebates, and other special charges and deductions are applied.

When you begin integration, consider standardizing discounts by adopting a combined approach that reflects both the acquired company's and your company's discounts. Depending on the size of the changes, you might want to introduce them in stages and attach them to incentives. You can also boost retention rates by communicating to customers how the combined organization offers more for the price — such as better products or improved customer service.

At the same time, ensure that what you're charging for your company's products and services accurately reflects any new value. To maximize your potential for profits, charge customers as much as they're willing to pay in exchange for the benefits they receive. A better offering, therefore, may warrant higher prices, as long as your customers agree the added benefits justify them.

## Looking forward

Reviewing and adjusting prices shouldn't be limited to the integration stage of your acquisition. You'll want to revisit prices regularly to ensure that higher prices aren't alienating good customers — particularly those you've recently acquired as part of your M&A deal. Conversely, confirm that you're not undercharging customers.

It's all about balance. To manage prices effectively, you must strike the right one between profitability and maintaining or increasing sales volume. ■

# Uncover your company's key value drivers

An acquisition target's financial performance naturally is central to a potential buyer's decision-making process. But many other tangible and intangible qualities can enhance a suitor's perceived value of a company, help close the deal and even land a higher-than-expected purchase price.

Key value drivers vary by individual company, industry and the particular needs of buyers. Most sellers, however, can benefit from scrutinizing their company to uncover the hidden gems and unique benefits it has to offer prospective buyers. Your analysis is likely to reveal negotiation points for price premiums and

discounts, but you need to be prepared to defend your asking price.

## Inner strengths

The price a business buyer is willing to pay is typically based on its perception of risk relative to return. Value drivers are the characteristics likely to either reduce the risk associated with owning the business or enhance the prospect that the business will grow significantly in the future.

Familiar value drivers include proprietary technologies, market position, brand names, diverse product lines

## Are you ready for buyers?

Knowing the value of your company is one thing; successfully conveying its value to buyers is quite another. Serious buyers will perform comprehensive due diligence, so be ready for them with a due diligence package that includes:

- ❖ Audited financial statements,
- ❖ Statements of validity or reasonableness for unaudited financials,
- ❖ A current business plan, organization chart and budget,
- ❖ Updated descriptions and cost and capacity information for production equipment and other major assets,
- ❖ Information about your company from trade associations, independent researchers and other outside parties,
- ❖ Contracts and other documented agreements that support deal points,
- ❖ Estimates of assets by qualified industry experts, and
- ❖ Correspondence with vendors, customers, and strategic partners that verify potential and forecasted growth.

and patented products. Some less-obvious value drivers you may not have considered are operating systems capable of improving or sustaining cash flows, well-maintained facilities, effective financial controls and fraud-prevention initiatives.

### A solid, diversified customer base

The potential to increase market share or gain access to customers brings many buyers to the negotiation table. These buyers will most likely focus on your customer size in terms of revenue or profitability; the number of new customers gained each year and the percentage they represent of the total base; and the number of customers who leave annually, and their reasons for leaving.

Buyers will ask what percentage of total sales is concentrated in just a few customers, because the larger the percentage, the greater the acquisition risk. The loss of a couple of major customers — which often happens when a company changes ownership — could dramatically harm a business's future.

A related value driver is your company's percentage of recurring revenues, or those that can be reasonably expected to occur in the future based on past trends and existing relationships. It may include customers under purchasing contracts. Because of its reliability,

this type of revenue has an inherently higher value to buyers than one-time revenues.

### Growth factors

Although some buyers make acquisitions to gain access to particular assets, most are interested in companies that have a realistic growth strategy. Your growth strategy could be based on one or more key factors, such as industry expansion, increased demand for your company's existing products, the development of new products or enhanced manufacturing capacity.

Whatever your growth drivers are, they and your larger strategy need to be well documented. Otherwise, a potential buyer may not apprehend or appreciate the growth opportunities your company represents. Well-documented value drivers, in fact, support asking prices and facilitate swifter deals.

The best way to convey your strategy to a potential buyer is with hard numbers via pro forma statements. These unaudited statements will contain a discounted future cash flow valuation of your company that helps buyers estimate an offer price.

### People power

One of the most important value drivers in any company is its people — particularly its management team. In addition to star talent, you need executives who are willing to stay with the company following a merger. A solid succession plan that has groomed individuals to assume greater authority is also likely to be attractive to buyers.

In many cases, deal negotiations stumble when a buyer believes that its target's future cash flows won't match, much less exceed, historical results. Having a management team that's willing and able to grow the business can easily translate to a higher purchase price. Potential buyers want to know that this team will be able to maintain valuable customer relationships and the company's reputation.

### Lucrative sale

When you sell a business, emphasizing its key value drivers can mean the difference between underwhelming offers and a lucrative deal. The value drivers buyers seek need to be in place before you put your business up for sale. So start thinking today about how you'll put your best foot forward. ■

# Ask the Advisor

**Q:** *How is the dollar's declining value likely to affect the sale of my business?*



**A:** Over the past few years, the U.S. dollar has lost value against most foreign currencies, including the euro, British pound, Chinese yuan, Japanese yen and Indian rupee. Although it's simple to enumerate the dollar's decline in value, it's harder to provide easy answers about its effect on the M&A marketplace.

## International business thrives

The dollar's loss of value is actually benefiting some U.S. companies with significant overseas business. Foreign customers taking advantage of relatively low prices for American goods are contributing to higher earnings for these businesses.

For example, some small manufacturers that began selling internationally only recently have, thanks to the depressed dollar, seen their international sales explode. This has helped them get a strong toehold in markets in which local businesses previously dominated. Business buyers are likely to appreciate a target with growing international business, and such a seller may be able to negotiate a higher purchase price.

The dollar's plummeting value also has made acquisitions of U.S. companies more appealing to foreign buyers that want to take advantage of the exchange rate. This perceived "discount" means that you may have a larger pool of potential bidders. In general, the larger the pool, the higher amount you may be able to ask.

## Costs on the rise

On the other hand, the dollar's depreciation may increase a selling company's expenses. This is particularly true if you purchase supplies directly from overseas vendors or rely on foreign labor.

And though the weak dollar may stir M&A activity among foreign companies, some deals may be hit by capital market uncertainty. In fact, the current credit crunch could stop some deals dead in their tracks. Also, foreign buyers may decide that the complexities

and costs of a cross-border transaction overshadow the potential for a good deal.

Other buyers may worry that today's currency imbalance won't necessarily translate to long-term value. A large part of the dollar's drop can be credited to lowered interest rates, and some economists are speculating that the end of rate cuts is imminent.

## Take heart

The degree to which the declining dollar affects a selling business varies. U.S. companies that buy raw materials domestically and make products in U.S. factories with American labor are likely to benefit from the stronger buying power of foreign customers. On the other hand, American companies that rely on foreign materials and other resources may be hurt by the declining dollar.

If conditions are particularly unfavorable for your business, consider waiting out this economic rough patch. But don't just assume a weak dollar makes this a bad time to sell your business. Many factors affect the M&A market, and if the right strategic buyer comes along, this may be an ideal time to sell. ■

