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M&A dossier

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M&A MASTERS GLOBAL 2009 SPECIAL EDITION

In this issue...

Opinion

M&A STRATEGIES IN UNCERTAIN TIMES

That, M&A plays a major role in the success and long-term viability of companies cannot be disputed. Yet, during the times of downturn, M&A takes a backseat perhaps for wrong reasons. The facts bear it out. According to research, about 60-70 percent deals closed during the slowdown actually perform better than those done when the going is good.

The slowdown that ensued during 2008 was unlike any in the recent past. And we are yet to see some broad directions. Expectedly, M&A deals were among the major casualties of this downturn, though it is moot point whether M&A in 2008 is comparable to liquidity-fueled 2007 or even 2006 for that matter. According to Thomson Reuters' estimates, global merger value topped about US$2.89 trillion, the lowest since 2005. Significantly, about 1,100 deals were cancelled. Except for China and Brazil, deal volume slumped in all major regions with the US witnessing a 38 percent drop year-on-year.

What's more the forecast for 2009 is equally grim. Experts estimate about 30 percent fall from 2008 levels to US$2 trillion. This, when Fortune 1000 companies are estimated to be sitting on US$1.4 trillion in cash and private equity funds planning to raise nearly US$ 900 billion in 2009. So, will the deals really taper off? Not likely.

Given the cash positions of both corporates and PE funds, it is unlikely that we will see a long lull. Once the global economy stabilises, the deal making should return with vengence. When stock markets get pummelled on account of liquidity and demand dips, the valuations of good companies transit from being attractive to compelling. Cash-rich companies that are looking for sustainable advantage in terms of growth and profitability can find no better time than a recession to make their M&A moves. When the economic outlook is poor for organic growth, accretive M&A deals look appealing. Only two factors apart from strategic fit will hold back the decision: 1) will the target companies survive the ensuing recession, for no acquirer likes to have a dud on their hands. 2) In the era of deleveraging and the credit being at a premium, how do they structure the financial closure? Once a decision for an acquisition is made, the normal drill of target screening, due diligence, deal closure and integration follow. These are some of the issues this edition discusses in detail.

One thing is for sure. Right now, everyone is biding their time and waiting for the macro-economic situation to improve. When that happens, we should see a frenzy of deal making. Next four to six quarters should be interesting to watch.

- Srinivas Macha

Buying During Downturn

Should companies bravely go for M&A in a downturn?

Contradictary as it may sound, research suggests that M&A done in the periods of downturn actually perform better than the deals inked when everything is hunky-dory. However, with credit getting squeezed and valuations falling, does M&A merit attention now?

By Nilesh Sharma

While empirical evidence suggests that most of the activity in the global mergers and acquisitions (M&A) market happens during the boom time, it is also true that anywhere between 50-70 percent of these deals fail to achieve their objectives.

This raises serious questions on the companies' ability to integrate the merged/acquired entities successfully. The reasons may be varied and could be either due to internal or external forces: a lack of comprehensive due diligence exercise before the deal, integration issues post-merger, and/or changes in the external market conditions – for the worse.

In the current market scenario, the onset of the credit crunch following the subprime mortgage market debacle in the US has had a significant negative impact on the M&A market. Uncertainty over the counterparties' credit-worthiness along with the liquidity squeeze in the global financial system has hit business confidence.

PLAYMAKERS ARE BENCHED

According to BCG Research, the level of global M&A activity has declined significantly in the last one year with deal values and volumes falling by around 30 percent and 15 percent, respectively, in 2008 compared to that in the previous year. This could be largely due to the reduced activity from private equity (PE) players, the 'poster boys' of the M&A market in the earlier years. PE funds, which, on account of a low interest rate regime and easy availability of credit, thrived on the leverage loan market to fund the big ticket mergers and acquisitions in the last few years, have seen the deal values and volumes fall by over three-quarters and a quarter, respectively, in 2008.

NOW IS A GOOD TIME...

Nevertheless, as indicated from the 'distressed' sale activities in the financial services space, both in developed as well as emerging market economies, a market in an economic downturn presents as good an opportunity, if not better, as the one during boom times. This is especially true for corporates which are relatively stronger and in a better financial shape. The weaker ones and those in financial distress are likely to align their interests with those of larger and stronger players through M&A

A merger or an acquisition in the midst of an economic turmoil further magnifies the importance of the key component that companies cite as the most crucial element – the strategic fit. When consumer confidence is low and sales from existing markets are hard to come, a merger or an acquisition could provide a company with economies of scale, entry into a new (growing) market, diversification of its revenue stream from a product and market perspective in an otherwise slowing environment.

In addition, liquidity squeeze or cash/credit crunch, especially when economic activities are down, forces a sense of discipline in companies and compels them to optimise utilisation levels. Therefore, an M&A could also result in the realisation of cost synergies at the operational level, which ultimately helps in creating value for the shareholders. This is further corroborated by the findings from BCG Research, which in its recent study on M&As in a downturn market, identified that M&A deals done during an economic downturn have a higher probability of creating value for the buyers than those done during an upturn.

FOR VALUE PICKS...

Also, an economic downturn presents an opportunity to acquire an otherwise expensive asset, especially in the case of companies in the emerging market economies, as valuations become attractive. Valuations of the much-coveted BRIC economies have retracted significantly from their peaks in 2008 with the P/E ratios of China and India, two of the most attractive and active emerging economies in the M&A market, currently at 14x and 9.5x, respectively. In addition, S&P500, the broad benchmark index for the US markets, has seen the average P/E ratio retract towards the long term average of 15-16x from the highs of 26x at the beginning of 2008. This is likely to bring down the valuation premiums that acquirers were paying to pick stakes in companies in the emerging markets. In addition, companies that were looking to enter into these markets to exploit the growth potential but could not do so due to stretched valuations will find the opportunity irresistible.

Planning & Executing M&A

An overview

With more than 50 percent of M&A deals failing to achieve their objectives, companies must get their script right for success. While it is easier said than done, here are some key factors that can make the difference

By Harshit Gupta

It is a known fact that a very high percentage of M&A deals, in excess of 50 percent, fail to meet the desired expectations inspite of a good strategic fit. According to research, poor planning, execution, people issues and losing sight of the big picture lead to failures. It is a given that disciplined planning and execution are vital for the success of an M&A deal.

Typically, an M&A deal goes through the following phases and steps:

Pre-merger phase

- M&A strategy and objectives
- Smart target screening
- Rigorous due diligence
- Understanding market dynamics

During-merger phase

- Transaction execution
- Integration plan development

Post-merger integration phase

- Integration of systems/processes
- Day 1 readiness

PRE-MERGER PHASE

M&A Strategy and Objective

Research indicates that companies often react to M&A opportunities as opposed to prepare for them. As a result, M&A as a strategy is not clearly ennunciated or built into the overall business plan. Without a clear plan for M&A, any deals may prove to be counter productive. A company must be clear about why it is doing an M&A deal. Answering following questions will certainly help.

- What are the options available to grow the business?
- Which geography the company would like to expand to?
- Which product line has the best potential?
- What is the risk involved in an M&A?
- Can the company mitigate the risks?

An M&A deal makes sense when organic growth is constrained. Therefore, clearly stating the objectives and evaluating various options to achieve them will give a fix on whether M&A indeed is the way forward. Typically, the key objectives of an M&A include the following:

- Economies of scale
- Gains from synergies
- Competitive edge
- Venture into new business, etc.

A company must ask if it is looking at augmenting any or all of these. Only when it is fully convinced, should it venture ahead. Considering the amount of risk involved, the company must evaluate if M&A is the most effective way to achieve their objective or there is a less risky option available.
If the company feels that M&A is the right way, then developing an acquisition criteria is a prerequisite. This helps in defining what sort of targets must be looked at even as it sharpens the idea of strategic fit.

Smart Target Screening

The M&A activity starts with identifying the right targets in the right markets. Targets must meet the acquisition criteria completely. Companies must maintain a 'pipeline' or a pool of potential targets such that precious time is saved when the M&A decision is made. The risk of not having a target pipeline could result in wasteful chasing of targets that do not meet the strategic objectives of the company. Ensuring a regular development and

Rigorous Due-Diligence

Financial	Legal	Operational Due-diligence
• Evaluate financials • Check for accounting or any other financial irregularity • Evaluate the impact of off-balance sheet items like contingent liabilities on the valuation	• Evaluate ongoing litigations and expected liabilities from them	• Understand current operations and formulate a strategy to integrate them • Identify hidden value drivers such as supply chain improvements, process optimization

enhancement of the target pipeline by keeping tabs goes a long way in speeding up the target selection process.

Rigorous Due Diligence

Due diligence should be conducted not only in the traditional areas such as the company's finances but also in other aspects such as legal and operational. While financial due diligence enables the company to access the financial feasibility of an M&A, legal due diligence helps it to evaluate the existing contracts, potential liabilities and risks. Operational due diligence can help the acquirer to understand the operations of the target and enable it to devise a strategy to integrate successfully to reap efficiency gains. Due diligence should actively check for accounting or other irregularities in the target company to avoid frauds.

Furthermore, the M&A process is time consuming. Hence, off-balance sheet items, such as pension liabilities and contingent liabilities, should be constantly monitored. In addition, information regarding culture, leadership, organisational capabilities, and customers must be gathered.

Understanding Market Dynamics

Understanding the business and market is of utmost importance to devise a strategy for entry into that market. Evidence suggests that most of the M&A activity takes place during the boom period. During this time, companies tend to be at the peak of their performance and command premium valuations. Entering into the market on the basis of current performance rather than future analysis could be dangerous.

Understanding Market Dynamics

Current Scenario	Outlook
• Understand the company's business and the industry it operates in • Identify the company's key revenue drivers • Identify the company's key cost drivers • Identify strengths and weakness of the company	• How key revenue and cost drivers are likely to behave, going forward? • Given the change in the key drivers, will we be able to achieve the objective of M&A? • Devise strategy to leverage on the company's strengths and eliminate the weaknesses

DURING-MERGER PHASE

Transaction Execution

A deal goes through only when the valuation of merging entities, deal structure and agreement are finalised. Considering the fact that it is a highly complex process involving shareholder approvals and accounting, legal, tax and compliance ramifications, transaction execution takes time. A rushed transaction execution could entail unnecessary legal and tax issues. However, once the deal is announced, merging entities should not lose time achieving the closure to work on post-merger issues such as integration of systems and processes, communication to various stakeholders and being ready as a unified organisation on Day 1.

Integration Plan Development

It is said that whether it is a merger or an internal restructuring exercise, three entities within an organisation - people, processes and systems - must be integrated and function as a cohesive unit to execute the strategic plan.

In an M&A situation, the scenario becomes complex as disparate systems, processes and, of course, people must be integrated smoothly. That calls for a strong, indepth and forward-looking integration plan, which could be developed while the deal is being finalised.

An integration plan addresses and to a great extent, mitigates the issue fallout of people, processes and systems. Furthermore, a disciplined implementation ensures success.

Broadly, the integration plan must address the following:

- Comprehensive information technology audit and integration
- Talent and HR processes integration
- Marketing plan integration
- Manufacturing integration
- Communication strategy
- Customer-retention strategy
- Procurement rationalisation

POST-MERGER INTEGRATION PHASE

Integration of systems/processes

Research suggests that incompatible cultures are a primary reason for M&A failures. However, other equally important factors such as improper audit of the people, skills and capabilities; a lack of a well-thought out and integrated go-forward strategy; and a failure to analyse, understand, and address customer and market issues. Apart from these, the less-than-expected cost savings or economies of scale from the merger typically point to faulty planning and target selection, cursory due diligence and/or inadequate integration plan.

People issues can emerge in the during- and post-merger phases and can significantly contribute to the failure. Culture clash due to new team organisations, confusion, fear, loss of key staff, all complemented by poor communication can devastate a merger. The Human Resources (HR) department can be instrumental in effective communication. HR, which acts as a face of the management, could be used to interact with the key

Avoiding Pitfalls: What Causes M&A to Fail?

Key Reasons

- **Lack of strategic rationale:** Focus on the target rather than the key strategy is a sure way to a failed M&A. More often than not, companies fight for a target company and end up paying huge premium only to wonder what to do with their win. With so many variables, such as evolving market, intensifying competition, and complex customers, a misfit acquisition is not an option.
- **Lack of rigorous due diligence process:** Due diligence, though it does not guarantee the success of an M&A, is a step that increases the probability of success. Due diligence forms majority of the planning phase and enables the company to select/eliminate a target based on several factors. Lack of strict due diligence might lead to selection of a wrong target and, thus, can lead to failure of the M&A.
- **Ignorance of market dynamics:** An in-depth study/ analysis of market dynamics is extremely important, especially in cases where a company is trying to venture into a new industry. If the market conditions worsen, the M&A could end up in jeopardy as the synergies/benefits the management expects from it might not be achieved.
- **Lack of communication:** Communication plays an important role in the entire M&A process. Poor communication could lead to uncertainty and insecurity in the mind of key resources and might result in loss of good talent. The loss of key resources is likely to shatter the company's plans to enhance its workforce through M&A.
- **Cultural differences:** Successful integration of the cultures of the entities is a crucial factor for the success of the M&A. The importance of cultural integration can be realised from the fact that cultural differences were a prime reason for the failure of Daimler and Chrysler merger in 1998.

employees, and make them understand the rationale of the M&A. The department should also clarify their roles in the new/merged entity. This is likely to kill the uncertainty and insecurity-related issues and boost employee morale.

In addition, M&A being largely an operational strategy, focused on cost saving and product augmentation, customer retention may take a back seat. An integration plan must build customer communication, and retention as a key go-forward strategy.

Lastly, IT, which helps translate and achieve business objectives, must be factored prominently in any integration strategy. It is IT's responsibility to continue the operations without any interruptions in the during- and post-merger phases. Considering that two disparate IT infrastructures must be glued together either by subsuming one into another or by building middleware, it can be very complex and companies can stumble if done inadequately.

Day 1 Readiness

The first quarter after a deal is closed is the most important from both internal and external viewpoints. From an internal point of view, uncertainty caused by fluidity at organisation-level, department-level and team-level staff restructuring can cause deep morale issues. An indifferent staff will most certainly hurt customer relationships through poor service and delivery.

In addition, delays in system-level merger and integration and re-definition of processes can add to confusion.

From an external point of view, the first quarter could be risky as customers could discontinue services. Lack of clarity in product/service availability, continuity and adherence to negotiated price contracts, discontinuation of locations on account of rightsizing among other things, if not handled properly and quickly, can result in loss of customers.

Hence, the need for the merged entity to be ready on Day 1 is critical.

INTEGRATION IS TOUGH, BUT POSSIBLE

It is now clear that nothing short of a structured and clear strategic objectives, expectation setting, layered implementation plans and senior staff-led zealous focus on creating and capturing value can make a deal a success. Companies must follow a time-bound, structured and a highly disciplined approach to post-merger integration, indeed, during the entire deal phase.

Otherwise, the result is a foregone conclusion.

Make or Break:

The Importance of Rigorous Due Diligence in M&A

Often, in pursuit of potential synergies, time pressure to complete the deal phase and save costs leads buyers to miss out on the opportunity to properly evaluate the risks involved in the target company's business

By Bharat Ramnani & Devendra Tambe

Over the years, mergers and acquisitions (M&A) have become an integral part of corporate strategy for creating shareholder value. However, despite considerable focus and interest, many M&A deals have failed to create the expected shareholder value. In some cases, they have even destroyed it. According to a number of studies, around 50-70 percent M&A deals fail in yielding the desired result.

While one cannot ascribe such an alarmingly high failure rate to a single factor, chances are that the buyers did not take enough pain to look into all aspects of the deal by following a thorough due diligence process.

Due diligence helps answer two key questions:

i) What value will the acquisition add to the buyer's business, and therefore, what price should be paid for the target company?
ii) More importantly, what risks will be assumed in the deal, and how will they be managed?

Often, the time and cost pressures to complete the deal quickly forces buyers to miss out on this opportunity to properly evaluate the risks involved in the target company's business. Other critical causes for M&A failure are 'absence or overestimation of expected synergies', 'culture misfit' and 'failure to foresee anticipated events'.

APPROACHING DUE DILIGENCE PROCESS

A proper and comprehensive due diligence covers multiple aspects of a target company, including Financial, Operating, Legal & Tax Compliance, IT, HR, Environmental and so on. Of these, financial due diligence is generally given most importance over other matters such as compliance, HR transition planning, employee severance liabilities. Some of these are occasionally ignored as well.

In addition, divergent views of external entities such as governments and regulatory bodies about businesses, can also be an issue. The failed merger of GE and Honeywell International in 2001 due to the opposition of European Competition Commission is a case in point. The merger was previously approved by the US Government. Sometimes, target companies are treated as symbols of national prestige leading to hurdles in the way of a smooth M&A transaction. The acquisition of Arcelor by Mittal Steel underlines the prestige symbol aspect. Strong resistance to the deal may have partly forced Mittal Steel to raise the offer by almost 33 percent over the initial offer.

Due diligence requires a mindset which raises right questions at every stage with an intent to find clear and reasonable answers. Having said that, due diligence should not descend into cynicism.

Due diligence requires a mindset, which raises right questions at every stage with an intent to find clear and reasonable answers. Having said that, due diligence should not decend into cynicism. It should consider the 'materiality' concept and never overshadow other aspects of the transaction such as business strategy and post-merger integration planning.

A strategic due diligence process must, at the least, be planned across the following main work streams - business analysis, financial & accounting review, HR systems and compliance issues.

BUSINESS ANALYSIS

This stage involves qualitative and quantitative assessment of the target's historical performance, addressable market size, growth prospects, competitive position and associated business risks. The objective is to develop rational estimates of the target's future revenues, earnings and, more importantly, cash flows. Even if the buyer has extensive experience in the industry and markets in which the seller operates, independent research on estimated market size and growth rates can greatly help in avoiding unpleasant surprises.

Blind pursuit of synergies without clear understanding of their nature and associated costs often leads to failure.

Business analysis assumes even more significance when there is a difference of opinion on key business assumptions between the buyer and seller. This may be particularly true for companies pursuing innovative products and businesses in their early stages of development, where the bulk of the value lies in intangibles. In such instances, one must pay special attention to each of the intangible assets such as customer relationships, assembled workforce, intellectual property rights, in-process research & development projects and trademarks. These intangible assets must be clearly identified and evaluated separately.

In such cases, the benefits of hiring a third-party/independent consultant often outweigh the associated cost. In particular, third party due diligence can be helpful in situations that involve the following:

- Fluctuating revenues
- Divestiture of a business unit of a large corporate
- Private or closely held businesses.

When Cadbury Schweppes wanted to acquire Adams Inc., a confectionary maker and a unit of Pfizer, in 2004, it found the task daunting. Lack of experience in managing a cross-border deal with high valuation (around US$4 billion) made Cadbury hire A.T. Kearney to analyse and assist in the acquisition. The advisors helped analyse issues such as carve-out of Adams Inc.'s operations from Pfizer without disruption in operations. The post-merger success of the company corroborates the importance of third party due diligence in M&A.

Let us now come to the important aspect of acquisition synergies. Blind pursuit of synergies without clear understanding of their nature and associated costs often leads to failure. It is critical to address qualitative questions such as:

- What is the nature of synergies that are expected to accrue from the deal? For example, cost synergies side may include economies of scale, common distribution channels.
- What are the foreseeable costs that need to be incurred to realise such synergies?
- Which of the identified synergies would accrue only to a specific buyer and may not accrue to other prospective buyers and, hence, may not be included in the purchase price?
- What is the expected value creation on account of such synergies, and have they been modelled properly in prospective financial information under post-merger scenarios?

FINANCIAL & ACCOUNTING REVIEW

Financial and accounting due diligence involves analysing whether the available financial information provided by the seller can be relied upon as true and fair. Apart from reviewing audited financial statements and available information, such as income statement and balance sheets, careful consideration should be given to notes to accounts and schedules, with special focus on understated and off-balance sheet liabilities. Off-balance sheet liabilities may include obligations for product warranty, guarantees on behalf of third parties and liability for derivative instruments.

Critical questions to address during the financial and accounting due diligence include the following:

- Whether the target has entered into financing and operating agreements, giving rise to unrecorded liabilities or contingent liabilities, which otherwise do not fall under purview of disclosure norms?
- If such liabilities are identified, what is the seller's motive of not bringing them to light earlier?
- How much will the acquisition price need to be adjusted on account of such unrecorded or understated liabilities?

HR SYSTEMS REVIEW

People-related issues often do not receive enough emphasis in M&A due diligence process. These issues encompass identification of key employees, liabilities arising out of their employment contracts, especially severance clauses in event of change of control and, last but not the least, compatibility of the target's corporate culture with that of the buyer. For instance, the failed merger between Geisinger Medical System and Hershey Medical Center (HMC) reflects the insufficient heed paid to the corporate culture. HMC operated in the style of collective governance wherein cooperation with independent and well staffed academic department was of paramount importance. This was in sharp contrast to Geisinger's corporate style of employing and managing, salaried physicians working full time in a multi-specialty group practice.

Hence, one should seek answers to the following:

- Who are the key people driving the target's business?
- How critical is retention of such people in the post-deal scenario to achieve desired goals?
- Who are the people in positions, which may become redundant in the post-merger scenario?
- What are the associated severance liabilities such as pensions, golden parachutes?
- What are the issues and costs associated with the alignment of compensation of the target's employees in the post-merger entity?
- Is the target's culture compatible with that of the buyer? What 'interventions' or changes will need to be brought about to streamline the workforce?

COMPLIANCE

Another very important facet of the due diligence process comprises evaluating whether the target is in compliance with different laws and regulations relating to tax, environment, legal and industry associations. There are a number of instances wherein ignorance or insufficient attention to anticipated issues relating to compliance has resulted either in failure of the deals or substantially increased acquisition costs.

Insufficient attention paid to anticipated compliance issues can result in failure of the deals or substantially increase in acquisition costs

One recent example is Vodafone of Hutchinson's acquisition of Essar's 67% stake worth US$11 billion wherein failure on part of Vodafone to properly assess its liability to deduct tax at source from purchase price paid landed it in litigation with the Indian

Income Tax department. An adverse judgment in the ongoing litigation could impose significant liability to the extent of US$1.7 billion and associated legal costs.

Hence, finding out answers to some of the following compliance-related questions is important.

- Are all important registrations, licenses and permissions in force and renewed?
- Are there any ongoing litigation or threats of potential proceedings against the target?
- Are there any anticipated changes in regulations, which can adversely impact the company's operations?
- Does the company have a consistent track record of complying with respect to laws of the land?
- Has the company violated any regulations with respect to environmental issues in the past?
- In transnational deals, whether the deal needs approval from regulators governing foreign investment?

THE 4-D DUE DILIGENCE!

The effective due diligence should ultimately look into four dimensions together – Business, People, Risks and Opportunity, and ask the following questions:

- What is the target company's value of business on as-is basis?
- What are the key value drivers that need to be managed effectively?
- What are the key business assumptions used for evaluation?
- What are the risks that such assumptions may not hold good?
- Will changes in key business assumptions significantly affect the deal price?
- How important are people currently running the business to value creation?
- What post-merger changes will be required to fully realise the anticipated value?
- Is there a clear assessment and planning to deal with post-merger integration issues?
- Considering the above factors, what is the value of the business, and what is the price an informed investor would pay?

IMPORTANCE OF DUE DILIGENCE FOR SELLERS

Due diligence is critical from the seller's perspective as well. It makes business sense for seller to conduct due diligence by thinking from the buyer's perspective and asking himself tough questions. One of the causes of lengthening of an M&A discussion is the inadequate anticipation and preparation to deal with 'thorny' issues by the seller that arise during the buyer's due diligence. The single most important question the seller should strive to address is, **how to objectively support key business assumptions to justify optimum valuation?**

The seller should compile the information in the manner in which the buyer can easily understand and analyse. Moreover, by performing sell-side due diligence the seller can enhance his negotiating leverage, as such due diligence brings forth previously unidentified issues to the fore and potentially reduces transaction costs of the M&A activity. It can benefit both the seller and buyer by addressing contentious issues earlier in the process, ultimately leading to a quicker, smoother deal closing.

> One of the causes of lengthening of an M&A discussion is the inadequate anticipation and preparation to deal with 'thorny' issues by the seller that arise during the buyer's due diligence.

OPTIONS FOR RISK MITIGATION

Basically, the value of any business is determined by discounting the expected future benefits (cash flows) with the risks that the anticipated cash flows may not be achieved. In high technology and innovative businesses, where market potential is not fully estimated, it becomes very difficult, if not impracticable, to foresee potential business risks involved. In such cases, the structure of M&A deal, particularly the discharge of purchase consideration can become an interesting tool to mitigate the risk of cost of acquisition being much higher than the actual returns.

For example, contingent purchase consideration in such cases can be an effective tool in mitigating risk. A business combination agreement may provide for the issuance of additional consideration contingent on specified events or transactions in the future. Some agreements provide that a portion of the consideration be placed in escrow to be paid to the seller when the specified events occur.

Though this may sound out of place, the idea of contingent purchase consideration can play an effective role to arrive at a consensus between a rational buyer and an interested seller, especially for transactions in emerging technologies and innovative business space. This is because there is incentive for both – the buyer significantly mitigates the risk of paying higher than the actual value and the seller could receive additional or premium consideration.

M&A Outlook

What does 2009 hold for global M&A?

Deal activity may have shrunk in 2008 but considering the amount of money raised by private equity funds on the one hand and overflowing war chests of corporates on the other, M&A in 2009 is seems interestingly poised

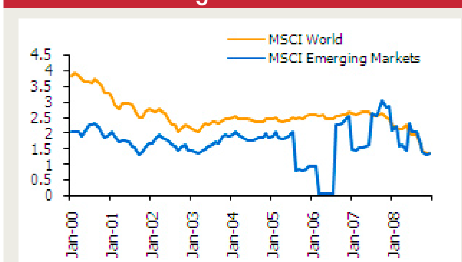
By Jui Kulkarni

Given the backdrop of global financial turmoil and how 2008 panned out, the economic outlook for the most part of 2009 looks grim. While developed economies grapple with recession, the developing economies are likely to face severe slowdowns in economic momentum. According to most estimates, a recovery in 2009, if any, is unlikely before the final months of the year. In fact, the current recessionary trends could deepen further in coming months, in which case economic recovery may likely ensue only in 2010.

M&A ACTIVITY COULD PICK UP BY 2009 END

Deal activity in 2008 shrunk for the first time since the recovery after the 2001-02 economic slowdown. The number of deals was down 11 percent year-on-year, while the value of M&A deals announced contracted by 30 percent in 2008. Although the current valuations in both developed and developing markets look compellingly attractive, the deals activity is likely to be muted in 2009.

Price-to-earning ratio



Source: Bloomberg

The swiftness with which the economic scenario has changed and the real possibility that more bad news may be in the offing is holding back decisions. The first half of 2009 should improve decision makers' visibility of the macro economic scenario. The attractive valuations will then increasingly be recognised. Improving liquidity in the following months should fuel the momentum for M&A to resume in full swing.

PE FIRMS COULD WAIT AND WATCH...

The previous M&A rally was supported to a large extent by private equity (PE) funds awash with liquidity in an environment of benign interest rates and easy access to credit. The credit crisis in the developed markets has reduced the flow of debt to a trickle, pushing out a large chunk of PE players from the deals market. As a result, PEs saw the tailwinds ease in 2007 and altogether vanish by the end of 2008. The share of PE funds in deal volume peaked in 2007 at 11 percent, while the share in deal value rose 22 percent in 2006. In comparison, PE M&A accounted for 3 percent and 5 percent of total deal volume and value, respectively, in 2000. In 2008, the value of deals announced by strategic investors declined 21 percent year-on-year and volume decreased 9 percent. Deals announced by PE funds, meanwhile, declined 70 percent in value and 24 percent in number.

However, PEs are not out of the game yet. In 2008, PE global fundraising hit US$554 billion, making it the second-highest fundraising year in the history for the industry. In addition, the number of PE funds seeking commitments remains at record levels. As of January 2009, a total of 1,684 funds are targeting an aggregate US$888 billion in commitments according to Preqin, an alternative assets research and consultancy group. Interestingly, a majority of investors remain positive towards PE. Preqin states that nearly 29 percent of investors intend to increase their PE portfolios in the medium to long term, while 67 percent plan to maintain their existing allocations. Only 4 percent were looking to reduce their allocations to PE funds.

With over US$1 trillion uncalled capital available to PE, of which around US$472 billion accounted for by the buyout funds, the action for deals could heat up sooner than later.

... WHILE CORPORATES MAY CALL SHOTS

Yet, it may be the corporate investors, who are once again likely to be at the forefront of the next wave of M&As. Perhaps for the first time since the great depression, and unlike downturns in the recent past, we are in the vortex of an economic storm encompassing so many geographies and sectors. Decision makers will have to make bold moves now to face the world that will eventually emerge from this storm. As a beacon, they will have to look at the deals that transformed businesses post the great depression. The sustained M&A wave in the 1950–70s led to the formation of conglomerates with highly diverse lines of businesses.

The balance of power is slowly but surely shifting to buyers. Apart from lower valuations, over-leverage and an uncertain economic environment could bring more sellers to the market.

The days when companies indulged in M&A to cut costs or gain access to new markets are fast coming an end. Focus on short-term value creation is being replaced by a more long-term thinking that borders on strategic transformation of the merged entity. Increasing globalisation, technology parity, mobility of capital and growth-oriented thinking by countries are likely to nullify the advantages of short-term goals.

We have already seen the investment banking industry, and also the wider banking industry, fundamentally change in the US. The caveat, however, is this transformation was quick and crisis-triggered rather than through some kind of a strategic framework. The next wave of successful deals will be initiated by decision makers (rather than forced on) with a solid vision of where they see their companies in the next few decades.

Strategic investors looking for deals right now could face reduced competition for deals (and, consequently, get deals at attractive valuations) from PE funds. Corporate investors have the wherewithal to carry out strategic M&A deals. As per the Boston Consulting Group (BCG)'s survey of European companies' 2009 M&A plans, 'M&A: Down but not out' released in December 2008, the S&P 500 companies have experienced an average 70 percent rise in their cash surplus since 2000. On an average, profitability is also higher.

Private funds will flow-in through sovereign wealth funds (SWFs) and private investment in public equities (PIPEs). SWFs, either on their own or through joint venture with strategic investors, could provide funding for deals. Lack of credit may hold back large PE-funded deals for some time to come. Instead, PE firms seem to be settling for minority stakes in public companies. In fact, many of the recent rescue-deals involved PIPEs. As per PlacementTracker, PIPE deals worth $109.7 billion were executed as of December 12, 2008, relative to $83.5 billion in 2007.

TRANSFORMATIONAL AND NOT INCREMENTAL

The reasons for M&A have fundamentally changed now. Going by BCG's survey, such transformational deals are likely to rule the roost. Willingness of companies to undertake large transactions in 2009 indicate that they look at the current economic downturn as an opportunity to carry forward 'bold and potentially transformational deals', which shape industries and restructuring transactions and change the business mix of companies. While nearly half the companies surveyed said they expect transformational deals in their industries in 2009, almost 60 percent felt restructuring transactions will rise. The need 'to fill a strategic gap' emerged as the most cited reason for making an acquisition. The fact that a target's strategic fit was voted the single largest factor for determining a deal's attractiveness underlines the long-term perspective of strategic investors.

CASH IS KING IN BUYER'S MARKET

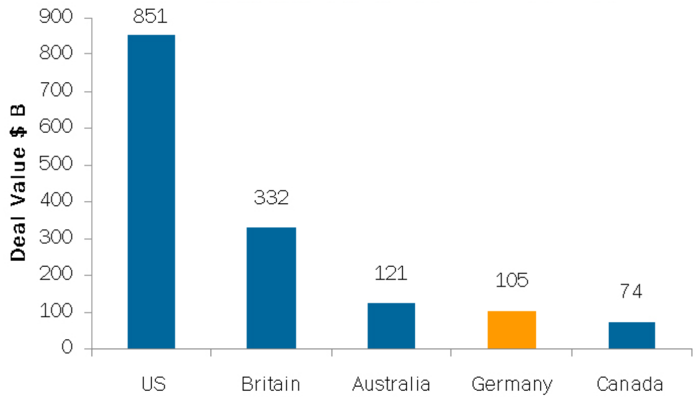
We are unlikely to see the leveraged deals that fueled the M&A boom in the recent past, as credit is scarce and costly. Leveraged Buyouts (LBOs) dominated the scene in 2007 when, at the height of the leveraged M&A boom, around 15 percent of US deals had an all-stock compensation structure. It grew to 40 percent in 2008. However, shares and cash will likely be used as compensation in deals executed in 2009, supported by a fall in stock valuations and cash piles accumulated by companies during better economic conditions.

The balance of power is slowly but surely shifting to buyers. Apart from lower valuations, over-leverage and an uncertain economic (read demand) environment could bring more sellers to the market. We expect to see distress sales and rescue deals. Sellers are also coming to terms with the fact that heady valuations of the debt-backed deals in 2007 are history. As per the IMAP's M&A Market Intelligence Update presented in October 2008, 73 percent of the members believed that it is a 'buyers' market', 23 percent felt it is a 'sellers' market and 15 percent saw no change in the balance of power. 'Lack of funding', 'Bad Economy' and 'Lack of Buyers' were cited as the top three impediments to deal making. The buyers' market is also likely to be reflected in non-compensation related deal terms. When polled about deal design techniques that could help get deals completed, using more of 'Contingent Payments', 'Reduced Leverage', 'Seller Financing' and 'Seller Risk Retention' were the most popular responses. Terms of PIPE deals executed in the past quarter are favourable to the buyers. Many include attractively priced warrants, high-dividend paying preferred stock and/or features such as board seats, voting rights and veto rights. Such features were not usually included in PIPE deals in the past.

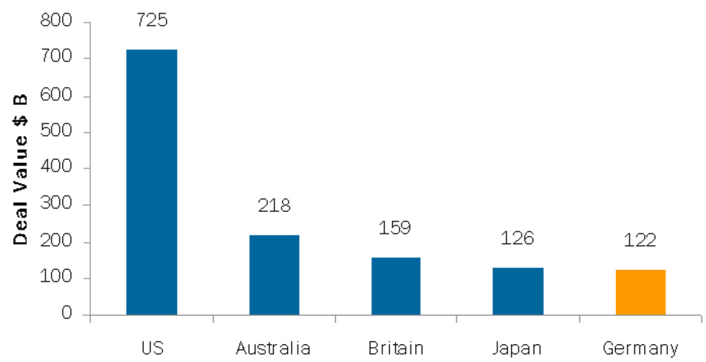
From the developments in both the PE market and war chests of solid companies, it may seem that it is a matter of time for deal making to pick up globally.

Global M&A in 2008*

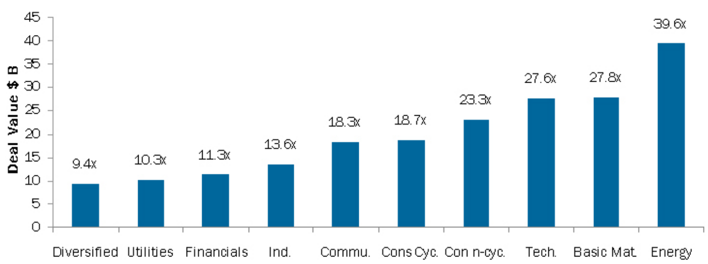
2008 M&A Activity - Top Target Countries



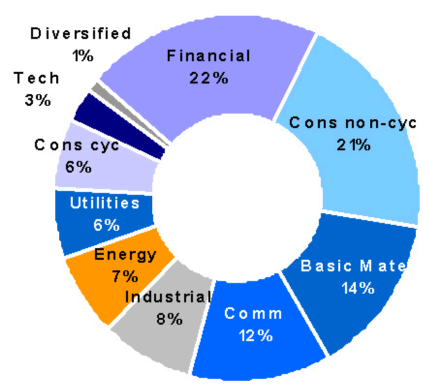
2008 M&A Activity - Top Acquiring Countries



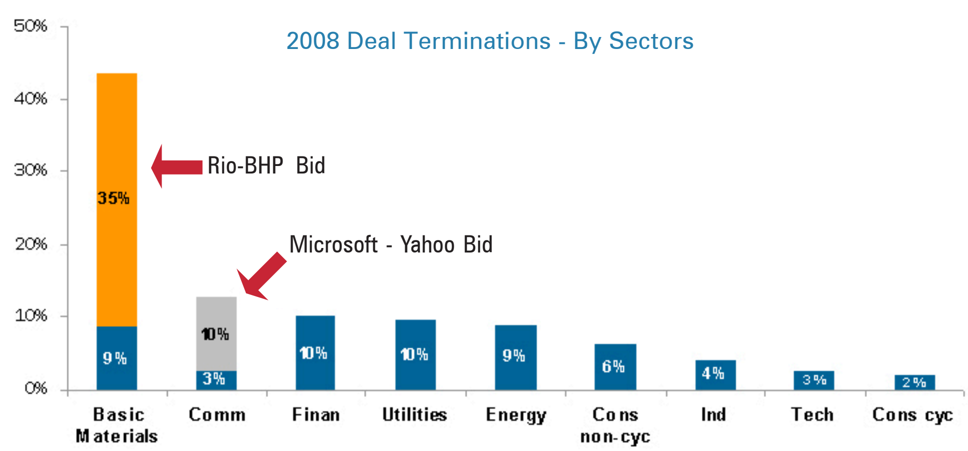
2008 Deal Valuations - EBITDA Multiples



2008 M&A Activity- By Sectors

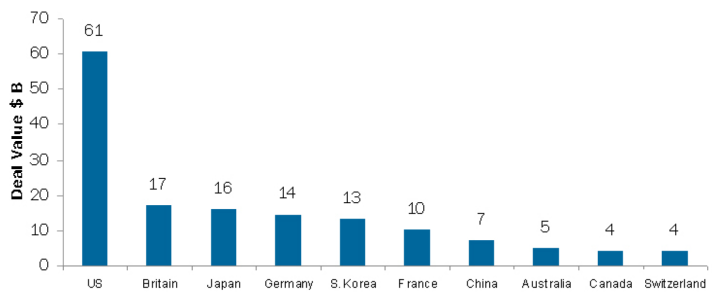


2008 Deal Terminations - By Sectors

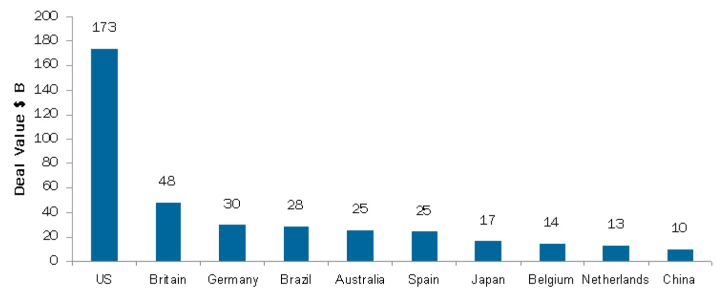


* Source: Bloomberg, Announced Deals

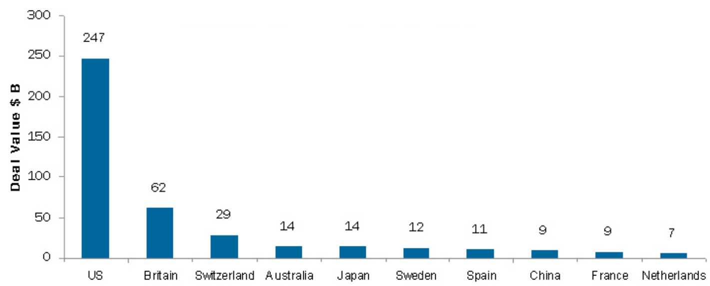
2008 M&A Activity - Industrial Sector



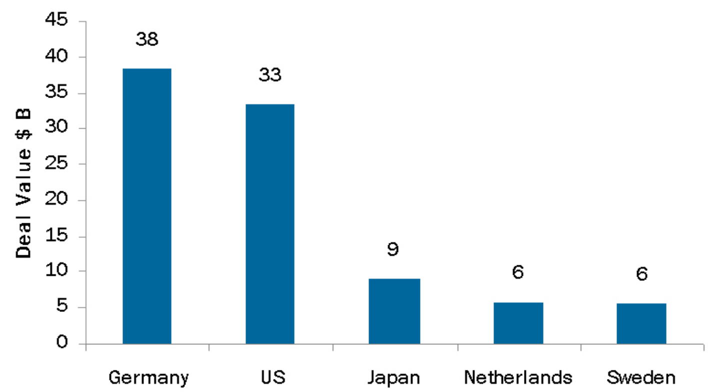
2008 M&A Activity - Financial Sector



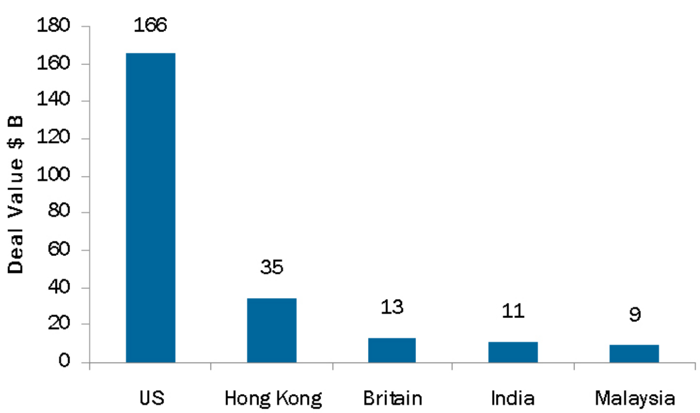
2008 M&A Activity - Consumer Non-Cyclical Sector



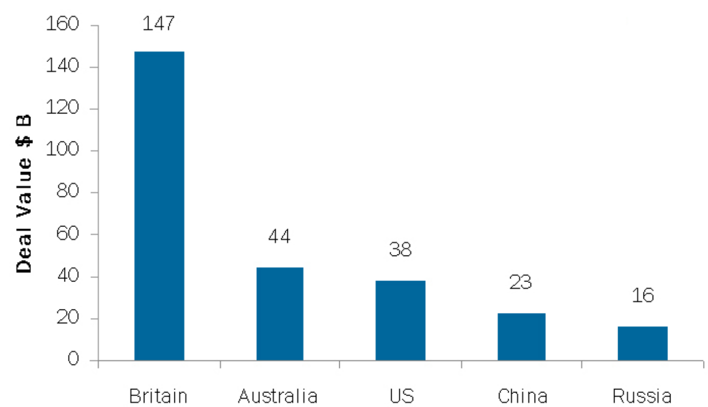
2008 M&A Activity - Consumer Cyclical Sector



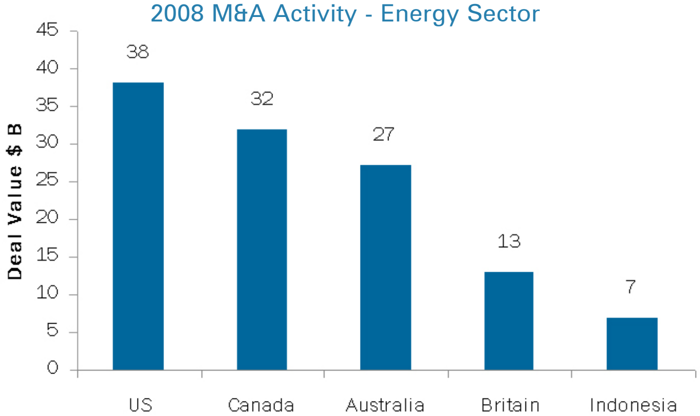
2008 M&A Activity - Communications Sector



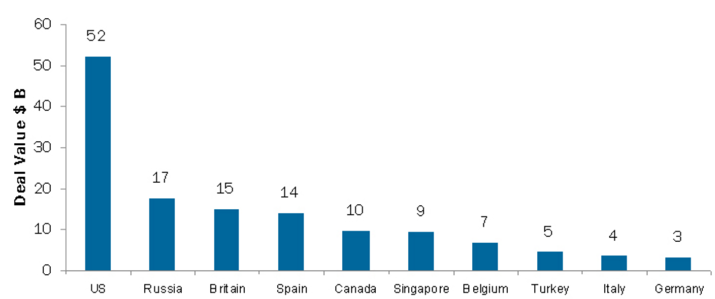
2008 M&A Activity - Basic Materials Sector



2008 M&A Activity - Energy Sector



2008 M&A Activity - Utilities Sector



Emerging Markets: How They Stack Up

Particulars	Brazil	Russia	India	China	Poland	Czech Rep	Hungary	Slovak Rep	Romania	Croatia
Economy Snapshot										
GDP ($bn) 08 est	751	1,253	828	1,568	435	184	106	72	53	38
GDP growth % 08 est	5.2	7.0	7.9	9.7	5.2	4.0	1.9	7.4	8.6	3.8
GDP growth % 09 est	3.5	5.5	6.9	9.3	3.8	3.4	2.3	5.6	4.8	3.7
Per Capita Income $	3,913	8,861	698	1,181	11,415	17,797	10,514	13,360	2,455	8,606
Population (mn)	191.9	141.4	1,186.2	1,327.7	38.1	10.3	10.1	5.4	21.5	4.4
Pop (15-64 years)	66.8%	71.2%	63.3%	71.9%	71.4%	71.2%	69.3%	71.7%	69.7%	67.2%
Human Development Index	0.80	0.80	0.62	0.78	0.87	0.89	0.87	0.86	0.81	0.85
Banking Overview										
Total assets/GDP	0.71	0.21	0.81	2.31	0.38	0.16	0.32	0.19	0.24	1.02
Total loans/GDP	0.24	0.14	0.40	1.16	0.25	0.07	0.19	0.08	0.15	0.67
Number of banks (listed)	29	51	38	10	15	2	1	5	3	21
Top 5 banks' share of loans	83%	86%	60%	82%	70%	N/A	N/A	N/A	N/A	95%
Security markets overview										
Mcap ($bn)	473.8	190.1	335.6	1,449.4	45.2	26.8	12.3	0.3	4.0	12.6
Mcap/GDP	63%	15%	41%	92%	10%	15%	12%	0.4%	8%	33%
Number of companies listed	596	1190	3495	1558	428	84	41	121	103	364
Mcap composition by industry (Ranking)										
1	Telecom	Utilities	Telecom	Banks	Banks	Utilities	Oil & Gas	Banks	Banks	Telecom
2	Banks	Oil&gas	Steel	Oil & Gas	Utilities	Banks	Telecom	Engg/Cons	Aluminum	Oil & Gas
3	Beverages	Telecom	IT	Insurance	Mining	Coal	Pharma	Food	Utilities	Banks
4	Inv. Trusts	Banks	Electrical	Coal	Beverages	Real Estate	Utilities	Pharma	Homebuilding	Food
5	Utilities	Utilities	Tobacco	Utilities	Broadcasting	Retail	Financials	Chemicals	Oil & Gas	Tobacco
Business environment										
Ease of doing business index*	125	120	122	83	76	75	41	36	47	106
Corruption perception index*	80	147	85	72	58	45	47	52	70	62

* lower index value indicates better business environment

Source: IMF, Reuters, Bloomberg Aranca Research

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