KPMG
cutting through complexity

Buy Right:

a road map for successful acquisitions

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Introduction

Mergers and Acquisitions (M&A) have long been used as a way to scale up operations and broaden portfolios, enter new markets, acquire new customers, obtain new resources, remove competitors and more.

M&A transactions therefore have the potential to generate significant shareholder value for those who successfully complete them. Success, however, is not guaranteed and research of completed transactions regularly reveals that a large proportion of deals fail to deliver the value they promised.

KPMG recently conducted a roundtable discussion with a cross-section of serial M&A dealmakers drawn from private equity, public and private companies and KPMG professionals to explore the drivers behind successful transactions and the common pitfalls to avoid.

This publication sets out KPMG's insights into how to *Buy Right* and provides a road map to help set you on the path to achieve successful M&A outcomes.

Road map

For successful acquisitions

A successful acquisition is typically the product of a robust strategic rationale, a clear understanding of the risks and rewards and the acquirer's ability to take control, capture value and manage risk.

1 Clear strategic rationale

A well defined vision of success, and the assumptions which must hold true to support this

2 Engaging targets

The manner in which you first engage with a target sends an important message

3 Structuring the deal

Protect the value of the business and maximise potential net returns

4

Robust view on synergies

Those accountable for delivery must be involved in development of targets and take ownership

5

Focused due diligence, beyond financial and tax

Validate the value hypotheses and understand key operational and commercial drivers and risks

6

Understand the people and culture

Understand and plan for cultural differences and communicate continuously and consistently

7

Integration and value creation

Start post deal planning early, protect business as usual and collaborate to deliver value

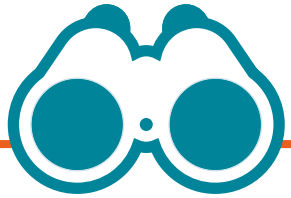
8

Benefits tracking

What gets measured gets done – track delivery versus plan

1 Clear strategic rationale

For a deal to be successful it must be supported by a clear strategic rationale that demonstrates how the deal is going to generate value for the acquirer. This is a critical keystone that underpins the deal – all key decisions can then be referenced back to this strategic rationale.



"Being clear on the strategic rationale enables us to articulate where we see the value and to then test that during due diligence."

CFO, Global Agribusiness

Having a clear and documented strategic rationale helps retain focus during the deal process, guides structuring and due diligence activities, supports the final price paid, and also provides the discipline to renegotiate or even walk away from the deal if this rationale ultimately no longer holds true.

The approach of private equity (PE) firms is a good benchmark when it comes to acquirers that typically have a well-defined strategic rationale. Under the PE model, investments are made with the end game in mind – a successful divestment. As such they will typically have a clear investment thesis before formally engaging with the target. A well thought out investment thesis will set out how the PE fund plans to make the acquisition, increase value and deliver a strong return on divestment. This in turn helps provide the deal team with a set of discreet hypotheses that can then each be validated to support the final investment decision.

A clear vision of success, and the assumptions that must hold true to support this, needs to be understood by the deal team and advisers, and provides a critical reference point against which key deal decisions can be evaluated.

"When it comes to a clear, strategic rationale, one of the pitfalls we have seen is that companies may go into a deal that looks quite attractive in the first instance, but they fall short on having that clearly documented or articulated. The deal process is dynamic; as you learn more about the target your views on the benefits and risks change. Unless you have a clear strategic rationale, you can miss that point where perhaps it's no longer a good deal and you need to think about walking away."

Kaare Damgaard, Director, Deal Advisory, Strategy, KPMG

Engaging targets

Having developed a clear strategic rationale, the challenge is to scan the market and identify, qualify and engage suitable targets for acquisition. There will rarely be a perfect match and targets, once identified, may also be very difficult to qualify and engage. Private companies in particular can be very secretive about the financial performance of their business and hence it is not uncommon for vendors of private companies to reject approaches as they are suspicious as to whether potential acquirers are genuine.

It is important that the process of identifying, qualifying and engaging potential acquisition targets be conducted in a professional manner. Even carefully managed, it is often the case that buyers will need to "kiss a number of frogs, before you find your prince". There are, however, a range of strategies that can be deployed to improve the chances of identifying a better target and ultimately completing a successful acquisition. These include:

- testing the key attributes of the target listing against your strategic rationale to eliminate unsuitable candidates
- utilising intermediaries, particularly advisers, to initially approach targets. This helps lessen that sensitivity that many vendors have to unsolicited approaches and sends a strong message to targets that the buyer is serious and prepared to spend money
- approaching targets professionally using Confidentiality Agreements and other documentation to instil confidence with the vendor that the approach is legitimate and well considered

"Identifying, qualifying and properly engaging acquisition targets is a combination of art and science. Done well, it serves as a sound platform for the rest of deal. Most deals fall over down the track when this is poorly executed."

Kim Harpøth Jespersen, Partner, Deal Advisory, KPMG

- discussing valuation parameters early to eliminate vendors with unrealistic pricing expectations, and
- creating good documentation around early discussions to clarify what has been agreed and what is yet to be agreed – deals often become unstuck down the track when this is not done.

The objective of a well executed target engagement process is preliminary agreement between a buyer and seller on a deal, built on a trust that both parties will behave appropriately going forward. It is commonly reflected in M&A circles, that in the absence of a signed binding contract, all you have is trust.

The written evidence of this agreement can be a 'Terms Sheet', Heads of Agreement or a Non Binding Indicative Offer (NBIO). A good NBIO is a well constructed document that captures, in laymen language, the deal that has been agreed between the parties and should a serve as a foundation to move to structuring the deal.

Structuring the deal

Structuring the deal encompasses a wide range of factors, from the form of the acquisition itself (shares or assets) through to the form of consideration, payment structures, funding the consideration and other contractual considerations. Ultimately the objective when structuring the deal is to position yourself as the acquirer to realise and protect the inherent value you see in the transaction, while also adequately meeting the objectives of the vendor to agree a deal.

Transaction documentation

The sale and purchase agreement needs to accurately reflect the negotiated terms of the deal and include clear definitions and examples to avoid misinterpretations in the event of a dispute. An acquirer should seek to incorporate relevant warranties and indemnities from the vendor as protection against key risks or areas of uncertainty (subject to negotiation). In addition, this is where agreed terms such as whether the business is to be delivered debt free or with an agreed level of working capital are documented.

Earn outs are a common mechanism employed by acquirers to structure the payment of consideration to the vendor. Earn outs can defer and link the payment of part of the consideration to the performance of the business in subsequent years. It is critical when developing earn out mechanisms that they are clearly defined and documented.

Retention amounts can also play an important part in deal structuring and are useful where there is uncertainty about a vendor's ability post completion to make a payment in the event of a warranty or indemnity claim, or, where there is uncertainty with respect to the quantum of a liability, e.g. environmental remediation.

"A sub optimal financing structure can impact on management's time in terms of dealing with financiers, which can become a major distraction from delivering on the synergies and premise of the original transaction."

Kim Harpøth Jespersen, Partner, Deal Advisory, KPMG

Funding the deal

When considering an acquisition target and the anticipated funding required, capital management both across the short to medium term should be well thought through to optimise shareholder returns while managing financial risk within an acceptable level.

Capital providers (both debt and equity) will take confidence from a well thought out and structured capital raising process which will likely result in a lower cost of capital. Early consideration of debt finance and, more importantly, the most appropriate form and structure including terms and conditions (pricing, covenant levels, security, conditions precedent etc.) will allow management more flexibility to operate business as usual and realise synergies post acquisition rather than meeting stringent financier requirements.

Tax considerations

Early assessment of the transaction structure is critical from a taxation perspective to ensure the outcomes for the purchaser, the vendor and the target are appropriate. The form of the transaction structure will be influenced by the decision to carry out an asset or share acquisition.

Having a clear understanding of the respective tax attributes, of not only the target business but also those of the vendor and purchaser, are an essential part of planning a transaction. Greater awareness of tax attributes allows for certain transaction structuring opportunities such as pre-transaction dividends so vendors may unlock additional value.

Tax attributes (such as cost base of the target's assets, capital structure of target and tax losses) will be influenced by the entity types which are to be parties in the transaction (i.e. company, fund, or partnership), and consideration should be given to the various entity types from both a tax perspective and an ongoing commercial perspective. Another critical aspect of transaction planning is the impact of transaction taxes such as registration taxes on real estate which should also be considered.

"Having a clear understanding of the respective tax attributes, of not only the target business but also those of the vendor and purchaser, are an essential part of planning a transaction."

Jacob Lie, Partner, KPMG ACOR TAX

4 Robust view on synergies

Our research shows that typically almost half of cost synergies and performance improvements are paid in the purchase price and yet almost half of all acquirers are performing little synergy analysis prior to completion.

A common pitfall is that a high level view on synergies is compiled by the deal team without an appropriate level of operational involvement. This can result in the deal value being underpinned by a set of theoretical synergies and when these are ultimately handed over to an operational team to deliver, some serious operational obstacles are identified, dis-synergies discovered and/or there is no real buy-in from management.

Before committing to the deal, a robust analysis of synergy and performance targets should have been completed. Be confident about what is achievable before including them in the purchase price, and plan to exceed the original synergy and performance targets. This reduces the risk of paying away too much of the value upside and this detailed upfront thinking also helps inform subsequent planning around delivery.

The approach to developing the synergies can be aligned to the broader transaction process, i.e. a preliminary top-down view for the indicative offer stage and then a detailed bottom-up build during due diligence prior to a final binding offer.

"A synergy plan is like any other plan; developing a plan is easy – it's the execution that's hard. So you need buy in, clear measurements of success and you need to hold people accountable based on those measurements."

Private Equity Investment Director

Forming a view on synergies is not an exact science, revenue synergies in particular are often hard to quantify and as a result buyers are typically reluctant to either pay these away in the price or to announce them to the market as targets. When assessing synergies, we typically recommend forming a view on a base case (high level of confidence) and a stretch case (additional upside with some risk).

From a pricing perspective and public view, the base case becomes your reference point but the stretch case informs your higher internal management targets. This not only helps ensure you don't pay for value that can't be realised, but also keeps upside potential available to offset those inevitable risks and obstacles which will arise during implementation.

"Typically what is announced to the market is a conservative base case, and then there's the stretch case behind the scenes that management is chasing."

Kaare Damgaard, Director, Deal Advisory, Strategy, KPMG

"You look at synergy potential in a very different way when you are responsible for the delivery. In our organisation it's imperative that the team that receives the asset and is going to be involved in the delivery, signs off on the targets."

General Manager, Strategy & Commercial Finance, Large Fashion Company

Focused due diligence, beyond financial and tax

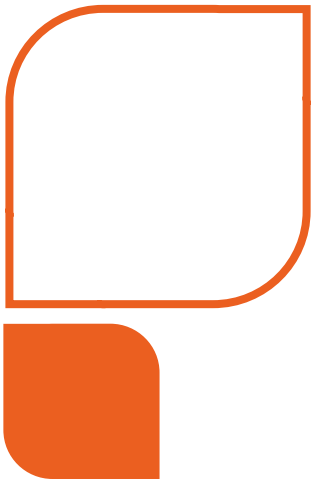
Due diligence should be targeted to prioritise the validation of the deal rationale and value creation assumptions. If these continue to hold true then the diligence process can continue to cover the broader business risk considerations; if they do not then it helps provide the discipline to walk away.

We are increasingly seeing this played out by way of a phased approach to due diligence. The due diligence is targeted and aligned firstly to testing the investment thesis and only once these are validated does the diligence expand to cover the broader financial and business risks.

A base level of financial and tax due diligence is now the norm on most transactions and considered an imperative from a good governance perspective. However, it's just as important to develop a thorough understanding of the operational and commercial aspects of the target company.

"I've seen people take out a due diligence checklist and try to work through that, which is fraught with danger because you're not thinking about problems or hidden gold that may exist in the business. What you don't want to do in a due diligence process is go in deep on all the ancillary pieces that may not make or break the deal. If there's a strategic rationale for why you're doing the deal, you need to get really comfortable with the key assumptions that support that – the rest is just housekeeping."

Private Equity Managing Director



"People are now much smarter in terms of how they do their due diligence. We did due diligence on a target that had a number of complications and we were finished in about four days. We went in with real clarity about what the threshold financial issues were, and within four days we had formed a view and were gone. I don't think we would have experienced such a quick process even two or three years ago."

Dale Treloggen, Partner, Deal Advisory, KPMG

Commercial due diligence can help you understand the market dynamics, competitive landscape and the key drivers of business performance in a particular industry or sector – particularly important if the transaction is being made to diversify into new areas. In addition, developing a good understanding of the target's operations will help you to identify what drives current performance and develop an understanding of the current baseline performance from which synergies and upside opportunities can be assessed. It can also help you identify current operational shortcomings that will need to be remediated.

It is important to involve operational management during the due diligence. Otherwise there is a risk that key operational issues are missed and also you increase the risk of knowledge not being transferred from the deal team to the operational team who, worse still, may be tasked to deliver a value creation plan that they have had no input into.

"Having framed up the strategic rationale with discrete testable hypotheses that you can corroborate or otherwise through due diligence, then to the extent that due diligence proves them up you go ahead; if it doesn't then it provides the discipline to walk away. That way you focus your attention on what's important rather than the box ticking exercise."

CFO, Import and Distribution Business

6 Understand the people and culture

In our experience, developing an informed view of the target's culture and identifying key cultural differences early and planning to overcome them is a key deal success factor. Previous KPMG surveys have found that acquirers that paid attention to these cultural factors were significantly more likely to deliver a successful deal. Also, uncertainty in any transaction typically results in value erosion so the more uncertainty you can remove through regular and consistent communication, the better.

Undertaking a cultural assessment of the target helps to identify gaps where your way of thinking is one way and the target's way of thinking is completely different – once clear on those gaps you can work out how to manage them and position key communications accordingly. Equally, it helps to identify where there is an alignment between cultures early on and to leverage these to get some momentum and to help bridge some of the gaps identified.

All interactions with the target throughout the transaction provide opportunities to gain insights into the target's culture and also the key people talent. It is important to try and identify the key talent early and to put plans in place to retain these key individuals.

Post completion, an effective communication plan is critical. People do not like uncertainty – an effective communication strategy helps to remove uncertainty and this is vital in protecting value.

"What are the things people don't like? Change and uncertainty. Right down to the factory floor, staff are always wondering whether they're going to lose their jobs. It comes back to the fact that communication is critical in these environments to reduce that uncertainty gap."

Private Equity Investment Director

"It's important to really understand the value drivers of a business. Often it's the intangibles, e.g. culture or the entrepreneurial spirit of the target, particularly when it comes to revenue synergies. There have been numerous examples where a large corporate has acquired a smaller entrepreneurial company and has struggled to maintain the momentum of the business let alone deliver growth."

Kaare Damgaard, Director, Deal Advisory, Strategy, KPMG

7 Integration and value creation

Before you sign the deal you need to be comfortable that you have a clear plan of how you will deliver the value post completion.

This provides confidence at the time of committing to the deal that you have a plan to realise the value required to meet your success criteria. This helps in identifying, investigating and factoring into the price any post deal operational issues – these issues could be deal breakers.

In order to be able to develop this integration or value creation plan, your operational team will need to have been involved during the due diligence, or at the very least have received a full briefing and handover from the deal team. You can then use the time between signing and completion to develop a detailed plan to enable you to start delivering value from day one.

An effective integration or value creation plan will begin with some key principles locked down upfront which will serve to keep the plan aligned to delivery of the strategic rationale and end state vision. Ideally these are set with input from senior target management so as to ensure key alignment across both organisations and consistent on-message communication.

When looking at the pitfalls of deals that have failed to deliver shareholder value, a common area of feedback is that companies found that they did not start post-deal planning early enough. Many corporates are now alert to this and will no longer approve a final investment decision unless there is a sufficiently developed integration/value delivery plan in place at time of signing.

A big risk post completion is distracting management from business as usual (BAU) and seeing the underlying performance of the business suffer as a consequence. Too often acquirers under estimate the time and effort required to implement integration/value creation plans. If you can have dedicated resources focused on this task the risk of adversely impacting BAU is greatly diminished.

"We involve our operational team throughout the due diligence process – we will not sign off on a deal unless they've been involved and they've signed off on the integration plans. The people that are going to be delivering it have to be the architects of the plan – they key is to be able to hit the ground running."

CFO, Import and Distribution Business

"A deal isn't done at completion. Theoretically it's done, but then the hard work begins to actually create or deliver the value you have paid for. There are some real challenges around taking an investment thesis and then converting that value, but also there's the opportunity to do a much deeper dive with full access post completion to identify additional value and maximise the returns."

Kaare Damgaard, Director, Deal Advisory, Strategy, KPMG

8 Benefits tracking

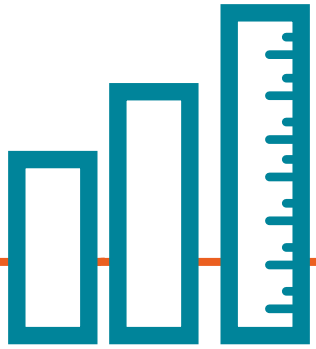
One of our observations across many deals is that management teams often fail to track the benefits that are delivered from a transaction effectively. Many times management will only have an indication of whether value has been delivered versus an accurate measure of actual benefits realised and how this compares back to the original investment hypotheses.

Benefits tracking needs to be simple and visual to ensure buy-in across the organisation. There may be a detailed financial model at the heart of this but if the people in the business do not understand what you're trying to achieve it will not be effective. A simple visual dashboard is an effective tool. An important part of benefits tracking is determining the operational and financial baseline of the acquired business and the key performance metrics – this provides the base from which to track the impact of your value creation initiatives.

Setting yourself up to track benefits also brings a discipline to the synergy and value creation assumptions themselves – in order to track these you need a good understanding of what drives these benefits and the key assumptions. The discipline of tracking actual benefits versus plan also helps you become better and more informed when it comes to future transactions and value assumptions. Tracking of benefits also means that people are held accountable for the delivery of key value drivers.

"Our businesses have visual metrics, both lead and lag up on a board so the people can see how we're going daily. Having that through the integration process is critical. That gives you the opportunity to adjust your integration plan where the metrics tell you to. But if you're not measuring it, it's far less likely to happen."

Private Equity Managing Director



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