Managing the rollercoaster

Executive summary

- The ACT's recent mergers and acquisitions masterclass examined the current landscape for M&As and looked at the processes that corporates need to undertake to ensure their deals are a success.

PETER WILLIAMS REPORTS ON THE ACT'S MERGERS AND ACQUISITIONS MASTERCLASS.

One of the M&A themes of recent years has been the dramatic growth in the private equity industry. At the ACT's M&A masterclass, held in September in the City and sponsored by Close Brothers and Allen & Overy, Darren Redmayne, Head of the Private Equity Coverage Group at Close Brothers, said that only a few years ago private equity had been akin to a cottage industry.

Examining transaction types, Redmayne said that companies were constantly evaluating the benefits of being publicly quoted compared with private ownership. He said it was now possible for companies to access the liquidity they required other than through the public market while many boards were aware of the heavy regulatory burden of being a public company.

The era of the corporate merger – with the deal recommended by the board – appears to be a thing of the past. For sale signs can hang outside companies these days without doing any harm to reputation or the price obtained. Redmayne said that auctions involving a small number of potential buyers were increasingly sophisticated, and heralded the end of exclusive off-market deals.

One of the hottest sectors at the moment by volume is central and eastern Europe, which is an increasingly attractive M&A market.

Looking at the role of advisers, Jonathan Trower, of Close Brothers Corporate Finance, said it was intriguing how teams of advisers worked together on deals. He said the investment bank still had the traditional role of lead negotiator and adviser. In terms of financing, he questioned whether companies should always accept advice coupled with "muscle", and said the rise of the independent was "quite noticeable in the M&A market".

Trower also said that, increasingly, eyebrows were raised over the British concept of vendor due diligence and that top-up due diligence was frequently performed by the buyer in auctions. Up to now, plcs have tended to give certain warranties, but this practice may cease as private equity sellers don't provide warranties.

The key in an auction process is preparation, preparation, preparation, which identifies the risk areas. The last thing wanted during an auction process is any surprises.

A key tool of the private equity market over the last few years has been the use of leverage. For instance, in the retail sector all private-owned companies are more highly geared than their publicly quoted counterparts. Private equity firms are in an aggressive search for the lowest cost of capital and it has to be recognised that public companies are not running an investment portfolio.

Trower said that public companies had started to imitate private equity in the way they were incentivising the senior people involved in the company. He suggested there might be opportunities for public companies if private equity deals went wrong with the current contraction in the credit market.

At the time of the conference it appeared that while mid-sized deals could be accomplished, large deals were not going to be completed until the underwriting backlog had cleared. Trower suggested that the current credit conditions were bound to have an effect on M&As in the short term but that it would still be possible to do deals. Barring a recession, the market would pick up mostly because there was a lot of private equity money looking for a home. Also, trade buyers have the balance sheet capacity to do deals as long as the finance can be pieced together.

MANAGING A TEAM Managing the M&A team – both internal and external members – is a rollercoaster, which can be stressful, according to Jonathan Osborne, Head of M&A at Shell. Osborne has worked on a series of multibillion transactions, including Shell's $7bn offer for the minority share in Shell Canada, which closed in April 2007. He said that how you managed the deal would improve the chances of success.

The M&A process can be divided into three major phases: strategy formulation, deal execution and integrate/divest. And while there may be a large number of people working on the deal, Osborne said there were three internal and three external people who were key

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and who helped to maintain continuity across the three phases. The internal core team is the deal lead (usually from the business), along with the finance and legal lead. On the external team, the financial, legal and accounting advisers are key. The core members of the team need to spot where there are potential issues and who to turn to to resolve problems (such as specialist tax or PR advisers). Osborne said that in a deal it was important "not to leave issues hanging out there".

Osborne referred to the purchase of the minority shares in Shell Canada , where there was a range of issues to be dealt with, including the need for commercial confidentiality when the chances of leaks were considered high. When the deal was known, questions arose in the media over "hollowing out corporate Canada" and the loss of one of the country's largest listed companies. A more technical issue was the structuring of the accounting and the tax treatment of the offer to the option holders so that they received the level of payout they were expecting.

One of the questions asked in an M&A deal is when to use an investment bank. Osborne said: "Clarity on why you are using a bank helps selection and management of the bank."

If the deal is a public market transaction, then generally an investment bank must be used. The corporate can also use an

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investment bank to provide specific local and technical knowledge, a relationship with the counterparty, and experience with a class of buyers.

To select an adviser, Osborne told the conference that a corporate could opt for the classic process or the upfront choice. The classic process involves a confidentiality agreement, a "hymn sheet" and a beauty parade. The advantage of this method is that the M&A team can assess the bank teams from a broad range of banks, different perspectives emerge during the beauty parade, any conflicts of interest can be checked early on and competition on fees is stimulated. With the upfront choice, one bank is selected from pre-selected house banks where there is prior knowledge of the team. Although a conflict check is still required, this process gives greater confidentiality.

A concern of treasurers involved in M&A deals is the level of fees which advisers seek to charge. The standard structure involves a retainer and a success fee. However, Osborne described the variations that were possible, such as a percentage of the deal size (this makes particular sense for divestments), and a ratchet is also used. Increasingly common is the idea of a discretionary fee element. This can be useful when it is not clear how the deal and the associated work will turn out. The other common variation is a two-stage element.

When negotiating the engagement terms it is vital that there is one team in the company which interfaces with the investment banks so that there is a single point of entry. Osborne also encouraged companies to keep a database of fees paid and while being robust on fee negotiation not pushing fee levels too low as this can be counterproductive. It is also helpful to have standard pre-agreed engagement letters in order to prevent wasting time.

PRE-ACQUISITION Two of the major pre-acquisition issues which corporates need to manage are, first, due diligence and the role of the legal adviser and, second, funding the deal. The conference heard from Alun Eynon-Evans, a member of Allen & Overy's corporate department, whose work includes a managing role on the $60bn three-way demerger of Tyco, the electronics, engineering and healthcare company. Eynon-Evans said that due diligence was easy to manage badly, hard to manage well and could generate walls of information that tell very little about the business. Historically, due diligence has been performed but due diligence reporting has not, and while businesses have become more complex the due diligence methodology had not changed.

It is important to decide on the purpose of due diligence. It can be used to identify the consents needed for the deal (is it an EU merger case, for example?) and it defines the deal structure. It quantifies known liabilities and should uncover unknown ones, and it should confirm title to assets, especially property. It should identify the contractual protection needed, especially indemnities.

A crucial role is to identify show-stoppers, which, Eynon-Evans said, did happen. Although one of the key elements of the due diligence process is the data room (a room filled with files and folders of information that cannot be removed), this is giving way to virtual data rooms. While that makes sense in a digital age, Eynon-Evans did suggest that online access needed to be restricted in a similar way to physical access.

In any deal the board will look to the treasurer to play a high-profile role in securing the funding. David Brent, Group Treasurer of BAE Systems, the global defence and aerospace company, told the conference about the acquisition of United Defence Industries in June 2005 for $4.2bn. The deal was BAE's first significant US acquisition and was followed in July 2007 by the acquisition of another US company, Armor Holdings, for $4.5bn.

The UDI acquisition was partly funded with cash, including the proceeds of a £354m equity placement, partly with a drawing from a $3bn acquisition facility. The drawing from the acquisition facility was refinanced in the US rule 144A market through the issue of $1.75bn of term debt, made up of $500m floating-rate note due 2008, $500m fixed-rate note due 2010, and $750m fixed-rate note due 2015.

Brent told the conference that certainty of funds was paramount and that funding in an auction had to cover a range of share prices. The starting point for determining the amount is acquisition price plus the debt in the target. The debt in the target is likely to require refinancing due to a change of control clause. The directors need to be confident the combined business can be financed and one of the key pieces of assurance is to produce a consolidated cashflow forecast covering a 12-18 month period and factoring in downside scenarios.

As well as the target's funding, it is important to review the funding of the acquirer to ensure there are no likely covenant breaches. The treasurer should also consider the timing of any consents required such as competition approvals and so on, and look at the potential impact on the funding.

Peter Williams is Editor of *The Treasurer*.
editor@treasurers.org