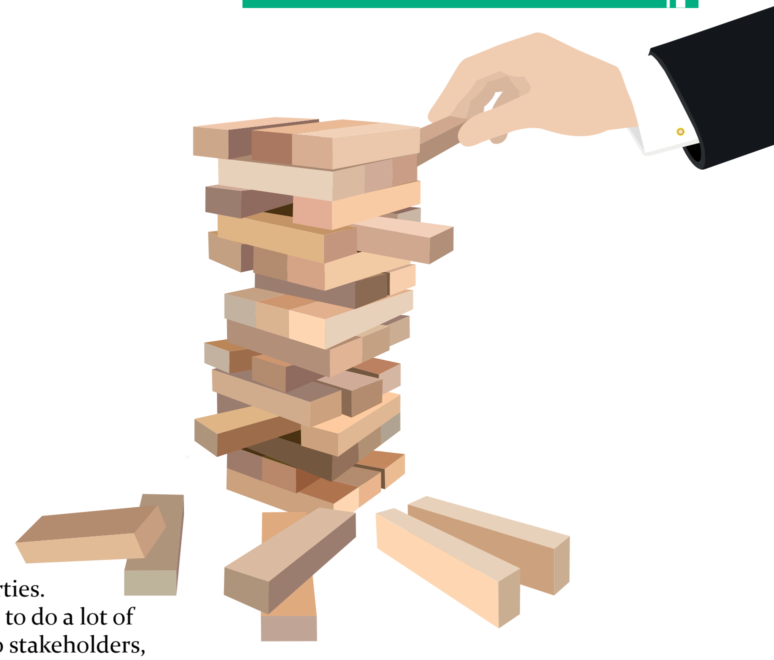
Proceed with care

Due diligence is an important part of the M&A process. Will Spinney explains the treasurer's role



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M&A encompasses both acquisitions and disposals. But due diligence refers to the process of identifying those issues that increase risk when a company adds to its assets with an acquisition. An acquisition is likely to change a company's products, geography, size and the markets in which it operates. It will also bring in new ideas, management and processes.

What should a treasurer consider when faced with an acquisition of a new business?

Financial strategy

The change that an acquisition brings may be large enough to require a fresh look at financial strategy. New products and markets will increase risk – although greater diversity may perhaps reduce it. This greater risk may be combined with higher debt finance to enable the acquisition to take place.

A riskier credit profile requires a different financial strategy. A very large acquisition can push a company from having an investment-grade credit rating to having a speculative-grade rating. This has huge implications in terms of the available markets, price and liquidity for its debt. Existing investors in the company's investment-grade paper are likely to be shocked by a large downwards move in a company's credit risk profile, but even smaller moves can cause its lenders to face higher capital charges.

An acquisition may also change a company's investment intentions, so a high dividend payout policy might be replaced by a high investment strategy.

Treasurers should also look at the issues of interest rate risk and translation risk as well as at changes to how interest rate risk management is structured and the currency split of financial assets and liabilities. Of course, the acquisition itself might require funding in a currency that necessitates some risk management, bearing in mind that acquisitions aren't certain until they are actually signed by all parties.

So the treasurer needs to do a lot of modelling and talking to stakeholders, beyond simply financing the actual acquisition itself.

Financing in the target

The next stage for due diligence is to look at how the target is financed and what other liabilities it has, together with how much cash it holds.

So a full picture is needed of the target's:

- Bank and other lender relationships;
- Terms and conditions of borrowed funds;
- Use of bank guarantees, letters of credit, surety bonds, etc;
- Asset finance;
- Derivatives (and their collateral implications); and
- Supply chain or export finance.

Particular attention must be given to any financing that is repayable on demand, on a change of control or where cash collateral – for example, on letters of credit and guarantees – may be required on demand. Enough liquidity must be available so that these can be met on acquisition.

Spare cash, and there usually is some in most businesses, brings its own challenges. Some cash may be trapped, either for tax, FX control or other regulatory reasons, and will always carry counterparty risk, which needs to be understood and managed.

Pension schemes

Pensions, whether defined benefit (DB) or contribution schemes, are always a difficult area in acquisitions. A DB deficit may require funding, and trustees or fiduciaries may react to the sponsor being acquired by insisting on large contributions to reduce what they see as an increased risk, or perhaps as a result of opportunism. In some countries, regulatory authorities may take on this enforcement role. Pension schemes need to be carefully examined for valuation assumptions and risk because discount rates do not reflect a market price for liabilities.

Cash management and treasury design

Next, the treasurer needs to look at how all the parts of the acquisition are funded on a day-to-day basis, and at how the treasury is structured. Most treasurers will not want to duplicate these activities beyond the short term, so they should plan to bring them within their own structure. It is often the case, however, that something is done better in the acquired company than it is within the acquirer – perhaps there is a superior treasury management system, for example – so the treasurer should go with the best.

Treasury design is not usually a showstopper, however. And it can almost certainly be left until after the acquisition has completed, then managed on a more leisurely basis.

Conclusion

Acquisitions are exciting and a good time to be a treasurer. The treasurer should befriend the people within the acquired company and establish trust from day one, since it can be threatening to be acquired. While the treasurer will inevitably miss some small things, as long as they've ticked off the major points, they will have done their job.

Will Spinney is associate director of education at the ACT