



Mergers and Acquisitions: One Size Does Not Fit All

Over the last two years, the processes for mergers and acquisitions (M&As) have become more complex and require a disciplined approach as credit markets have tightened, bid-ask spreads between buyers and sellers have widened on deals, and proposed deals have come under greater scrutiny from management and boards. In this CFO Insights piece, "Target Screening and Evaluation: One Size Does Not Fit All", we look at emerging disciplines at the very front end of the deal – improving the buy-side process with a focus on target screening and evaluation with the intention of aligning the target's value drivers with the strategy of the acquirer. Done well, target screening can improve the odds of a successful transaction. A well-defined process can also greatly increase the efficiency of a company's M&A strategy, as many potential value killers are identified much before significant organizational resources are deployed to unproductive deals or transactions.

Know Your Target; Know the Red Flags and Pitfalls

Target screening is the systemic first level review of potential acquisition candidates to identify a refined list of companies for further due diligence and consideration. For companies seeking to acquire other companies, there's a large list of potential targets ranging from standalone companies to subsidiaries to divisions of other companies or even carved out entities. A disciplined target screening process can create a focused list of targets from this group which are more likely to meet the needs of the acquirer. Key to success is starting with a sound acquisition strategy and a clear investment criteria and strategy that is broad enough to so that a viable option is not excluded straight out of the gate. Even though this universe will be vast – especially when you consider not only the companies but individual divisions, brands and products – it should be so by design at the outset. The long list of initial potential targets is then dramatically shortened by applying screening criteria.

Defining a set of guiding principles and screening criteria at the front end is critical to the buy-side success. The screening criteria vary substantially across companies. It could, for example, include criteria such as size, geographic footprint, scalability, EBITDA, leverage, market share, and earnings impact.

Today, boards demand more information and justification for acquisitions. They are increasingly interested in the sustainability of the target's business model, the competitive advantage, and the post-merger requirements to make the deal a success. They are also more focused on M&A activity from a risk management perspective. Because of this, target screening has taken on new levels of importance for management. In this context, business development groups, CFOs and finance organizations who help devise a disciplined, iterative process for target screening can



increase the efficiency and effectiveness of their M&A processes by quickly identifying deal breakers and excluding those mergers or investments unlikely to meet key financial and non-financial criteria.

Strategic Fit Often is Viewed as a Primary Corporate Objective and a Critical Factor in M&A Analysis

Acquisitions are often driven by considerations of strategic fit. Both quantitative and qualitative factors can be explicitly considered in the target screening process to assess the fit. The targets that pass through the initial and subsequent filters should be compared and prioritized based on consistent criteria. For example, a company can create a strategic fit assessment matrix. It may contain targets' competitive position (i.e., distribution channels, competitor retaliation and risk of substitutes), proposition to buyers (i.e., product portfolio, pricing and quality) and power relation to suppliers (i.e., economies of scale, supply contingencies and supply chain). All these factors may be debated and challenged to garner an objective review and decision-making structure. Beyond a summarized version of strategic fit, select companies within the target screening process may be supported by deep dive profiles to better assess their value and integration potential. These profiles should include business segments and product lines, company financials, manufacturing sites, selected transaction history, recent company news, and potential risks.

While investigation of how each target would fit into the acquiring company's overall M&A strategy is still a key factor in screening, it is by no means the only one. More specific and highly nuanced questions need to be addressed to produce an optimally screened shortlist.

Screening these targets for the strategic fit also involves avoiding a number of red flags and potential pitfalls early on, before a huge amount time and resources is invested. After screening for these show stoppers, the list of viable options will be substantially shorter. Only then will the more in-depth value analytics be applied.

Typically, companies evaluate the strategic fit, by:

- Considering how each target would contribute to M&A strategy;
- Applying more subjective screens, including product fit, integration challenges, etc.;
- Identifying unique challenges and red flags for each target and potential acquisition.

Red Flags -- Avoiding Common Pitfalls

As part of target screening and the initial evaluation process, many of our clients find it is important to give due consideration at an early stage to a few key factors that can undermine the potential value of a target or its strategic fit. Some examples include:



Consider comparability of accounting standards, policies and practices.

When it comes to screening criteria, comparability of accounting is rarely considered. If you are looking globally and comparing company reports, it is vital to the application of that information that you know which accounting standard is being used. Is it IFRS, US GAAP, or local country GAAP? How does that impact the metrics?

Depending on the answer, the screening metrics might be useless because there are significant differences and you may not be comparing apples to apples. Industry specific characteristics can compound seemingly small differences into great ones. For example, you need to know whether you will have to record certain derivative or other hybrid instruments as liabilities and mark them to market through the income statement. There may also be structural implications here – is the transaction a merger, the acquisition of a whole company, the purchase of a particular business division or asset, or a JV or other type of investment?

Reflect the deal impact on the buyer's balance sheet and income statement.

Where is the value in the target business, will it show up on the balance sheet as an asset (liability) and what will the impact be on future earnings? Are there significant accounting policy differences between buyer and seller that would need to be conformed? Has the impact been reflected in the accretion/dilution analysis?

Know the tax considerations.

Understanding some basic tax structuring concepts and characteristics of the target can have a meaningful impact on both cash and book taxes. Does the target have any NOL's? If so, is their use subject to limitations? Does the transaction provide a step-up in basis of the underlying target assets? How will the transaction be financed and will the interest charges be tax deductible?

These factors can all have a meaningful impact on valuation and other key deal criteria. Analyzing some tax considerations up front also allows you to introduce key structuring decisions early on in the process.

Understand the capital requirements for the transaction.

Beyond the initial purchase price, will the target require a significant cash infusion for working capital and growth? If significant capital is required is it financeable in a tight credit market?

An airtight case may have to be made to get financing, even with abundant cash on the books.

If you as the buyer are already carrying significant debt, how much powder do you need to keep dry in the form of cash reserves to service that debt? What impact will this transaction have on certain key credit covenants?



Think about liabilities that may not be on the books.

Is there a major contingent liability lurking behind the scenes that could be a deal killer? A quick search of potential litigation or environmental claims may save significant time down the road if there is an issue not disclosed in financial statements.

Are there any operating lease obligations that may be required to come back on the balance sheet? What is the funded status of the benefit plans and the need for cash going forward? How does this differ from the liability reflected on the balance sheet and the charges recorded in the income statement?

Identification of an issue early may impact the valuation of the target, lead to different deal structuring and potential elimination of the target from consideration.

Consider deal risks holistically.

What do you know about the individuals with whom you are negotiating?

High level background checks or negative article and other internet searches on the company and selected management could easily flush out key risks or concerns about a company's or management's background and reputation.

How about Foreign Corrupt Practices Act (FCPA) enforcement and the significant exposures companies and investors face in today's regulatory environment?

For example, U.S. regulators have frequently stated that they expect buyers to perform effective due diligence on sellers exposed to potential corruption risk, taking into account the target's base of customers, extent of operations in corruption-prone countries, industry risks, existence of anti-corruption compliance programs and controls and the use of local third parties to assist in business generation or other government interactions. Failure to do so can result in serious consequences, including successor liability for the seller's pre-closing violations. This liability may include sizable criminal and civil fines and penalties, investigative costs, loss of contracts, reputational damage and the imposition of a third party monitor to help with future compliance.

Has the existence of these potential exposures been factored in to your overall assessment of deal risk?

Look for financial and operational red flags.

Is one customer driving significant revenue? If so, what is their creditworthiness?

Are there any key suppliers or components that could be at risk? Is this an industry where a transaction may cause employees or customers to leave immediately after announcement? If so, how will this change your valuation metrics and interest in the company?

While not all of these can be identified at an early stage, early identification can eliminate a target as a potential candidate. Significant concentration of risk can lead CFOs to overvalue a target or underestimate the overall risk of the transaction.



Beware of window dressing.

In preparation for a sale many companies put their best foot forward. In some cases, adjustments are made to paint the rosier possible picture to the buyer universe. Cutting through short-term increases in sales, profit or cash flow to understand if they are driven by operational improvements or window dressing is key.

Consider the target's forecasts and key value drivers in light of your own assumptions to see if the relative valuation and growth rates are appropriately considered. If a target has made more favorable rate case assumptions, inflation assumptions, labor negotiation assumptions etc., these should not necessarily command a higher premium. Finding this out later in the process can lead to value disputes after an LOI has been signed.

Avoid cherry picking.

A holistic target screening process with clear and well-defined criteria avoids cherry picking a winner as a target. Instead, it identifies a potential subset of assets to acquire. While there are numerous other potential pitfalls and value killers, the above are some of the more common mistakes we find left unattended in the screening process that undermine target value and strategic fit.

Benefits of Screening

The rewards of a well-executed target screening process can be invaluable. If screening is done properly, CFOs and deal teams will be more focused, aware of viable alternatives, confident as to the benefits and risks, and better equipped to respond to competitive M&A situations. Similarly, a good screening process can provide the board with a thorough acquisition story consistent with the company's strategy.

Finally, a good process provides a deeper understanding of potential integration pitfalls which can help maximize the probability of integration success. If not, companies may miss important considerations that can increase the potential for integration failure.

Time to Revisit Your Screening Criteria?

Although the processes involved in screening for potential targets remain generally similar to what was followed in the pre-recession era, with smaller business development teams, an enhanced focus on global M&A for earnings growth, and an increased sensitivity to risk management and governance practices, the level of scrutiny and factors for consideration have multiplied.

The more involvement that the CFO, the finance team, and their external advisors have upfront in understanding the strategy and screening criteria, the tighter the overall process will be and the more accurate the focus on appropriate business risk areas and value drivers. This also allows the subsequent measuring and accountability to be



aligned with the goals of the broader organization just as well as those of the financial team.

Are you confident that your existing screening model has evolved with your strategy and the changing global landscape and is presently giving you the best possible acquisition targets? Even if you have previously given your model considerable attention, are you sure that the factors you applied are as relevant in today's market as they were when they were devised? In a market environment subject to evolving trends such as regulatory reform, accounting convergence, and rapidly changing guidelines, changing tax rules, board governance requirements, and the state of credit markets, it might be time to revisit the details of your screening and evaluation process.

To increase the likelihood of efficiently identifying, closing and integrating an accretive deal, it may be wise to begin by broadening the pool of possible targets and then applying a refined screening process. The CFO and finance function should have appropriate input into the design of the process to obtain a strategic fit and avoid common pitfalls along the way.