

A winning M&A strategy - the value of experience

BCCH Business Seminar

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The M&A market in 2009

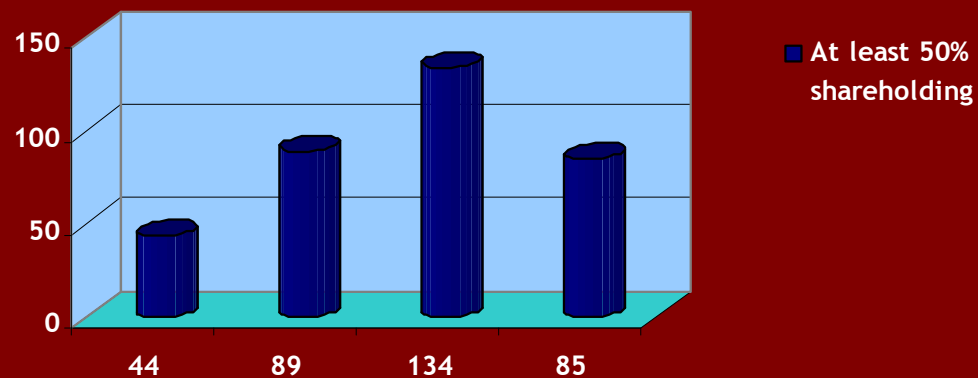
- A total of 488 M EUR PE and venture capital investment in Hungarian firms in 2008 vs 491 M EUR* in 2007,
- Lower number of transactions with decreasing value in 2009,
- Majority of the PE transactions include large individual buyouts, more than 25 % of the buyout transactions in the region were concluded in Hungary,
- Preferred industry sectors:
 - Communication/IT,
 - Life sciences,
 - Industrial products,
 - Logistics and delivery
- Business planning has become difficult due to the uncertainties in the real economy, time frame of concluding M&A transactions has become longer,
- Buyouts and other transactions move slowly due to the uncertainties of company valuations and liquidity constraints,

*EVCA Pereg Analytics 2008

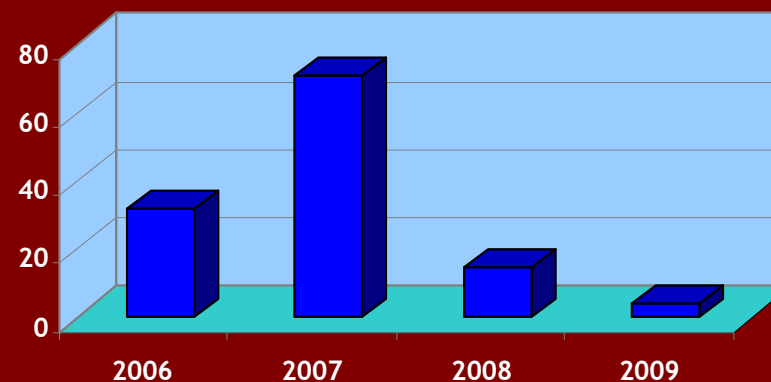


Market review in numbers

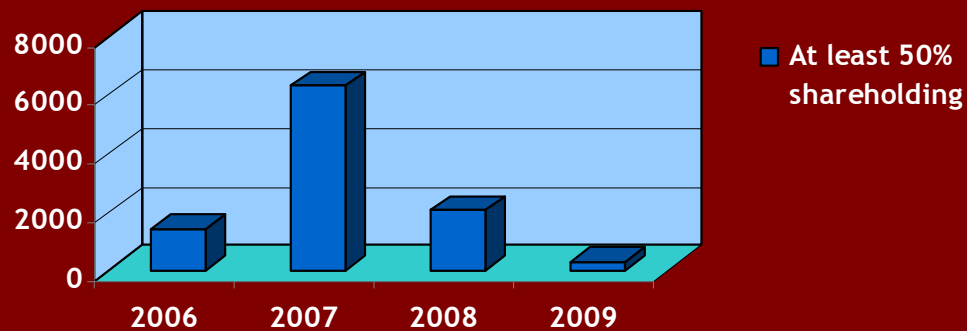
Number of the M&A transactions of the Hungarian companies



Typical value of an M&A transaction (million EUR)



Value of the M&A transactions of the Hungarian companies (million EUR)



Outlook for 2010

- 2010 is expected to be the year of slow revival
- Role of PE and venture capital funds becomes more important, regional funds raised considerable capital for investments in CEE, due to the still lacking bank financing PE and venture capital funds are in privileged position,
- Where most transactions could be expected:
 - Acquisitions with market consolidation purpose,
 - Restructuring opportunities,
 - Growth capital investments
- Buyouts with high leverage cannot be expected,
- Due to decreasing company valuations trade investors are expected to come back to the region,
- In 2010 the winning JEREMIE funds are also expected to start their operation, this could bring about 30 smaller size transaction mainly in early stage and seed capital,



Who is the potential investor?

Trade investor:

- Acquires 51-75 % business share
- At fixed price and/or 2-3 years earn-out structure
- The aim is to increase the market share and to grow
- Funding members usually keep 49-25% shareholding
- Trade investor adds market relations, synergy to the growth of the business besides financing

Financial investor:

- Acquires minority shareholding combined with capital increase, up to 25-51%,
- The aim is to invest in an accepted business plan in order to implement it with the negotiated profit forecast,
- Fixed investment term, with the aim of an exit with the projected level of return,
- Investor can assist in implementing the business plan with its business network,
- Transparent operation based on the expected financial reporting system.

The question is: What does the investor invest in?



Facing the obvious I.

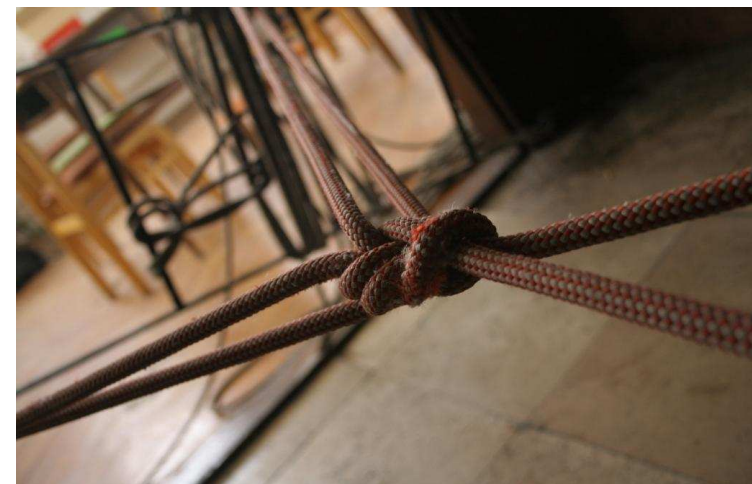
- ...the price negotiations are difficult to be based on a transparent balance sheet and/or business planning process as BS usually does not reflect the values to be created for the shareholders and business projections are difficult to be justified by the previous years' results.
- Who is going to manage the company? Management rights and positions are linked to the majority shareholder, earn-out goals could be difficult to reach if the selling shareholder who is entitled to the earn-out is not in a position any more to influence the management.



Typical issues

Typical issues raised during the legal due diligence:

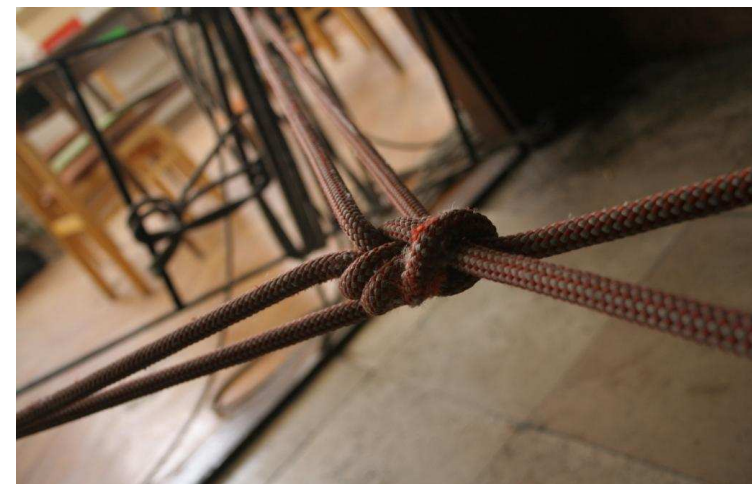
- „Trivial” corporate insufficiencies (example: lack of shop-floor council (50 employees) and sufficient employee delegation to the SB (over 200 employees))
- Assets which serve the interest of the business to be sold are not or not clearly belonging to the target
- Mystery of related party contracts with the seller group
- Cross guarantees for debts of the seller (mother company)
- Employment versus exclusive service contracts
- Lack of clarity with state aid goals, required achievements and status...



Typical issues

Typical issues raised during the financial due diligence

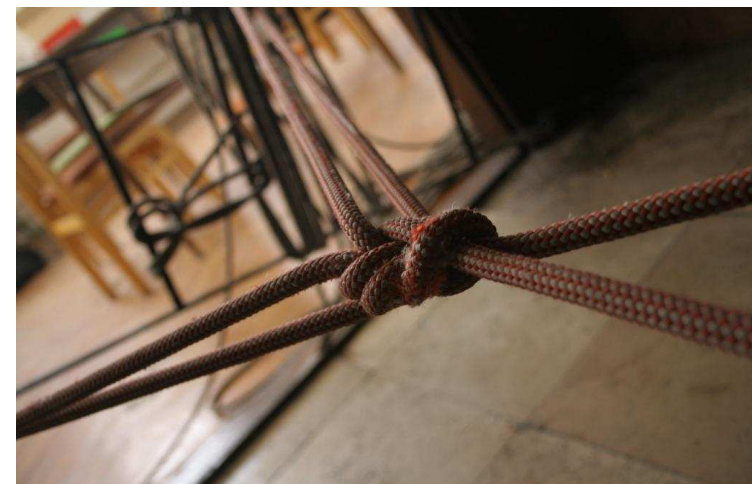
- The content of annual reports is not sufficient (no business report, the notes on the accounts do not show the necessary information)
- Accounting policies and rules are not sophisticated enough, usage of the policies is inconsistent regarding the years analyzed,
- Accounting systems are not closed and not consistent, documentation is not proper,
- Balance sheets reflect a number of non-recurring items due to earlier ad hoc business decisions



Typical issues continued

Balance sheet

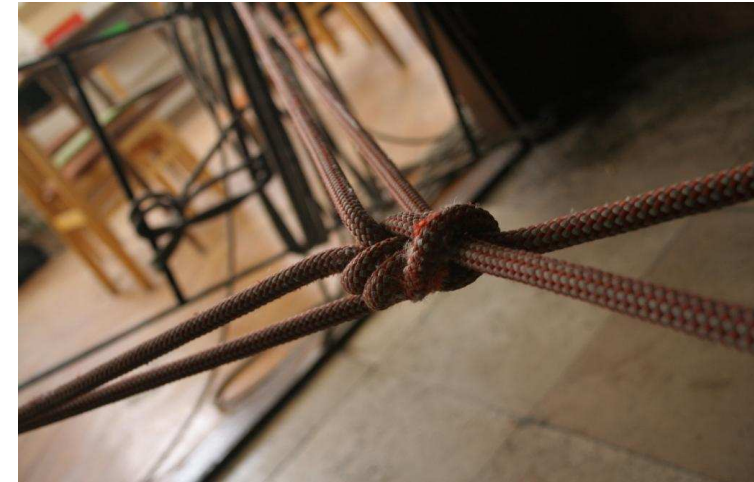
- Equity often contains revaluation reserves (not realistic valuation of assets)
- Undercapitalized companies -registered capital kept at minimum level
- Valuation of assets is often unrealistic (problems with depreciation and accounting for loss of value)
- Hardly any provisions
- The company's operation is often financed by shareholders' loan or by loans/transactions with related companies:
 - Transfer pricing problem
 - Documentation - the transaction vs the real content



Typical issues continued

P&L

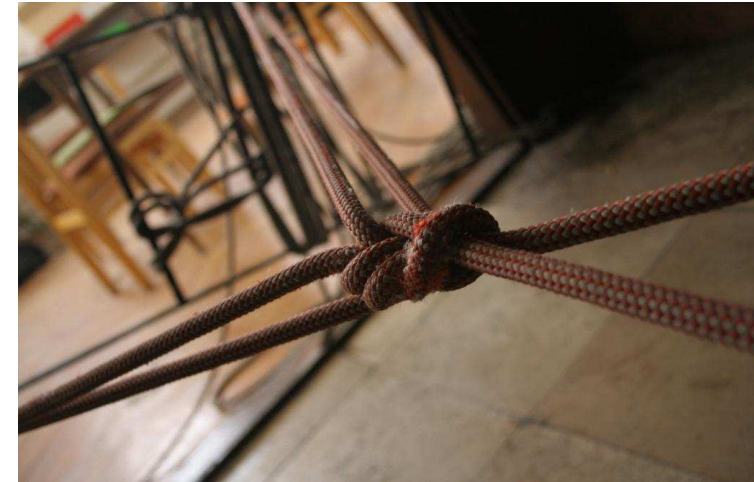
- Revenues and costs accounted are often unrealistic,
- Sometimes P&L does not catch the total revenue,
- Cost of labour is unrealistic,
- It is difficult to judge the real earnings ability and track record of the company as profit is often not realized by dividends
- Profit declared is kept at low level



Typical issues continued

Tax

- Shareholder loans, other different transactions with shareholders and related parties,
- Transfer pricing risks - transactions with related or legally non-related parties of the shareholders, deliberately fragmented company structures, activities,
- Labour costs shown at unrealistic levels,

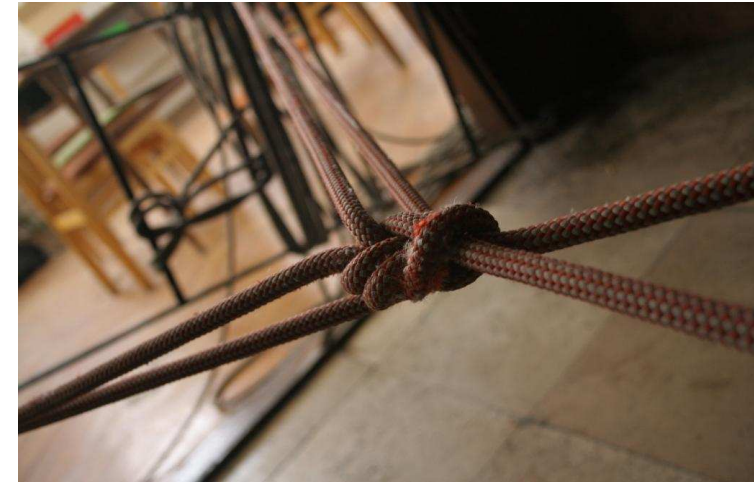


Typical issues continued

Soft areas

Five roadblocks:

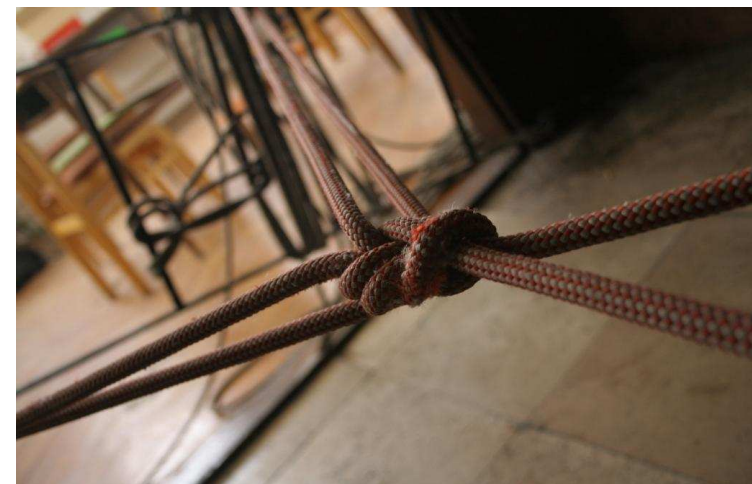
- lack of a vision for the future
- the shadow of the leader - blocking the new wave
- weak integration team
- failure to focus on people during the fusion of the companies' culture
- lack of clear and regular communication



Typical issues continued

In the transaction's point of view:

- Lack of transparency - leads to uncertainty
- Historic financial performance is not comparable how to support the business plan? - uncertainty in the price negotiations
- What kind of indicators, ratios, formulas can be taken into account at the time of fixing the exit strategy? - uncertainty in the contractual background



Uncertainty..

Mistrust...

Hesitation...

Time wasting...



Facing the obvious II.

- If you succeed in the valuation of the company...
- If you succeed in the negotiation of a **term-sheet** with the main conditions of the transaction, then
- **the adjustments for the pricing can be agreed upon**
- The evidence for the price adjustment factors is brought up by the financial, legal and business due diligences!



Term Sheet

- Contains the **material conditions** of the transaction and may constitute an agreement between the parties for an exclusivity to negotiate an agreement on the basis of its terms. Usually a TS is backed up with a confidentiality agreement.
- Main conditions of a transaction:
 - Price:
 - ✓ Fixed or varies subject to conditions
 - ✓ Earn-out (must be well defined, transparent goal setting and way of calculation, possibly with example)
 - Transaction timing/milestones (due diligence, preparation of documentation, etc.)
 - Agreement on management rights:
 - ✓ Decision making levels, scope of decisions
 - ✓ Scope of decisions of the managing director,
 - ✓ Right of nomination of the operative management
 - ✓ Management rights over daughter companies
 - Regulation on Deadlock situations
 - Regulation of transfer limitation and exit rights



Setting the price

- ✓ Price influencing factors from the due diligence:
 - Settlement of loans and transactions with shareholders and of transactions not related to the business
 - Off balance sheet items (pl. guarantees, law suits, etc.)

- ✓ Difficult to calculate the effect on the price of the following items:
 - Periods not covered with full scope tax inspection
 - Certain off balance sheet items, like shareholder guarantees
 - Transactions with related parties if not market conditions were used
 - Certain labour cost items
 - Environmental issues



Due diligence as the next stage of facing the obvious

- Potential losses which cannot be calculated or are not revealed until the closing of the transaction, or the price of historic „sins” will be represented by indemnities undertaken by the Seller in the sale and purchase agreement, which will further decrease the price,
- Potential ways of settling indemnities (and warranties) without further decreasing of the price:
 - Only damages above a certain level are claimed,
 - Determination of a maximum level of damages
 - If earn-out goals are met, the parties do not require further indemnity
- Guarantees for indemnity (and warranties):
 - Partial payment of price,
 - Bank guarantee,
 - Shares on escrow account,
 - Assignment of dividends,
 - Assignment of insurance in relation to indemnity



Thank you for your attention!

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