

The evolution programme

Mergers and acquisitions – balancing the risks with the opportunities

It is a rule of thumb that the greater the opportunity, the greater the risk. While mergers and acquisitions can transform your business significantly by improving your profitability and making a new range of options available to you, research reveals that two thirds of acquisitions fail to generate value for anyone other than the vendor.

While there are typically a number of factors for this low success rate, one of the principal reasons is the acquirer's failure to plan sufficiently to gain a full understanding of what you are acquiring and what you are going to do with the business when you have acquired it. Even before you have identified a target for acquisition, you have to be clear about your objectives for going down this route and recognise that acquisition is not a goal in itself – it is only a means to the end of achieving your business vision.

In this information sheet, we examine some of the reasons for acquiring or merging with another business; offer some planning tips to maximise your chances of being one of the third of acquisitions that succeed; and highlight some of the common pitfalls.

Why acquire?

There are five main reasons why businesses decide to go down the acquisition route instead of concentrating on organic growth.

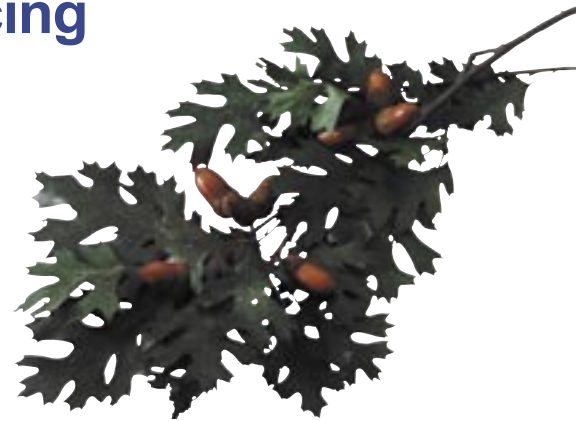
1. Instant access to emerging markets where organic growth would be too slow to maximise the potential of these markets

2. Access to new products/services/ intellectual property/technology that would otherwise be difficult and costly to develop internally
3. Access to a new customer base who may be willing to buy the products/ services of your existing business as well as those they already purchase from your acquisition target
4. Critical mass that will provide the resources to take on competitors on your own terms
5. Defensive reasons, such as where industry consolidation into a few key players, so a merger or acquisition is the only means of ensuring survival.

Once it is clear that the M&A route is the most suitable to achieve your business aims, the effectiveness of your planning and due diligence can make the difference between success and failure.

M&A planning tips

1. Do not underestimate how long or how much time an acquisition will take. Ensure there is sufficient management resource to investigate, negotiate and integrate the acquisition. If there isn't, consider using external help. If the senior management team is going to work on the acquisition, you must not neglect your existing business. Ensure that you have a good second tier of management to stay focused on the day to day operations so that you have a business left if the acquisition falls through.



2. Make sure that you understand what you are buying. Proper due diligence of markets, financial performance, legal contracts, environmental issues, systems, people issues (including unions), insurance arrangements and pensions is essential. If you don't have the relevant in-house expertise, appoint a good team of professional advisers with the appropriate experience to carry out a detailed assessment of the target, present a realistic view of the quality of the business and give you an independent view of its suitability to meet your business objectives.

Make sure that your investigations provide answers to the following questions.

Commercial due diligence checklist:

- *what are the key drivers to sales and profitability?*
- *are there any contractual "poison pills"?*
- *how healthy is the order book and what else is in the sales pipeline?*
- *what are relationships with customers and suppliers like?*

- *what is the quality of the company's underlying earnings?*
- *what are its underlying cash flows?*
- *what is the quality of its assets?*
- *are there any major liabilities (e.g. long leases) that aren't on the balance sheet?*
- *do I have enough money to be able to afford it, and will I have enough working capital if projected sales don't materialise?*
- *how sensitive is the business to changes in its trading environment?*

With this information you will not only be able to work out how you can achieve synergies with the new business but also be able to calculate the right price to pay for it.

3. Undertake a detailed and objective assessment of the target's management team. Do they provide complementary skills to your own or are you simply going to end up with two finance directors and two IT directors but no sales, marketing or human resources expertise? Are you going to be able to get on with the individuals or do you foresee personality and cultural clashes from day one?
4. Focus on the strategic assets that you are acquiring – people and customers – and seek to protect them from the outset. Proper communication with all stakeholders to avoid any uncertainty is fundamental. Internal and external public relations will be very important to ensure that key staff and customers, in particular, fully understand the implications for them of the merger or acquisition. Consult with them and involve them as much as possible to keep them motivated and loyal. Without good people and customers no business is worth anything, so don't lose them before you even do the deal.
5. Develop a post-acquisition integration

strategy at an early stage and implement it as soon as possible. The failure to plan for integrating the two businesses from the perspectives of culture, systems, processes, corporate identity and customer communication is a major barrier to achieving real value from an acquisition.

What are the pitfalls?

The main danger to avoid is overpaying. No matter how sound your strategy and planning may be, there is no overall value enhancement as a result of the acquisition if you pay too much for the business. In addition, high financial gearing could expose the business if your trading environment changes, e.g. a competitor decides to start a price war, or there is over-capacity in the market following the acquisition.

If you have done your due diligence thoroughly, you should be able to make a good judgement of the right price to pay. Obtaining full details of any major liabilities such as long leases, unlet premises or outstanding loans will provide you with the ammunition to negotiate the price down.

Don't place too much reliance on either historical transactions or sales forecasts as a basis for agreeing a price. The value of a business can vary dramatically in response to market forces; a profitable past is no guarantee of a successful future. Use your understanding of the current marketplace and the information gleaned from your due diligence. If you don't think the price is right, be prepared to walk away rather than feel pressured to go through with it.

Culture clashes may be a "soft" issue, but a unified culture is key to successful integration. Internal feuds can destroy synergies and other elements such as customer service. If the culture of the target business is significantly different from your own, think very hard about proceeding with the acquisition.

Other common pitfalls are poor controls and incompatibility of systems. Control systems will require close monitoring during the early

phases as this is where problems are most likely to arise. System incompatibility can also cause a major headache, resulting in serious operational issues and the loss of valuable management time.

Frequently Asked Questions

- Q. *Have can I avoid overpaying for a business?*
- A. Carry out a rigorous investigation so that the realistic financial benefits of the acquisition can be assessed. Then set the maximum price you are prepared to pay and stick to it. The view of an external party on the proposals is often useful as management can get too close to a deal.
- Q. *What happens if I change my mind?*
- A. Pull out as soon as you can before you incur more cost. This is why proper planning is so important as it will help you to identify deal-breakers (large liabilities, large egos, customer or key staff haemorrhaging) at an early stage and avoid racking up serious costs before withdrawing.

Conclusion

Despite the challenges involved in acquiring another business, if you have done your homework properly and adopt a disciplined approach to assessing the commercial impact of the deal, a successful acquisition can provide a huge boost to your business. The addition of different management skills, a fresh perspective and new ideas can spur you on to achieve your corporate ambitions with renewed energy, enthusiasm and enjoyment.



These notes have been prepared as a general guide. They are not a substitute for professional advice. Neither PKF (UK) LLP nor its partners or employees accept any responsibility for loss or damage incurred as a result of acting or refraining from acting upon anything contained in or omitted from this guide.

PKF (UK) LLP is a limited liability partnership registered in England and Wales with registered number OC310487. A list of members is available at Farringdon Place, 20 Farringdon Road, London, EC1M 3AP, the registered office. PKF (UK) LLP is authorised and regulated by the Financial Services Authority for investment business and insurance mediation activities.

The PKF International Association is an association of legally independent firms.

PKF (UK) LLP operates a code of conduct to ensure that all types of data are managed in a way which complies with the Data Protection Act 1998. If you do not wish to be informed about the services we offer and forthcoming events, please contact your local office.