CONTROL PREMIUMS

The Control Premium being paid needs to be considered separately to overall deal value

Executive Summary

It is not enough to think about valuations in change of control situations as a simple offer price. LCC advocates that Bidders must clinically dissect the valuation framework to examine what additional performance the Control Premium for a deal means in terms of potential payback, risk and operations.

With the empirical evidence of failed M & A deals high, it is an essential element of any deal to understand just how difficult the task of additional performance is. And the higher the Control Premium paid, arguably the higher the bar.

Boards should require their Managers and Investment Bankers to present analysis justifying not only the deal & its valuation, but specifically the Control Premium – with a focus on how material increased performance will need to be delivered whilst not increasing the risk profile of the Target.

Introduction

A bedrock of Mergers & Acquisitions practice is that any transaction for control needs to take place on the basis of the acquiring party (Bidder) paying a premium to the current share price/valuation (Control Premium) as an incentive to existing shareholders to sell out their parcel of shares in the company to be acquired (Target).

Investment Bankers will quote general market statistics on what is expected by Target shareholders in order for them to part with control. Depending on market conditions, and the quality of the Target company in question, one will typically field opinion that a proper Control Premium might be 30% + of a share price, such as a Volume Weighted Average Price across a 20 trading day period.

LCC's view, however, is that against this backdrop of market pressures, Bidder Management Teams and Boards of Directors need to carefully consider fundamental operational aspects of any transaction, and what the specific Control Premium for any opportunity is justified to be considered.

A broad based approach is not appropriate. A bespoke approach to analysis is required. Every deal is different.

Control Premiums need to be considered on a deal by deal basis, "one size" does not fit all

Separating Control Premium From Base Case

We believe that there is a fundamental benefit in separating the Control Premium to be paid from the base case valuation of the Target.

Maintaining visibility on 'how much more' is being paid allows productive dialogue to be maintained on the additional challenges to growth and performance that will need to be met by the Bidder if it is successful in the acquisition.

Our experience is that Managers and Boards can behave differently when faced with the single dimension of how much a deal will cost. When faced with the additional considerations of what the Control Premium represents in respect of required boosted performance from the Target – Boards & Managers appear to be more considered to rid the situation of 'deal fever'.

CONTROL PREMIUMS

The M&A Strategy can have a direct impact on the level of Control Premium that should be considered

Traditional M & A Rationale

A Bidder is paying up for the opportunity of capturing value from an asset base that cannot be extracted by the current management team and Board. The justification for the deal, and associated Control Premium, must be that the Bidder is highly confident of creating value in combining the Target with existing operations.

In order to arrive at a positive investment decision, the Bidder must be convinced that there is a fundamental & sustainable positive payoff that is achievable from the transaction. Traditional M & A thinking as to why to expand via acquisition includes objectives such as :

Consolidation	The deal will allow the Bidder to effect both cost savings and synergies. Typically such an approach is used in a mature market situation where margin improvement by combination of businesses enables a barrier to competition to be maintained
Intellectual Property	The Target represents an IP opportunity that the Bidder will not be able to replicate in a timely or cost effective fashion. Often used where a Bidder may be seeking to step change its business framework (trying to pick tomorrow's winners early), where a business model 'gap' exists or alternatively where talent or technology / business process is attractive
Horizontal Expansion	The Target represents a solid foothold base to move cross border or cross sector. Such a move can be achieved by acquisition in a more timely and efficient fashion than via organic means. Typically an approach used in moving into fast growing markets, complimentary product or service lines or new geographies / territories
Optimisation	Bidder believes that it can optimise and improve the Target's performance. This is typically undertaken via asset base rationalisation (sale, restructuring, etc.), performance improvement or synergistic initiatives such as cross selling of products into common channels (sometimes a big challenge)

From even such a simple observation of such basic M & A strategies it becomes obvious that it can be more difficult to generate returns from certain strategies than others.

Great care needs to be taken on Consolidation styled strategies, for example, given that highly competitive markets by their nature have limits in which matters such as Gross Profit Margins can be improved. Against such a competitive landscape paying a high Control Premium needs to be carefully weighed up – as it may take many years to generate a satisfactory return, if it is achievable at all.

One only needs to review the procession of failed 'roll ups' across Australia and internationally to appreciate that bringing multiple businesses together is difficult enough, but when high valuations are added to the picture the corporate recipe understandably often turns toxic.

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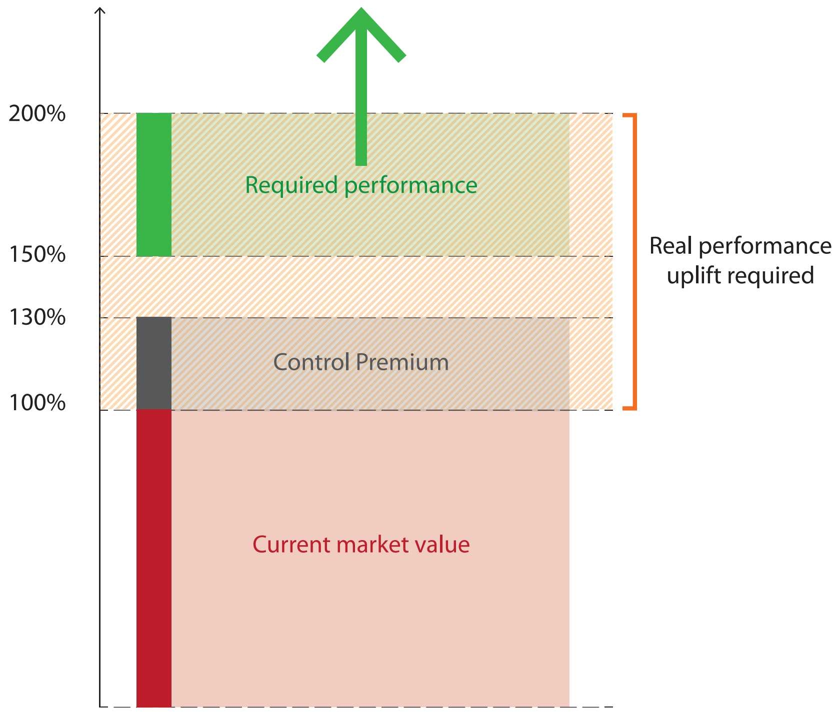
Boards and Management need to focus on the boosted performance that will be required from the Target

The Investment Decision

Leaving aside the methodology by which value will be extracted from the Target, the Bidder must be satisfied that the use of capital to effect a Transaction provides better growth opportunity than alternate organic options. Its investment decision.

The Bidder also needs to be pragmatic on the performance that will be needed from the Target post completion of a successful transaction. Its investment payback.

Figure 1: The Performance Challenge



Risk & Future Performance

A Target pitch typically paints a picture that tomorrow's performance will be solid when compared to that of today. Where that performance shifts quickly in the next year or so the term 'hockey stick' is often applied given the performance profile when graphically plotted.

Of course some companies are driving through positive step change, but naturally if that benefit was going to be delivered with great certainty in the near term a larger questions looms – why would the Target be available for acquisition in the first place for any valuation other than an exceptionally high Control Premium / valuation?

The non core asset argument tends to be put away when strong cashflows can be enjoyed.

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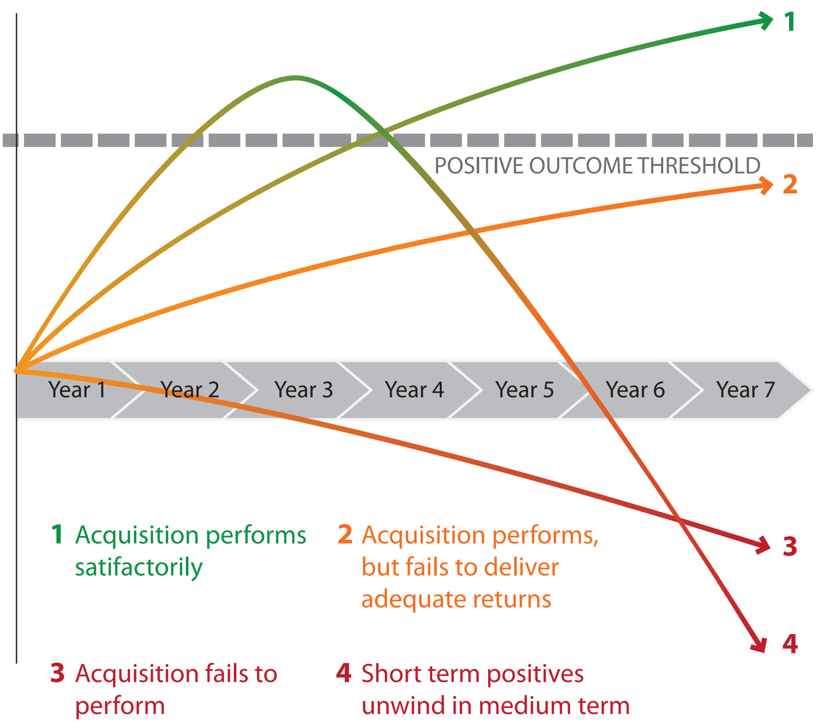
How does paying a Control Premium alter the risk profile of the Target?

The addition of a Control Premium to the existing value of the Target increases the risk of satisfactory performance of the Target in the hands of the Bidder. In order to justify an investment return on that transaction linked valuation, the Bidder must improve corporate performance over and beyond the cost of the acquisition and deliver even greater results.

In many instances this really means that the Bidder must make the Target perform in a way that it has never performed historically. Even historic results carried forward will not be enough. The Bidder needs to extract more.

Much of the ability to improve the performance of Target is linked to Risk. During the course of assessing value, and therefore justifying the Control Premium, the Bidder needs to continually consider not only the materiality of risk on various issues, but the potential for that risk to manifest itself. This then needs to be considered across different timeframes, given the various heads of risk can be more material at different points in time (*e.g. companies competing in cyclical markets)*.

Figure 2: LCC Risk Framework



Under the *LCC Risk Framework Approach* one is looking for elements of the Target that will fall into the 'red zone'. An example of such a 'red' risk might be a contingent environmental issue or a key client contract that is in jeopardy, should the deal proceed. The higher the frequency of items that might fall into this zone the larger the potential impact on any performance going forward – and correspondingly the more difficult the business case for a large Control Premium exists (*if one might want to do the deal at all*).

Macro factors affecting Target's business environment can also be considered in this way.

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Adjust the Control Premium to account for additional "leakage"

Additional Leakages

Any consideration of a Control Premium needs to also take into account the potential additional leakages that might transpire during or after a transaction. These vary from predictable to unpredictable, and might include :

- Costs of restructuring operations, including redundancies, vacation of properties, etc.
- Transaction costs that are required to be incurred in order to complete any deal.
- Unexpected 'soft' impacts that might arise, including loss of productivity from workforce, resignation of staff members and a slowdown in activity from customers in advance, or following completion of any deal.
- Macro economic factors which might arise mid deal, including shifts in economies, regulatory changes (*real or mooted*) and volatility in interest rates, commodity prices or foreign exchange markets.

At best such events effect the Control Premium that should be considered – at worst, again, the potential for additional leakages is so great that the fundamentals of the deal itself are called into question.

Avoid "deal frenzy", focus on rigorous analysis

Sensitivity Analysis is Critical

'Deal frenzy' has no place in the analysis of whether a deal will prove to be a positive. Yet many acquirers we interact with become somewhat mezmerised by the opportunity of concluding a deal.

The Bidder, however, can often fail to realise that the deal represents a moment in time where significant value can be passed to the Target, with little prospects of the Bidder receiving a satisfactory outcome.

The Control Premium needs to be carefully considered on the basis of the probability of outcome in each year rolling forward. As previously mentioned, even a sound financial result might represent a failed deal as basic KPIs of investment are not returned. Whilst this note does not comment on funding arrangements, in passing it should also be appreciated that the incorrect capital structure in completing an acquisition can place the Bidder under great stress – or worse, as certain recent examples testify.

Great operational performance with too much debt can still lead to failure.

CONTROL PREMIUMS

Paying large premiums increases the risk of post transaction failure

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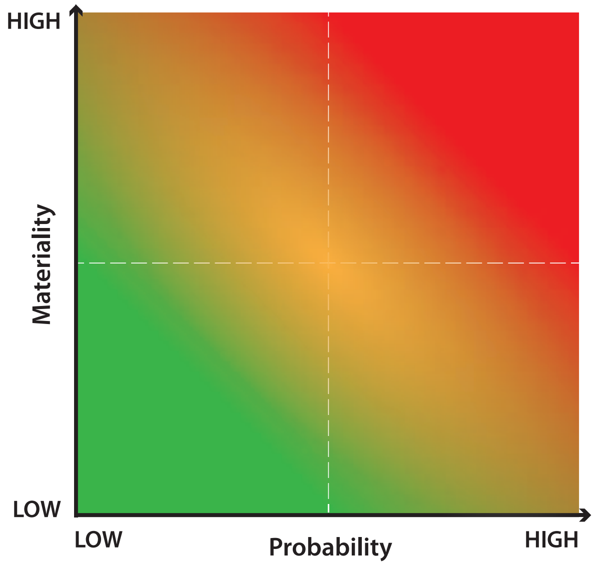
Figure 3: Performance & Issue Risk Assessment



Given the uniqueness of each acquisition there needs to be a clear understanding and agreement of the anticipated future performance that the Bidder requires in order to justify the transaction – and the Control Premium to be considered.

LCC's approach is to develop multiple tools to allow risk to be appreciated, including *"Heat Maps"* as above.

Concluding Thoughts

At the core, of any M&A deal there are 2 basic decisions that need to be made. Firstly, does the Bidder want to do a deal? If yes then secondly, what should the Bidder pay?

Paying over the top premiums rarely lays the foundation for a successful transaction. Bidders must process all due diligence information vigorously, consider risks carefully and assess the intrinsic value of any Target in isolation before then moving to financially determining what an appropriate Control Premium might be.

LCC believes that management and Boards should require significant levels of confidence that post merger benefits will flow. Such a position can only be arrived at by rigorous analysis during the deal assessment phase.

In the event that valuation with Control Premium fails to win the support of the Target's Board of Directors, the Bidder must be prepared to walk away. The emotional disappointment of not winning a deal will fade. A financial handicap resultant from an overpriced deal will linger for considerably longer.........

This Note was authored by Nicholas Assef in LCC's Sydney office.