



INSIGHT

Private Equity: The Uncertainty Discount

When considering acquisition bids from private equity firms, factors other than price may weigh heavily.

by Mark Working

In today's active market for private company acquisitions, it is the norm for investment bankers to solicit and receive bids (or indications of interest) from a diverse group of buyers that includes both corporate

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entities and private equity firms. In some situations, criteria other than price may weigh heavily on the choice of alternatives. In spite of intrinsic benefits related to business and organization continuity, private equity proposals may not show as well when measured against the “three S’s” in the lexicon of investment bankers – speed, simplicity, and certainty. Although the indications of value may be comparable, the road to closing a deal with a private equity firm can be longer, more complex, more expensive, and thus, less certain.

CORPORATE / STRATEGIC BUYERS

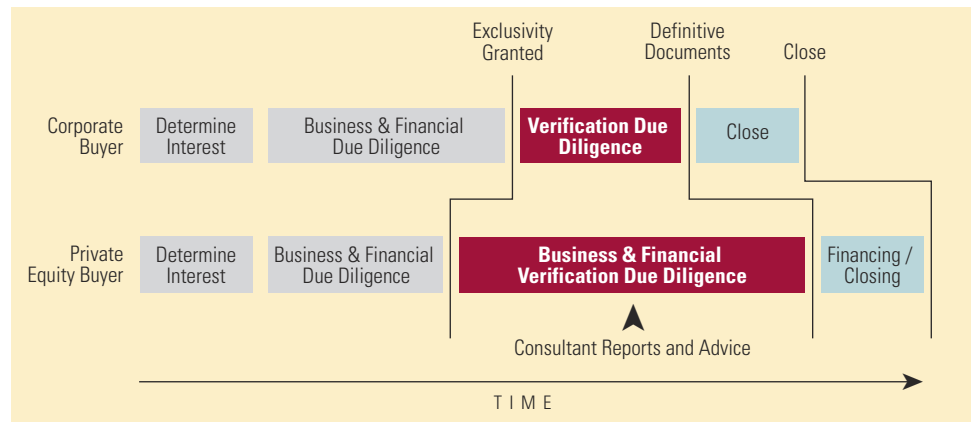
Corporate or strategic buyers usually exhibit several common characteristics. The decision makers are already familiar with the dynamics of the industry and have well-formed opinions as to the appropriate strategy for the business. Corporate buyers are often seeking specific capabilities or characteristics that are needed to further an existing strategy. Aspects of the target firm that don't fit with that strategy, such as people, facilities, and costs associated with duplicative or

ancillary functions, are discarded. Corporate acquirers are often larger companies with the capacity to integrate the acquired business into its organization, and thereby reduce managerial and operational risks. Larger firms often do not need to arrange outside capital to complete an acquisition and their due diligence efforts tend to focus on verifying the quality of the assets rather than the target's entire business model. They often already know and are comfortable with the target's customers and product/service demand characteristics. Much of the strategic

people are quick learners and insightful in analyzing opportunities; but, in most cases have limited knowledge of the industry and the specific company under consideration.

At the point in the sale process that potential buyers submit acquisition proposals, corporate buyers are more likely to have already concluded that the target company fits with its objectives. At the same time, a rival private equity firm may only be able to submit a conceptual proposal that is subject to confirmation of its investment thesis. Before being willing to close a transaction, private equity managers will need to be as comfortable as any strategic buyer with the target company's business strategy, its position in the industry, and its value proposition. However, that effort represents a commitment of time and resources not required by many corporate buyers.

Transaction Timeline: The private equity due diligence process is time consuming and expensive.



buyer's activity leading up to closing is associated with integration planning, rather than re-evaluating the business proposition.

PRIVATE EQUITY BUYERS

In contrast, the private equity buyer typically is staffed with intelligent, financially astute business people with expertise in investment analysis, transaction management, and financing. Private equity firms manage investment funds for others (individuals, pension funds, endowments and corporations), with a mission to search out opportunities to invest in “good companies.” These smart

OUTSIDE CONSULTANTS

In an attempt to accelerate that learning process, private equity firms often rely on outside consultants. This help is typically provided by industry experts (former industry executives), market researchers, management consulting firms, and financial specialists (accounting firms). Each will interview employees, conduct independent research, and evaluate reams of data with the objective of generating written reports that will illuminate the target firm's strengths and weaknesses, competitive position, and

industry environment. These reports serve multiple purposes. First, they may unearth valuable insights that can be used to confirm the investment thesis or provide a basis for a decision to either walk away or revise the terms of the acquisition proposal. Second, these reports are commonly used to support the investor's efforts to arrange debt financing for the acquisition. And, lastly, the reports paper a file that documents that the firm has behaved prudently in making the acquisition.

These reports are not simply formalities. The professionals conducting the investigations bring their own perspectives to the deal, each of which may differ from the views of the private equity firm. And, although the private equity firm pays them, if they never come up with any intelligent insights to protect their clients or reduce the purchase price, they cannot claim to be adding any

real value. The upshot of all of this is that a private equity acquisition proposal may amount to an option to complete a transaction that is subject to the opinions of outside consultants and arranging the funding necessary to close.

The private equity investigation process takes time and is expensive. So, it is no surprise that these firms are hesitant to incur much of that cost until being selected as the buyer and having a legally binding agreement that restricts the seller from continuing to pursue negotiations with other parties.

CONSIDER THE ISSUES

The takeaway for owners contemplating the sale of their privately-held business is that, prior to selecting a private equity firm over a corporate buyer, it is prudent to consider the following issues:

- What is the firm's reputation with regard

to timing, integrity, and perseverance in prior deals?

- Which experts will be involved; what are their specific missions; what will be needed from the company to complete that work; and how long will it take?
- Can the transaction that has been proposed be financed? Are proposals already in hand that fit the financing requirement? And, what must be done to turn those proposals into commitments?

An assessment of these concerns leads to estimates of the additional time, cost, and probability of closing. The difference between the hurdles to closing with a private equity firm and other corporate or strategic buyers is a reflection of the private equity uncertainty discount. ♦

The Corporate Imperative: Building Economic Value

Measuring the adequacy of operating earnings against invested capital.

by Michael T. Newsome

“You only get richer by investing money at a higher return than the cost of the capital to you.”

Roberto Goizueta, Late CEO of Coca-Cola

It is a stubborn reality that a business that fails to consistently earn its cost of capital returns less than the resources it devours. Senior managers of the firms with whom we work can talk at length about efforts to grow sales or strengthen earnings, but the capital employed to generate those earnings is often neglected. So the question is, how can corporate performance be measured in a way that captures the impact of the two fundamental drivers of shareholder value—operating profitability and invested capital?

Fortunately, there is a financial measurement framework known as “Economic Value Added (EVA¹)” that simply and effectively couples earnings and capital efficiency. EVA was introduced in the 1980's by Stern Stewart & Co. and has been widely adopted by large corporations and investors. Over the years, EVA has proven to align management decision-making and shareholder goals around the creation of economic value, which should be the governing objective in both large and small companies.

Stern Stewart coined the term EVA, but it is by no means an original concept. It is firmly rooted in the neoclassical notion of economic profit, which was defined in 1890 by the prominent British economist, Alfred Marshall, as “What remains of his profits after deducting interest on his capital at the current rate.”

EVA can be expressed as net operating profit after tax (NOPAT), less a charge that represents the cost of all of the debt and equity capital invested to produce those profits. As illustrated in the example below, economic (or shareholder) value is only created if profits exceed the business' cost of capital. Firms that consistently generate positive EVA over time are building shareholder value, a conclusion

EVA = NOPAT - (K _w x TC)	
NOPAT	= net operating profit after taxes
K _w	= weighted average cost of capital
TC	= total debt and equity capital

that has been repeatedly demonstrated in studies of public company share prices.

While EVA is a relatively easy concept to grasp, the actual calculation can be a bit more challenging. There is a meaningful difference in the information presented in financial statements based on GAAP accounting conventions and the economic information

that is most relevant to shareholders. It is usually necessary to adjust certain accounting expenses and balance sheet items in order to better pin down true economic profits and capital investment. A couple of areas that typically merit some refinement include:

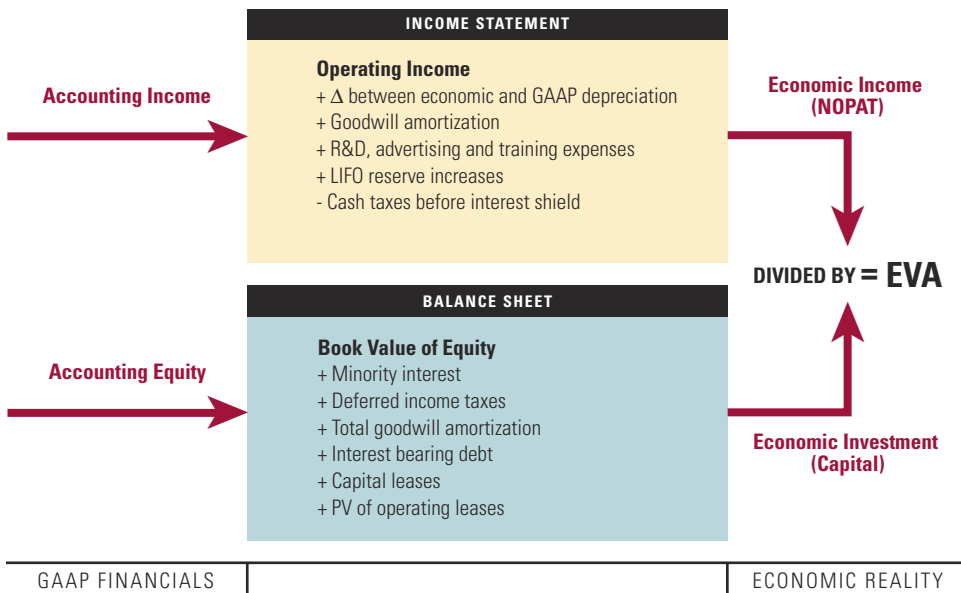
Fixed Asset Depreciation—from a tax perspective faster depreciation is better. But, accelerated depreciation is seldom an accurate reflection of the useful economic life of a particular asset. So, if corporate assets have longer (or shorter) lives than reflected by the accounting schedule, then depreciation expense should be fine tuned to reflect the real economic obsolescence of the assets.

Advertising and Marketing—accountants are compelled to expense these costs when incurred because they have no realizable liquidation value. In reality, promotional expenditures often correspond directly to future customer acquisitions or the development of a brand that has long-term proprietary value. Under certain circumstances, it's reasonable to capitalize these expenditures

Income Statement			
Sales			\$ 100,000,000
Operating Profit			10,000,000
Income Taxes	35.0%		(3,500,000)
NOPAT			\$ 6,500,000
Balance Sheet			
Debt Capital (after-tax cost)	25,000,000	4.6%	(1,137,500)
Equity Capital	15,000,000	25.0%	(3,750,000)
Total Capital	\$ 40,000,000	12.2%	\$ (4,887,500)

EVA **\$ 1,612,500**

EVA Adjustments: Calculating true economic profits and investments.



and amortize them over time.

Research and Development—the same logic applies to R&D expenditures, as these investments are only made with the expectation of future returns. From an economic perspective, R&D outlays should be amortized over the period of years in which there is an expected earnings impact.

Of course, there are other expenses and balance sheet items, such as deferred taxes, inventory, training and development expenses, restructuring charges, and goodwill amortization, where some adjustment may be justified in order to better to reflect the real economic profit a business generates. For most companies, simple rules, consistently applied, are better.

ECONOMIC VALUE CREATION

Top-line growth does not equate to added shareholder value. In the absence of capital discipline, growth (even profitable growth) may erode shareholder value. This is why some high-flying companies fade into oblivion

following a growth binge. Firms that employ EVA find that it is a consistent framework with which decisions can be weighed on exactly the same terms—the incremental shareholder wealth that a particular action will create or destroy.

There is an abundance of familiar measures of corporate performance (Sales Growth, Earnings Growth, EBIT, EBITDA, ROE, RONA, EPS, etc.), yet none offer the clarity of EVA:

- It drives home the necessity of focusing on capital efficiency, as well as revenue growth and profitability.
- With some training, the concept can be understood by all levels of an organization.
- It is adaptable. If revenues, costs, and invested capital can be allocated, EVA can be broken down on a company, division, plant, store, project, customer, or product line level.
- It can be retrospectively measured on an annual basis to evaluate corporate performance

or over multiple periods to gauge the benefits of an investment that requires several years to prove itself.

- It is a forward-looking planning tool to evaluate the impact on value of a prospective capital investment or acquisition.
- It is a useful incentive compensation yardstick by putting managers on the same footing as shareholders.

VALUE DRIVEN STRATEGY

Successful companies possess one or more of the following attributes: a clear sense of the target customers; a well-honed marketing strategy; a reputation for exceptional service; or products/services that are unique in terms of cost advantage, performance, or brand perception. In order to have a successful strategy, business leaders are obliged to define competitive advantage(s) and core businesses and then direct the firm's resources—people, time, and capital—towards building that core business. In the absence of a strategy that both leverages competitive advantages and focuses on the core business, it is difficult to achieve the governing objective of building shareholder value.

EVA is not a substitute for a well-conceived strategy. It is a measurement tool that can be used to guide the decisions and actions of managers towards those activities within the strategy that build economic value. To reap the benefits of EVA, more is required than simply tracking the metrics. Employees must have a clear understanding of the actions that have a direct impact on economic value.

A value driven strategy requires the discipline to assess the impact of decisions on value and a compensation program that rewards actions that increase shareholder value. ♦

Please visit the Insight page of www.ZacharyScott.com to access a more detailed example of an EVA calculation.

¹ EVA is a trademark of Stern Stewart & Co.

Making M & A Successful—Due Diligence

Due diligence by successful acquirers extends well beyond verifying data.

by William S. Hanneman

In the last edition of Insight, we explored the value of a clear strategic vision to the success of a merger or acquisition. If the opportunity makes strategic sense, and the initial proposal is attractive to the seller, the acquisition process moves into the “due diligence” phase. Black’s legal dictionary defines due diligence as “the diligence reasonably expected from and ordinarily exercised by a person who seeks to satisfy a legal requirement or to discharge an obligation.” In an M&A

context, these investigations are most often designed to test the accuracy of business and financial assumptions through the analysis of a much greater level of detailed data.

In our opinion, this definition and scope of effort are far too narrow. Due diligence undertaken by successful acquirers extends well beyond simply verifying data. In the business acquisitions in which we have been an advisor, a much more robust diligence process has been sought that, in addition to assuring full

disclosure, re-tests the transaction’s strategic rationale and identifies the synergies likely in a business combination. Then, these findings were used to refine both the value of the target business and the deal structure. The critical element of the due diligence review is a feedback loop back to the M&A team to allow them to consider the risks and opportunities discovered in the investigation for the purpose of determining a precise set of conditions on which to move forward or to

M & A Success *continued from p.3*

abandon the opportunity altogether.

TEST THE STRATEGIC LOGIC

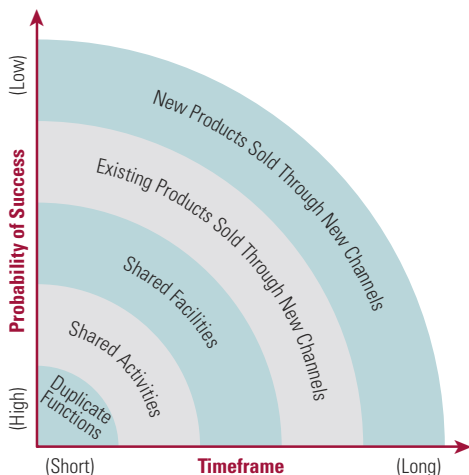
The overriding objective of a due diligence investigation is to test the information and assumptions that underlie the deal's strategic logic and to second-guess the value conclusions. The question—"just what are we really buying?"—can't be probed too deeply. Enforcing that discipline throughout the due diligence process helps to guard against pursuing a deal based on the idealized image of the target company garnered from its well-hyped public profile, the quality of its products, or its brand reputation. The due diligence investigation should dig out the real story beneath an often varnished surface.

In a strategic review, buyers cannot rely solely on information provided by the target company, but must build their own "bottoms-up" view of the opportunity and the competitive environment in which it operates. This typically means an independent evaluation of customers, suppliers, and competitors. The conclusions of that assessment must define the value drivers—revenue, cost, earnings, and capital investment requirements of the combined enterprise. It is important to avoid preconceived notions or over confidence that often permeate M&A deal making.

WHERE ARE THE SYNERGIES?

It is almost always a challenge to be realistic about the synergies that an acquisition will deliver. Acquirers routinely over-estimate the value of potential cost and revenue benefits and downplay the difficulty of achieving them. This is a major reason why acquisitions

M & A Synergies: What will they deliver?



all too frequently yield substandard returns.

The due diligence process should carefully distinguish between different kinds of synergies, the probability and speed at which they can be realized and the resources required to reap the benefits. As illustrated by the chart above, savings derived from eliminating duplicative costs through consolidation can often be won relatively

quickly and easily. Further out the scale, the benefits from introducing new products to new distribution channels often prove to be both tantalizing and elusive. Ranking potential synergies in this way forces a distinction

Acquirers routinely over-estimate the value of potential cost and revenue benefits and downplay the difficulty of achieving them.

among possible synergistic initiatives. The potential benefits on the outer portion of the scale should be accorded a much lower value (if any) than those closer to the center.

The due diligence effort should also identify potential "negative synergies," such as loss of customers, added costs, or investments necessary to combine the businesses. In our experience, these factors are often overlooked in the exuberance of deal making.

WHAT IS THE BUSINESS WORTH?

Ultimately for the due diligence review to be useful, the information gained must be used to craft a purchase agreement that

Transactions invariably gather momentum that is hard to resist. All too often, the dynamics of the process provides pressure to stretch beyond the justifiable value in order to get the deal completed.

mitigates risk and sets a purchase price that is a fair measure of the risks and opportunities in the business. To accomplish this, the

diligence team must communicate its findings to the negotiators working directly with the seller to structure the transaction. The challenge is to either negotiate away the unanticipated risks that have been identified or to quantify them and adjust the purchase price accordingly.

The final due diligence objective is to determine a walk-away price, which is the maximum value the buyer can economically justify for the benefits that a business combination may bring and the specific terms under which the price can be paid. To be clear, this is not necessarily the package that would be offered to the seller, but rather serves as the outer negotiation limit.

Transactions invariably gather momentum that is hard to resist. All too often, the dynamics of the process creates pressure to stretch beyond the justifiable value in order to get the deal completed. The temptation is to then search for synergies that will validate the deal. Due diligence should be designed to guard against this by establishing a definitive framework for an acceptable transaction.

CONCLUSION

Based on past experience, we can say without hesitation that a well executed due diligence effort can be the determinant of M&A success or a marginal or failed endeavor. In the final analysis, due diligence is the process of confirming the assumptions that underpin the deal's strategic logic and making suitable adjustments in order to avoid paying more than the business is worth or exposure to unforeseen risks. Once the real parameters of the acquired businesses are clearly understood, the investment thesis and value should be fine-tuned. The final step is to document the transaction under terms that support the strategic logic and apportion the risks appropriately. But, that's a topic for the next edition of Insight. ♦

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to ZacharyScott.com.

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