

Zachary Scott—an investment banking and financial advisory firm—has produced this newsletter designed to bring you a perspective on the private capital markets.



Zachary Scott
INVESTMENT BANKERS

PERSPECTIVES ON THE CAPITAL MARKETS

SUMMER 2005

INSIGHT

Success in Mergers and Acquisitions

To be successful, mergers and acquisitions need to be made with the company's strategic vision clearly in focus.

by Michael T. Newsome

Proclamations that businesses exist to grow bigger, become more diversified, make the most or best products, have the happiest customers, provide fruitful employment, pioneer new products, or serve the community only confuse the measurement of business success. In our view, busi-

Fundamentally, value is created when the combined enterprise ends up being worth more than the sum of each of the businesses before the combination.

nesses exist to guide scarce capital resources towards the most productive users and the most economically beneficial uses in order to increase the wealth of the shareholders.

Many business owners and managers view mergers or acquisitions as an effective path to building a successful business. Given the priority of shareholder wealth, what is really the point of a business combination if it fails to increase the value of the enterprise for the owners? As we have explored in past *Insight* editions, acquisitions all too frequently fall short of the value aspirations of their architects, the primary reason being lack of discipline.

Fundamentally, value is created when the combined enterprise ends up being worth more than the sum of each of the businesses before the combination. This means that the price paid for an acquired business must be less than it's contribution to the combined enterprise as measured by the cash that it will generate over its life.

For the most part, poor results are not solely the consequence of flawed financial analysis. There are abundant reasons why acquisitions fail to create value. At the time of

the transaction, the decision makers always have a rationale for the value ascribed to the acquired business and the benefits (synergies) expected from the combination. Based on the exact science of hindsight, business combinations more often go astray due to inadequate strategic vision, lack of discipline in due diligence, and/or inappropriate transaction structure. In this article, we examine the importance of strategic vision to acquisition success. Follow up articles will look at due diligence and transaction structure.

STRATEGIC VISION

Great companies are invariably led by people with a well-developed vision of what the business needs to look like in the future in order to realize the benefits of a competitive advantage in its chosen markets. The objective is to assemble a set of characteristics and/or capabilities that sustainably differentiate the business from its competitors and enable it to earn an extra increment of

return for the value delivered to its customers. In other words, a strategic vision is predicated on a deep understanding of the needs of the target customers and how to satisfy them (and, therefore, make lots of money). This is easier said than done; but the result is a roadmap for the interrelated judgments that must be made with regard to the products, service points, supply chains (purchased or manufactured), processes, and employee talents necessary to transform the existing business and achieve the vision. An acquisi-

Unproductive acquisitions are often detours from the roadmap in an effort to get a "good deal" or to just get a deal.

tion fits with the strategic vision if it serves as a shortcut (in time or cost) to progress along the roadmap. Provided that the benefits (future cash flow) exceed the acquisition cost, it may contribute new shareholder value.

Unproductive acquisitions are often detours from the roadmap in an effort to get a "good deal" or to just get a deal. Once off the trail, resources are diverted from the primary

(continued p. 2)

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The screenshot displays the Zachary Scott website with several key sections:

- STRATEGIC objectives:** A top navigation bar with links for About Zachary Scott, Services, Team, Case Studies, Insight Newsletter, and Contact Us.
- Exclusive Sader Representation:** A section describing the firm's expertise in Mergers, Acquisitions and Divestitures, including services like financial due diligence, valuation, and transaction structuring.
- STRATEGIC advice:** A section featuring a "LIVE IMAGING" article about the acquisition of Pharmacia Sandoz, detailing the strategic rationale and financial outcomes.
- STRATEGIC knowledge:** A section with a "LATEST INSIGHT" article titled "For the Fall 2004 issue of insight, click on the link below to download the pdf file." It also lists other recent articles such as "Merger and Acquisition 2005" and "Credit and Economic Update".

mission in an effort to realize the benefits of the “deal,” which in effect redefines the road map. Such deals are often made for reasons that are inconsistent with the strategic vision—diversification (tinker here and there), pursuit of quality (only the best), bargain deal (too cheap to pass up), sales growth (bigger is better), buy management (rather than hire), denying a competitor (can’t let them have it), or scarcity value (won’t be left out). These are rarely compelling reasons to buy another business, regardless of how attractive the price seems to be.

INVESTMENT THESIS

The preeminent investment consideration should be “How does this business combination strengthen our competitive position?” And should be closely followed by the query, “How does this opportunity measure up against other options for furthering the business along the strategic roadmap?” If these questions can be answered satisfactorily, then there may be a genuine strategic rationale for the investment. In the absence of a clear strategic vision, it is not uncommon for businesses to approach all opportunities as though they are equally likely to create wealth. Therefore, the most promising opportunities may be underexploited.

To improve the odds of creating value, the business combination must, in some meaningful way, result in either the acceleration of revenues and/or the elimination of duplicative costs. Opportunities to accomplish these

STRATEGY	RATIONALE	EXAMPLE
Product Line Extension	A wider range of products/services through an existing distribution channel or customer base.	Acquisition of Mikron Industries by Qualex Corporation to broaden product offering to a common customer base.
Market Extension	Broadening the geographic base of customers for existing products.	Acquisition of Portland based Arcenia by Ivey Imaging to put capabilities in close proximity with key customers and prospects.
Adding Capabilities	Buy or build. It may be less expensive or more certain to acquire technology or new capabilities.	Acquisition of Viking Industries by Pella Corporation to provide to this wood product company knowledge of vinyl window manufacturing.
Cost Reduction	Consolidation to achieve critical mass or eliminate redundant overheads.	Acquisition of Wards Cove plants by Ocean Beauty Seafoods to create sales efficiencies in the canned salmon market.

goals are likely to be found in four areas, as illustrated in the above table.

A business combination has to surmount two hurdles to create value—it must fit into a well-developed business strategy, and the price paid for an acquired business must be less than its contribution to the combined enterprise. Acquisition analysis and planning is an imprecise science at best. No one is omniscient with regard to changes in the competitive environment. It is easy to invest heavily in a deal where the sought after competitive advantages never materialize. Because the future is unknowable, it pays to be disciplined about pursuing only those oppor-

tunities that fit with the strategic vision and build real competitive advantages. The prospects for creating value improve significantly if the acquirer is dispassionate about both the ability to mesh the two businesses at an operational level and the timing of realizing the expected benefits of the combination.

Once an acquisition investment thesis is formed, the next step in the process is to conduct due diligence. This is where risks are identified, the investment thesis is confirmed, and the basis for apportioning risks in deal structure are determined. We’ll explore these two phases of the acquisition process in the Fall issue of *Insight*. ♦

Value vs. Price

Many owners view the value and price of businesses as the same, which can be a misconception.

by Mark D. Working

Price and value are not always the same. Price represents what actually occurs as a result of specific supply and demand conditions, while value is an economic concept that equates all future benefits from owning an asset to a single current amount. Price is what “is” and value is what “should be.” When an imbalance of supply and demand occurs, there can be a discrepancy between the two. It is this disconnect between price and value that is the stock and trade of legendary investors such as Benjamin Graham and Warren Buffett and was at the root of the dot.com bubble. In a public market, adjustments are constant as prices change on every trade. The market is always moving. In contrast, a private market has no such adjustment mechanism.

INTRINSIC VALUE VS. PRICE

Ultimately, the value of any asset is equal to the present value of expected future cash flows to be generated by the asset. Because future events are the driving determinant of value, there is plenty of room to debate all the variables that affect future cash flows,

not to mention the timing of the cash flows or the discount appropriate for the risk of the business. Nevertheless, in many cases a good financial analyst should be able to determine a range of “expectations” that knowledgeable investors would consider reasonable.

The price of an asset at any particular time is determined by supply and demand for the asset. The supply and demand dynamics are normally influenced by the availability of substitutes. In the case of a business, the availability of other similar business risk investments provides balancing pricing forces over a large market.

A NORTHWEST VALUE-PRICE DISCREPANCY

There currently appears to be just such a price-value anomaly in the market for North Pacific seafood processing quotas, most notably the pollock resource (the principal supply of filets for fish and chips and surimi, or Krab). In the 1990’s, this important fishery was an economic basket case as a surplus of Seattle based processors inefficiently competed head to head to process the allowed catch in an Olympic style (race to catch)

fishery. In 1999, the American Fisheries Act set in motion the rationalization of the industry by granting catch/processing quotas to individual vessels and shore-based plants. In turn, the allocation of quota allowed optimization of fleets, crew, and processing time, with the result being more efficient use of the resource and a tremendous increase in profitability and, therefore, value.

There remains meaningful opportunities for consolidation within the industry to drive efficiency. But efforts in that regard are currently frustrated by price expectations among quota owners that are well in excess of the economic value that most potential buyers can justify.

One of the provisions of the Act was to grant 10% of the pollock resource to regional Community Development Quota (CDQ) groups in an effort to foster local participation in the fishery and economic development. CDQ groups are empowered to “sell” the right to capture the resource to processors and to reinvest the proceeds in the industry. This has been a windfall for

CDQ groups, as they have derived millions of dollars for their share of the resource. They are obliged to reinvest a large portion of the earnings in the seafood industry. With overflowing coffers and few places to invest, CDQ groups have had the resources to bid aggressively for industry assets.

THE HIGH WATER MARK

North Pacific floating processors are the most efficient of all methods of capturing and processing the pollock and related species. The industry leader is American Seafoods Company (ASC), which as a result of its scale is recognized as the most efficient (and profitable) of all of the floating processors. As such, the value of the quota it controls should be the highest in the industry.

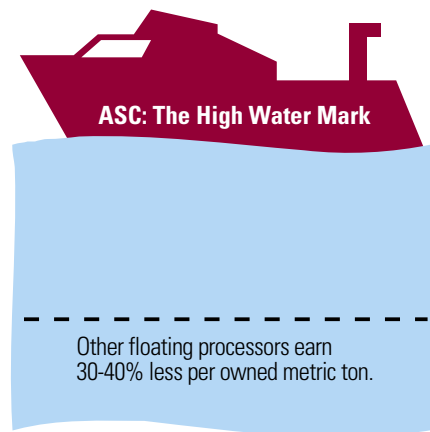
Using publicly available data on ASC, here's how "pollock math" works. Continuation of ASC's recent level of performance implies a discounted cash flow value of roughly \$600 million for the business. Part of ASC's value is associated with non-ASC owned resources. Granting \$50 million to those activities yields a \$550 million value for the processing capacity, working capital to conduct the business, and pollock quota, as illustrated in the nearby table.

As the industry's most efficient processor and the only source of public data, most quota owners view ASC's value per metric ton as the definitive value benchmark. In reality, it should not be the standard, but rather the high water mark based on the company's industry leading performance. Although information is not publicly available, indications are that other floating processors earn 30-40% less per owned metric ton than ASC. Shore-based and mothership processors purportedly earn even less per ton. Accordingly,

\$ in thousand	AMERICAN SEAFOODS		
	2002	2003	2004
Metric Tons Owned (000's)	216	217	217
Revenue	\$ 333,000	\$ 411,000	\$ 462,000
EBITDA	84,000	101,000	88,000
EBITDA / Ton	\$ 389	\$ 465	\$ 406
Enterprise Value			\$ 550,000
Less Working Capital			(58,500)
Quota and Processing Asset Value			\$491,500
Value per Ton			\$2,265

the value of quota held by smaller floating processors, catcher vessels, motherships, and shore-based processors should be less.

In every industry there is unrelenting pressure to drive ever greater efficiency. There is more efficiency to be created in the



bottom fishing industry through further consolidation of the quota and processing assets. But, unrealistic value expectations set on the basis of ASC operating performance, and reinforced by CDQ investment transactions, have stymied the efforts of investors to buy or invest in businesses in the industry over the past five years. When it is all boiled down to dollars per ton, owners continue to have trouble seeing that a ton of their quota is not worth as much as ASC's quota. Speculation of even higher values for ASC have left even the most aggressive CDQ groups unable to complete transactions at premium prices.

The effect of the growing amount of CDQ wealth, the requirement for reinvestment in the seafood industry, and the willingness of owners to wait for the "CDQ deal" has slowed transactions in an industry in which the age of ownership and the potential of consolidation synergies should be stimulating brisk activity.

Price and value disconnects do not continue unabated indefinitely. In this case, one simple event could "let the air" out of the balloon. CDQ groups, which represent the pricing force in the industry, are currently restricted, in terms of new investments, to the Alaskan seafood industry. A modification of the rules to allow CDQ groups to broaden their investment focus beyond the seafood industry would put North Pacific investments on the same grounds as other opportunities in the world. When that occurs, price and value will start to converge. Our view is that industry shareholders would be well served to consider consolidation opportunities, even if the prices do not reach ASC's high water mark. ❖

The Case for Independence in Private Company Boards

Independent directors can be a positive asset for private, family-owned businesses.

by William S. Hanneman

Having worked with hundreds of private, family-owned businesses over the years, we have found that the vast majority does not maintain active boards of directors or advisory boards that could be legitimately considered as independent. By that, we mean directors who are not employees or do not have another material (vendor or advisory) relationship with either the company or its principal shareholders. Indeed, if a functioning board exists, it tends to be populated with family members, company executives and/or rubber-stamping friends. Most would not come anywhere close to the standard of independence that public companies are now held to.

As corporate fiduciaries, directors and management are obligated to act for the ben-

efit of all stockholders. Of course, there are instances in which the interests of corporate officers and managers are not necessarily perfectly aligned with the interests of shareholders that are not active in the company's day-to-day affairs. For example, a conflict can arise where financial results may affect the level of management's compensation.

We have heard any number of reasons for not building an independent board.

- Confidentiality; our affairs are private.
- It is expensive; directors need to be compensated for their time and effort.
- It is a time consuming hassle to keep the board well enough informed to provide meaningful advice.

We suspect that the principal reason

why many private companies don't have functioning independent boards is that CEOs would rather not be scrutinized or have their business ideas challenged. Admittedly, the job of a private company CEO is lonely. Some family CEOs prefer it that way, as they do not wish to suffer the second-guessing or being called to account in the presence of family shareholders or management.

In lieu of an independent board, some private company CEOs often seek guidance from friends or outside professionals. While this counsel is certainly well intentioned, these advisors may be too close to the owner to provide impartial advice. Beyond the issue of objectivity, most service professionals are not qualified to provide the type of real-world business advice that CEOs often lack. To be

Private Company Boards *continued from p.3*

sure, there are various organizations, such as TEC or YPO, where CEOs of private companies can get objective advice from business peers. These organizations, for those who take participation seriously, can be quite powerful.

RESPONSIBILITIES OF PRIVATE BOARDS

Although private companies are not (yet) subject to the stiff requirements of Sarbanes Oxley (SOX), we believe that these businesses benefit by adopting the spirit of board independence that SOX imposes on public companies. Outside directors can add value to the business in four primary areas.

Setting Strategy and Company Policy

When populated with directors who have insight into the industry and/or expertise in related disciplines, the board is an excellent forum for vetting management’s business strategy. While management is immersed in the day-to-day tactical maneuvering of the

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business, a well functioning independent board should be focused on a longer-term perspective, assisting the management to clarify the vision of the business further down the road.

Advising, Evaluating, and Counseling the CEO

While private company directors serve at the pleasure of the owner, a board member who takes the role seriously can offer the type of coaching and constructive criticism that can help a CEO transition from the entrepreneurial skills needed to start the business to the leadership skills that are necessary to grow it. Outsiders are often well placed to act as a mirror, allowing the CEO to see how outsiders might perceive his actions and to provide both a sense of objectivity and a measure of accountability.

Resolving Conflicts Among Owners

Independent directors can play a pivotal role in mediating the agendas of the individual owners. All directors have a duty to act in the best interest of the corporation and all of its shareholders. We have often seen family disfunctionalities invade businesses. When it is allowed into the boardroom, it often contributes to an erosion of value. Independent board members are perhaps in the best position to assist in the resolution of such conflicts, especially if they have been around

GUIDELINES FOR PRIVATE COMPANY BOARDS

1. Appoint persons independent of management and shareholders who are free from material conflicts of interest.
2. Ideally, outside directors should have a degree of financial savvy and possess some knowledge that is relevant to the business.
3. Meet regularly and require that directors be well informed.
4. Ensure that financial reporting is accurate and that disclosure is routine and timely.
5. The priority interest of the board should be the shareholders. The Board does not report to management.
6. Fairly compensate Board members for their time and effort in assisting the company.
7. Periodically, review the performance of the CEO, as well as the performance of each Board member.

for a while and are judged to be impartial.

Overseeing Succession

Management succession can be a significant source of conflict within private companies, particularly family owned enterprises. Parents inevitably believe that their offspring are capable of taking the reins. Often, this notion is misguided. Professionals don’t want to deliver this sensitive message, but an independent board member is much more likely to have the standing to help the owner objectively assess the impact on the business.

Accurate Information to All Shareholders

As ownership is passed from one generation to the next and the shareholder group expands to include multiple generations, shareholder communication and knowledge regarding company affairs invariably suffers. Independent board members can provide

some comfort to those not actively involved in the business that they are getting accurate and timely information. Specifically, private companies should seriously consider the formation of an audit committee of the board, staffed predominately by outside

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directors, which is directly responsible for retaining and managing the company’s relationship with its outside auditor. This step helps to blunt any claim that management and directors are not entitled to the benefit of the business judgment rule. It would also provide comfort to creditors, insurance companies, other service providers, and passive shareholders who will increasingly judge the actions of private company management against public company standards.

In the course of our work with private companies, we have observed a positive link between well functioning boards and company performance. Firms that invite independent directors to assist in their governance seem to benefit from that guidance as they seek to cope with external competitive challenges, and internal issues. A formal board of directors, or an advisory group without the same legal standing, can be a very powerful tool to foster business success. ♦

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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