presents

How to approach the M&A round in optimum conditions ?

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We often hear talking about « M&A » or Merger and Acquisitions without really understanding the long process that is at work behind operations that are not only complex but also diversified.

The goal of this short introduction is not to give a profound analysis of M&A techniques, but to give a quick overview of the method that is at work during such operations.

This introduction also aims at presenting the different ways of assessing a company's value, as it is indeed the goal : evaluating the assets' value, which is the company's value.

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I. The different steps to evaluate a company

Starting with the gathering of information about the company and finishing with the sale price, every step of a Merger & Acquisition requires the use of specific tools and techniques.

The assessment of a company is based on a rigorous process which relies on a certain method more or less complex and which depends on the company's size as well as its business sector and the consolidation methods of the group's subsidiaries. The final value of a company is only the result of this process. However, the general principles and methods remain globally similar.

Seven key-steps can be identified in the process of an assessment mission.

1. Collecting the data

The first step is to gather all the information at hand about the firm: its products, its markets and competitors, given by public data (accounts published, Management report, press articles) or private (sector researches, notes of financial analysts). This step, which consists in getting a general view on the company, is often completed by meetings with the head of the company and the operational management, as well as visits on production sites, which does not apply in this case.

2. Operating an economic diagnosis

The economic analysis allows, before all, to apprehend the business model of a company or a firm from a strategic and financial point of view. The strategic analysis enables us to have an opinion on the competitive position of the company, on the opportunities of the market, and to assess its strengths and weaknesses. The financial diagnosis allows one to identify the causes of the company's long term economic and financial results, to analyze its financial structures and to assess its financial strength.

3. Choosing the right way of assessment

This double diagnosis, required for any assessment, is all the more important that it will determine the assessment method.
There are mainly 4 ways to assess a company:

- The patrimonial approach which is based on the evaluation of assets and the calculation of the private income generated by the goodwill.
- The analogical method based on the similar multiples companies and transactions.
- The actuarial method based on the updating of dividends compared to the cost of equity or the updating of available cash flow or cash flow compared to capital cost.
- The real option approach based on the hypothesis that shareholders hold a put option that is based on the company's assets.

The use of a specific method depends on numerous factors: the company's features, the purchaser's goals and the temporal aspects of the investment. The choice also depends on the accessibility of data or on the market conditions at the time of the assessment.

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4. Designing a business plan

Designing a business plan is a crucial step.
What are the mistakes to be avoided?
On a theoretical level, actuarial methods are generally the most suited as they are based on the fact that the value of a company equals the present value of cash flow generated from its economic activity. However, this kind of method requires the drafting of a business plan and the assessment of the amount of potential synergy with another company. The business plan is based on a certain number of hypotheses that are linked to cash flow evolution, working capital and investment expenditures.

5. Establishing the evaluation hypotheses and settings

Asking oneself the strategy-related questions, correctly evaluating the property and intangible assets, but also checking the quality of the due diligence … Here are a few tips to buy a company at its fair price.
Like other models aiming to anticipate market evolution or the behavior of economic actors, the assessment models rely on many hypotheses, that are reductive and simplifying, relating to the drafting of a business plan or the calculation of the discount rate. The given evaluation only makes sense in light of the hypotheses chosen. That shows the importance of testing the strength of hypotheses by altering certain settings (scenario analysis) or by effecting simulations (Monte-Carlo method).

6. Establishing a valuation range and concluding on the value

“The appraiser or analyst has to seek a valuation range by determining the minimal and maximal values”. (Jean-Etienne Palard)

The goal of any company evaluation is not to give a unique value to a company, because it simply doesn’t exist. In fact, the appraiser or analysts has to strive to identify the lowest and top values. The evaluation method must only be considered as tools here to help leaders and investors to make decisions. At this stage, acquisition audits may be due diligenced by both parties so to check up on the value of certain assets and liabilities.

7. Negotiating and determining the purchase price.

When all acquisition audits have been made, the negotiation stage may begin. Both parties will base their argumentation on evaluation reports and their conclusion. During this stage, advisors (bankers, lawyers) will generally intervene and will help sellers and buyers to set a purchasing price and to negotiate all terms and clauses of the transfer contract.

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II. The different assessment methods

We will here explain the 3 of the 4 methods previously mentioned above.

1. The actuarial method

The evaluation of a company according to the actuarial method is based on the evaluation of future cash flows generated by a company, given the risk of economic assets. That means that cash flows will be updated at a certain rate, called the discount rate, which reflects the risks of a company. The idea underlying this method is that the purchaser doesn't buy the flows generated in the past by the company, but the flows it will generate in the future (not the wealth of the past, but the wealth of the future).

But in fact, the cash flows used in order to value a society can vary significantly between actors. For some people, this will include the value of future profits, for others, this will include « cash-flows », or even all the dividends paid. In fact, the actor in charge of recovery will chose the trades which seem most reflect a society wealth-creation. This choice will be made on the future firm behavior. For instance, we will take into account more often dividends for an industrial firm for growing companies and « cash flows » will be taken into account for more innovating firms. « Cash flows » show the possibility of reinvestment from the firm in it activity which will make it able to create greater value in the long run.

There are mainly 3 methods of actuarial approach: Gordon-Shapiro, the Bates model and finally the **discounted free cash flow method that is the most commonly used.**

2. The analogical method based on the similar multiples companies and transactions.

The actuarial approach is based on complex forecasts that are at the heart of the final valuation of the company. Furthermore, simplifying methods, like the hypothesis of the constant-growth of the company on the long run, tend to limit the quality of valuation of these methods.
That's why bankers and financial analysts rarely use such methods, particularly those based on the updating of dividends that fails to really reflect the process of value creation. However, they mustn't be rejected because the method of discounted free cash flow is used nearly all the time to assess a company's value.
Nonetheless, the DFC method is not very comprehensive. It is systematically completed by comparative methods that allow to assess the value of the company while taking into account its market and competitors.

Indeed, the comparative approach is based on the following elements to assess a company's value:

- Similar transactions, ie at which value and multiples were similar companies purchased at.
- Companies that have a similar profile when it comes to markets, risks …
- Reference indexes such as CAC 40, the New Market, IT.CAC, that will be used whether or not we consider that the company is representative of the said index.
- An industry if we consider that the company's features are representative of a particular sector. The analysis will then be based on the analysis and data available about this sector in order to assess the value of the company.

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3. The patrimonial approach

The patrimonial approach considers the assets and liabilities of the company all the while taking into account unrealized differences and potential risks. However this method falls short when it comes to the valuation of intangible assets (Patents, operating licenses, brands, goodwill).
Ironically, evaluating intangible assets often needs techniques of the second “category”.
Ultimately, in many cases, the patrimonial approach resembles a mixed approach.

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