November 2013

The Global Corporate Advisor

The Corporate Finance newsletter of Crowe Horwath International

Welcome to the November issue of *Global Corporate Advisor*, brought to you by the GCA team in Central and Eastern Europe.

The world's appetite for food-sector deals is leaving everyone hungry for more. From our UK team, Geert Struyven highlights significant transactions in the food and drink sectors, which have bucked the depressive trend seen in other retail sectors.

Tomáš Podškubka is a Senior Manager at TPA Horwath in Prague, currently on secondment in our Auckland, New Zealand office. With assistance from colleague Gary McLoughlin, he has provided us with an in-depth examination of the purchase price allocation process.

Rounding out this edition are the results of a client survey conducted by Karl-Michael Krüger in Germany, on companies' expectations regarding the behavior of their M&A advisors.

As always, if you need M&A transaction support, valuations, M&A advice and related services, don't hesitate to contact your local GCA advisor.

Igor Mesenský
Regional Leader,
Central and Eastern Europe
+420 724 586 342
igor.mesensky@tpa-horwath.cz

Contact Us

The GCA team is here to respond to your needs relating to M&A transaction support, valuations and M&A advisory services. If there is a topic you would like us to cover in future issues of the GCA newsletter, don't hesitate to contact Peter Varley, Chairman of GCA at peter.varley@crowecw.co.uk. Alternatively, please contact your local member of the GCA team to discuss your ideas.

Inside This Issue:

Reliability is Key: Crowe Horwath's International M&A Advisory Activities

By Karl-Michael Krüger, Munich

In this article, I would like to update you on Crowe Horwath's international mergers and acquisition (M&A) advisory activities.

In the past, Crowe Horwath has been active in M&A advisory, but those activities primarily took place within domestic markets in several countries. About three years ago, Crowe Horwath made the strategic decision to expand its international M&A advisory activities. In addition, Crowe Horwath made another equally important strategic decision: to open our network to specialised companies from the market instead of building the expertise globally on an internal basis.

To achieve this, we allowed new M&A advisory specialist partner firms to join Crowe Horwath by becoming Business Associates rather than Full Members. The latter category applies to companies that offer audit or tax services, and means they have to comply with the strict international legal regulations that apply to their professions.

Once the decision was made to expand our M&A advisory activities, we felt we needed to create an overall vision and strategy, as well as a value proposition. This was an important step because not only had the M&A market seen a sharp decline in activity since the global financial crisis, but more companies and client segments had built skills and expertise and were increasingly taking part in the M&A process.

To better understand our clients' needs, we conducted a survey with a number of our international clients. This took place through telephone interviews and involved representatives from the C-level and owner-managed businesses. I would like to thank these clients for taking the time to share their views with us. These insights allowed us to better define a value proposition, a strategy and a resulting operational concept for an M&A advisory network that truly serves our clients' needs, and which does not emulate other offers currently on the market.

The survey demonstrated that primarily soft factors should play an important role in the creation and growth of our international M&A advisory business. This may have been in response to unprofessional – if not unethical – behavior shown by some players since the global financial crisis.

A key concern was that advisors may have a laid-back attitude towards potential conflicts of interest. Another concern was the relaxed attitude towards using insights gleaned from previous assignments to advise competitor clients in subsequent projects.

In our survey, consequently, examples of such unprofessional behavior (a lack of soft factors) included:

- no respect for conflicts of interest,
- poor work quality,
- client hopping, where advisors switch clients and unethically use information obtained from prior engagements, and
- breaking of confidentiality.

Aside from the softer skills and a need to act ethically in corporate cultures, companies are also looking for a number of other attributes in their M&A advisors, including reliable access to target companies and their decision makers in foreign countries, proven delivery capacity and a pragmatic rather than an academic approach. Clients are expecting us to deliver what we promise!

From the survey findings, our clients want a professional, state-of-the-art skill set and would like to benefit from an international presence in their target markets. This feedback has been very helpful, and will enable us to expand our presence in such areas.

Our status today

Crowe Horwath now has M&A advisory teams operating in 17 countries and regions, involving nearly 100 professionals. Our regional presence covers most of Europe, and is also relatively strong in the Asia-Pacific region – including Australia, India, Malaysia and Singapore. We have also seen encouraging results and growth in the Americas, especially in Argentina, Brazil and Canada.

In an operational sense, we conduct international conference calls on a twice-weekly basis, attended by a substantial number of senior executives. These calls help our M&A advisory work progress smoothly by addressing potential conflicts of interest, and dealing with issues as early as possible.

Furthermore, an international board and three regional sub-boards are responsible for the overall management and coordination of our international M&A advisory activities. This comprehensive structure differentiates us from looser arrangements, which are often based on referral relationships.

Our value proposition

Crowe Horwath's M&A clients benefit from the following factors.

- We continue to provide M&A advisory capabilities in key economic centers, and in other areas that are important to our clients' growth strategies. Our teams are on the ground, and we are building new teams where we do not have them yet. However, if we cannot provide the services you need in your target markets, we will let you know upfront.
- As one of the world's leading networks of audit, tax and advisory firms, we will bring significant technical skills and expertise, integrity and confidentiality to every engagement.
- Our growth strategy is focused on improving our relationships with key accounts across major sectors and locations. Our clients can expect state-of-the-art solutions wherever we can deliver them.

Our M&A mission statement is "reliability is key – we deliver what we promise."

We look forward to discussing how we can help you pursue your global M&A activity.

For more information

Karl-Michael Krüger is Chairman of Crowe Horwath's M&A Advisory Group and Managing Partner of Platinum Partners GmbH in Munich, Germany. He can be reached on +49 89 171 180 817 or mkrueger@platinum-partners.de. Platinum Partners GmbH is a Crowe Horwath International business associate.

Getting Purchase Price Allocations Right When Buying a Business

By Tomáš Podškubka, Prague and Gary McLoughlin, Auckland

A key element in a successful merger and acquisition (M&A) transaction is getting the purchase price allocation (PPA) correct. The PPA process involves allocating the price paid for a business across all its assets and liabilities. Under International Financial Reporting Standards (IFRS), the PPA process is compulsory for all companies, and it may be required by authorities in local jurisdictions.

Any investor seeking to undertake an M&A transaction should be fully prepared for this process. As Henry Ford said, "Before everything else, getting ready is the secret of success."

In this article, we outline the elements of a successful PPA process, including:

- identifying intangible assets
- selecting valuation methods
- calculating residual goodwill
- determining discount rates and reconciliations.

The components of a PPA can be seen in Figure 1.

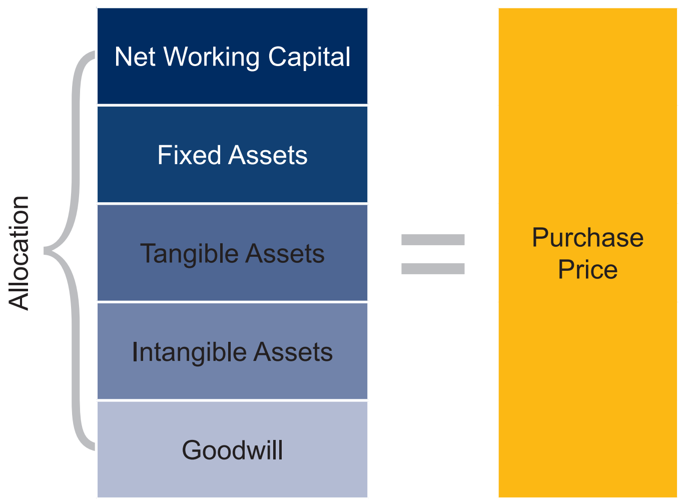

Figure 1: PPA components

Identifying intangible assets

A target company's intangible assets are typically the most valuable. However, they may not be specifically disclosed. To get the PPA process right, potential acquirers must identify all intangible assets and ensure they are properly documented.

In general, intangible assets are only reported in the financial statements when they are acquired as part of a larger transaction or in a transaction involving the transfer of intellectual party between unrelated parties. A reporting company cannot recognize and reflect its own organically developed intangible assets.

Based on our global experience with the PPA process, 20% to 50% of a purchase price relates to intangible assets (excluding residual goodwill). The exact proportion will depend on the sector in question. For instance, in energy, utility or real estate companies, intangible assets constitute a smaller slice of the purchase price; while intangible assets are more important for retail, consumer, life science and health care companies.

In the initial phase of the PPA process, companies need to identify all the intangible assets being purchased, including:

- marketing-related assets such as trade marks
- customer-related assets such as customer lists
- artistic-related assets such as copyrights
- contract-based assets such as franchising or licensing agreements
- technology-based assets such as patents.

Asset identification starts with an analysis of the target business' historic results. The goal is to uncover the intangible assets that have made the greatest positive financial contributions.

This process should take place prior to the acquisition, as it allows vendors and buyers to incorporate these valuable assets into the purchase price. To ensure a smooth deal progression and encourage maximum value offers, it is crucial that vendors detail all relevant intangible assets when buyers require this information.

Furthermore, the value of intangible assets is higher when they are safeguarded. In practice, this means that trade marks, patents and brand names are registered; internal processes and practices, business plans and growth opportunities are documented and protected; and customer bases are well maintained and readily accessible.

Selecting valuation methods

PPA valuations share similarities with traditional valuation approaches such as cost-, market- and income-based methods. However, there are some differences investors should be aware of.

The market-based approach may be difficult to use effectively in the PPA process. This is due to the disconnect between the value of the intangible assets and comparable market prices. For instance, intangible assets are often characterised by inactive markets, private deals and bundled transactions, which make it difficult to identify the contribution of a single intangible asset.

The cost-based approach is more widely used but still has its limitations. It is generally not a desirable option when valuing other commercial subject matter, such as an entire business entity. Also, when applying the cost method, the acquirer must take the issue of obsolescence of the intangible assets into account. This is a broader concept than depreciation, as it includes physical, functional and technological aging.

Finally, the income-based approach is used specifically for the PPA process, and is known as the multi period excess earnings method (MPEEM). This is regarded by industry professionals as the most appropriate valuation approach for intangible assets which directly generate revenue streams.

MPEEM determines the income attributable to an intangible asset by calculating the excess income derived by that asset, less a fair rental return for other assets involved in generating those funds. The assessed value of the intangible asset is the present-day value of its excess earnings.

Calculating residual goodwill

In the past, all intangible assets have been included as part of goodwill. Under IFRS, this is no longer the case, and goodwill only refers to intangible value drivers that have not been identified.

Purchasers must recognize goodwill at the acquisition date by calculating the residual goodwill value. This is the difference between the purchase price, and the net value of the identifiable assets (tangible and intangible) less liabilities assumed. The residual goodwill and indefinite-lived intangible asset values are required to be tested for potential value impairment each year after the asset is acquired.

The PPA process sets the starting value against which future values are compared to determine asset impairment (a decline in asset value). Any evidence of impairment will affect future profit levels and be scrutinized by auditors.

Determining discount rates and reconciliations

In this step, companies are ensuring consistency in the discount rates used to calculate current asset values. This step in the PPA process serves as a 'sanity check' to ensure that all the values ascribed to intangible assets are fair and comply with relevant requirements.

The reconciliation process seeks to ensure the weighted average return on assets (WARA) aligns with the weighted average cost of capital (WACC) for the target business. The assessed WACC – expressed as a percentage for the overall business is the typical discount rate applied to estimated future free cash flows to determine the current purchase price for the business. This price must then be used to underpin the PPA process.

In general, buyers will expect a greater rate of return from intangible assets (including goodwill), compared with net working capital. Buyers want higher returns from intangible assets as they can quickly lose value if a business encounters financial difficulties and are difficult to separate and sell away from an operating business.

How PPA works in practice

In this example, an acquirer purchases all of the target company's shares for an agreed purchase price of US$8 million.

A valuation conducted by the buyer was based on normalized annual EBITDA of US$1.82 million, and a risk adjusted EBITDA multiple of 5.5 times estimated earnings. The agreed enterprise value (US$10.0 million) was determined by applying this multiple to future annual earnings (US$1.82 million). As at the valuation date, the target's institutional debt totalled US$2 million. The PPA process can be seen in Figure 2.

The WARA for all of the assets employed in the business is 18.25% – which sits roughly between the lowest returns of 6.0% for net working capital, and the highest return of 25.0% for residual goodwill.

The effective WACC is 18.18%, which is the inverse of the multiple applied to the target (being 100/5.5 times). The similarity in WACC and WARA values suggests the PPA is appropriate for the transaction.

Asset Class	Fair Value	Percentage of Enterprise Value	Risk Adjusted Return per Asset Class
Net Working Capital	500	5.0	6.0
Plant	1,500	15.0	10.0
Machinery	1,000	10.0	12.0
Trade Mark	2,000	20.0	20.0
Patent	1,500	15.0	20.0
Customer Relationships	1,000	10.0	20.0
Residual Goodwill	2,500	25.0	25.0
Enterprise Value	**10,000**	**100.0**	**WARA**

Figure 2: The purchase price allocation process

Preparing to succeed

The PPA process can be highly demanding and is much more than an accounting exercise. Vendors should come well prepared by ensuring all intangible assets are identified, documented and protected. This will help maximize the purchase price. Buyers need to be diligent in understanding the business they are trying to acquire, including its intangible assets.

During this complex process, the input of trusted advisors can help buyers and vendors avoid costly surprises and complete successful transactions. Crowe Horwath has extensive experience in helping both parties manage the PPA process and we would be delighted to discuss how we can help your business.

For more information

Tomáš Podškubka is a Senior Manager at TPA Horwath Prague, in the Czech Republic. He completed this article while on secondment at Crowe Horwath's Auckland office in New Zealand. Tomáš can be reached on +420 222 826 351 or tomas.podskubka@tpa-horwath.cz. Gary McLoughlin, Principal at Crowe Horwath (NZ) Limited assisted Tomáš in preparing this article. Gary can be reached on +64 9 308 1605 or gary.mcloughlin@crowehorwath.co.nz.

The UK Food Sector: A Case Study

By Geert Struyven, Kent

Since 2008, the retail sector has been depressed due to a weak economic backdrop, a sustained squeeze on household incomes and a lack of consumer credit. Despite this, there has been no shortage of high-profile deals in the food sector.

Most notably, in 2010 Kraft acquired Cadbury in the UK for £11.9 billion, and in February this year we saw the landmark US$28 billion acquisition of Heinz by Berkshire Hathaway and 3G Capital.

These deals were by no means the only significant transactions. What do stand out are the valuation multiples. Heinz and Cadbury were both valued at 14 times EBITDA, a significant premium on their prevailing share prices.

A strong brand will ultimately secure such premiums, since customers tend not to fundamentally alter their food consumption patterns or behavior based on global economic conditions.

This, of course, is subject to avoiding disastrous public relations. For example, Coca Cola's heavily promoted launch of Dasani 'pure' water in 2004 went badly wrong when it was revealed that the water was tap water. It was also contaminated (albeit in minute traces) with bromide. Five weeks later, Coca Cola pulled the brand at a huge financial cost.

Consumers are also relatively insensitive to price increases if their brand loyalty is strong. Building a resilient brand reduces the risk to investors and increases valuation multiples.

Based on this, we believe that the food and drink sectors are attractive markets in which to invest.

In the UK, we have many fast-growing and acquisitive food manufacturing and distribution clients. One of Crowe Horwath's longstanding clients in the food sector is The Real Good Food Company plc (RGFC), a diversified food group listed on AIM (the London Stock Exchange's market for growth companies).

RGFC owns Napier Brown Foods, Europe's biggest non-refining sugar distributor; Garrett Ingredients (dairy ingredients and sugar); Renshaw (icings, marzipan and caramels); R&W Scott (chocolate coatings and jams) and Haydens Bakery (pastries and desserts).

RGFC was set up and listed in 2003 as an investment holding company to facilitate the acquisition of businesses operating in the food sector. It initially acquired three food-related businesses: Haydens Bakery, Eurofoods and Seriously Scrumptious. In the same year, Napier Brown Foods had its own IPO on AIM. With Crowe Horwath's assistance, RGFC acquired Five Star Fish in 2004.[1]

In 2005, RGFC made an offer for Napier Brown Foods, a listed group of businesses supplying sugar and sugar-derived food products.[2] We provided all the financial due diligence and tax structuring advice on Napier Brown Foods, and acted as the reporting accountant on its re-admission to AIM.

Shortly afterwards, RGFC sold Five Star Fish for a substantial profit as it was deemed non-core to the Group's continuing operations. Again, Crowe Horwath provided advice on the sale.

In 2008, in light of the global financial crisis, we assisted RGFC in refinancing its debt facilities by introducing a specialist asset lender, PNC Financial Services. These facilities have recently been renewed until 2017, and were extended to £50 million.

Historically, RGFC has largely sold under its own label, but over the last three years it has started to sell other brands as well, allowing the business to expand. It is therefore no surprise that RGFC's value is steadily increasing. However, it has some way to go before it achieves the multiples seen at the top end of the market. At the end of October 2013, its price-to-earnings ratio was 8.4, compared to the FTSE average for food manufacturers of 10.9.

RGFC is also expanding internationally and now exports to more than 30 countries. It has opened sales offices in the US (where it supplies Wilton, the largest maker of cakes in the US) and more recently in Europe, where it opened up a distribution center.

RGFC's recent developments

1 The three main businesses acquired in 2003 and 2004 were:

- Haydens Bakery, which supplies and produces high-value bakery products and desserts with strong production skills in hand finishing and laminating yeasted dough products, and utilizing quality fresh fruit in products sold to grocery retail customers.
- Five Star Fish, which supplies pre-prepared frozen fish to the food services sector. The business is based in Grimsby, Lincolnshire, delivers to 100 customers nationwide and employs approximately 200 people.
- Seriously Scrumptious, which manufactures high-quality cakes and individual-portion bakery products for the retail and food services sectors. Its production operations are based in Devizes, Wiltshire.

2 NBF trades through its subsidiary, Napier Brown & Company, which in turn operates the businesses of each of its subsidiaries – Garrett, Sefcol, James Budgett and Renshaw Scott – in two trading divisions: Ingredients and Renshaw.

highlight the importance of clear brand distinction; product and geographical diversification alongside continued product development; and sourcing products and raw materials at acceptable prices.

We are proud to have been involved in RGFC's growth from the beginning and we continue to provide proactive advice to help this business achieve its ambitions. RGFC will increasingly benefit from the GCA network and global reach, and is an excellent example of how we build long-term relationships with our clients.

For more information

Geert Struyven is a Corporate Finance Partner of Crowe Clark Whitehill LLP, based in Kent, England. He can be reached at +44 (0)1622 767676 or geert.struyven@crowecw.co.uk.

Regional GCA Leadership

China
Antony Lam
antony.lam@horwathcapital.com.cn

East Asia
Mok Yuen Lok
yuenlok.mok@crowehorwath.net

Eastern Europe
Igor Mesenský
igor.mesensky@tpa-horwath.cz

Indian Subcontinent / Middle East
Vijay Thacker
vijay.thacker@crowehorwath.in

Latin America
Roberto Pérez
roberto.perez@crowehorwath.com.ar

Oceania
Dan Cotton
dan.cotton@crowehorwath.com.au

Southeast Asia
Alfred Cheong
alfred.cheong@crowehorwath.com.sg

USA / Canada
Marc Shaffer
marc.shaffer@crowehorwath.com

Western Europe
Peter Varley
peter.varley@crowecw.co.uk