Ernst & Young Discussion with Businesspersons

Ludwigsburg

July 25, 2006

- Prof. Dr. Dieter H. Vogel -

Business Growth through Acquisition

The perspectives of the strategic and the private equity investor

Ladies and Gentlemen,

Talking to businesspersons about the need for growth is like carrying coals to Newcastle. In contrast to the doubters in politics, businesspersons know for a fact: There is no such thing as sustainable economic success without growth.

For a while, stagnate sales can be compensated by internal cost management. But only for the short term. Costs increase incessantly, there is no degression of unit costs, price increases impede the market, profits become smaller and the specific capital expenditure increases. It is no longer possible to balance the costs of deployed capital resources and borrowed capital, not to mention realizing excess profit to increase the company value. If the company reorients itself toward growth, the opposite happens. Specific costs decrease. There are pricing latitudes. Above all, however: growth-oriented companies radiate activity and vitality, and they are attractive to managers, employees, customers, and suppliers.

Obviously, business success cannot be attained without strict cost management as well. Cost reduction is the small step, growth is the big one, and the combination of the two is what assures success.

Fig. 1:
AT Kearney
Study

Long-term analyses such as the AT Kearny Growth Study 1999 prove that the companies with the greatest growth in sales are also able to achieve the greatest increase in value. Accordingly, companies that grow continuously at rates above the average for the sector achieve the highest increase in value. “Value Growers" invest mainly in core businesses and do not get bogged down in experiments. They are innovative and on known ground, they are also willing to take risks. Their portfolio shows internal and external areas of growth in well-balanced proportions.

Fig. 2:
Internal
Growth

Why isn’t internal, organic growth the sole answer to the growth question? There is nothing wrong with organic growth. It is and will remain the high school of entrepreneurship.

Organic growth cannot be arranged from above. It also cannot be achieved solely by capital appropriation. Internal growth that surpasses market growth requires a corporate culture that allows managers to be entrepreneurs, demands and promotes ideas and initiatives, recognizes performance, and accepts errors.

Companies that excel at this can achieve growth rates double those of their competition and thus achieve an above average increase in value. But look out! When growth rates are too high, say, three or even four times those of the sector, value increasing growth can easily turn into value destroying growth. Case studies show that depending on the capacity of the given market, the increase in value that was at first disproportionately higher than growth leads to below average increase in value and afterwards even reduction of value.

In short: The rate of internal growth has its limits.

Fig. 3: Bases of external/ internal growth

External expansion through acquisitions or other business connections remains as a strategic option in the competition with internal development. Growth through M&A transactions always makes sense if the economies of scope outweigh the disadvantages of integration costs, the risks of greater complexity, and the dangers of cultural tensions. If one figures in the “time” factor, the external expansion option in light of overall pressures as well as overall opportunities in many cases becomes a must that no businessperson can afford to pass up.

Acquisitions make it possible to overcome financial as well as regulatory market entry barriers. They reduce the risk of innovation in that the demonstrably successful innovator is simply bought. The critical “time to market” can thus be shortened considerably. Acquisitions also bridge large head-starts in technology, provide immediate access to capacities and quite often result in the acquisition of qualified management for dealing with one’s own concerns. And last but not least, buying the competition to calm the market can also be an acquisition motive.

Internal expansion steps are without a doubt more easily customized and they have a negligible risk profile. Nevertheless: Sole reliance on internal expansion would be more dangerous than abandoning oneself to the dangers of the M&A world. And these dangers do indeed exist.

Fig. 4: Process Overview

The M&A statistics of strategic investors are as stable as they is unfavourable. More than 50% of acquisitions cause the company value to increase at a lower rate than the sector average and can therefore be classified as failures. The rate of success in mergers is even lower. Measured in terms of total shareholder return, around 2/3 of all mergers are failures. In contrast, divestments, mostly in connection with focusing resources on core companies, in most cases lead to the increase in value of the ceding company. The fact that capital markets reward divestments and penalize acquisitions and mergers is something to think about.

The most frequent cause for the grim M&A statistic lies in the lack of planning of the transaction and the restructuring procedure during the M&A process. Insufficient planning, enthusiasm, disillusionment, confusion, searching for those at fault, punishment of those who were not at fault, and accolades for non-participants are well-known characteristics common to many M&A processes. It is so easy to do. Whoever follows the illustrated basic structure has a good chance of success. A similarly solid value analysis accompanies a solid M&A concept, which follows a phase (that must be professionally conducted) of the actual transaction and then results in an integration that is well-planned and implemented with resolve. If, however, emotional motives come into play, such as fascination with the size or the phenomenon of overestimating oneself, failure is usually the result.

Back to the rational approach: The economic goal of an acquisition can only be the sustainable increase of the value of the companies participating in the transaction. Or in IDW language: The sum of the cash values of future payment flows to the investors must be higher after the transaction than before.

Fig. 5: Synergies

For strategic investors, synergies are the typical tools of this wondrous value increase. Even though synergies are frequently overestimated, they do actually exist. There are negative as well as positive synergies. The negative ones usually manifest themselves on their own; the positive ones, however, do not. They must be developed.

Negative synergies come from transaction costs, the direct consequential effects of the transaction, such as the dwindling of the customer base, as well as the one-time expenses of synergistic effects that are later positive. These, in turn, can be grouped into three essential areas: economies of scale, economies of scope, and the effects of growth.

The positive result of the size effect can only be judged in the individual case. The digression of unit costs from production to management is evident up to a critical quantity. Above and beyond this quantity, bureaucracy and organization consume the advantages. One must not forget that greater production numbers, with new products, for example, also entail greater risks.

Economies of Scope are a special case of the scale effect. The idea here is to achieve competitive advantages through module and platform concepts or the creation of centres of excellence. The proofs of success are not clear-cut. Often the instigation of advantages that look convincing on paper is hindered by the complexity of the solution, the distance to the final product, and emotional resistance.

With the same priority, acquisitions and mergers create growth potentials that go beyond the going-it-alone concepts in business volume and margin effects and thus can likewise be classified as synergies. It is not easy to identify and implement them. They must therefore be concretely defined and integrated into a time framework. Otherwise, the danger is great that they will disappear with the lack of transparency of the day to day routine and either not happen or overlap with effects that could also have been achieved without acquisition.

Acquisitions of private equity firms end up without synergies. Nevertheless, they are more effective on the statistical average than acquisitions of strategic investors, even if one factors out the effects of typical LBO financing. This gives cause to doubt the synergy hypothesis, which suggests that synergies are the main reason for added value when companies join rather than go it alone.

It is a fact that simply removing inefficiencies can contribute to increasing results in acquired companies considerably more than can synergies. This is not a rebuttal of detecting and implementing synergies, but rather the proof that one should not rely excessively on theories but rather use common sense as well. It is also proof that the surest way to raise company value, also just as in acquisitions, is improved and more efficient management.

Fig. 6: The PE Concept

How are private equity investors different from strategic investors as far as growth is concerned? In principle they are not at all. They both focus their priorities on internal growth of their portfolio companies and supplement them with further acquisitions, so-called add-ons. Having the same goals, however, does not mean following the same path.

A private equity investor is not a sector insider. The entire transaction process is thus more systematic, more analytical, and more matter of fact than that of a strategic investor. If serious weak points emerge in the course of the transaction process, the purchasing process is then aborted. In contrast, strategic investors believe in their own ability to correct such weak points.

Outside consultants are employed in all stages of the process: strategy consultants and market research institutes or marketing consultants, then transaction teams of accountants and law firms and, last but not least, investment banks. The fund management, which even in portfolios worth tens of billions seldom consists of more than a dozen professionals, thus broadens the project’s capacity 3, 4, or 5-fold. The results show that it is worth it.

At this point it is a good time to mention that our host E & Y is a major player in several of these segments.

Another important difference: Like the investor, management is also a shareholder. This excludes conflicts of interests. The success of management is linked to the success of the fund. They thus inevitably act in concert.

In summary: Companies must grow if they wish to survive. Organic growth is good, but not enough. Those who want to be better than their competition must acquire. Acquisition, however, requires skill. The high rate of failure shows the major shortcomings of strategic investors. Private equity investors show how it's done.

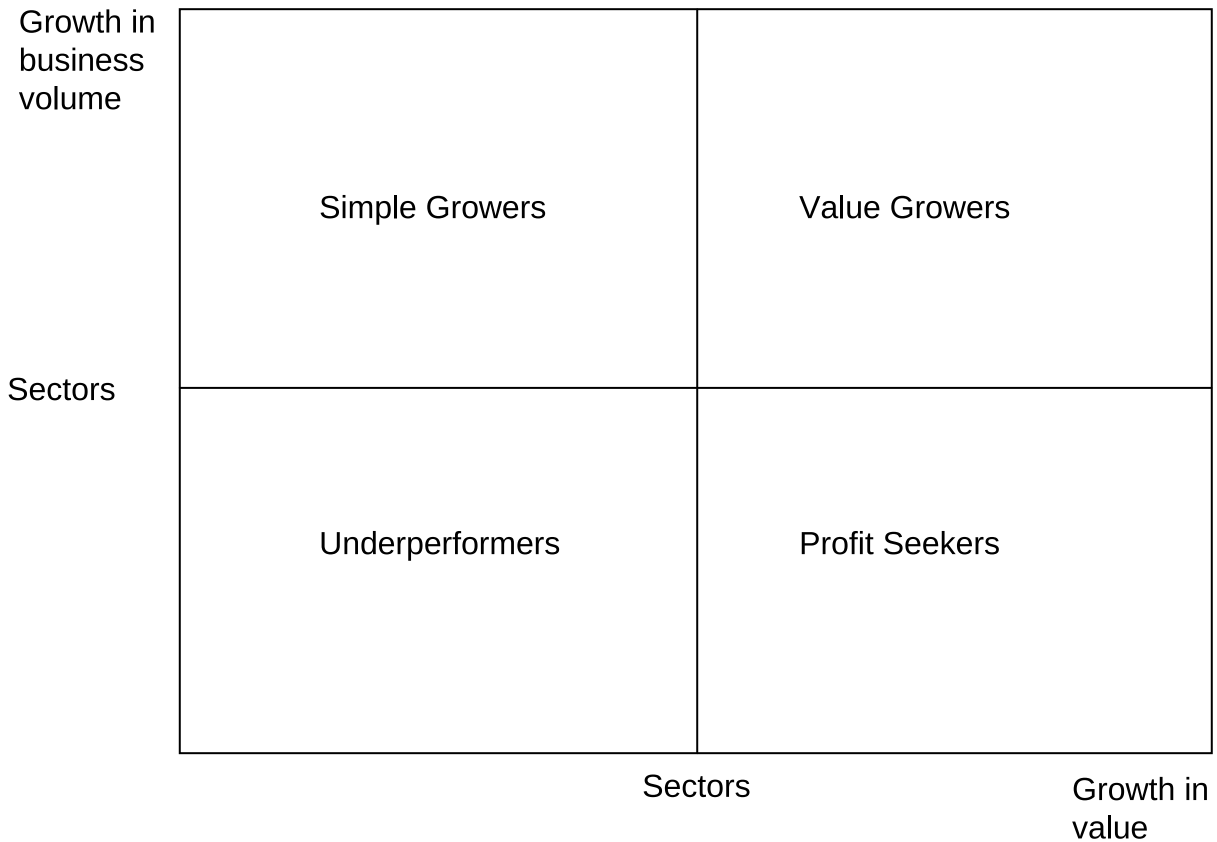


Fig. 1 Growth Matrix
(compare AT Kearney Growth Study 1999)

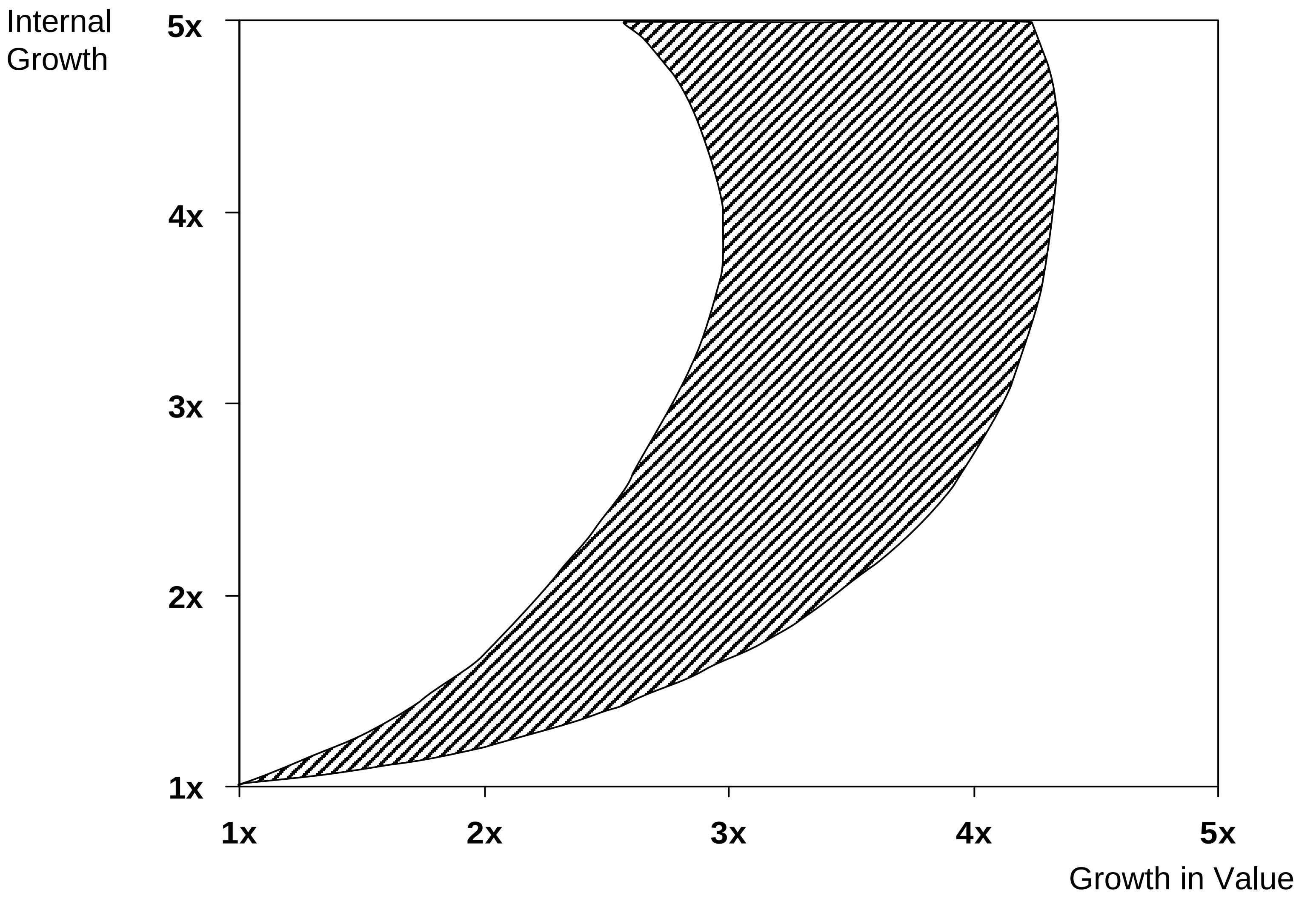


Fig. 2 Limits to Internal Growth (schematic diagram)

External	Internal
- Overcoming barriers to market entry - Reduction of innovation risk - Purchase of technology - Purchase of capacity - Purchase of management - Sector consolidation	- Tailor-made expansion concept - Less risk

Fig. 3 Bases for External vs. Internal Growth

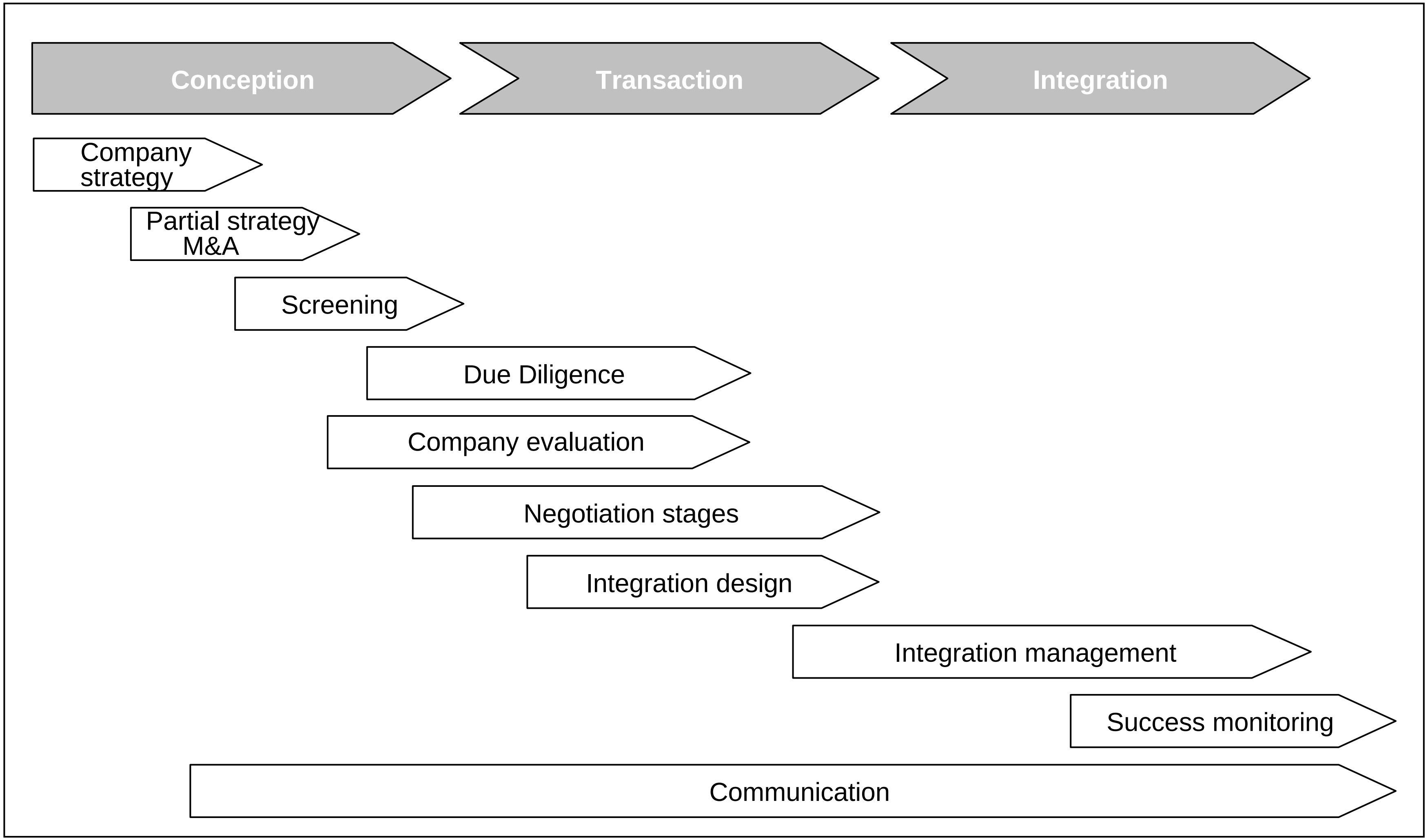
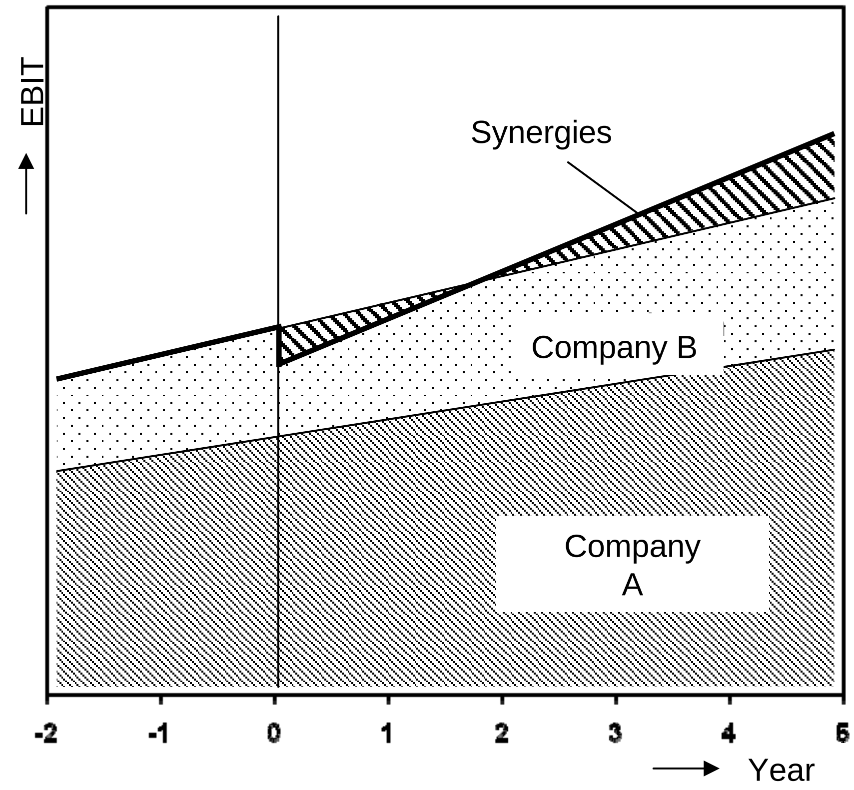


Fig. 4 Process Overview of a M&A Transaction

Negative Synergies

- Transaction costs
- Operative one-time expenses
- Dwindling of customer base
- Coordination costs
- Costs from less than ideal compromises
- Costs from self-absorption



Potentials for Synergies

- Economies of Scale
- Economies of Scope
- Growth Effects:
  - Expansion of the product palette
  - Development of new regions
  - Achievement of system suitability
  - Development of service-function
  - Opening new sales outlets
  - Development of new products
  - Acquisition of skilled management

Fig. 5 Synergies

Process Steps	Private Equity Investor	Strategic Investor
M&A Strategy	- Regular - Team mixed 1)	- Once in a while - Team internal
Screening	- Project related - MR external 2)	- Irregular - MR internal
Due Diligence	- Continuous - Team mixed 3)	- Partial - Team internal
Company Evaluation	- Market oriented - Team mixed 4)	- Fundamental - Team internal
Synergies	- Secondary - Team mixed5)	- Primary - Team internal
Negotiations, Contracts	- SPA - Team mixed 6)	- Purchasing contract - Team internal
Financing	- Project-related - LBO	- Unstructured - Concern financing
Integration	- Stand-alone - Target	- Absorption - Investor
Management Incentives	- Small fixed sum - High participation	- High fixed sum - Bonus, options

[Internal teams mixed with: 1) strategy consultant, 2) marketing consultant, 3) accountants, other experts, law firm, 4) investment bank, 5) strategic consultant, accountant, 6) law firm

Fig. 6 The Private Equity Concept in Comparison