CROSSBORDER
PMI ADVISORS

Value Creation Manual

Introduction

The primary responsibility of all company management is to create value. While there may be debates as to which stakeholders of the company should be recipients of the value, in the broadest sense of the term, value underpins the entire philosophy of the company. Whether the aim is to maximize financial returns for shareholders, or to provide a social contribution, or to provide superior quality to customers, all are linked to value.

The responsibility to create value is a constant in daily operations, and companies develop continuous improvement plans, execute on these plans and measure the value being created. This value is not something self-proclaimed, it is validated by the stakeholders themselves, through the stock price, through customer satisfaction, and through people retention.

While absolute value is current, value is often driven by the expectations of future outcomes and the risk of these outcomes. M&A represents a risk undertaking, it involves the exchange of a risk free asset (cash) for a business with expected future cash flows, both from the business and from the synergies anticipated from integration of the acquired business with existing operations. The risk is inherent in the acquired business itself, but in M&A exacerbated by impact of the deal on status quo either on people retention or on general business disruption during the integration. Consequently, there is an increased pressure to create value to earn the returns from the deal that the stakeholders expect.

In this Value Creation Manual, we explore value and discuss opportunities for value creation from each of the sources and provide guidance as to how to proceed to further analyze these opportunities and turn them into actionable value creation plans. This marks the beginning of the journey of creation of sustainable value.

What is value

Before we can discuss value creation, we should first understand the meaning of the value and how it is measured. "Value" can be defined as the importance, usefulness and monetary worth of something. In financial terms monetary worth is the principal measure. When asking about what is the monetary worth of something, then in most cases the answer is "what do you want it to be", i.e. value is the worth determined by the recipient. In the case of cash, the monetary worth is the same amount in the same currency. For other assets, we are reliant on prices determined by willing buyers and willing sellers. Some of these prices are quoted readily by liquid exchanges such as for marketable securities, but availability of reliable price data reduces quickly and value needs to be determined on a case by case basis after that.

In the case of a company or business, including those which are listed on exchanges, value is usually determined by one of four methods. Each of these have pros and cons, and even the most reliable of these ultimately resort to broad assumptions which can be subjective. These methods can be summarized as:

a. Sum of underlying asset values: This is one of the simplest methods, in which the value of the company is determined by the sum of the underlying values of it component assets, either by reference to the book values or some available market values. This method is flawed as it does not fully consider the value of an asset within the business itself, and also fails to ascribe a value to all of the underlying knowhow and intangibles. For example, this method is not appropriate to value an asset lite business like consulting.
b. Comparable transaction method: This method looks at the value attributable to transactions involving similar companies. This represents a true value of a deal between a willing buyer and willing seller, but is flawed as each company is different from each other and the motivations of the buyers and sellers and their perceptions of compatibility and synergy vary significantly.
c. Comparable company method: This is similar to the comparable transaction basis, by looking at stock prices as indicators of value of comparable companies as a function (multiple) of a financial metric (such as EBIT, or EBITDA), and not restricted to M&A. This helps reduce the impact of unlike companies, however, as no two companies are truly the same, this flaw still exists. However, the value of shares traded on an exchange vary from M&A, in that exchange prices do not consider the value attributable to acquiring all the shares of a company, and also do not consider the value perception of the buyer from compatibility and synergies.

d. Discounted Cash Flow (DCF) Method: The DCF valuation method is often considered the most sophisticated method used by academics, as it considers the precise contents of the target business. This method looks at the forecast cash flows of the business and the risk of such cash flows taking into account the time value of money. These forecast are often the subject of detailed modelling and simulations, but despite the detail, the cash flows are estimates, and so are many of the risk factors going into the discount rate (some of which are determined from “comparable companies”). Additionally, the valuation approach to outer years of a financial projection, which are by definition the most unreliable) are often valued using an assumption of a perpetual growth rate or terminal multiple.

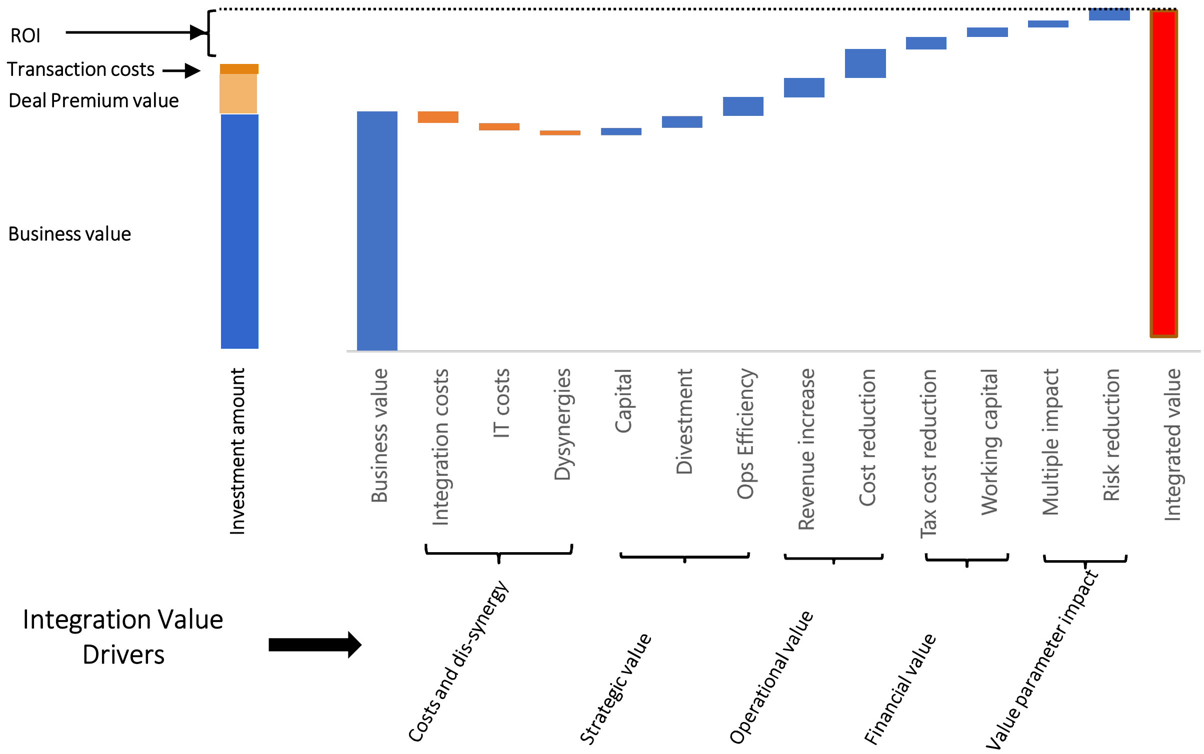
While there are inherent flaws in the first 3 methods, and there is flaw of “garbage-in, garbage-out” in the DCF, these are the methods used in practice. In this manual we shall examine value creation from the perspective of cash flow generated from operations and other, and the risk position from the impact of integration or the level of governance and control over the business.

The importance of value creation

The driver for value creation is discussed in the introduction above. However, its importance is illustrated by the value bridge overleaf.

During the M&A process, the value of the business to be acquired is determined, but in a competitive deal environment this is unlikely to be the price negotiated and paid. The Buyer will either offer or be required to pay a premium on the business value in order to “win” the deal. The amount of premium varies deal by deal can be substantial, and in tender offers premiums of 30-50% of market are not uncommon. A sophisticated buyer will have already justified this premium through the impact of control, reducing risk and through synergies during integration. A less sophisticated buyer, may simply agree to the premium with the “hope” of making it up, potentially justifying this by the avoidance of the impact should a competitor win the deal instead.

There will also be various costs incurred during the deal. For accounting some of these are considered investment costs, others will simply come out of post deal profits. Pre-deal costs include banker fees, financing fees, due diligence costs, and potentially not insignificant costs such as travel, should the deal be a complex crossborder transaction. All together a budget of 5% of transaction cost is prudent. Post deal comes the costs of integration from advisors, rebranding costs, further



travel, people retention, and of course IT, combined can easily amount to a further 5% of deal value. The IT transition cost has many variables and can be very significant. If the deal is a carve-out then the cost of separation and new licenses for the interim model may be borne by the buyer. Then further costs can be expected in moving to the target operating IT model. If the business is IT complex, large in scale, multi-geography, highly customized, data-mingled and transitioning between different platforms, the IT integration cost can be very substantial indeed.

From an operational perspective, especially in carve-out deals, a certain level of dis-synergy can be expected at least initially. In addition to these, in all integrations there is a real risk in underperformance caused by the distractions of the deal and the integration, and lack of focus on the core business. So in total, if there is a 50% premium, 5% each pre-deal and post deal costs, and for illustration 10% in dis-synergy and value dip, that only leaves 30% of the value of the business. This means value equivalent to 70% of the business value must be created before any return is achieved, and stakeholders also have a minimum expected return likely to be double digit. Returns on the deal less that stakeholder expectations will lead to a decline in stock price.

The above illustrates that value creation is not just an incidental "nice to have" objective, it is a must and potentially a very significant business imperative. Value can be found in one of 4 areas each of which are discussed in the following sections. These include strategic sources, operational sources associated with the planned synergies and business improvements, and financial sources. Value capture also requires a well-planned logical approach, accompanied by deep analysis, and robust change management. If properly executed, there is a potential reward of additional value from the impact of risk reduction and increased value multiples from the market associating the business with higher quartile performance.

The approach to value creation in practice

Continual improvement should be embedded in the operational Kaizen philosophy of any company, and with this comes continued value growth. However, step changes and significant value creation opportunities are generally associated with three events. Firstly, pre-divestment there is the chance to scrutinize the business to either identify any latent or remaining synergies, or to redesign the operating model to present a more attractive investment opportunity to potential buyers. The latter is particularly relevant in the case of carve-outs when the business is to be operated on a standalone basis.

Secondly, there are periodic strategic and operational reviews where value creation initiatives are identified and incorporated into business plans. In such cases the value creation initiatives are often prioritized and phased to ensure optimal resource allocation.

Finally, there is value capture of synergies during the integration phase following a deal. This includes planned synergies which were validated during the due diligence and those additional opportunities identified post deal.

The process of value creation is not dissimilar to any other business change project in that it would comprise a definition and assessment phase, a design and construct phase, and an implementation, operate and review phase.

The define and assess phase includes first the identification of the opportunity and a top down assessment to validate the feasibility and evaluate readiness. While the assessment begins top down, as the opportunity becomes clearer there is often a requirement for deep analysis to arrive at the final decisions. In addition to the size of the benefit, the one time cost and the complexity and risk of execution also require assessment, such that the initiatives can be prioritized into to waves beginning with the largest and easiest ones first before jumping into the smaller and/or most complex opportunities.

The design and construct phase begins with the completion of the initial analysis, if necessary, before mapping each opportunity down to specific task plans for the implementation. These plans should also identify dependencies and critical paths, and include implementation of a measurement system to monitor progress.

Implementation begins to execute the tasks using a controlled and managed process, with regular reporting of status, achievement of milestones, and capture of risks and issues for monitoring and decision on countermeasures as necessary. As initiatives become implemented their operation should be reviewed and monitored against the original plans.

The following sections review the specific approach and consideration across each of the major value capture areas.

Inevitable dis-synergies

While there may be little publicity about the subject, there are dis-synergies in all deals. The challenge is to manage them carefully and keep them to a minimum. To do this it is important to begin with to identify what the dis-synergies are. In carve-out deals, dis-synergies and the impact of the carve out on one time and standalone costs will be at the center of due diligence, but many stock deals include hidden carve-out elements. The main areas of dis-synergy include the following:

People costs: An important assessment in a carve-out is the organization carve-out and the identification of double hatting in the management of the vendor shared with the target business. If the buyer is unable to replace these activities, additional people may be required to operate the business on a standalone basis. While some of the impact of this can be managed by combining FTEs, to maintain appropriate management and segregation of duties some incremental cost is inevitable (e.g. a splitting business unit, will require 2 CFOs after the split). In stock deals the incremental headcount often arises for 2 reasons, a) replacing the strategic management or other activities performed at HQ, outside of the business being acquired, and b) fulfilling any additional management and reporting needs of the buyer.

Introduction of idle assets: In spinning off a business or in separating from the seller, shared facilities or assets are often identified. For facilities, these can often be handled by subleases without additional costs, however some space dis-synergies may arise (for reception areas, meeting rooms etc). Assets can be more problematical and the easiest solution maybe replacement, but this will come at an additional cost or lower utilization.

Loss of economies of scale: All groups have their own procurement arrangements for materials and other overheads and services which will attract volume discounts. In addition to volume, the discounts are often influenced by the status and negotiating power of the companies concerned. In transferring the business to a new owner, new volume discounts will apply, and if the buyer has lower purchase volumes, is less well known, or not as good at negotiating, then costs will begin to increase. This is often seen in cross-border deals, where the buyer can even be larger on a global basis, but at a local level less well known. A further challenge can be with purchasing from low cost countries, which can be broken down into international suppliers production in LCC, and “deep LCC”, ie local producers, which can be less easily accessible or manageable unless you have a strong procurement presence in that territory.

To measure the level of volume discount loss, a good approach is to look at the purchase volume of the target business as a percentage of the seller as a whole. The lower the percentage the greater the risk of loss of volume discount. Benchmarks can be useful in this evaluation.

Information Technology: In all M&A, IT represents a significant issue. In carve-outs, IT can be a significant dis-synergy from putting in place inefficient "quick fix" or temporary solutions to address the needs of the carve-out. There can also be increased license costs, people and other operating costs. In integrations, IT transitions and new system implementations involve often high one -off costs. However, there are often potentially significant synergies to be enjoyed from IT, from right sizing the environment for the target business or by taking advantage of cost savings from outsourcing or cloud migration that may not have been considered by the seller of the business. To fully understand the impact of IT, synergy or dis-synergy, a detailed analysis of the as-is, and to-be environments and related cost is necessary.

In addition to the area of synergy, IT is also a common cost feature, both one time and recurring, as an enabler of the operational changes in value creation, as discussed in the sections below.

Strategic sources of value

Strategic sources of value are those areas of value created through taking strategic actions, such as changing capital structure or through review of the business portfolio and undertaking divestment.

Capital Structure

There has been much study of the impact of capital structure on value, even attracting Nobel prizes. It is not intended to repeat or analyze this in detail, but companies should review their capital structure from time to time for value creation opportunities, and acquisitions and divestments present an appropriate time to consider in more detail. There are many variables in determining value, but there is no magical formula to determine what is optimal. Value creation opportunities need to be assessed on a case by case basis, with an understanding of the market sentiment at that time, and also to consider the market trends and reactions to other companies structures.

Basic valuation theory discusses determining value using a discounted cash flow approach by discounting future cash flows of a business by the weighted average cost of capital (WACC). WACC is determined determining the average of the cost of equity and the cost of debt weighted by the market values of the underlying debt and equity in the capital structure. If this weighting changes, then the average changes. As debt takes priority to equity in the liquidation of a company, debt is less risky and therefore attracts the lower cost (interest rate). Consequently one would expect the higher the debt weighting the lower the WACC and hence the higher the value.

A further enhancement to this analysis is that interest on debt is tax deductible, so the cost of debt needs also be reduced by the tax saving gained. This adds to the preference of debt over equity in the capital structure. This can sometimes been seen in private equity investments, where there is emphasis on the value creation effect of the highly leveraged model, even to the extent of undertaking “leveraged recaps”, where additional debt is raised to repay some of the equity holders, thereby providing a cash return, and restating the debt ratio and tax shield at the same time.

In reality, the above holds true, and that it is preferable to finance deals by the cheapest method possible. This would be using own cash (retained earnings) first, followed by debt, followed by equity. Debt and equity can have different sub varieties, such as mezzanine debt, and preferred stock etc.

However, the above theory only really works in marginal situations when the deal itself is small in comparison to the company as a whole and the additional debt being raised is a small percentage of total. As the earnings of the company are available to be paid out as debt interest or shareholder dividends, higher interest payments means the lower amount of availability for dividends. As earnings used in valuation are forecasts and subject to fluctuation, the higher the amount of debt interest, means the higher the risk that it may not be possible to pay the anticipated amount of dividends. This means there is much more risk and volatility, which means the cost of equity used in the WACC increases. Similarly as more debt is taken on the risk of default on interest payments can also increase, and consequently the higher the cost of debt becomes too.

In addition to the risk based issues on cost of debt and equity, as interest cost increases, it will reach a point when it no longer becomes possible to obtain a tax deduction, either economically or through thin capitalization rules. In practice, in addition to interest rate increases as more debt is taken on, the debt providers will increasingly impose covenants which will restrict the overall debt amounts.

All in all, the WACC will form a "U shape" with a optimal point possible. Determining this point, will be determined by business performance, macro-economy and many other factors including how the capital structure and dividend philosophy of the company compares of its peer group. To consider, the capital structure will need to involve a detailed simulation of the facts and circumstances at the time.

One issue that has not discussed above, is that of global deals. This requires even more simulation. The same factors of debt and equity need to be considered, but the distribution around the group is also important and any optimization of debt pushdown. This will mean the tax deductibility of interest and tax rates differs by country, but also there may be differences country by country of the amount of cash which may be repatriated to HQ and the ultimate shareholder. If cash becomes trapped in anyway, this impacts the overall valuation hypothesis of "free cash-flow". A further and much more complex issue in such global deals is the currency of the debt and its impact on hedging the foreign currency cash flows and it treatment in valuation. This is discussed in the financial sources of values section below.

Portfolio Management

At the time of an acquisition, there is often a limited ability to pick and choose and some of the businesses acquired include areas outside of your core strategy. In your core business too, as your strategy changes over time, or as markets change, some businesses become less core, or begin to perform at levels lower that desired.

In the same way as value is determined cashflows as discounted by a WACC (with the WACC being the average cost or return expected by capital holders), any business with cash flows producing a return on invested capital lower than expectations can be said to be destroying corporate value. In such a case, urgent action should be taken to either improve the operating performance, or to get rid of the business by divestment or closure.

As a result, to support value creation the groups activities should be analyzed periodically to ensure current activities are generating value. This requires a combination of deep financial analysis and strategic analysis. The first cut would be to analyze activities into those fully aligned to strategy, those not aligned, and those in the middle ground. Those aligned you will have a tendency to retain, and those not aligned you would seek to divest or close. However, strategic analysis is only one consideration and understanding the financial return position is also important to drive your ultimate decision making.

To determine the financial return requires a complex and detailed segmental analysis of both cash flows and related capital (assets). However, this analysis needs to be performed on a like for like basis, by analyzing cash flows and assets directly relating to the business, those cash flows and assets shared with other businesses which would change should one or more businesses be divested, and those which would remain fixed in principle. An simple example of each of these could be (respectively), the cost of a salesman (and related assets) 100% dedicated to business X, the marketing department producing pamphlets e.t.c. for all business, and the group level sales director and strategy group. When considering business X, the items in the first group are allocated entirely to that business. The group level items support the entire group, and are essentially fixed costs for the group irrespective of whether business X is performed or not. If business X was substantial, then divestment may enable scale efficiency changes at group level. Similarly, business X would require replacement support for group activities either if to be standalone, or acquired by a new group. The middle group of activities require careful analysis and allocation to individual business, and also confirmation whether such costs or assets are fixed or variable.

This enables all businesses to the be classified between the strategy classification (In, Out, Neutral) and the financial performance (negative return, positive return less than target, greater than target return) both on a contribution basis, and full absorption basis. This facilitates a decision making process. Anything out of strategy is a candidate for divestment or closure, however, if these businesses are making greater than target returns, the divestment timing may be deferred if supporting emerging strategic businesses. Any business making negative returns is a candidate probably for closure, however, these may be retained if they are a loss leading part of strategy. This is only indicative, and future improvement of returns, need or lack of need for additional investment, ability to adopt alternative operating models, in particular in divestment, and also the impact on stranded costs of the group following a divestment are all important factors for value creation.

Operational improvement

Behind all assessments of value are the cashflows of the business, the biggest driver of which are the underlying operating profits of that business. It therefore goes without saying that operational improvement will drive the creation of value. In addition to the absolute amounts of profits, the performance metrics of a business both financial and non-financial when compared to a peer group, serves as a measure of operational excellence and the level of risk. Performance improvement to create a best in class operation helps the business achieve premium values at the upper end of the range of possible values. There are eight drivers of operational cash flow, seven of which are profit driven. In addition however, all drivers require enablers to support their sustainability, and the cost (or savings) of the required enabling functions for all operational improvements should also be considered. These drivers and enablers are discussed below.

Operational efficiency

Each of the operational improvement areas, can be classed as either an efficiency, an effectiveness, or an optimization. An efficiency is defined as a possible cost reduction in achieving a fixed result. Effectiveness is a possible improvement in an outcome from applying the same cost to alternative activities. An optimization is the most profitable combination of outcome and cost for a given performance hypothesis.

While efficiencies can be considered throughout the organization, the scope of efficiency at a micro level is broadest in manufacturing sites, where lay-out, and activity scheduling can have significant impact on the time and cost of input.

To understand efficiency of the input and process, it is necessary to define the desired output or range of outputs in terms of overall production volume. Then for each product or range of products the manufacturing process should be mapped out into stages understanding the materials, labor effort, equipment and utility needs. This then develops a production plan, which can then be tested for efficiency. The determination of efficiency can be determined cost item by item, considering both internal factors and also external factors by benchmarking against any best in practice peer groups, which may be available.

For labor, it is important to understand the number of people, by activity, and define the number of shifts, and targets for overtime etc. Activity should consider direct activity, break scheduling, training, shift changes, maintenance activity etc.

A higher level of labor efficiency analysis comes in the cost benefit analysis of automation, which leads to the efficiency of machinery and process. This would look at set up time and the impact of changes in batch size and its trade off against inventory holding cost.

Understanding the cost of quality has many levels. Firstly, there is the level of scrap, but a clear analysis of time in the process into inspection time, rework time and the correlation between them provides a guide as to any redundant steps. Can inspections be reduced without impacting the level of rework. Is data captured on root causes to know how and when to change the process to reduce scrap or rework, or to determine if the issue is a process issue or a design issue.

Similar to quality, is the machine overall performance, and the level of maintenance. Is maintenance cost understood and its relation to production time. What are the levels of unplanned maintenance time. The area of maintenance is also an area for analyzing and considering the balance of internal versus outsourced maintenance.

The cost of infrastructure can include the use of the various utilities in the process, and in the waste process. For each of these, the alternative sources, and applications need to be considered, and also the availability of often local incentives or environmental factors. Can power be generated inhouse, as opposed to purchased, can surplus generation be sold. Are there local sources of water, and what are the specific local environmental restrictions on water discharge, air discharge or noise limitations, that need to be considered.

While supply chain is considered separately, internal logistics is an important factor in production efficiency. One component of this is the management of inventory obsolescence at both material and product levels. Another is the control of loss or damage during packaging and whether the design or process here is optimal. Finally, the site layout, use of trains or automation between stages and subassembly holding points should be analyzed to minimize the cost of movement through the production process, and the existence of road-blocks.

Finally, there are the macro level considerations of production and whether the production strategy is aligned to corporate strategy. Is automation and outsourcing appropriate. Is production engineering efficient, and is there an appropriate level of co-ordination between sales and marketing, R&D, production, engineering (and packaging) at the design phase of new products. It’s important to avoid needless cost wastage from misses such as designing square parts to fit into round holes.

Asset Footprint

Consideration of the asset footprint is a strategic macro issue, which is important to get right, as changing the footprint is often costly and has a long lead time. However, such footprint considerations are a common feature in M&A especially involving multiple overlapping locations.

Considerations going into the determination of the asset footprint can begin with understanding the capacity and utilization profile of the group, and also comparable unit direct costs. Next is understanding the relative activities, interdependencies and any specific skills or other requirements. While machinery can be potentially relocated, it often much more difficult to relocate people en-masse, and careful consideration should be made around the trade off between reduced direct cost, and maintaining production quality and or other efficiency.

In considering new sites, these can be driven by changes in customer and supplier base, but also by the levels of variable cost and also maintenance (Older offices may have cheaper rent, but require more maintenance or running costs). Then there is the consideration of operational efficiency and necessary. This can sometimes get sensitive and include the themes of moving back office locations from expensive city centers to remote suburb locations, which can lead to significant savings but often at the expense of decreased morale, higher staff turnover, increased commute expense, and unforeseen operating issues.

Related to the footprint question is the cost benefit analysis of buy or build, and insource or outsource decisions, and similarly understating the optimal fixed cost implications in high growth or volatile market conditions, one time cost of footprint changes, and the stability of some of the cost drivers behind the footprint decisions. Recent history has shown the "low-cost" facilities in certain areas of China a few years ago, for example, are now very costly either absolutely, or as caused by staff turnover and excess retraining cost.

Supply Chain

In all manufacturing and supply organizations the supply chain is such a significant component that small percentage savings can drive significant values of value improvement. In M&A, the acquisition of the target company with its own purchasing function and supply chain, often provides large and visible value creation opportunities, but realizing such synergies without disrupting supply requires careful planning, and in cases where material source is a disclosure to (or requires approval of) the customer, such savings may have a long lead time.

Supply chain considerations include those at a strategic macro level and at a transactional micro-level. The strategic issues are largely related to supply chain design and the ability to secure stable supply of materials and be able to provide stable customer service and cost performance. Sourcing involves the strategic consideration of low cost sourcing versus the risk of stability and quality. Purchasing from a low cost country, could involve purchasing from known international players based in that country, which provide a certain level of stability and cost saving, or achieving a often much more significant local-local supplier with unknown stability and quality.

The next considerations include supplier concentration, economic order quantities, efficient inventory holding policy, warehousing foot print and logistics. Each of these add a cost element to the overall supply chain and need simulation. The warehousing consideration is also likely to consider if there is a difference between direct purchase or purchasing through a local affiliate, when there is a potential tax leakage on the affiliates local profits from buying and on-selling. On importation, it is also important to consider the benefits, but associated compliance and running costs, of bonded storage or free trade zones. With logistics, the decision could be between internal or outsourcing, sea or air, and also shipment size to align with container specifications. All of these will similar influence the hub and spoke decisions of warehousing versus customer fulfilment and any variations to shipping cost or delivery lead time. In some industries with lean or just in time processes, the customer is likely to have rigid specifications to build into the supply chain and more-so into your production planning process. Similar issues to supply chain can be replicated in customer service centers, maintenance and aftermarket parts.

Purchase order quantities are a component of the inventory and logistics decision, but on a much higher level centralization of purchasing or at least supplier negotiation can bring with it significant cost advantages, from supplier bundling. Again this needs to be risk validated to avoid too much concentration, and supply disruption like that seen in certain industries which had a significant supply base located in the region effected by the Japanese Tohoku earthquake and tsunami.

Overhead Reduction

The problem with overhead is that the devil is in the detail. Irrespective of the level of control in an organization, the scope for overheads to creep is substantial, especially in cases where there is significant growth or diversification or of course shortly following M&A.

With business units, management are focused on profitability, with overheads the question to be asked is about value add, and at a much higher level duplication around a group. Benchmarking headcount and cost by function can support a view of the overall saving ability, but deeper dive and activity analysis can provide surprising results, and potential for savings are always possible in large groups. It is not unheard of for different people to be hired around the group to undertake the identical task or analysis, similarly large companies can find that they can pay multiple times over for the same data or publication.

The top down approach to overhead reduction will come from a analysis at the lowest level possible of the costs and headcount by function and activity. This can then benchmarked against peers or available industry data, but it can also be internally benchmarked between divisions, countries, and also trends over time. Cost categories showing relatively higher increases over time are candidates for closer examination.

Once candidates are identified detailed analysis can seek to identify the cost savings. Potential approaches and common opportunities by challenging the as-is state include:

- Analysis of use and performance monitoring of external contractors
- Centrally controlled detailed job descriptions, with challenges of duplications
- Indexing and sharing (in libraries/data-warehouses etc) of data analysis both internally produced and externally purchased
- Central logs of data or publication purchase, subscriptions, memberships etc, to avoid duplication and to leverage discount negotiation
- Central control, or at least central logging of all external contract and contract terms,
- Review of airline, rent-a-car, hotel use, for additional volume savings, and or compliance with existing regulations. Preferred provider programs, especially with long haul travel, can provide significant savings.
- Control over purchase of software, applications, and technology peripherals
- Use of corporate credit cards, which often provide for substantial group level kickbacks

This list could continue, but a similar common sense approach, searching for standardization or centralization helps to support leverage in negotiations. Similarly, the creation of sensible group policies and monitored from both a value add and compliance perspective help keeping focus on such costs.

Revenue Enhancement

Revenue growth is a frequent theme of most synergy plans in M&A, with the ability to cross sell products through the different networks, being a common feature. Often such statements are made without detailed validation or planning and in reality the amount of cross-selling synergy becomes a disappointment. However, in M&A and even in a steady state review there is an opportunity to create value from straight revenue enhancement.

First, there is the strategy side of sales, which can enhance, or at least protect, by being ahead of the curve, by understanding market needs and trends, and acting accordingly to be a first mover and leader as opposed to a follower playing catch up. This requires close collaboration of the sales function and the R&D or design functions to maintain the competitive advantage.

While cross-selling is a real prospect, focus on and strengthening account management is a pre-requisite to realizing this target. The sales function should be aligned to the specific markets to which they are selling, each of which have different characteristics, but quickly moving to sales alignment across the group, with clear responsibilities and aligned incentives important. This includes:

- Clear account priorities and consistent terms
- Account responsibility and common face to the customer, clearly focusing on common customers after M&A
- Moving to the best of both worlds but managing cost when aligning terms, prices, logistics etc

Also linked to cross-selling is the detailed analysis of product portfolio in terms of product specification, price point, and profitability. This analysis enhances revenues by minimalizing cannibalization by internal competing products. This also supports the brand positioning and marketing spend decisions. In some industries, this detailed analysis can identify price elasticity at product, region, timing, and customer level, which could indicate opportunities for price increases, without volume impact, or volume driven profit improvements from price decreases, which will immediately drive additional revenue and profit.

Increased marketing spend can also drive revenue, and it is a difficult question as to whether sales determines available spend, or whether spend determines revenue. The business marketing function will want to gather data and intelligence to answer these questions, and keep track record of historical marketing effectiveness. In the end, marketing can be considered an investment cost and the same considerations of return on investment, apply equally at the macro level, the middle ground advertising and marketing, and the micro-level selling activities.

Sales Channel Rationalization

The deep analytical approach for price point changes supplemented with market intelligence is also a driver of value from sales channel rationalization, or differentiation. The types of sales channel adopted will vary by type of product and market dynamics, but multiple channels are available, as shown below:

Direct selling using sales reps	***Resellers***	***Wholesale***
Sales outsourcing to third party networks	***White labeling (your product sold under others branding)***	***Export***
Retail sales	***Direct marketing***	***Agents***
Automated retail through kiosks or vending machines	***Value Add Resellers***	***Multi-level marketing***
E-Commerce	***OEM sales***	

A sales channel represents a route through which an end customer sale can be secured. For success, each channel will have different direct cost bases (for example own sales people or not), with have a different cost of distribution, and will require different levels of advertising and alternative marketing. While the product being sold may be identical in all cases, the price point to the market may differ, reflecting the different levels of value add, potential for after service, and even brand premiums. Each of the above sales channels, also involve third parties and the risk and rewards (ie. Profits) will be shared by each participant involved.

The decision on the optimal sales channel will depend on your company's overall strategy and appetite for risk, and the support provided by detailed analysis. The analysis, however, is more than a pure financial calculation, it needs to consider the broad range of customer reaction, and ability to influence and grow the ultimate market demand. An example here could be the choice of retail versus wholesale, where you may be able to reduce inventory risk or cost to market through adopting a wholesale strategy, but you reduce your own price point, and have reduced ability to direct respond to changing customer trends. You also need to consider the action of competition, and carefully manage any potential conflict or cannibalization should a multi-channel strategy be followed.

Commercial Optimization

Commercial Optimization is about trade-offs to reach the optimal profit position and optimal value. In many of the above mentioned operational drivers, a certain amount of trade-offs are considered. Your pricing strategy, and sales channel strategy each involve an analysis of optimization.

Henry Ford's is famously quoted as saying "you can buy any colour of car as long as its black". This is an example of a commercial optimization. Reducing the number of potential colours, reduces the changes in the painting process, which increases efficiency of production and potentially also enables knock on volume discounts in paint procurement. The trade-off is customer choice. In Henry Ford's time, then customers had very few alternatives choices or car, and so the impact was minimal. Today, with a wider variety of choice, reducing your offered colour range, could impact customer demand.

Many of the commercial decisions come down to some portfolio decision or strategy. In addition, to colour, it could be size range, other technical specification, packing or shipping policy, payment terms, or the like. To what extent should you try to meet all customer requirements, if fulfilling some will earn lower that your expected profit levels, or may even be loss making.

Each of these decisions again requires detailed analysis of the consequences, and a deep understanding of market sentiment. This can be significantly influenced by the culture of the market, and also your philosophy or desired reputation. Customers in some market are happy to buy lower quality product (for a lower price), accepting a higher/quicker failure rate, while other markets may insist on high quality and reliability. Getting it wrong significantly impacts the value perception. Subject to your philosophy, you may wish to follow a strategy of a premium high quality provider, thereby giving you potential to elevate your position to one of lower price elasticity.

However, each optimization decision may also become a complex portfolio discussion, or a brand positioning discussion, with decisions on one part of the portfolio, being important to the others. For example, continuing with a lower profitability product, may be required to achieve the recognition to support the sales of other products.

Enabling Functions

Enabling functions are included here, not directly as an area of operational improvement, but as an essential step for realizing the improvements discussed. By enabling functions, we mean any function which enables the smooth operation of processes and operational management. These include areas such as technology and other areas such as finance and HR management. Additionally, compliance or philosophy related functions could be considered as enablers of the desired operating style of the company.

In any operational improvement or other change through pursuit of other strategic options, such activities are not one off actions, but are actions which must stick and become embedded in the underlying business processes. Such changes may be simple system modifications or introduction of new levels of reporting, but in other cases, a whole new infrastructure may need to be considered. For example, if a consumer products companies decide to introduce an e-commerce sales strategy, not just the e-commerce platform, but the reporting, supply chain, and marketing functions (among others) will require significant modification or extension in order to undertake the new business.

In all assessments of operational improvements these enablers should not be ignored. In improvement of existing business, such changes to enabling functions appear to be a cost or negative value element, but this is not necessarily the case. If value is captured from operating improvements through doing things differently, then similarly they are enabled differently, and likewise there is an opportunity to drive value through efficiency changes in enabling functions. If the value creation initiative involves divestment of a business or the cessation of an activity, this should be the trigger to examine the enabling function infrastructure to “right-size” for the post improvement environment.

Efficiencies in enabling functions may also available in a steady state, no-change, situation, through each function embedding a continuous improvement kaizen philosophy. Changes such as migration to the most efficient new technologies provide value creation opportunities.

Value creation, and enterprise wide awareness and incentivization of such, should be considered as a core management objective.

Financial sources of value

Financial sources of value are the technical areas of the back office where significant value can be created or eroded. Generally these are associated with accelerating the cash inflow or deferring the outflow, but can produce absolute value improvements.

Working Capital

Operational improvements are generally based around the operating result or profits. However, value doesn't comes from profits, it comes from cash. Profits of the business, however large, are a meaningless set of numbers unless those profits can be turned to cash and paid out to stakeholders. One of the main bridges here is that of working capital, comprising receivables, payables and inventories.

a. Receivables. Receivables are sales recorded which have not yet been paid for by customers. The principles of value creation would suggest increasing the speed of settlement and reducing the risk of non-collection. Improvement the speed of cash collection is more than just a simple matter of pushing customers to pay earlier, though this may be an option. This requires a careful assessment of the customers credit worthiness, their purchase volume and how the customer evaluates your sales price versus payment terms. Step one, as with many improvements is a detailed analysis of the as-is position, how it benchmarks against competitors, and the value creation potential of accelerating payment or reducing risk. This can then be compared with cost of receivable insurance, effect of settlement discounts, and price volume effects. Next is the decision on whether to demand customers accelerated payment, make discount offers, or whether to keep cash flow improvement internally. Simple actions in account management, such as aligning your invoicing processes with any customer cut-off dates, or introduction of auto-settlement through direct debit or similar, can have a one time value enhancing effect.
b. Payables. In the opposite way to receivables, a value uplift can be achieved through delaying settlement to suppliers. Again this should be considered against the risk to price concessions provided by those suppliers, the attractiveness of settlement incentives offered, relative power of your company versus that of the supplier and the practice of direct competitors. These can all be assessed through benchmarking and annual reviews by procurement.
c. Inventory. When considering cash flow, it would appear obvious to want to receive money from customers before you pay suppliers, but in most industries, this proves difficult because of the inventory holding and manufacturing process. Inventory comprises any raw materials feeding the

production process, products in the process of production, completed production not yet sold, and any products purchased for resale. As an absorber of cash resources, to create (or preserve) value, inventory should be kept a minimum. Easy to say, but countless companies struggle with the complex dynamics of inventory management. Efficient inventory management requires discipline, adoption of advanced management techniques and robust technology linking demand management, sales, production planning and procurement, with real-time update and feedback loops. There are libraries of texts which discuss these areas extensively, but some key considerations include:

- Efficient ordering: Optimization of inventory considering the cost of purchasing versus the cost of holding the inventory ordered.
- Just-in time manufacturing: Attempting to avoid inventory build-ups by arrival at the precise time and location for each production stage
- Even production (Heijunka): increasing efficiency through standardizing production
- Process Kaizen and continual improvement and learning
- Waste elimination
- One-piece flow: Production planning to achieve even workflow flow of production stages, elimination transition time between steps.
- Quality improvement: Through built in testing, automatic defect checking (jidoka), or mistake proofing techniques (Poka-Yoke)

The above are improvement processes in there own right, but implementation and/or step changes will follow the process of defining the customer value proposition, mapping the value flow, creating an efficient flow leading to a customer pull through, as opposed to the push, and eliminating the waste and redundancies.

Asset Financing

There are many forms of asset financing available, but whether any have a significant impact of equity value depends on the underlying terms. Each scheme needs to be simulated on a case by case basis, but as asset financing is essentially using the assets of the companies to raise cash, the considerations are similar to those in the capital structure discussed above. Asset financing can however attract various accounting treatments (on or off-balance sheet treatment), which may impact the perception of value by analysts subject to the level of disclosure of each scheme, such as suggesting a lower level of gearing than actual.

Common asset financing schemes include:

- Lease or Buy considerations
- Asset sale and leaseback
- Receivable securitizations
- Special purpose vehicles and partnerships.

Foreign Exchange

For global businesses foreign exchange represents a significant challenge, and strong FX management is important for value creation or value protection. FX is an important factor in trading in foreign currencies, and also ownership of investments such as foreign subsidiaries. A simple example is purchasing something in a foreign currency. While you record the purchase based upon the exchange rate at the date of purchase, the ultimate cost could be higher if the exchange rate changes before you pay. A similar effect impact is experienced with selling product. Sales and purchases however, generally are short term events and the exchange risk can be protected (at a known cost) by hedging. FX management becomes more complex when considering long term budgeting, but the impact can be minimized hedging forward.

Foreign operations and foreign investments are more complex. When such operations are established or acquired, investments are determined based upon financial performance and cash flow projections. However, such cash flows are in foreign currency, and over a long term period as considered by a valuation the impact of exchange rate fluctuations can be significant. Similarly over a longer term, cash repatriation to the parent and onto to the ultimate stakeholders doesn't necessarily follow operating cash flow, as exchange controls and rules on earnings distribution exist. Over the last 50 years the US dollar has moved over 150% against the UK pound and a similar rate against the Euro since its introduction, and 350% against the Japanese Yen. Economic theory links exchange rate movement to differences in cost inflation (also a cash flow assumption), differences in taxation and interest rates (a component of the cost of debt), but there is no hard formula to eliminate the risk, and hedging instruments do not contemplate such long term scenarios. The closest you can get to risk minimization is investment hedging and underlying sophisticated cash flow simulation to minimize your exposure.

Investment hedging can be compared to "apples and oranges". Cash flows in each currency are considered separately and are financed ultimately by external capital or debt in the same currency. (In simple terms if you buy a US$ asset generating US$ cash flows, you should borrow US$ to do so). In reality of course it is much more complex as the US$ asset (subsidiary) probably also has foreign currency cash flows of its own. A more sophisticated but more complex approach would be to break down the cash flows of each member of the group into the underlying transactional currencies, and build up a “like currency consolidation” to map out the cash flow footprint and then design group financing as a blend to match the footprint. However, in developing countries, product purchases are often imports purchased in mature currencies, but sales and local expenses are in denominated in local currencies. If there is a large proportion of “exotic” currencies, you will need to resort to financing in the currency which is most closely followed by the exotic one. (for example the trends in the Polish Zloty or Central African Franc closely resemble those of the Euro, which can be used as a de-facto hedging currency.).

Taxation

The value creation opportunities of tax planning are real. Tax planning should not be confused with tax evasion, but at times can become confused. Value creation is concerned with creation of enhance cash flows returns to stakeholders. While tax authorities (home and overseas) can also be considered as stakeholders, value is more often than not determined after tax has been settled, thereby increasing the importance to manage the group direct and indirect tax expense.

There is an entire profession and libraries of text books on the subject of international tax planning, and this manual doesn’t seek to duplicate these. Tax planning is important to value creation because each country in which you do business has its unique set of tax rules, these specify, among many others:

- What entities are subject to tax (Corporations, branches, partnerships etc).
- What types of income are subject to tax, and how is income classified by source (eg, trading profits, investment income, financial income, capital gains, other specific income of an industry type (eg. Forestry, real estate, financial services)
- How the taxable income from each source is determined and how tax is calculated
- What types of transactions are subject to indirect tax through addition (VAT, Excise, Stamp tax, duties etc) or withholding (Salaries, interest, royalties, dividends etc)
- How are indirect taxes calculated
- Tax reliefs available (including credits for tax incurred in other countries)

Step one in any tax planning and value creation plan is to understand your global business profile (asset ownership and utilization, income types and expenses etc) and all the different components of the countries in which you operate.

For international transactions involving more than one country within the group, it is important to determine how income gets shared between countries. Here another set of rules comes into play, Transfer Pricing Regulations. While it goes without saying if you earn profits from the same transaction in more than one country, you would prefer to have more income in the country with lower tax, Transfer Pricing rules set the basis for determining what is an acceptable level of profit to be earned in a country, which are normally linked to transactions between unrelated third parties. However, there is often conflict and lack of clarity, even though the OECD has its own guidelines, and analysis and defense documentation is recommended.

Intercompany charges for HQ services, brands, IP, and interest, each require separate analysis. For interest it is also common to have thin capitalization rules restricted tax relief on interest on intercompany lending. Another important consideration is the Tax Treaties between the countries concerned, which are pre-agreed principles between governments on the taxation of transactions which involved two countries (eg. Which country gets to tax the capital gain, withholding tax on interest and dividends).

Finally, a subject often talked about is tax havens. Some countries impose little or no tax, or tax in a particular way making tax on a certain income much lower than in other countries, or have treaties which are very favorable, that it is desirable to use one country over another as a party to a transaction, or as an owner of investments. These differences continue to exist and should be considered, but many countries are tightening their treaty shopping and tax haven rules, reducing the value impact in the longer term. A word often used here is “substance” and “business purpose”. In a trading relationship between country A and country B, why is a large amount of business income channeled through an entity in the Caribbean?

In all tax planning, rules change, and so what may be best now, may not be the best in the future. While the future is unknown, any plan can include contingencies in the event of adverse changes to the global landscape affecting your company. Making changes for no reason, raises red flags to any tax authority and so care should be taken and in each case defense documentation prepared. Fortunately, an M&A transaction provides such a significant event, where structures can be changed in anticipation of the post deal operating model, with many reasons of substance to support changes. As a result, the post deal value creation plan, should include a detailed tax plan for execution upon or very closely following the deal or post deal re-organizations.

The bottom line is to consult an international tax expert and model out or simulate the impact of your tax structure.

Enhancement of valuation parameters

In all of the above, we have considered the impact on cash flow on value, with the premise of increasing or accelerating the amount of cash available for stakeholders will create additional value for them. However, other factors to the amount of hard cash, can also have a value creation effect and should not be ignored.

Risk reduction

In the section above on "what is value", we discussed the impact of risk. Value is a measure of the current, cash flows arise in the future, and in the time between now and when the cash is crystallized, the accuracy of the future hypothesis can change. This is risk. Risk can come from a variety sources both external, such as the economy, changes in market demand for your product or services, tax rules etc; and internal, such as internal controls, performance of people, ability to negotiate or keep ahead of the market. Managing this risk is extremely important not just in protecting value but can also be used to create value, by communicating and demonstrating to the market that your company (and it's forecast cash flow) is a lower risk proposition that other companies. It is emphasized that both the communication and demonstration points are important, just saying you are low risk, when evidence from, say, missing a quarterly performance target demonstrates otherwise.

Steps which can be taken here to reduce risk, and create value are:

a. Implement Enterprise Wide Risk Management (ERM) practice. This, like quality assurance practice in manufacturing and business processes, is a practice to document risks both macro and micro throughout the group, identifying effects, outlining plans to mitigate or other countermeasures, and putting in reporting processes to monitor and to trigger actions. These should be part of regular board and stakeholder reporting.
b. Adopting "Best Practice Governance". This is a broad area but covers the overall organization design. What is appropriate depends on your overall size and complexity, so as to avoid incremental costs of enhanced control and governance exceeding the value benefits obtained. In smaller organizations, clear rules and internal controls to operate and monitor compliance may be sufficient. In larger organizations, independent committees covering internal control and audit, executive remuneration, ERM, Ethics and Compliance may be more appropriate.

c. Tone (and behavior) from the top. Top management messaging around purpose and values, both externally and internally, can help promote the "under control, low risk" image
d. Incentives and KPIs. Embedding purpose, behaviors and value creation into daily activities of all levels of management and staff, helps create an environment where collective activities will achieve the purpose and will create value. Aligning KPIs not just with strategy, but with business purpose objectives, and to the creation of value, helps to ensure people are rewarded for doing the right thing, and become motivated.

Valuation multiples

Risk is measured by a discount rate used in valuation calculations. Risk can be absolute, but it can also be relative to a peer group. This relativity comes in the selection of a risk premium, and volatility with the market.

Valuations also consider corporate value comparison to underlying cash flow conditions, and it is common to discuss value as multiples of EBITDA and similar.

The key to both of these analyses is peer group comparison of similarly valued companies. Demonstrating that you are a lower risk company, can put you in a peer group with a higher value multiple than others, or rank you closer to the top end of the range. Your cash flow performance from your value creation plan coming from all the activities listed in this guide, can similarly lift you up the rankings. If you turn a greater % of your customer sales into cash available for stakeholders, you may also be considered to be in the higher end of the range valuation multiple group. This may sound illogical, but the effect of a sound valuation creation plan could mean not only higher absolute EBITDA and cash flow, but for every dollar of EBITDA, stakeholders may ascribe a higher % of value. This is the double impact of Value Creation.

In Summary

As discussed at the start, in M&A, the success of your deal depends on your ability to create value. In all M&A, there will be transaction costs, there will always be premiums paid to secure the deal, there will always be integration and post deal costs, and also pressures on performance due to slips in employee motivation, or taking the eye of core business performance. The gap to provide stakeholders with the return on investment they expect comes from value creation. Your management and deal teams will (hopefully) have synergy plans, but there can also be additional value creation opportunities out there.

In a non-M&A environment too, value creation identification and planning is an integral part of providing enhanced stakeholder returns. We have also discussed increased governance and decreased risk can also support value creation.

However, value creation planning alone is meaningless without the delivery. For this, a concerted effort is required throughout the organization, and to facilitate this, KPIs and related incentives should be aligned to the value creation plan.

We began by saying value underpins the philosophy of the company, and we end by saying Value Creation should be embedded in your philosophy. Value creation is not just the idea and responsibility of a few top management, it is for all the company to live buy. Value creation ideas should be encouraged and rewarded, the value creation plan should be committed to and owned, and through embedding KPIs the entire company is motivated....to create value and to achieve the company purpose.

How we can help

Crossborder PMI Advisors supports its clients by being an "Engineer of Value and Success". As with all engineering projects, success begins at the strategic planning phase, and continues through deal execution, to subsequent value capture. Our approach to value creation considers all sources of value including the value enhancements possible through structure and reduction of risk. This brief Value Creation manual provides a brief outline of some of the considerations included in our approach.

Crossborder PMI Advisors offers a wide range advisory services on both the buyside and sellside of cross-border deals. All services are specifically tailored to working in a multicultural crossborder environment, and range from cultural and overall PMI advisory services, to a modular approach to PMI, Carve-outs, Joint ventures and alliances, and other related areas. As such we offer a flexible approach to working with our clients, including working with your other PMI advisors in a cross-border SME capacity.

At Crossborder PMI advisors, our mission is simple: To help our clients succeed in cross border M&A. The key to crossborder success is to do the right deal, to pay the right price, and to manage your investment through realizing synergies, reducing risk through effective governance, managing people across cultures, and global leadership.

We look forward to working with you on your global journey, and in your Value Creation. Please contact us any time for further information and to discuss your needs at: info@xbpmi.jp

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PMI ADVISORS

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PMI ADVISORS

Contact:

Crossborder PMI Advisors

Tokyo Sankei Bldg, 1-7-2 Otemachi, Chiyoda-ku, Tokyo, Japan 100-0004

Tel: +81-80-6626-9525

For further information or RFP, please mail to: **info@xbpmi.jp**

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