Growth Finance Expertise

Mergers and Acquisitions

Bank of Ireland

Begin

Introduction

Irish businesses, such as Version 1 in technology and Glanbia in agrifoods, have shown that a well-executed Mergers and Acquisitions (M&A) strategy can deliver market beating growth and profitability. There is a strong level of M&A activity in the Irish mid-market space. This is driven by a number of factors:

- **Funding:** Increased availability of bank, equity and vendor loan notes in the Irish market is enabling businesses to make acquisitions.
- **Business Cycle:** Many businesses are experiencing strong growth again, having become leaner from a cost perspective in recent years. This can drive higher levels of profitability and repayment capacity.
- **Market Change / Investment:** Technology (i.e. cloud / digital / social) is impacting upon many sectors, this offers opportunities to rethink business models and invest for the future. At the same time, businesses risk losing out in the market place if they fail to adapt. Often new owners, management and funding can enable a business to grow in times of rapid market change.
- **Shareholders / Owners:** Many management teams, who delayed exiting their businesses to manage the impact of the recession, have successfully stewarded their companies to growth and are looking to transition.

Bank of Ireland provides a range of business finance products that can be combined to enable a successful acquisition. Bank of Ireland is in a unique position to understand the challenges and opportunities facing businesses in all sectors. This knowledge has been further enhanced by our teams of sector and transaction experts supporting our Relationship Managers who help customers pursue growth strategies. When it comes to completing the transaction, Bank of Ireland ensures that the credit terms offered are delivered.

Why Bank of Ireland?

Delivery

- Record of delivery of M&A funding in complex transactions across key sectors
- Confidence in credit terms offered

Transaction

- Team skilled in structuring credit proposals
- Mix of credit and lending experience

Relationship

- 85 skilled Business Banking Relationship Managers in our retail network
- Work with the new management to understand growth opportunities
- Supported by the Sector and Transaction Support teams

Sector

- Team of sector experts recruited from the industry with real ‘hands on’ experience
- Relevant sector insights and benchmarks to inform value added customer dialogue
- Support the application through the credit process

Bank of Ireland funded Mergers and Acquisitions

In the table below we highlight some recent M&A approvals from Bank of Ireland Business Banking.

Background – Networking Technology Company			
Facility	**Purpose**	**Metrics**	**Security**
▸ €0.7m term loan provided over 3 years	▸ Acquire 100% shareholding in a competitor business	▸ Leverage 1.8 times ▸ Debt service cover 1.51 times ▸ Equity 41% / Bank funding 59%	▸ Company debenture on borrower and acquired company ▸ Cross company guarantees ▸ Element of personal recourse from shareholders ▸ Keyman cover
Background – Manufacturing Company			
Facility	**Purpose**	**Metrics**	**Security**
▸ €1.2m term loan provided over 7 years	▸ Acquire 100% shareholding in a competitor business	▸ Leverage 4.02 times ▸ Debt service cover 2.29 times ▸ 100% Bank funding Note – significant capex from cash flow in previous 18 months and strong net worth in acquiring company	▸ Company debenture and charge over borrower’s premises ▸ Company debenture on acquired company ▸ Cross company guarantees

Background – Business Services Company			
Facility	**Purpose**	**Metrics**	**Security**
▸ €2.2m term loan provided over 5 years	▸ Acquire a division from a competitor business	▸ Leverage 2.6 times ▸ Debt Service cover 1.49 times ▸ 38% equity / 62% bank funding	▸ Company debenture, charge over borrower's trading premises and charge over investment property ▸ Element of personal recourse ▸ Keyman cover

Background – Business Technology Consultancy Company			
Facility	**Purpose**	**Metrics**	**Security**
▸ €1.5m term loan provided over 5 years alongside €0.6m Invoice Discounting line Note – additional €0.9m Invoice Discounting facility provided for working capital purposes	▸ Acquire 100% shareholding in a complementary business	▸ Leverage 1.8 times ▸ Debt service cover 1.53 times ▸ 20% equity / 80% bank funding	▸ Company debenture on borrower and acquired company ▸ Cross company guarantees ▸ Keyman cover

Mergers and Acquisitions Timeline/ Process

Our experience shows that an acquisition broadly follows the process outlined below. It is Important that the acquirer has mapped out the process and risks (and mitigants) with their advisors and funders. An efficiently run process not only improves the chances of success but preserves management "bandwidth" to focus on running the existing core business.

Each phase has specific considerations / risks

Phase	Preparation	Discover	Due Diligence	Negotiation	Closing	Integration
Activities / Milestones	▸ Prospecting ▸ Industry sources ▸ Consultants ▸ Active sourcing ▸ Internal feedback	▸ Agree acceptable deal parameters with owner ▸ Draft teaser ▸ Draft investment memorandum ▸ Draft NDA ▸ Establish product / service review process	▸ Finanacial model ▸ Source funds ▸ Equity investors ▸ Revised proposal(s) received ▸ Meetings with preferred backers ▸ Finalise Heads of Terms	▸ Legal due diligence ▸ Avoid auction ▸ Sign letter of intent (LOI)	▸ Final opinion ▸ Warranties ▸ Sign contracts	▸ Integration plan ▸ Communication plan ▸ Transition team
Purchaser considerations	▸ Preliminary discussions with funders and advisors ▸ Define process / roles	▸ Reference transactions ▸ Log communications ▸ Review process	▸ Determine financing available ▸ Invoice discounting ▸ Deferred consideration ▸ Outside equity	▸ Do the results of the due diligence impact upon the valuation?	▸ Determine escrow / hold backs	▸ Key employee / customer retention ▸ Functional skill transfer ▸ Central management transfer ▸ Culture ▸ IT & Systems ▸ Available 'slack' resources

Key Considerations

Building blocks for successful M&A

Deal Logic

Management consultants McKinsey identified the following key ways in which an acquisition can add value:

1. Improving the performance of the target company

a. It is easier to improve the performance of a company with low margins and low returns on invested capital (ROIC) than that of a high-margin, high-ROIC company.

b. Larger companies with greater market shares can reduce their unit operating costs to levels below those of smaller, less efficient rivals.

2. Consolidate and remove excess capacity from an industry

a. The combination of higher production from existing capacity and new capacity from recent entrants often generates more supply than demand. Companies often find it easier to shut plants across the larger combined entity resulting from an acquisition, rather than closing the least productive plants and end up with a smaller company.

b. While there is substantial value to be created from removing excess capacity, all other competitors in the industry may benefit from the capacity reduction without having to take any action of their own (the free rider problem).

3. Accelerate market access for the target's (or buyer's) products

a. Companies sometimes purchase a smaller company and use their own large-scale sales force to accelerate the sales of the smaller company's products.

4. Acquire skills or technologies faster or at lower cost than they could be built

a. Technology based companies buy other companies that have the necessary technologies to enhance their own products, in order to acquire the technology faster than developing it, avoid royalty payments on patented technologies or keep the technology away from competitors.

5. Picking winners early and helping them develop their business

a. Make acquisitions early in the life cycle of a new industry or product line long before most others recognise that it will grow significantly.

b. This acquisition strategy requires a disciplined approach by management in three dimensions:

   i. You must be willing to make investments early, long before your competitors and the market see the industry's or company's potential.

   ii. You need to make multiple bets and expect that some will fail.

   iii. You need the skills and patience to nurture the acquired businesses.

Due Diligence

Due diligence is a very detailed and extensive evaluation of the proposed merger. An over-riding question is – Will this merger work? In order to answer this question, you must determine what kind of 'fit' exists between the two companies. This includes:

Investment Fit – What financial resources will be required, what level of risk fits with the new organisation, etc.?

Strategic Fit – What management strengths are brought together through this M&A? Both sides must bring something unique to the table to create synergies.

Marketing Fit – How will products and services complement one another between the two companies? How well do various components of marketing fit together - promotion programs, brand names, distribution channels, customer mix?

Operating Fit – How well do the different business units and production facilities fit together? How do operating elements fit together – labour force, technologies, production capacities?

Management Fit – What expertise and talents do both companies bring to the merger? How well do these elements fit together – leadership styles, strategic thinking, ability to change?

Financial Fit – How well do the financial elements fit together - sales, profitability, return on capital, cash flow?

In the chart below, we highlight the key areas that require attention in a due diligence process based on Bank of Ireland's experience. However each sector has its own areas that require focus and we recommend you consult with advisors with experience of your sector.

Key Areas of Due Diligence

Area	Focus
Financial	▸ Capital structure / operation and financial ratios ▸ Financial statements and auditors reports ▸ Accounting practices and any changes over the past 5 years ▸ All business plans submitted to banks / investors / state agencies over the past 5 years ▸ Accrued liabilities ▸ Review of CapEx / schedule of fixed assets / depreciation methods ▸ Compensation ▸ Tax liabilities and assets (R&D, tax credits, etc.) ▸ Review inventory costing system
Legal	▸ Articles of incorporation ▸ List of top suppliers and customers with related contracts and warranties over the past 5 years ▸ Property and equipment leases ▸ Loan agreements ▸ Franchise and joint venture agreements ▸ Non disclosure and non compete agreements ▸ Employee contracts and any pending legal actions
Customer and Market	▸ Key suppliers / competitors ▸ Trends / threats / substitutes ▸ Details of key customers who have exited
Product	▸ Evidence of intellectual property held / licence agreements and related legal actions ▸ Customer interviews
Systems	▸ Review of all higher value plant and machinery ▸ Review internal KPIs ▸ All IT assets owned / rented? Hardware and software asset management approach ▸ Information security policies and infrastructure

Metrics and Valuation

The vendor and their advisors will seek to maximise the price, therefore having clear value expectations going into the transaction is crucial. Valuing any company is not an exact science and there will always be an element of judgement in arriving at the price. Broadly, there are three methods employed:

- **Market based valuations:** Method of determining the appraisal value of an asset based on the selling price of similar items or companies and adjusting accordingly for the asset in question.
- **Net Asset valuations:** Value of an entity's assets minus the value of its liabilities.
- **Discounted cash flows:** Future free cash flow projections discounted to present value.

In addition to applying metrics at the point of valuation, it is important that the acquirer determines how the value of acquisition will be assessed in the future. Often this is done on a Return on Capital Invested basis. The wrong acquisition can severely harm a company's profitability.

Partners

Having the right advisors and financial backers can make or break a deal and the terms and price of acquisition can determine growth and viability of the entire business. It is important to have advisors that understand your business and legal and financial issues.

Structure:
The financial structure will evolve throughout the transaction; however, it is important that at an early stage, the vendor, acquirer and their advisors arrive at a rough outline of the structure that they believe is appropriate, as the financial structure often determines the price an investor can afford to pay for the business.

M&A Financing Structure

- It is essential to ensure a healthy mix of debt and equity to achieve the right balance between maintaining ownership and control of the business, achieving the appropriate funding levels required and managing the appropriate business gearing ratios.
- Aside from deciding on the overall amount of debt it is also important that the debt is structured appropriately.
- Detailed planning and sensitivity analysis are essential in ensuring there are no surprises going forward
- Bank of Ireland provides a range of business finance products that can be combined to deliver the right mix for your business. One such product is Invoice Finance, a flexible and increasingly prevalent funding tool that releases the value inherent in your trade debtors, often your biggest asset. Funds may be released from the debtor book at an early stage, to assist in the purchase of the business and also to provide an ongoing source of working capital.

When putting together an appropriate structure, it is important to consider the following:

- Cash flow is the most important factor and it is of crucial importance that the acquirer has a detailed understanding of projected cash flows. Profit generation is important, but capital expenditure, depreciation, interest, dividends and other factors such as restructuring costs come into the equation, making cash generation the key driver of valuation.
- The 'quality' of the cash flows is another consideration, which includes the predictability of future orders (backlog), the prospects for the marketplace, and the types of customers. The higher the quality of the cash flows, the more debt a company should be able to raise.
- Depending on the nature of the company's trade there may be certain periods when expenditure exceeds income. Likewise, the timing of tax payments and outflows may dictate when the company will be short of cash in certain periods. When determining an appropriate structure it is important to plan for these fluctuations.
- In general, at least some of the bank debt will need to be secured by assets held by the company. In addition to the projected cash flows, the bank will also consider the realisable value of the assets it will take security over.
- Tax considerations such as the tax deductibility of interest (but not dividends) and the timing of tax payments.

The various sources of finance and the number of factors taken into account, means that securing an acquisition is a matter of integrating different layers of funding. This provides a structure which enables the purchase price to be paid yet enables the business to operate with some freedom in the future. The main criteria of the various finance providers are as follows:

1. **Debt Finance**
   Evaluating the level of debt that the business will support is the first step in coming up with a financing structure. As noted above, this will generally depend upon the cash flow of the business, the asset coverage available, and the interest coverage – Bank of Ireland has guideline ratios in mind for each of these. Among the key features for the business to consider in any debt package will be:
   - Track record of the lending institution to deliver on credit offer
   - Sector understanding
   - Interest rate
   - Repayment profile
   - The security required and financial covenants.

2. **Equity Finance**
   The level of equity may be influenced by the amount of debt that the business can support. Equity may be in the form of 'quasi equity' with no repayment of any kind until bank debt is fully repaid.

   The key features to look for in any offer of equity finance will include:
   - The deal structure (the relative split of ordinary shares, preferred shares and other instruments)
   - Management's equity share (and the funding that they are required to provide)
   - Whether any equity stake is dependent upon achieving a particular level of performance (a ratchet)
   - Non financial terms such as any constraints over the operations of the business
   - The dividend and interest structure

3. **Vendor Finance**
   Vendor finance can be either in the form of deferred loans from, or shares subscribed by, the vendor. The vendor may take shares alongside the management in the new entity. This form of finance has been more common in the current economic climate as it bridges the price gap between vendors and buyers.

Integration

The acquirer throughout the process needs to consider how the two companies are going to be profitably combined. Boston Consulting Group identified the following key factors for optimising functionality post-merger.

- **Information Technology:** IT can generate 15–20% of total synergies and as high as 30% in information-intensive industries. It is advised to develop a dedicated, cross-functional IT integration team.
- **Production:** Optimising synergies in this function requires companies to first determine the ideal design for the manufacturing network.

Appendix

Glossary

Deferred consideration:
An element of the purchase price that is to be paid at some point of time in the future. Payment can be contingent upon the outcome of defined future events.

Enterprise value:
The debt-free value of a business equivalent to the business valuation plus the level of debt to be absorbed by the purchaser.

Equity Kicker:
A mechanism whereby holders of debt or mezzanine finance are given the option of subscribing for shares, usually at Exit.

Exit:
The point at which the Institutional Investors realise their investment. Venture capitalists may, depending on the business and their own situation, look to achieve an exit in anything from a few months to over 10 years.

Fixed or floating charge:
A legal mechanism whereby security over the assets of the business is granted.

Goodwill:
The difference between the price which is paid for a business and the fair value of its assets.

Institutional Strip:
A proportion of the total finance provided by Institutional Investors, which may include some or all of ordinary shares, preference shares and loan stock.

IRR Internal rate of return:
The average annual compound rate of return received by an investor over the life of their investment. This is a key indicator used by institutions in appraising investments.

Loan stock:
Subordinated debt which carries fixed interest and is repaid in a defined period, typically on Exit.

Newco:
A new company formed to affect the buy-out by acquiring the operating subsidiaries.

Senior debt:
Debt provided by a Bank, usually secured and ranking ahead of other loans and borrowings in the event of a winding up.

Subordinated loan:
Loans which rank after other debt. These loans will normally be repayable after other debt has been serviced and are thus more risky from the lender's point of view.

Warranties and indemnities:
Legal confirmations given by the Seller, regarding matters such as tax or contingent liabilities, to assure the acquirer that any undisclosed liabilities that subsequently come to light will be settled by the Seller.

Business Banking

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Bank of Ireland is regulated by the Central Bank of Ireland.