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Enhanced Analytics Initiative — study of the coverage of extra-financial issues in research on mergers and acquisitions

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Terminology

EAI	Enhanced Analytics Initiative
Members	Asset owner and asset manager members of the EAI
M&A	Mergers and acquisitions
Research Providers	Providers of investment research to EAI Members, including broker-Providers (e.g. Citigroup Global Markets) and non-broker-Providers (e.g. Innovest Strategic Value Advisors)

Summary and parameters of original study

Approximately two-thirds of large-cap companies do at least one non-trivial acquisition each year[1]. With historically high free cash flow margins, uninvested private equity capital[2] and cheap debt costs seemingly set to sustain the current mergers and acquisitions (M&A) cycle, intelligence on pending M&A transactions has become increasingly important for long-term investors looking to:

- Evaluate the merits of pending transactions for stock selection or ownership decisions
- Allocate assets strategically to or away from consolidating sectors
- Engage with major investee companies on M&A strategy
- Ensure that all financially material factors are taken into account in the M&A decision-making process
- Develop a systematic approach to investment decisions on M&A events

The corporate finance analysts who advise company management on M&A are also an important consumer of M&A and other investment research. This 'positive feedback loop' means that it is particularly important that investment research in this area reflect the best interests of owners.

As such the Enhanced Analytics Initiative (EAI) has chosen to profile the response of the investment research community to M&A, and in particular to investigate whether analysts

[1] Defined as deals valued at over US$5m; Bernstein, January 2005
[2] A May 2006 survey revealed that: a) 80% of the FTSE 100 was being publicly discussed as being involved in mergers, acquisitions and buy-outs and b) borrowing by UK private equity firms stood at £680bn, equivalent to more than 40% of the market capitalisation of the FTSE 100

covering M&A are addressing the full range of issues that are material to the long-term, diversified asset owners and managers that characterise the EAI.

This paper summarises a study of the coverage of extra-financial issues in M&A investment research. The study was produced by onValues Ltd. for the Members of the EAI, and was primarily based on the body of broker and independent research considered by the EAI since the inception of its biannual evaluations of investment research[3].

The study was motivated by the interests of EAI Members, who are:

- Long-term, long-dominated holders of equity and fixed income
- Globally diversified
- Active owners (exercising voting rights and engaging with investee companies)
- Interested in both fundamental research on a per-asset basis and in macro and portfolio effects

Observations from the EAI research body

Framework

We observe that the M&A reports in the EAI research body fall into three broad categories:

1. Systemic research into the general effects of M&A on investors i.e. 'Does M&A destroy value?', how to play cyclical trends in the M&A market, etc.
    - ➔ Generally including ex-post analysis of transactions
2. Top-down sector- or region-specific research that considers drivers and likely events in sectors where a 'shake-out' is perceived to be required to improve efficiency, or the effect of the regulatory or behavioural peculiarities of a region on M&A activity
    - ➔ Such research generally covers sectors with strong strategic rationales for consolidation, under-geared capital structures and strong free cash flow
    - ➔ The research is of use e.g. in strategic asset allocation
3. Event-driven research that considers the merits of potential or pending transactions

In appraising whether M&A research reports addressed the full range of issues[4] that are material to long-term investors (we refer to this as 'enhanced M&A research' in this paper), we classified our observations into four categories:

- Strategic considerations
    - ➔ Commentary on the business sense of the transaction for the counterparties
    - ➔ Commentary on the transaction in the context of the long-term best interests of investors
- Role of management
    - ➔ Analysis of management motivations other than the strategic drivers
    - ➔ Interactions between management and shareholders
    - ➔ Execution ability
- Valuation
    - ➔ Calculation of the fair value of the transaction based on the strategic considerations
- Financing

[3] Research published between February 2003 and June 2006
[4] Including extra-financial issues

- ➔ Analysis of the various financing options available for the proposed transaction at the proposed value (and their long-term implications)

Examples of enhanced M&A research for the categories above include:

- Strategic considerations
  - ➔ Issues arising from differing corporate or national cultures and languages (especially in cross-border transactions)
  - ➔ Impact of combining corporate governance regimes of counterparties
  - ➔ Impact of transaction on intangible assets
  - ➔ Sector- and region-specific extra-financial issues based on the counterparties, e.g. inadvertent inheritance of environmental liabilities through an acquisition
  - ➔ Impact of transaction on long-term regulatory risk for the combined entity
- Role of management
  - ➔ Drivers for management (including remuneration effects) — are management on both sides incentivised by M&A completion bonuses or based on creation of value over the long-term?
  - ➔ CEO personality / (over-)confidence in his and the company's abilities
  - ➔ Identification of conflicts of interest and perverse incentives
  - ➔ Relationship between management and strong and transparent shareholder rights in approval of transaction
- Valuation
  - ➔ Long-term forecasts for revenue and cost synergies (which fully integrate material extra-financial issues)
  - ➔ Explicit mention of possible revenue dis-synergies (from the disruption of a company's ability to execute and sometimes directly from efforts to reduce costs)
- Financing
  - ➔ Long-term impacts of financing on capital structure

Observations and conclusions

- **The overall volume of enhanced M&A research is low**. Despite the reasonably-sized body of research that has been considered by the EAI and a sustained M&A bull market, we identified only a small number of reports that considered the impact of extra-financial and other 'enhanced' issues (such as the examples given above) on M&A. This is the expected product of two factors:
  - ➔ Low coverage of M&A as a whole
    - – Researchers unable to publish due to their institutions being involved in the transaction (or potentially involved in future transactions)
    - – Difficulty in executing M&A research given the large number of unknowns (value of two or more assets + value of combination, transaction risk, etc.)
  - ➔ Low coverage of extra-financial issues in general investment research relative to the total volume of research produced (despite the rapid growth witnessed by the EAI)

- Among the extra-financial issues observed, **coverage of corporate governance issues is the most abundant**. It is rare to encounter M&A research that considers the impact of environmental and social issues on the transaction rationale and value. Coverage of cultural fit and other impediments to integration and execution is particularly conspicuous by its absence

- The general level of **analysis of extra-financial issues in M&A research is lacking in sophistication and transparency**. Although the reports we studied generally flag extra-financial issues as having an influence on a consolidating sector or the merits of a particular transaction, it is rare for a report to state explicitly that extra-financial issues materially affect the value of a proposed transaction, and rarer still for this effect to be quantified

- Given the crucial dependence of the fair value of a deal on the ability of management to deliver the transaction benefits, it is surprising that an analysis of existing management quality, retention and motivation of human capital, and other issues relating to **management execution risk was missing from a number of the transaction-specific reports** we examined

- In order to evaluate the fair value of a transaction and the likely long-term impacts for the counterparties it is necessary for the research to provide long-term financial forecasts for the counterparties on a standalone and combined basis. The **research seen on the Boots / Alliance UniChem transaction provided good examples of long-term, transparent financial modelling**

- Evidence exists to suggest that even where the strategic rationale, the capability of management of delivering the benefits, and the fair value of a transaction are well understood by observers, the choice of financing can be a useful additional predictor of whether the transaction is likely to add value for investors[5]. We **would therefore expect to see greater attention to the financing options available to the acquirer and their long-term implications**

- We observe that historical precedents are seldom included in research into on-going M&A events. We believe that **the use of precedent transactions analysis could be expanded in transaction-specific analysis**, notably in the following areas:
  - ➔ Qualitative evaluation of strategic considerations — does the proposed transaction bear the hallmarks of previous well-studied transactions (particularly in terms of downside risk)?
  - ➔ Benchmarking of the magnitude of forecast synergies against synergies actually delivered by historic transactions in the sector
  - ➔ Benchmarking of transaction multiples against precedent transactions (particularly against multiples from transactions executed during 'cool' markets)

[5] Cash or mixed cash / paper transactions are generally thought to be less risky for the acquirer than pure share transactions