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The New Geography of M&A

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Consumer-facing companies have long known that it pays to tailor products for local tastes as they enter emerging markets. McDonald's offers a McAloo Tikki sandwich in India — a patty made of peas and potatoes. In China, Kraft's iconic Oreo cookies come with green tea filling. For marketing executives, success is all about understanding the customer.

The same imperative holds true for a different class of professionals who are increasingly finding customers in emerging markets in Asia: corporate executives in the automotive and industrial sectors seeking to sell assets or businesses.

The volume of mergers and acquisitions is rising toward the peaks seen prior to the financial crisis. Every Monday seems to bring a slew of new announcements of high-profile deals. Historically, the participants in these sales processes have been a relatively homogeneous lot — Western companies or private equity firms. And because they tend to speak a common financial language, the attributes they look for have tended to be similar: EBITDA, cash flow, strategic fit.

But the world is changing; the world's center of economic gravity is moving toward Asia. Most analysts project that China is on a path to overtake the U.S. as the world's largest economy. Even considering its recent growth troubles, Japan sports the third-largest GDP in the world. With its population of 1.2 billion, India is a rising consumer and commercial power. So to a degree, it's not surprising that companies from these countries, as well as from industrial powerhouse South Korea, have become significantly more active and sophisticated in the global M&A market.

Understanding the strategic intent of potential buyers from different regions and how they may differ from traditional purchasers — and from one another — is crucial. It is important to adopt what we call a market-back approach to positioning assets or entities for exit. This involves taking a broader view of the potential universe of buyers, understanding their different needs and values, preparing assets for sale long before the initiation of a sales process so they can appeal to a large array of potential purchasers, and understanding the nuances and cultural differences that may affect the outcome. To succeed to the fullest possible extent, companies need to move away from the quasi-automated approach of focusing on EBITDA and cash flow, and instead recognize the key business, cultural, and procedural attributes that will be important for buyers in the future.

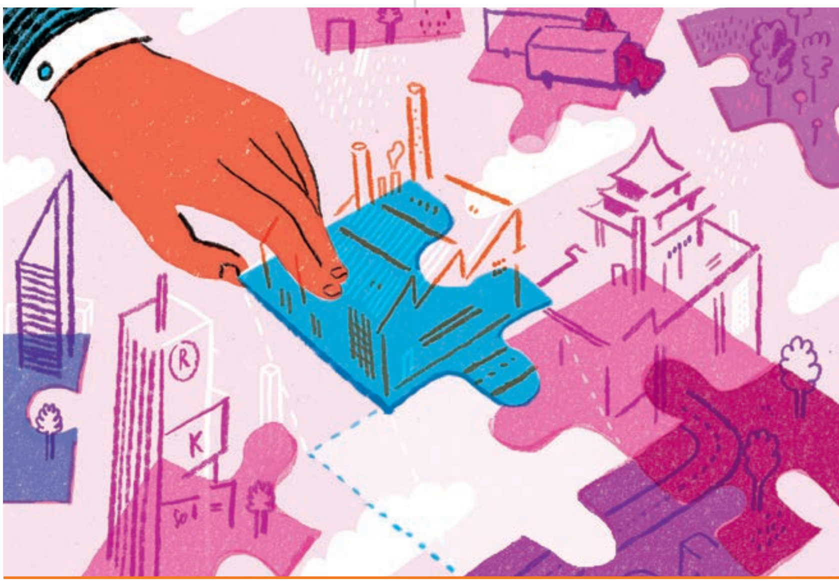


Illustration by Peter Oumanski

Gauging Value

Companies that are considering selling assets must ensure that their investments are channeled in a way that will attract the new cast of buyers. But value is in the eye of the beholder. A host of factors can make a company or business division particularly attractive — for example, fundamental performance (growth and EBITDA margins), intellectual property and proprietary technology, and the customer base and diversified geographic exposure. Different buyers from around the globe will place different emphases on these attributes.

Focusing only on profitability and growth in cash flow is a proven method of enticing U.S. private equity buyers. And Western buyers generally tend to place a higher priority on strategic fit. But a Chinese family-owned company may not care as much about last quarter's EBITDA, especially if the deal will allow the company to obtain valued technology that it can further develop for the massive local market. By contrast, a state-owned enterprise (SOE) in China has to take into account broader public agendas, and may be more interested in maintaining employment in its province than in hitting a cash-flow multiple. Companies in both India and China often place a higher weight on brand than Western companies might, because acquiring premium brands allows them to differentiate themselves from local competition.

Investments by current owners that may not make much sense from the standpoint of short-term profitability can add value when it comes to pitching the company to a new global audience.

As a result, investments by current owners that may not make much sense from the standpoint of short-term profitability — such as pumping up investments in R&D — can nonetheless add value when it comes to pitching the company to this new global audience. The intellectual property and know-how gained can trump the value that was lost by having a slightly lower EBITDA margin.

As an example, consider a transaction announced in September 2014. Ficosa, a Spanish manufacturer of rearview mirrors for cars, entered into a capital and business alliance with Japanese technology company Panasonic. In the years prior to the deal, Ficosa had invested in building electronics into the mirror to differentiate itself from the competition. Whereas many Western peers focused on how such a partnership could work in terms of cost synergies, Panasonic viewed Ficosa as an opportunity to gain valuable "real estate" in the driver's vision area. The Japanese hardware and software supplier saw taking a 49 percent stake in Ficosa as an opportunity to leverage its own automotive technologies and gain further access to certain European car manufacturers such as BMW. By investing in R&D, Ficosa expanded the market of potential buyers, gave itself more options, and likely wound up with a stronger valuation.

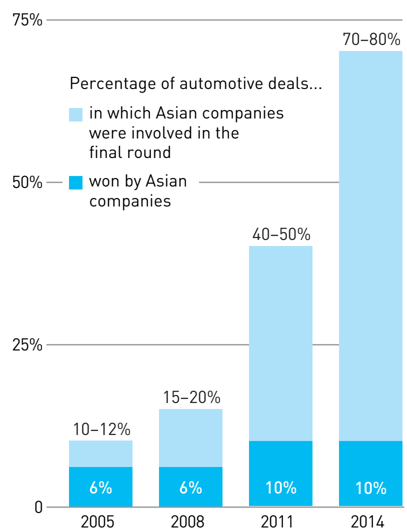
One important differentiating factor to consider is the "cost of constitution." That is, when buyers from emerging markets evaluate opportunities, they may ask themselves how much it would cost them to build, from scratch, a business comparable to the one currently for sale. In 2010, Geely, a private Chinese car company, acquired Volvo Cars of Sweden from Ford Motor Company. Geely had approached Ford as early as 2007 about a potential acquisition, even though Volvo's business was sagging. Ford — and other Western automakers — didn't see much value or potential for the brand. However, Geely's chairman and founder, Li Shufu, clearly identified Volvo as a strategic steppingstone for his own company. This acquisition would enable Geely to become one of the leading private Chinese car manufacturers in a domestic market otherwise dominated by SOEs. It would also allow Geely to gain control of a strong brand that would give it an international presence — both rarities for Chinese carmakers at the time (*see exhibit*).

Understanding Diversity

Just as the rise of Asian buyers has brought a wider range of motivations to the scene, it has also presented a wider range of ownership structures. In Europe and the U.S., companies are typically classified as publicly held or privately held, and the latter are often owned by families or financial sponsors. Asian companies, however, inhabit a much more diverse spectrum. Their particular circumstances can influence

Exhibit: **Rising Involvement of Asian Buyers**

The proportion of automotive deals with an Asian buyer involved in the final round has risen sharply in the last decade. So too has the portion of transactions in which an Asian company was the purchaser.



Source: CapitalIQ, Rothschild

management's strategic agenda, affect financing, and enable M&A to be seen in a much broader context. In Japan, many companies belong to *keiretsu*: conglomerations of businesses linked by cross-shareholdings to form a robust corporate structure. Therefore, it is important to understand how an asset may fit into the larger strategic puzzle of a potential Japanese buyer. SOEs in China are often able to obtain favorable financing from local banks to support a strategic acquisition.

Sellers must also become comfortable with a broader range of sales processes. In our experience, compared with their Western counterparts, Asian buyers often require a lot of time as they assess opportunities. The pace and priorities not only reflect the overall organizational structures and decision-making processes, but can also typically also be traced to cultural factors. Not allowing some extra time for a Japanese player to conclude detailed and rigorous due diligence may jeopardize a potentially important buyer and value creator. Having an advisor with a local team who understands the potential buyer is particularly important when involving Chinese parties, given the gauntlet of regulatory approvals through which any deal must pass.

The key is to start early in planning for a more diverse world. Cereal companies don't wait until the boxes are on the shelves of local retailers to start thinking about how their products will appeal to new consumers. The process begins much earlier — with everything from the recipe to the design of the box. Similarly, owners of corporate assets have to think further in advance about potential buyers of their assets, and the concerns and needs of these buyers.

Taking a market-back approach and segmenting buyers may allow for the construction of a better strategy for grooming an asset over the duration of the ownership period. Of course, earnings and financial fundamentals will continue to be paramount in the eyes of many buyers. But the range of factors that may be considered has expanded. Whether parties ultimately negotiate over a multiple of EBITDA, or the future value of a technology, or the economic stability a buyer could create in a specific geographic area if running the factories, or the impossibility of the buyer's accomplishing a desired goal without the new asset, the goal is the same: To end up with a best final offer that sits at the real value threshold of a buyer. Knowing the motivations of all potential customers will soon be part of every smart seller's strategic agenda. +

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