Attractive M&A Targets: Part 1
What do buyers look for?

An analysis of the financial characteristics of acquisition targets

A study by the M&A Research Centre at Cass Business School, City University London, and Intralinks | **September 2016**


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Executive summary

Can an analysis of financial measures, such as growth, profitability, leverage, size, liquidity and valuation provide insights into which companies are likely to become acquisition targets? How do these measures differ for private vs. public targets? And what is the relative importance of these measures in predicting the probability of a company becoming an acquisition target?

This study seeks to answer these questions, revealing how the financial characteristics of companies correlate with merger and acquisition (M&A) activity in often unexpected ways.

It investigates **six key financial measures** of a global sample of 33,952 public and private companies, with annual revenues of at least US$50 milllion, over the period 1992-2014.

We find that these six measures are statistically **significant predictors** of a company becoming an acquisition target. We also find that significant differences in the values of these measures affect the relative likelihood of being acquired.

According to our findings, acquisition targets share the following characteristics, which we will discuss in detail within this report.

GROWTH: Target companies have higher growth than non-targets. Companies with much higher or much lower growth than the average are also the most likely to become acquisition targets.

Our study finds that growth of target companies, as measured by their three-year compound annual growth (CAGR) in sales, is 2.4 percentage points higher than that of non-targets.

Companies in the **top or bottom deciles** for growth are on average 20% more likely to become acquisition targets in any given year than companies overall.

PROFITABILITY: Private target companies are more profitable than private non-targets, whereas public target companies are less profitable than public non-targets. Private companies with much higher or much lower profitability than the average are also the most likely to become acquisition targets. Public companies with much lower profitability than the average are also the most likely to become acquisition targets.

Since 2000, profitability of private targets, as measured by their ratio of earnings before interest, tax, depreciation and amortisation (EBITDA)/sales, is 1.2 percentage points **higher** than that of private non-targets.

Private companies in the **top or bottom deciles** for profitability have on average a 20% probability of being an acquisition target in any given year – 41% more likely than private companies overall.

Since 2000, public targets are 1.7 percentage points **less** profitable than public non-targets. Public companies in the **bottom two deciles** for profitability are on average 40% more likely to become acquisition targets in any given year than public companies overall.

LEVERAGE: Private target companies are significantly more leveraged than private non-targets and private companies with much higher leverage than the average are also the most likely to become acquisition targets. Public targets have lower levels of leverage than public non-targets, especially since 2008. Public companies with much lower leverage than the average are also the most likely to become acquisition targets.

Private target companies have over **three times more** leverage, as measured by their debt/EBITDA ratio, than private non-targets. Private companies in the **top two deciles** for leverage have on average a 28% chance of being acquisition targets in any given year – twice as likely as private companies overall.

Since 2008, public targets have 11% **less** leverage than public non-targets. Public companies in the **bottom two deciles** for leverage are on average 30% more likely to become acquisition targets in any given year than public companies overall.

SIZE: Private target companies are significantly larger than private non-targets, whereas public targets are significantly smaller than public non-targets. Private companies which are much larger or smaller than the average are also the most likely to become acquisition targets. Public companies are increasingly more likely to become acquisition targets, the smaller in size they are.

Private targets are 63% **larger**, as measured by their total sales, than private non-targets. Private companies in the **top or bottom deciles** for sales are on average 29% more likely to become acquisition targets in any given year than private companies overall.

Public targets are 55% **smaller** than public non-targets. Public companies in the **bottom half** of the percentile distribution for sales are on average almost 70% more likely to become acquisition targets in any given year than public companies in the top half.

LIQUIDITY: Target companies have lower levels of liquidity than non-targets.

Liquidity of target companies, as measured by their ratio of current assets/current liabilities, is 4% **lower** than that of non-targets. Companies in the **bottom two deciles** for liquidity are on average 35% more likely to become acquisition targets in any given year than companies overall.

VALUATION: Public target companies have lower valuation multiples than public non-targets. Public companies with much lower valuation multiples than the average are also the most likely to become acquisition targets.

Public target companies are valued at a 17% discount to public non-targets, as measured by their ratio of enterprise value (EV)/EBITDA. Public companies in the **bottom three deciles** for valuation are on average 30% more likely to become acquisition targets in any given year than public companies overall.

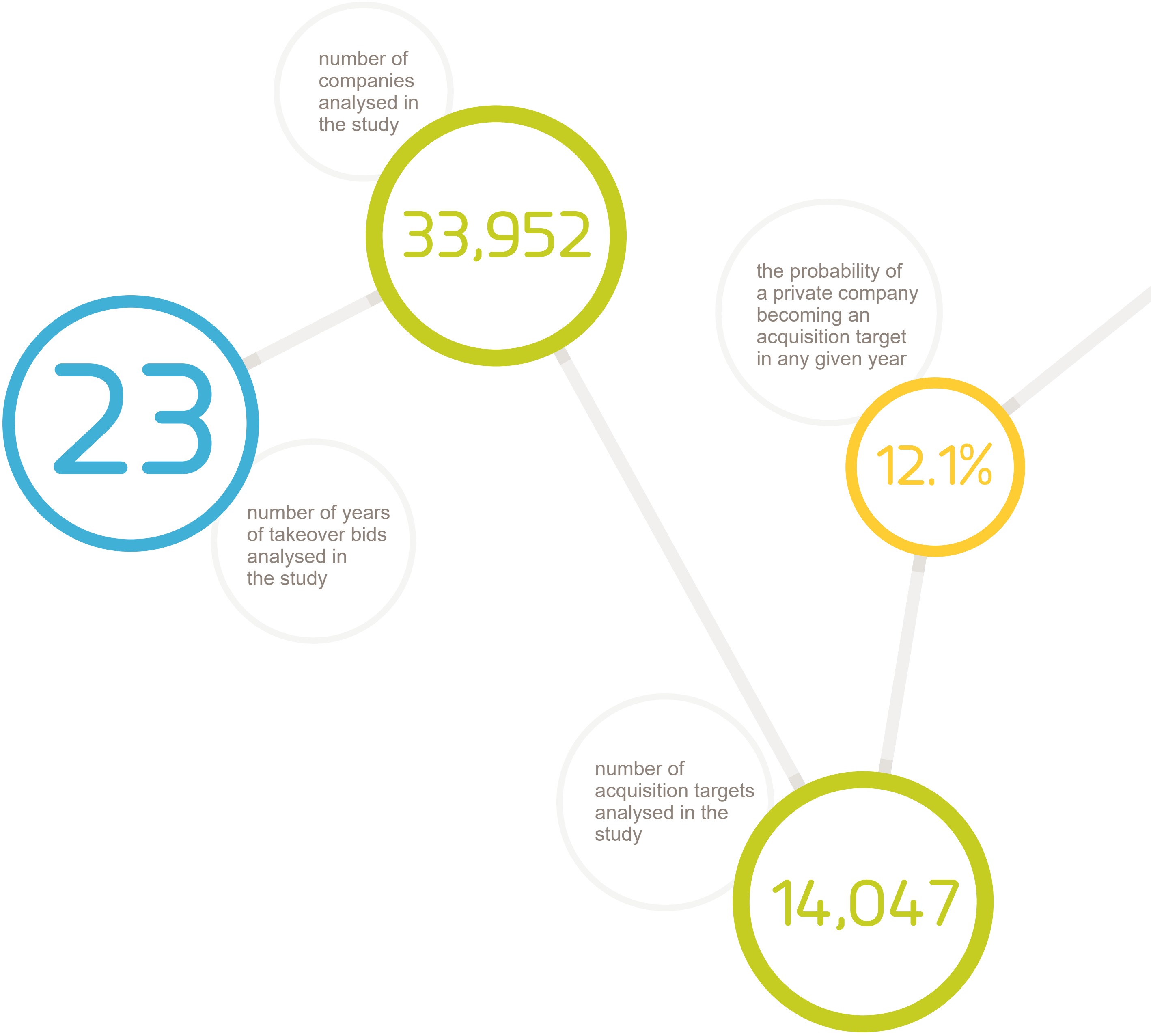
30-second summary

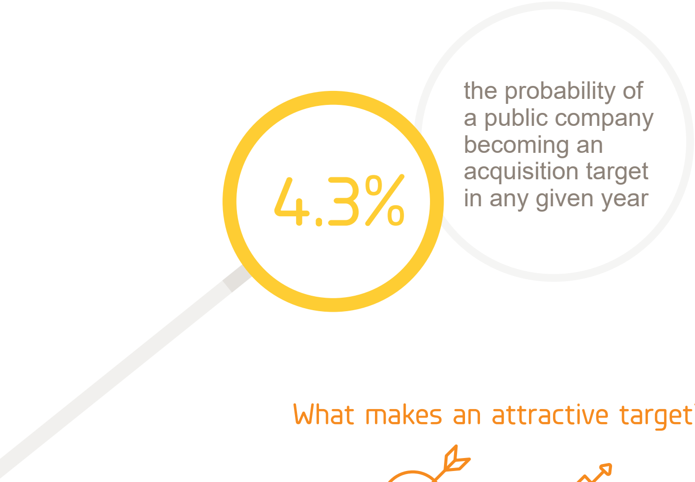
This study investigates **six key financial measures** of a global sample of 33,952 public and private companies, with annual revenues of at least US$50 million, over the period 1992-2014. We find that these six measures are statistically **significant predictors** of a company becoming an acquisition target. We also find that significant differences in the values of these measures affect the relative likelihood of being acquired.

According to our findings:

- **Private companies** are more likely to become acquisition targets if they are large, fast-growing, with high profitability, high leverage and low liquidity
- **Public companies** are more likely to become acquisition targets if they are small, fast-growing, with low profitability, low leverage, low liquidity and low valuations
- **High leverage** and **large size** are the two most statistically significant predictors of a **private** company becoming an acquisition target
- **Small size** and **low profitability** are the two most statistically significant predictors of a **public** company becoming an acquisition target

At a glance: key findings





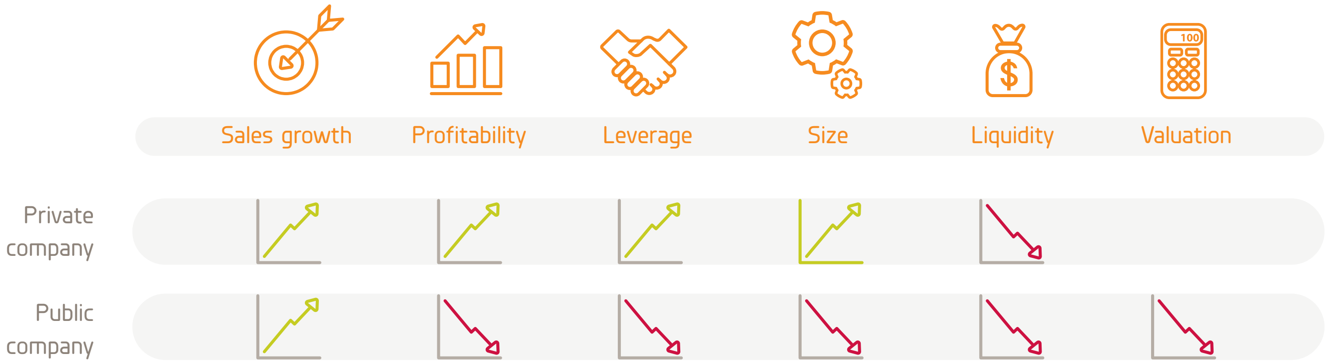
High leverage & large size

the two most statistically significant predictors of a private company becoming an acquisition target

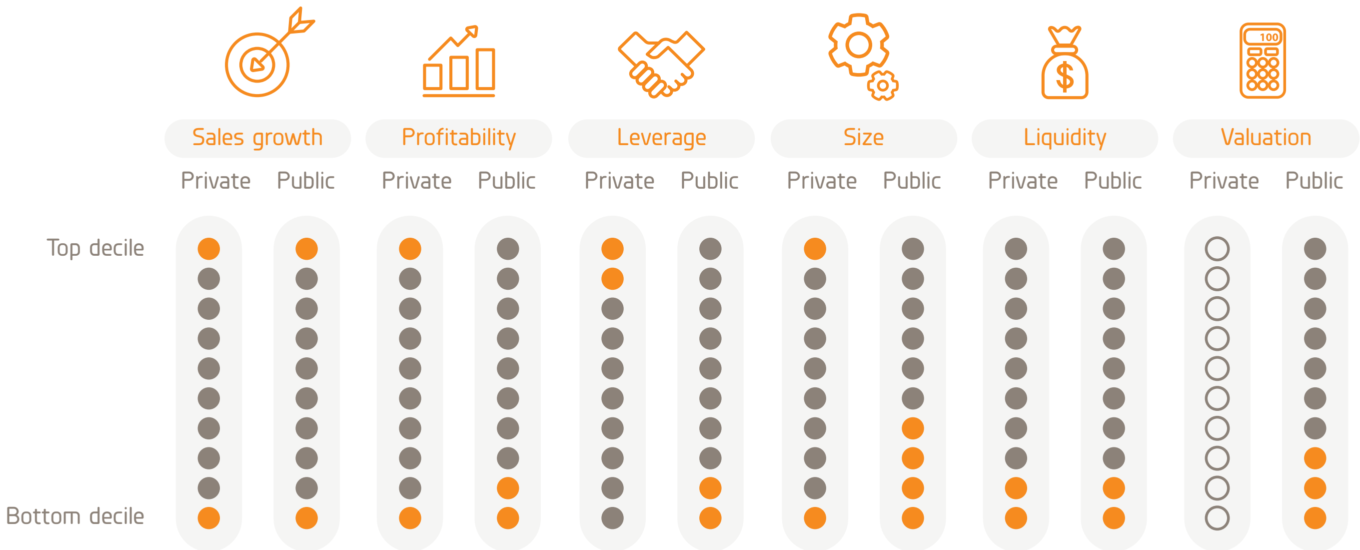
Small size & low profitability

the two most statistically significant predictors of a public company becoming an acquisition target

What makes an attractive target?



What makes a company most likely to become an acquisition target?



Introduction and methodology

The sample in this study comprises a global dataset of public and private companies, with minimum annual revenues of US$50 million, during the period 1992-2014. The sample includes 24,507 unique public companies and 9,445 unique private companies, a total of 33,952 unique companies, which translates into 275,713 firm-year periods.

The financial data for the sub-sample of public companies was obtained from Datastream and the financial data for the sub-sample of private companies was obtained from Thomson One Banker. Data on takeover bids for the target companies was also sourced from Thomson One Banker.

Within the sample, target companies are defined as companies subject to a “change of control” takeover bid, where the acquirer is proposing to acquire more than 50% of the target.

The study examines six financial measures of the companies in the sample to identify if any significant differences exist between companies that become the subject of a takeover bid in any given year vs. those companies that do not. These measures are:

i. growth (three-year compound annual growth (CAGR) in sales) prior to takeover bid;
ii. profitability (ratio of three-year average earnings before interest, tax, depreciation & amortisation (EBITDA)/sales) prior to takeover bid;
iii. leverage (ratio of three-year average debt/EBITDA) prior to takeover bid;
iv. size (sales) prior to takeover bid;
v. liquidity (ratio of current assets/current liabilities) prior to takeover bid; and
vi. valuation (ratio of enterprise value (EV)/EBITDA) prior to takeover bid.

These financial measures of the companies are analysed for the study period as a whole and also during five distinct M&A cycles:

a. the 1992-1999 expansion of the M&A market, the latter part of which was accompanied by a boom in internet/technology stocks;
b. the 2000-2002 M&A market contraction, following the bursting of the 1990s early internet/technology stock market bubble;
c. the 2003-2007 expansion of the M&A market, which was accompanied by an increase in corporate and consumer credit, leverage and financial derivatives;
d. the 2008-2009 M&A market contraction, which was marked by a global financial crisis, a reduction in liquidity and lending, bank failures and government bailouts of financial institutions; and
e. the 2010-2014 period, which has been marked by an uneven recovery, global monetary easing, low inflation, low interest rates and a significant increase in very large transactions (mega deals).

For each of the six financial measures, the probability of being a target is analysed based on a percentile ranking of the companies along each measure. This allows us to see how the likelihood of being acquired changes with respect to changes in the value of each financial measure. The percentile ranking of each company was constrained to companies from the same region, industry and for the same year.

A probit regression analysis is performed to see if any of the six financial measures (independent variables) are statistically significant predictors of the likelihood of being acquired. The dependent variable in the probit model is a dummy variable which is equal to one if the company is acquired in a given year and zero otherwise.

Based on the results of the regression analysis, a predictive model is built which calculates the probability of a company being an acquisition target.

As part of the study, interviews with 20 executives working for corporate acquirers and 20 executives working for private equity (PE) firms were conducted by Remark. These M&A professionals offer their insights and provide context to the research findings.

M&A market cycles and the probability of becoming an acquisition target

The period from 1992-2014 has been marked by five distinct M&A cycles, as described in the Introduction and methodology. The aggregate volume (number) of acquisition targets in the study sample over this time period is shown in Figure 1.

Over this time period, the annual *probability* or *likelihood* of being an acquisition target, defined as the number of companies that are the subject of a takeover bid as a percentage of all companies in any given year, is shown in Figure 2.

As can be seen from Figure 1, the volume of M&A activity over the study period has exhibited significant cyclicality and variance. The average of the absolute annual percentage change in the number of acquisition targets is 18.2%, with a standard deviation of 13.1%.

From an *individual* company's perspective, however, the probability of being an acquisition target in any particular year is much lower and this probability exhibits significantly lower variance than the year-to-year changes in the number of companies that become acquisition targets. As shown in Figure 2, the average probability of being an acquisition target in any given year is only 5.1% and the standard deviation of this probability is only 1.4%.

Figure 1. M&A market cycles and acquisition targets, 1992-2014

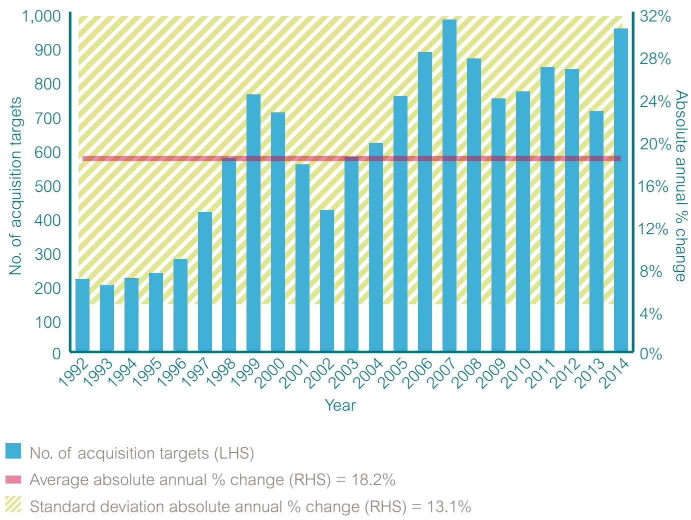


Figure 2. Probability of being an acquisition target, 1992-2014

Six characteristics of acquisition targets

1. GROWTH

Target companies have higher growth than non-targets. Companies with much higher or much lower growth than the average are also the most likely to become acquisition targets.

Growth is always going to be attractive to a potential buyer. As shown in Figure 3, our study finds that target companies have **higher growth**, as measured by their CAGR in sales in the three years prior to a takeover bid, than non-target companies.

The reasons for this are straightforward, as the partner of one Hong Kong PE firm explains: *"Sales growth helps us understand the business culture to a certain extent. It shows us that the management is dedicated to achieving higher sales targets in order to bring in more revenue for the business."*

As Figure 3 shows, the growth "premium" of targets over non-targets was higher during the market downturns in 2000-2002, 2008-2009 and also during the period of historically low inflation and lower global economic growth seen since 2010. Growth is even more highly valued by acquirers during periods of economic or market volatility and low inflation.

"Positive sales growth is a key requirement for us, so if we see a target with a high rate of sales growth, we will be open to buy it at high valuations," says the partner of a PE firm based in the Czech Republic.

Companies are also most likely to become acquisition targets if they have either much higher or much lower growth than the average. As shown in Figure 4, companies in the **top or bottom deciles** for growth are on average 20% more likely to become acquisition targets in any given year than companies overall.

"High sales growth is a direct indication that the company has something unique or new that customers are interested in and we thus look for that uniqueness and newness as more important," points out the director of M&A and investments at an Indian private company.

Figure 3. ALL COMPANIES: percentage points difference, targets minus non-targets, in average 3-year CAGR in sales prior to takeover bid

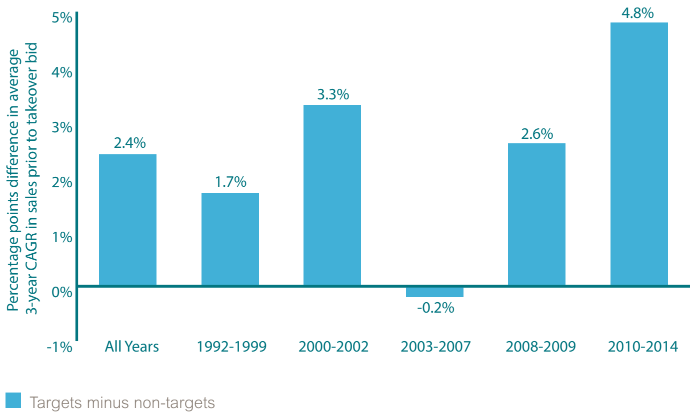
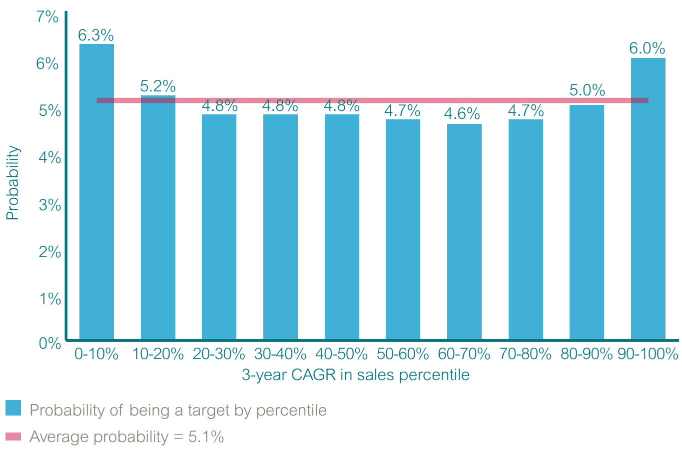


Figure 4. ALL COMPANIES: probability of being an acquisition target by 3-year CAGR in sales percentile prior to takeover bid



"The current market is a revenue-based market where the valuation of a company is defined by its revenue growth rather than how profitable the company was," observes a partner at a Czech PE firm.

He adds: *"The faster the company is growing, the more value and attention the company gets regardless of whether the company has profitability or not. We would always want to associate with a company that is growing fast and gaining value as our primary goal is increased value for our target."*

"Low sales growth businesses can be a good deal if they are affordable and have the potential to improve sales in the long run by getting funding assistance to develop the operating quality and also improve the business objectives by injecting more capital into the business. The profits can be capitalised on in the long run," says the executive vice president of M&A at a German public company.

This view is supported by the senior vice president, M&A of a US public company: *"We would conduct a detailed analysis on the company's financial position and its operational processes, and try to find a solution to improve sales growth by investing in new technology or by replacing the management."*

"Low rate of sales growth can be dealt with and this is not a parameter that can mark down a potential business model. The only part to complete here is to identify the weak areas and fix them to fully leverage the potentiality and to make the most of the hidden synergies," says the head of M&A at a Japanese public company.

"Sales growth and business growth go hand-in-hand."

Head of M&A of a French public company

2. PROFITABILITY

Private target companies are more profitable than private non-targets, whereas public target companies are less profitable than public non-targets. Private companies with much higher or much lower profitability than the average are also the most likely to become acquisition targets. Public companies with much lower profitability than the average are also the most likely to become acquisition targets.

As shown in Figure 5, private targets have **higher profitability**, as measured by their three-year average EBITDA/sales ratio, than non-targets.

The difference is particularly apparent since the bursting of the 1990s early internet stock market bubble in 2000, since many acquisition targets during that period were loss-making internet/technology firms. Since 2000, profitability of private targets is on average 1.2 percentage points higher than that of private non-targets.

"High profit margins are a sign of success and therefore acquiring such an entity is absolutely successful," says the managing director of a US PE firm.

"We will purchase a company with higher profit margins if the valuations and business description suit our need," says the partner of a US PE firm. *"It is a less risky option to consider and the chances of success are higher if a suitable target is identified and available for sale, which again is rare in today's business environment."*

Bigger profits also mean faster payback, notes the vice president of M&A at a US public company: *"High profit margins can help clear the loan for the acquisition at a faster rate, thus bringing added monetary benefits to shareholders and owners of the acquiring business."*

For public companies on the other hand, the opposite is the case. As shown in Figure 6, since 2000, public targets are on average 1.7 percentage points **less profitable** than public non-targets.

In our regression analysis, low profitability is the second most statistically significant predictor, after small size, of the probability of a public company becoming an acquisition target.

Overall, these findings are consistent with rational capital markets behaviour. Public companies by their nature are in the public eye and will attract attention – and corporate action – should their performance not meet shareholder expectations. Low-profitability

Figure 5. PRIVATE COMPANIES: percentage points difference, targets minus non-targets, in average EBITDA/sales prior to takeover bid

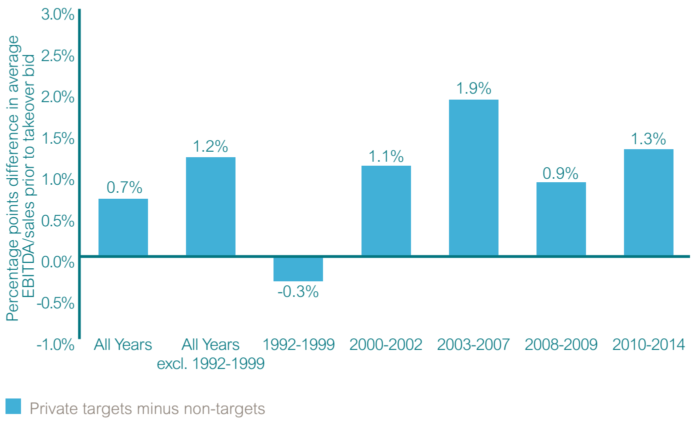
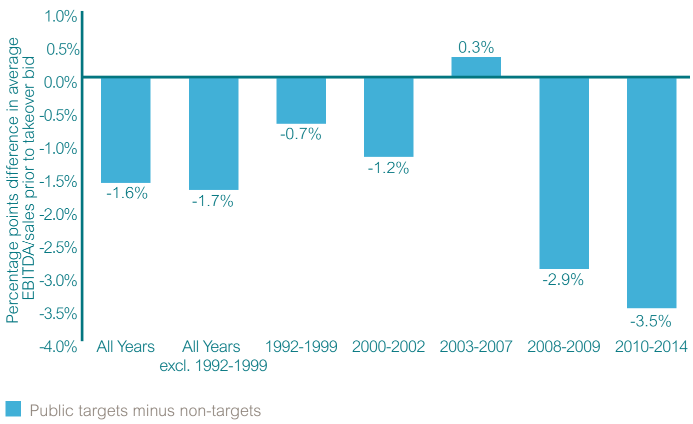


Figure 6. PUBLIC COMPANIES: percentage points difference, targets minus non-targets, in average EBITDA/sales prior to takeover bid



public companies are also more likely candidates for cost savings through merger synergies. Inefficient private companies, however, can operate for years without attracting attention. It is the highly successful, high-margin, private companies that are more likely to attract the attention of acquirers.

Our study also finds that private companies with **much higher or much lower** profitability than the average are also the most likely to become acquisition targets.

As shown in Figure 7, private companies in the **top or bottom deciles** for profitability have on average a 20% probability of becoming acquisition targets in any given year – 41% more likely than private companies overall.

However, for public companies, our study finds that having **lower than average** profitability increases the probability of becoming acquisition targets. As shown in Figure 8, public companies in the **bottom two deciles** for profitability are on average 40% more likely to become acquisition targets in any given year than public companies overall.

Why would companies with low profitability relative to their peer group be more attractive acquisition targets?

"A low profit margin does not matter to us if the target has a high growth rate and has innovative technology," says the director of M&A at an Indian private company.

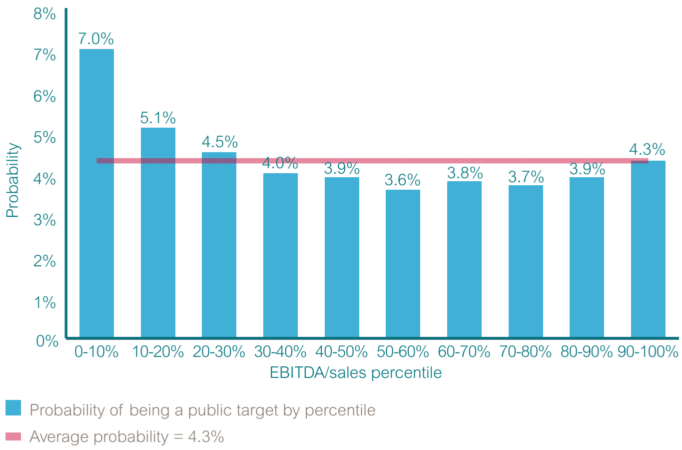
"To enter into a new market, low profit margin companies are good targets. They can be acquired at low valuations and with a majority control that gives straight access to the market," adds the head of M&A at a Japanese public company.

For the CFO of a Canadian private company, a target with a low profit margin may be attractive: "*We would invest in a company that does not have a high profit margin if it adds value to any of the companies under us. We would invest in them if we feel it has the potential to grow with a bit of capital and help from our management. We would also invest if we wanted to enter a particular sector and want to diversify our portfolio.*"

The prospect of obtaining favourable valuations for low-profitability firms is highlighted by the managing director of a Chinese PE firm: *"We prefer investing in businesses where we know we can fully use our management capability to turn them into profitable ventures. While acquiring a business with low profit margins, we can take advantage of negotiating on the valuation to suit our needs."*

Figure 7. PRIVATE COMPANIES: probability of being an acquisition target by EBITDA/sales percentile prior to takeover bid

Figure 8. PUBLIC COMPANIES: probability of being an acquisition target by EBITDA/sales percentile prior to takeover bid



"Profitability and valuation are directly linked to each other."

Partner of a UK PE firm

3. LEVERAGE

Private target companies are significantly more leveraged than private non-targets and private companies with much higher leverage than the average are also the most likely to become acquisition targets. Public targets have lower levels of leverage than public non-targets, especially since 2008. Public companies with much lower leverage than the average are also the most likely to become acquisition targets.

As shown in Figure 9, our study finds that private target companies on average have over **three times more** leverage, as measured by their debt/EBITDA ratio, than private non-targets. This difference appears well established and has persisted over the five M&A cycles since 1992.

"Leverage is highly attractive to us," says the partner at a Hong Kong PE firm. *"As a private equity business, we have the ability to take risks and are assured of creating significant value from these kinds of businesses. High leverage ratios come at very reasonable valuations and hence it is easy to invest in larger entities when there are high leverage ratios. The situation becomes very attractive for us to invest in, provided the business has potential to improve."*

As shown in Figure 10, however, public target companies have **lower** leverage than public non-targets. As shown in Figure 11, prior to 2008, public targets had on average **6% lower** leverage than public non-targets. After 2008, that difference increased sharply to **11% lower** leverage, indicating that acquirers of public companies have become more risk-averse following the 2008 global financial crisis.

"High leverages mean low valuations and we take such risks only if the company is capable of improving their performance through added investment," says the managing director of a Chinese PE firm. *"The business should possess good employees and management and should stand out in the market. The leverage ratios help us negotiate the deal to our benefit, making it an absolute success to our business if the right strategies are applied to facilitate growth."*

Figure 9. PRIVATE COMPANIES: median debt/EBITDA prior to takeover bid

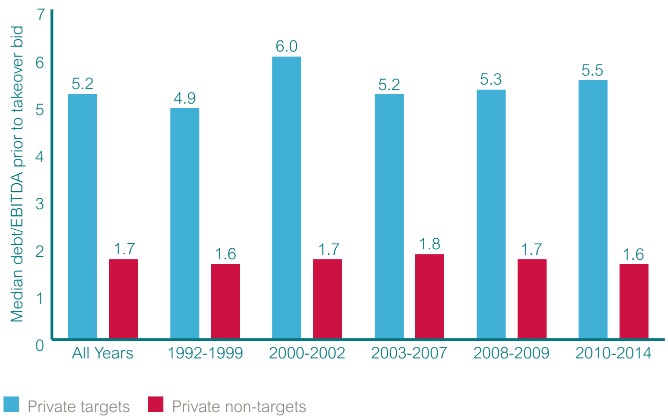
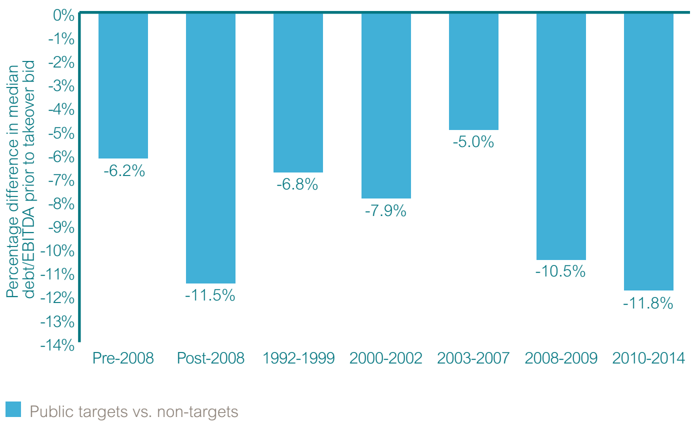


Figure 10. PUBLIC COMPANIES: median debt/EBITDA prior to takeover bid

Figure 11. PUBLIC COMPANIES: percentage difference, targets vs. non targets, in median debt/EBITDA prior to takeover bid



As shown in Figure 12, private companies in the **top two deciles** for leverage have on average a 28% chance of becoming acquisition targets in any given year – twice as likely as private companies overall. For private companies, there is a striking relationship between **increasing** levels of leverage and the probability of becoming acquisition targets. The most highly leveraged private companies are the most likely to become acquisition targets.

In our regression analysis, high leverage is the most statistically significant predictor of the probability of a private company becoming an acquisition target.

For public companies, the relationship between leverage and the likelihood of becoming acquisition targets is the opposite: as shown in Figure 13, public companies in the **bottom two deciles** for leverage are on average 30% more likely to become acquisition targets in any given year than public companies overall.

In our interviews, corporate acquirers were less positive than PE firms regarding the attractiveness of targets with high levels of leverage.

"Leverage is not at all accepted by our management. It has proven to be very unsuccessful in an acquisition and therefore we are hesitant in considering a business with high leverage," says the head of M&A and corporate alliances of a Japanese public company.

"Higher leverage means higher risk and we are not looking to take risky steps to fulfil our development goals. Leverage ratios reduce the returns to shareholders and therefore they are a bad mark on the target's position in the market when considered for acquisition," adds the vice president of business development and M&A of a US public company.

"It would be a risky choice and we would have to look into the company carefully. Some companies are able to get back large returns and have very good strategies when it comes to paying back debts. We will invest in them if we are assured of the returns we need," says the CFO of a Canadian private company.

Figure 12. PRIVATE COMPANIES: probability of being an acquisition target by debt/EBITDA percentile prior to takeover bid

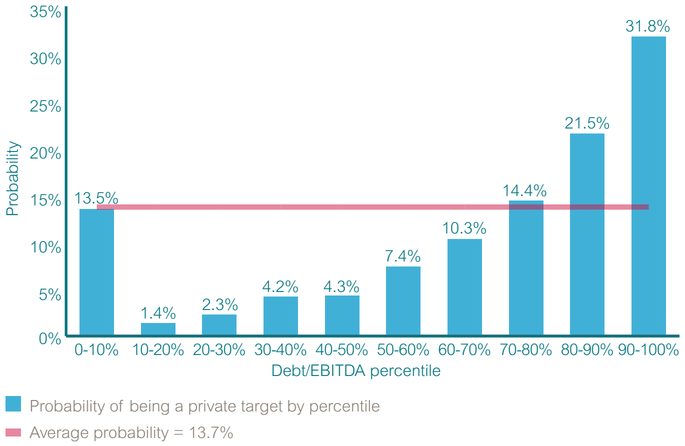
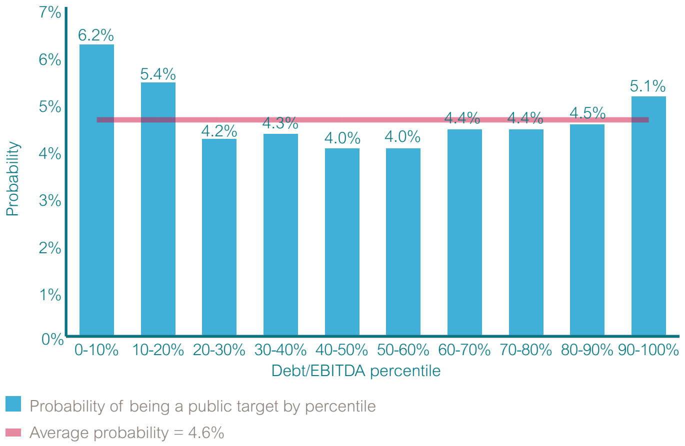


Figure 13. PUBLIC COMPANIES: probability of being an acquisition target by debt/EBITDA percentile prior to takeover bid



"High leverage would result in a prompt negotiation for the buyers as valuations and prices of assets are offered at least values."
Managing director of a Swedish PE firm

4. SIZE

Private target companies are significantly larger than private non-targets, whereas public targets are significantly smaller than public non-targets. Private companies that are much larger or smaller than the average are also the most likely to become acquisition targets. Public companies are increasingly more likely to become acquisition targets, the smaller in size they are.

Size is a statistically significant predictor of the probability of a company becoming an acquisition target, but the relationship is different for private vs. public targets.

As shown in Figure 14, pre-2008, private targets were on average **14% larger**, as measured by their total sales, than private non-targets. Post-2008, the difference in size between private targets and private non-targets increases dramatically: private targets are now almost 2.5 times larger than private non-targets, indicating that acquirers of private companies see size and scale as a significantly more important measure than before.

"Acquiring a larger market base and customer base is very important and we look for companies that can help us achieve this," says the CFO of a Canadian private company. *"This would also affect our profits and help us grow efficiently."*

"The size of the business is most important to us. We believe in maximising our energy capacity and so acquiring bigger energy-producing assets makes us more renowned in the energy industry. Thus we are able to overcome competition and achieve a greater market position," says the head of M&A of an Italian public company.

For public companies, the relationship between size and the likelihood of becoming acquisition targets is the opposite of that for private targets. As shown in Figure 15, public targets are on average **55% smaller** than public non-targets.

Figure 14. PRIVATE COMPANIES: percentage difference, targets vs. non-targets, in average sales prior to takeover bid

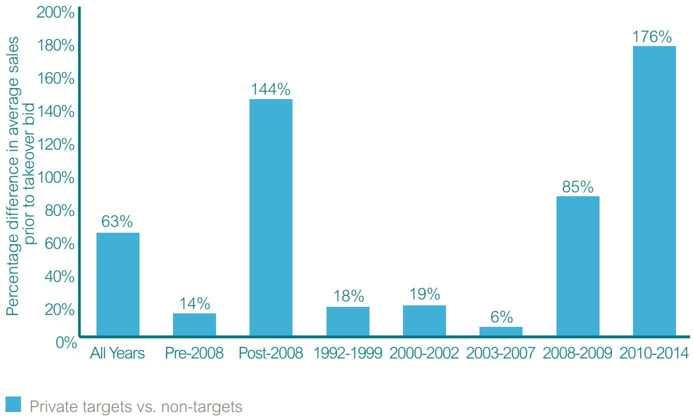
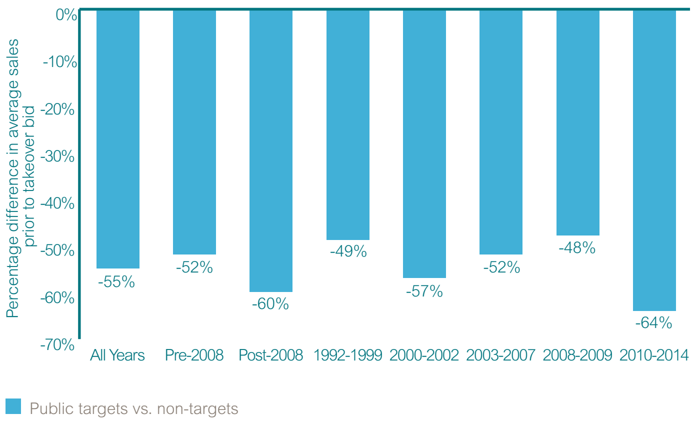


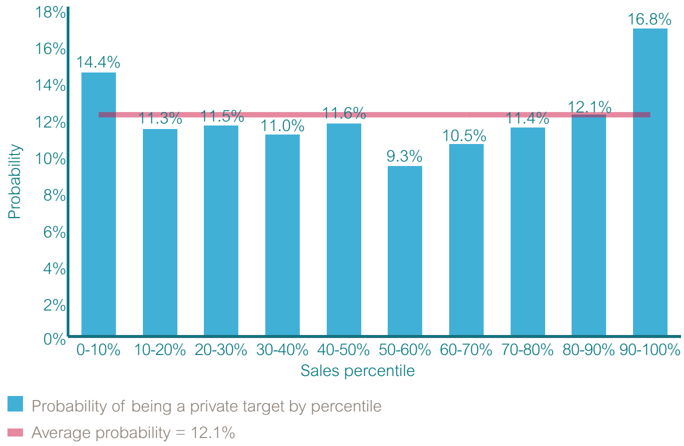
Figure 15. PUBLIC COMPANIES: percentage difference, targets vs. non-targets, in average sales prior to takeover bid



As shown in Figure 16, private companies in the **top and bottom deciles** for sales are on average 29% more likely to become acquisition targets in any given year than private companies overall.

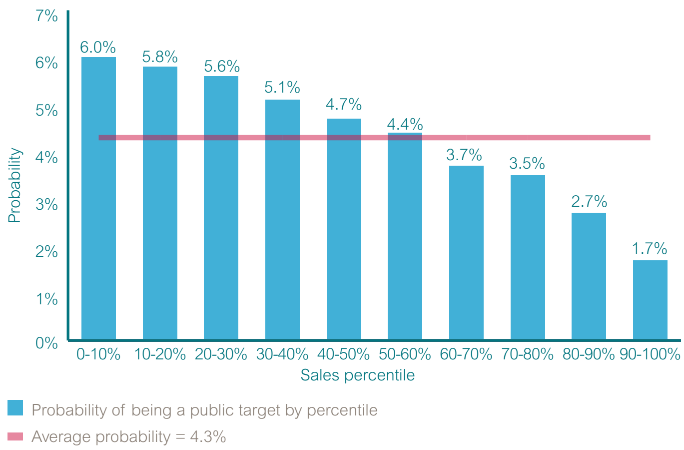
As shown in Figure 17, for public companies, size acts as an increasing deterrent to the likelihood of becoming acquisition targets. Public companies in the **bottom half** of the percentile distribution for sales are almost 70% more likely to become acquisition targets in any given year than public companies in the top half.

Figure 16. PRIVATE COMPANIES: probability of being an acquisition target by sales percentile prior to takeover bid



> *"Fitting a sizable target into our valuations is very important to make the deal a success."*
>
> Head of M&A of an Italian public company

Figure 17. PUBLIC COMPANIES: probability of being an acquisition target by sales percentile prior to takeover bid



5. LIQUIDITY

Target companies have lower levels of liquidity than non-targets.

As shown in Figure 18, our study finds that liquidity for target companies, as measured by their current assets/liabilities ratio, is on average **4% lower** than for non-targets.

As shown in Figure 19, companies in the bottom two deciles for liquidity are on average 35% more likely to become acquisition targets in any given year than companies overall.

One explanation for this finding could be that low levels of liquidity are associated with companies in financial distress, which are therefore more vulnerable to becoming acquisition targets.

Figure 18. ALL COMPANIES: percentage difference, targets vs. non-targets, in median current assets/current liabilities prior to takeover bid

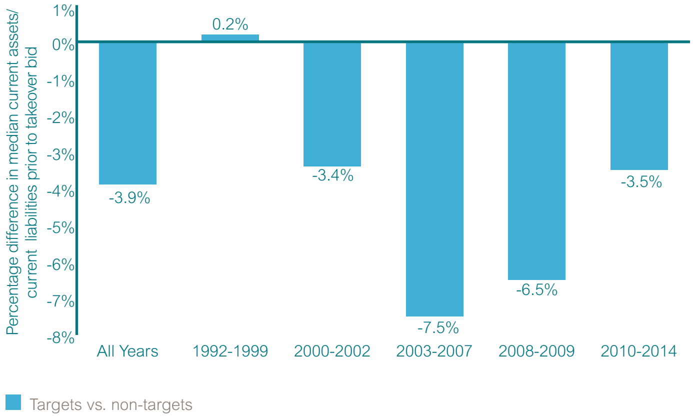
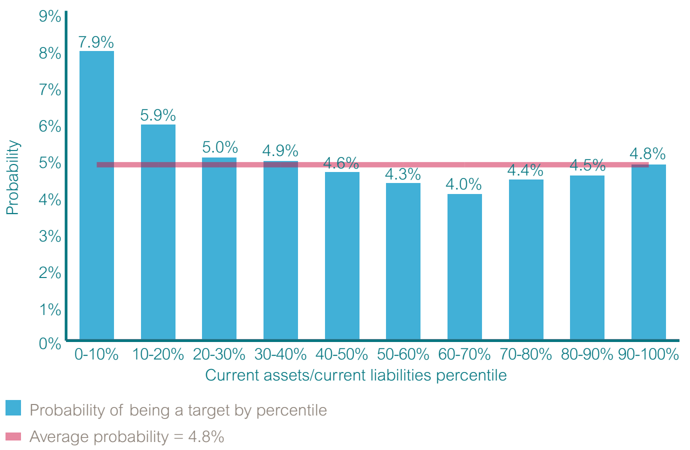


Figure 19. ALL COMPANIES: probability of being an acquisition target by current assets/current liabilities percentile prior to takeover bid



6. VALUATION

Public target companies have lower valuation multiples than public non-targets. Public companies with much lower valuation multiples than the average are also the most likely to become acquisition targets.

As shown in Figure 20 and Figure 21, our study finds that the average valuation of public target companies, as measured by their EV/EBITDA ratio, is **17% lower** than that of public non-targets. This valuation gap has persisted over the five M&A cycles since 1992 and is highest during market downturns, such as in 2000-2002 and 2008-2009.

One explanation for this is that acquirers target undervalued companies in general, and also take advantage of those companies whose valuations have fallen significantly more than others during market downturns.

Valuation is a critical consideration for any business weighing up an acquisition target, as pointed out by the managing director of a Chinese PE firm: *"We prefer a business that is undervalued but has the potential to grow if managed and organised appropriately to suit the business objectives. We focus on valuation and leverage as both of these factors determine the actual value of the deal and our decision depends on the investment we are considering making. So both of these factors are very important."*

"We have a certain limit that we can invest in acquiring a business so we try and stick to our budgets," says the director of M&A and strategy at a US public company. *"We thoroughly gauge the business's valuation because it has a great impact on the returns we expect."*

Figure 20. PUBLIC COMPANIES: average EV/EBITDA prior to takeover bid

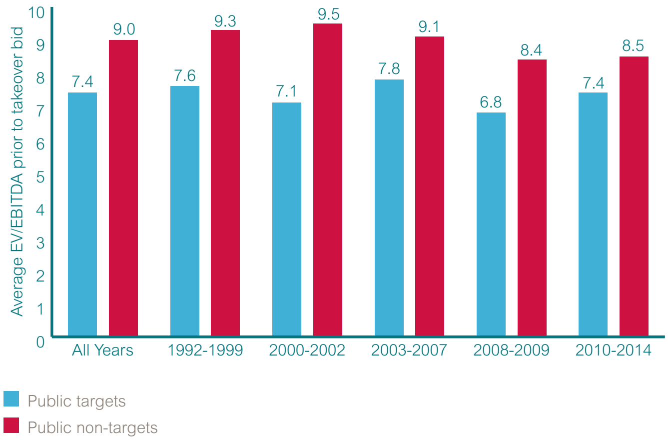
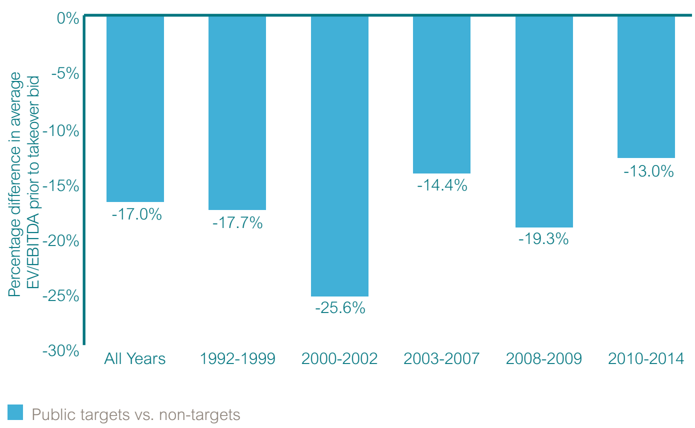


Figure 21. PUBLIC COMPANIES: percentage difference, targets vs. non-targets, in average EV/EBITDA prior to takeover bid



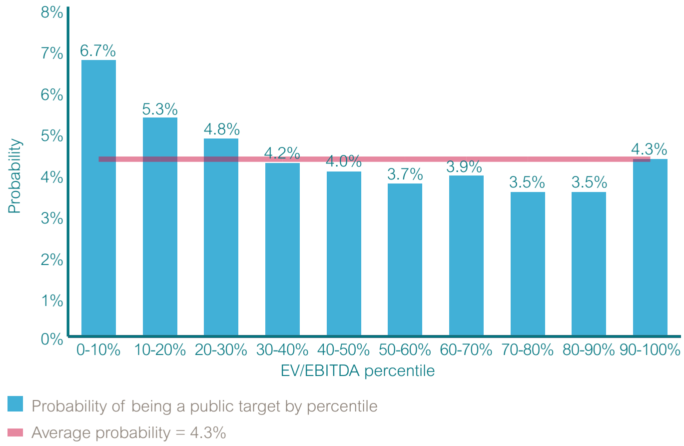
As shown in Figure 22, public companies in the **bottom three deciles** for valuation are on average 30% more likely to become acquisition targets in any given year than public companies overall.

"*Valuations are most important. If we are able to achieve accurate valuations for the target's assets then the deal would end up having significant positive synergies and thus profits, making our goals achievable,*" says the senior vice president of M&A at a US public company.

"Valuations are important because to avoid risk we need to make sure we are taking the right steps to fulfil our growth objectives by purchasing businesses for what they are worth and then use approaches to improve the business position in the market by applying growth strategies to bring added value to the investors," says the managing director of a French PE firm.

"Valuation determines if we have paid a fair price for the business and its assets, and also determines the added value we would create in the years to come."
Head of M&A of a Chinese private company

Figure 22. PUBLIC COMPANIES: probability of being an acquisition target by EV/EBITDA percentile prior to takeover bid



Non-financial considerations

While the financial indicators examined by our study remain among the most important measures of target companies looked at by buyers, our survey respondents also gave some insights into the non-financial attributes of companies they consider important when evaluating potential acquisition targets.

"We look at the value and the name the company has made for itself in a particular region," says the head of M&A and strategic investment at a Singaporean public company. *"We believe in sustainable growth and have been focusing on companies that have been a part of it. But we also look at the way business is carried out and the culture within the company."*

Many of our survey respondents point to intangibles such as brand value, the capabilities of management, legal and regulatory compliance, social responsibility, risk management and reputation – with culture often being mentioned as a key factor in business growth.

"The target's culture is very important. Having a clear understanding of the target's culture will reveal several insights, making it easy for the acquirer's management to take control and introduce new growth methods to help the business grow at a faster rate, benefiting all the people involved in this operation from the management right up to the employees," says a partner at a UK PE firm.

Reputational factors figure prominently, with one respondent highlighting their pivotal contribution as a marketplace differentiator: *"Social responsibility and market reputation are the two most important non-financial characteristics because, through these, we can gain a competitive edge over peers in the target's industry, raising the level of success we are likely to achieve,"* says the partner of a South Korean PE firm.

Not surprisingly, regulatory and legal compliance was uppermost in the minds of many: *"These factors can create huge damage to the business's objectives if the threats and the risks are not identified in the early stages,"* observes the managing director of a Chinese PE firm. *"The impact is significant and it can result in deal failure too, hence it is a very important non-financial aspect that has to be examined carefully to eliminate risks."*

This point is taken up by the senior director of M&A of another Chinese company, who also emphasises the need to focus on the human dimension: *"The most important non-financial aspect that must be measured is the level of compliance maintained by the organisation as it has a direct impact on the business performance and future objectives. Apart from that, the management capabilities and employee capabilities should be gauged as these can impact the growth synergies in a very big way. Dissatisfied employees will result in low business performance and therefore analysing these possibilities is a must."*

Glossary of terms

- *Target*: a company with minimum sales of US$50 million in a given year which was subject to a “change of control” takeover bid in that year.
- *Non-target*: a company with minimum sales of US$50 million in a given year which was not subject to a “change of control” takeover bid in that year.
- *Sales growth*: CAGR in sales from year -3 to year -1 prior to a given year.
- *Profitability*: average of the ratio of EBITDA to sales from year -3 to year -1 prior to a given year.
- *Leverage*: average of the ratio of debt to EBITDA from year -3 to year -1 prior to a given year.
- *Size*: sales in year -1 prior to a given year.
- *Liquidity*: ratio of current assets to current liabilities in year -1 prior to a given year.
- *Valuation*: ratio of enterprise value to EBITDA in year -1 prior to a given year.
- *Enterprise value*: market capitalisation + preferred shares + minority interests + total debt - cash.
- *EBITDA*: earnings before interest, tax, depreciation and amortisation.

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