Mergers & Acquisitions – cooperation with an entrepreneur from Central and Eastern Europe

A practical guide part I

Author: Bartosz Kondaszewski

April 2011
A few years ago Central Eastern Europe became one of the favourite regions, attracting investors’ interests. There are several reasons for this, from the historical, geographical and political to the macroeconomic. CEE has been attractive for companies looking for outsourcing hubs, production operations, new prospective markets and demand, operations diversification as well as investments ideas. This trend affected, inter alia, the mergers and acquisitions area in the region. A large number of international players have already invested in the region or are looking for investment opportunities. We have prepared a short guide for those considering entering the CEE market via an acquisition. The guide is primarily focused on those potential issues and problems an investor might encounter while looking for an acquisition in Central Eastern Europe, mainly regarding companies’ and owners’ characteristics.

Historical draft

Due to historical reasons Central Eastern Europe in general started its post-World War II recovery and development later and significantly less dynamically. There are many reasons for this, including Soviet dictatorship, a regulated economy system and the non-acceptance of the Marshall Plan, offered by the US government for all European countries to recover after the war. These realities, lasting until the late ’80s, were not unimportant for the region’s economies, enterprises and entrepreneurs. It is therefore important to be aware of these aspects when approaching companies in the region and to realise that the companies’ and owners’ characteristics might be different from those commonly observed in Western Europe and USA.

Areas of interest

There are three main classes of features that a party interested in investing in a company located in CEE has to take into consideration. Whilst a division into three groups is made for transparency reasons, all the following aspects are obviously closely interrelated, intersect with each other from an intra-company perspective and to a certain extent derive from and are linked to the economic environment. The characteristics discussed in this paper relate mainly to mid-sized companies and small companies i.e. with revenues ranging from EUR15m to EUR75m for mid-sized and below EUR15m for small companies. However, it may also be appropriate for large entities.

These are issues related, firstly, to the owners themselves; secondly, issues related broadly speaking to finance; thirdly, aspects related to company operations and companies themselves.
Owners related issues

To start with the first group i.e. issues related to owners, potential investors will very often encounter companies established in the late ‘80s or early ‘90s, the time of the Fall of Communism in the region, with companies founded by a regional entrepreneur and where the founder was and remains to this day the CEO. This situation raises a range of issues to be aware of.

Founder = CEO

First of all the founder quite often has an inner conviction that he or she has over the past years obtained a full knowledge of the industry and the business and that an investor is not necessary, let alone an advisor. This is the initial area where PMR usually starts its work advising on the buy-side i.e. clients who want to invest in the region. PMR opens a discussion about the targeted company’s historical development, current situation and future prospects and what has to be done to achieve the forecast. One of the major PMR competencies in the M&A advisory process is to the establishing of relations with entrepreneurs and educating them to some extent as to what an investor might offer them and what various options of future development are available to them. This quite often results in an entrepreneur’s change of attitude, from being reluctant to being open to further discussion.

Other issue resulting from the situation where a founder remains company CEO is that if an investor enters such a company there might be a problem of perspective separating the founder from the company operations. It is therefore important to fully understand how the company operations are performed, who is the ultimate decision-maker in major aspects and in daily operation, if there is a skilled middle management structure and, if so, to what extent the duties are delegated. This is one of the areas that PMR investigates at the stage of the initial target company visit, resulting in a summarizing Meeting Memorandum, delivered to the client.

If the company founder remains the owner for 10-20 years the problem that might often appear is the excessive value the owner associates with the company compared to a rational valuation outcome i.e. a sentimental value. Obviously, no investor is interested in meeting the owner’s valuation expectations including sentiment. From PMR’s perspective this problem is one of the major reasons for establishing good relations with the vendor. Even though on a buy-side project we advise investors, having a relationship with the seller allows us to discuss valuation issues and transaction expectations with him, something which is highly valuable in executing the later stages of an M&A transaction.

Ownership structure

Small and mid-sized companies in Central Eastern Europe are often family owned businesses, not a business partners owned businesses. Discussions with companies owned by business partners are quite transparent as at the initial meeting the company is represented by all owners or by a representation of owners, supported with powers of attorney issued by the absent parties. In the case of family owned businesses, the representing party is quite often only the CEO (one of the family members), without the power of attorney. Therefore, it is extremely important in the early stage to verify the actual intentions of all the owners to engage in later steps with a full awareness of the situation. In the majority of cases PMR is able to verify owners’ intentions during the initial meeting or during follow-up discussions.
 Owners’ readiness to run the company after the transaction

When approaching a company managed by the owner an investor may quite often face the dilemma of whether the owner will be motivated enough to successfully run the company on behalf of the investor during the transition period. There are two aspects that provide the answer to this. First, it has to be verified if there is a middle management potentially able to take over the owner’s duties if the motivation issue occurs. Second, is the deal structure related. If an investor expects the founder/owner to run the business in the after-transaction period PMR always suggests this be taken into consideration when providing an initial offer and constructing a Letter of Intent. Whilst, in general, solutions based purely on the owner’s cash-out from the business are less motivating than earn-out oriented solutions, it is always a matter for careful analysis in each particular case.

Family members employed in the company

In family-owned companies it is often the situation that family members are employed on different levels of the company in different departments. It has always to be verified if the situation is healthy i.e. if the value provided by the family member corresponds with his or her position and salary. It happens that, when investigated, the value for money turns out rather poor. It is important from the point of view of the company valuation and potential future post-transactional cost optimizations. Quite often well-established relations with the company founder/owner enable easy identification of the “weakest links”. It has to be born in mind that, especially in the buy-out type of transaction, the current owner and his or her family is going to gain a significant amount of cash in exchange for the company. Therefore, if clearly described to the owner, it is in his interest to identify these “links”.

Finance related issues

As it is still in the context of approaching a CEE based company, it refers only to region-specific items.

There are several key issues to be considered, mainly in terms of Income Statement and Balance Sheet. In general it is important to normalize the Income Statement i.e. exclude those items that will not occur once the investors steps into the owner’s shoes. To give a few examples: it might be owner-related additional costs that are not crucial for running the business (family costs covered by the company); one-off items’ effects on Profit and Loss account, where reoccurrence is highly unlikely; interest paid to the owner on a loan given to the company; profits/losses from investing which generated a cash surplus in risky financial instruments such as the stocks or derivatives not used as a hedging instrument etc. These elements may affect the apparent profitability of the company - especially Net Profit - but, in reality, the company’s operational picture might be different than presented in the accounts. From the Balance Sheet perspective it is important to verify if all fixed assets are used in the core business, as some may appear to be pure investments of the owner’s, with the company being used as a vehicle. It is sometimes the case that the owner does not take loans from a bank as a rule i.e. the company development might be even less dynamic but not burdened by interest-bearing debt. From an investor’s perspective this may be an attractive opportunity to leverage the transaction and achieve a higher return on invested capital (ROIC).
Operations and administration related issues

Legal entity

The first element to be considered in this group of factors is the legal entity under which the targeted company operates. An investor may still encounter fairly big companies in the region operating as a sole entrepreneur or general partnership. Obviously, many companies operate as public limited companies or joint stock companies where an investor purchases company shares to acquire control. For the transaction to be effective where companies operate as partnerships or as sole entrepreneurs an investor has to clearly define the subject of the acquisition as the transaction will then concentrate on the acquisition of the organized part of the business. PMR is able to help the investor in defining the assets that constitute the organized part of the business and assist in the preparatory works of transactional documentation. In the case of a takeover of an organized part of the business it is also important to execute the transaction in the most tax-efficient manner. PMR is able to suggest local professional advisors that have over time proved their skills in this type of transaction.

Scope of activity

The second aspect that requires verification at the initial stage is the company’s scope of activity. It seems fairly common that a particular company has more than one business focus. If the areas of activity do somehow relate to each other it might be potentially attractive as value adding. It is, however, possible to find companies that seem to suite an investor’s target profile at first glance whilst in reality offering a wider range of products or services, utilizing company assets not in the scope of the investor’s interest. This issue has to be communicated to the owners at an early stage of discussions to verify if separation is acceptable for the owners and to discuss how it might work. This is the area where PMR, using established relations with the owners, may try to convince them to perform a curve-out of the uncore business, suggesting various options discussed previously with the investor. As the procedure of the curve-out is often quite complex, it is therefore important to closely cooperate with the owners.

Accounting standards

The last aspect relates to the accounting standards used by the company’s financial department. In CEE regions it is still common to use local accounting standards that, with accession to EU structures of particular countries, are more and more harmonized with IFRS. However, there are still many discrepancies. PMR is able to provide investors with a comprehensive statement that precisely matches industry-related requirements. It is therefore crucial at an initial stage of cooperation to define the targeted company profile, the information required by the investor to be able to make decisions on further steps and the financial data and their presentation in order to provide the investor with as clear a picture as possible.
Summary

All the above-mentioned points are examples of issues that might be perceived as either threats against a transaction, region-specific aspects to be aware of and cope with or, for some parties, as general remarks that may also refer in some cases to other geographical reasons, especially other emerging markets. Nevertheless, every investor attracted to the CEE region has to be aware that Central Eastern Europe countries, though getting closer to Western economies over the past 20 years, still have ground to make up. Therefore, for an investor to be able to execute fast and successful acquisitions in the region it is highly recommended to gain the support of an advisor familiar with regional realities and who is experienced in buy-side transactions.
PMR Consulting (www.pmrconsulting.com)
provides a wide range of services in 20 countries of Central and Eastern Europe, including market entry feasibility studies, sourcing, CI (competitive intelligence), strategic advisory, FDI assistance (M&A and greenfield projects), quick consulting as well as any other services and support a company might require to enter a market, find a business partner or gain reliable information. Our services are always tailored to the specific requirements of our clients, many of which are Fortune 500 companies.

PMR Research (www.research-pmr.com)
is the specialised custom research unit of PMR. It offers a full array of qualitative and quantitative research methodologies, providing services such as customer satisfaction studies, brand awareness and brand image research, distribution and competition studies, segmentation analyses, fieldwork, online surveys and customised analyses of selected branches of the economy. PMR Research’s services are available in over 20 countries of Central and Eastern Europe.

PMR Publications (www.pmrpublications.com)
provides reliable market intelligence for business professionals interested in Central and Eastern European countries as well as other emerging markets. Publications by PMR analyse the business climate in the region, in particular in the construction, retail, IT, telecommunications and pharmaceutical sectors.
PMR Publications offers both free and paid subscription newsletters, internet news portals and in-depth reports.

Contact PMR

PMR Consulting
tel.: /48/ 12 296 22 50
fax: /48/ 12 296 22 99
e-mail: info@pmrconsulting.com
www.pmrconsulting.com