Crowe Horwath

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The Global Corporate Advisor

The Corporate Finance newsletter of Crowe Horwath International

GCA May is brought to you from India and the Middle East. We start with a Q1 2013 wrap-up of M&A market activity in these regions – India showing a mixed performance, while the Middle East and North Africa had a busy quarter and the outlook remains positive for the rest of 2013.

From our colleague Rafael Stroobants, we learn a valuable lesson about undertaking company valuations in emerging markets such as Venezuela. This article draws on Crowe Horwath's extensive experience in valuing companies in Venezuela to illustrate the types of issues buyers should understand.

Meanwhile, Torsten Haupt provides an overview of how GCA assisted Catalyst Capital to acquire 30 retail outlets in Germany in a transaction valued at €154 million.

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The GCA team is here to respond to your needs relating to M&A transaction support, valuations and M&A advisory services. If there is a topic you would like us to cover in future issues of the GCA newsletter, don't hesitate to contact Peter Varley, Chairman of GCA at peter.varley@crowecw.co.uk. Alternatively, please contact your local member of the GCA team to discuss your ideas.

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Closing the Deal: How Crowe Horwath Helps Companies Execute Successful Property Transactions

By Torsten Haupt, Frankfurt

Crowe Horwath Germany has extensive experience in helping real estate companies complete complex deals. In 2012, we helped European investment and asset management company Catalyst Capital (Catalyst) undertake a €154 million transaction to acquire 30 retail outlets in Germany totaling 125,000 square metres in a combined asset and share deal.

Hunting for assets

Since its inception, Catalyst has invested more than €4.5 billion in global real estate assets, including more than €1.1 billion in 35 shopping centers. The company's goal is to build its portfolio to create a sustainable base for future growth, through active asset management and engaging with tenants and local partners.

In 2012, Catalyst was seeking to expand its property portfolio by potentially undertaking the aforementioned German deal. The portfolio included retail warehouses, supermarkets, discount outlets, self-serve stores and hypermarkets. The properties were mostly in mid-size, but high-traffic locations and predominantly located in Bavaria, Baden-Württemberg and North Rhine-Westphalia. The main tenants included established German retail chains such as Edeka, REWE, Real, OBI and Hornbach.

Managing the transaction

However, the potential acquisitions were highly complex. To secure the properties, Catalyst had to deal with the legal structures of 30 different properties, which involved multiple entities across several jurisdictions. The company engaged Crowe Horwath to assist in the execution of the successful deal.

During the transaction, we worked closely with Catalyst to comprehensively address the taxation and partly commercial issues stemming from the deal. We helped the company select the most appropriate tax structures; conducted tax and financial due diligence on the target companies that owned the retail properties; and examined the tax issues associated with the share price and facility agreements.

We also carefully examined how the acquisition would help Catalyst meet its corporate goals. This led us to recommend an acquisition strategy based on equity and asset purchases.

By engaging our services, Catalyst was able to undertake a robust due diligence process that encompassed tax, financial, and integrity issues, and ensured risks and rewards were properly allocated between the buyer and sellers. This detailed process – which took place over a number of months – delivered an optimal solution for Catalyst.

On 26 November 2012, Catalyst took ownership of all 30 properties. The main lender and lead arranger was pbb Deutsche Pfandbriefbank AG, which provided €85 million. The Austrian Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse Aktiengesellschaft provided an additional €21.5 million in stretched-senior debt.

Ongoing support

As the deal progressed, we assisted Catalyst to integrate the new properties into its operations. This involved establishing cost-efficient accounting processes within the company's existing systems, which allowed Catalyst to reduce costs across the group of properties.

Further, our team is helping Catalyst complete key compliance tasks after the transaction, including managing regulatory filings and maintaining adequate records.

Catalyst was pleased with the outcome of the deal.

"We structured the transaction in good cooperation with the seller," said Steven Jedlicki, Director at Catalyst Capital in Frankfurt. "A sound balance of long-term and medium-term leases, strong anchor tenants, plus the potential for optimizing individual locations are cornerstones of our strategy."

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A Valuable Lesson: Undertaking Company Valuations in Venezuela

By Rafael Stroobants, Crowe Horwath, Venezuela

Accepted practices in developed markets aren't always replicated in less developed locations, like Venezuela. For instance, valuation is a largely standard activity in developed economies, but can be substantially more challenged in command economies and emerging markets.

This article draws on Crowe Horwath's extensive experience in valuing companies in Venezuela to illustrate the types of issues buyers should know. As the Venezuelan Government privatized assets from 2007–2009, we helped multinationals undertake valuations, due diligence and negotiations. Later, we offered similar services for the acquisition program of state-owned oil company Petróleos de Venezuela S.A. (PDVSA).

To help explain our valuation lesson, we will use the example of PDVSA seeking to acquire a smaller competitor, which we have called ABC Enterprises – a Venezuelan-registered and British-owned producer of high-tech gas containers.

'Fair' valuations

In the context of acquisitions, the concept of fair value is often used to value companies. Fair value is the price at which an asset is sold in an open and unrestricted market where buyers and sellers are acting at arm's length. In Venezuela, few of these elements are present.

For example, once PDVSA expresses interest in acquiring a company, no other buyers will compete and the target´s options are limited. This eliminates an open and unrestricted market. Also, Venezuela's public institutions and state-owned enterprises do not always act at arm's length or without compulsion.

However, government institutions and companies such as PDVSA are adopting fair value approaches as defined by International Accounting Standards (IAS). They also generally comply with treaties with countries such as France and Spain, which emphasizes the importance of fair value in the case of acquisitions by state-owned companies. This helps ensure PDVSA´s acceptance of fair value as a basis for valuations and acquisitions.

Valuation techniques

In Venezuela, state-owned companies prefer to use book values as the basis for valuations in mergers and acquisitions instead of income-based methods, which are based on the net present value of future cash flows. The Venezuelan Government is unwilling to pay for 'value that has not been realized yet'. For this reason, the government prefers to acquire assets rather than equity.

Fortunately, in our experience, valuations are very similar under both approaches. This is because during company acquisitions, Venezuelan law requires the government to pay the value of the assets and compensation for future earnings (known as 'lucro cesante'). However, it is important to note that state-acquisition laws are currently being reviewed and the recognition of future earnings will be scrapped.

Based on our advice, during the purchase of ABC Enterprises, PDVSA chose to acquire equity instead of assets and determine its fair value according to IAS guidelines – a factor which helped secure the approval of the company's internal audit and control departments.

Cash flow forecasts

A key element in valuations is calculating the discounted future cash flows of acquisition targets. Buyers need to decide which cash flow forecast they will use: one based on the owner's business plan and market appreciations; or will it be the cash flow from the buyer's business plan that takes into account economies of scale and product synergies?

This is a challenging issue when an acquisition gives the buyer a controlling share in the target company and where buyers do not have access to complete information. Further, even in mature markets, notions of value can vary substantially due to differences in underlying cash flow forecasts and risk projections, for instance, during takeover bids.

In our example, ABC Enterprises' business plans were radically different from that of the state-owned buyer (PDVSA), in terms of markets and segments to be served, sales channels, price structures, costs, profit targets, financing and cost of capital. This resulted in completely different net present values of free cash flow to equity.

In order to resolve these differing views, Crowe Horwath encouraged PDVSA to follow the 'buyer-seller' concept of fair value and take into account their respective notions of value. In fact, the following 'range' of values was calculated:

- minimum value (based on asset value, liquidation value, or value in use)
- buyer's value (business plan of an average 'hypothetical' investor)
- fair value (exchange between a buyer and seller acting at arm's length)

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- seller's value (which stems from the business plan of the present owners)
- maximum value (valuation at maximum capacity and optimum market conditions)
- PDVSA value (value of PDVSA's business plan for ABC Enterprises).

Figure 1 summarizes the projected outcomes of PDVSA's acquisition of ABC Enterprises.

Within this range, fair value is calculated by either estimated value (net present value of the most likely scenario) or expected value (weighted average of net present value of each business plan, with further weightings assigned to specific risks). Under normal conditions, ABC Enterprises would probably not be expected to sell because the projected net present value of operating the business (seller´s value) is higher than the prices likely to be offered by PDVSA or another investor (buyer´s value). In our example nevertheless, an agreement was reached around Bs.230 million (US$36.6million).

Managing exchange rates, inflation rates and discount rates

In the valuation of ABC Enterprises, Crowe Horwath needed to decide if the company's free cash flow should be expressed in Bolivars or US dollars. Sales are conducted 90% in local currency (the Bolivar), and 10% in US dollars. However, the company´s official currency for accounting purposes is the US dollar.

The question is closely related to Venezuela´s monetary policy: the country has strict exchange controls, with a fixed rate and a total prohibition of acquiring hard currency through parallel (semi-legal or black market) channels. It is even illegal to predict future devaluations in financial calculations or to refer to non-official exchange rate markets. The currency (Bolivar) is not convertible abroad. Under current regulations, any Bolivar-based cash flow generated by a company can be used to pay dividends, be reinvested or fund the purchase of other assets – but only in Venezuela.

The repatriation of dividends in foreign currency to overseas shareholders – though completely legal – requires an authorization process that is unpredictable and can take months or years. In spite of all these controls nevertheless, inflation in the country is rampant.

Figure 1: Projected outcomes of PDVSA and ABC Enterprises transaction

ABC Enterprises						
	Minimum Value	**Buyer's Value**	**Transaction Value**		**Seller's Value**	**Maximum Value**
Scenario	*Book value of equity (adjusted after due diligence)*	*Business plan of potential investor (acting at arm's length)*	*Fair value = Negotiation target*	*Value for PDVSA = Negotiation limit*	*Business plan of present owner (controlling shareholder)*	*Potential value (max. capacity use and market prices)*
Equity value	**137,642,650**	**184,709,672**	**200,618,756**	**220,680,631**	**239,831,722**	**261,441,165**
Net asset value	**137,642,650**	**146,517,039**	**146,517,039**	**146,517,039**	**146,517,039**	**146,517,039**
Fixed assets	148,182,402	148,182,402	148,182,402	148,182,402	148,182,402	148,182,402
Working capital	8,298,974	8,298,974	8,298,974	8,298,974	8,298,974	8,298,974
Other assets less liabilities	-9,964,337	-9,964,337	-9,964,337	-9,964,337	-9,964,337	-9,964,337
Debt (bank)	-8,874,389	-8,874,389	-8,874,389	-8,874,389	-8,874,389	-8,874,389
Added value of going concern		**38,192,632**	**54,101,716**	**74,163,592**	**93,314,683**	**114,924,126**
Estimated value of intangibles:						
Market goodwill		38,192,632	38,192,632	38,192,632	38,192,632	38,192,632
Control prime			15,909,084	15,909,084	15,909,084	15,909,084
Other intangibles (PDVSA business plan)				20,061,876		
Other intangibles (ABC Enterprises business plan)					39,212,967	
Other intangibles (maximum business plan)						60,822,409
Note: Equity Value in US$	**32,009,919**	**42,955,738**	**46,655,525**	**51,321,077**	**55,774,819**	**60,800,271**

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Based on these considerations, Crowe Horwath and PDVSA agreed to undertake calculations in Bolivars (which is in line with IAS), using 'real' cash flows (without inflation) instead of 'nominal' cash flows. However, simply converting a future Bolivar cash flow into US dollars at today´s exchange rate or ignoring the impact of inflation on working capital, leads to huge overestimations of net present value.

To address this, Crowe Horwath designed a calculation model for PDVSA that carefully balanced exchange rates, inflation rates and discount rates, resulting in identical values in US dollars and Bolivars, both in real or nominal terms, allowing PDVSA to carefully deal with currency, inflation and risk-related challenges.

Conclusion

During an acquisition, it is crucial for a buyer to accurately calculate the value of its target. However, this can be a particularly difficult task in developing or state-controlled economies. We recommend companies to work with expert advisors who can help deliver accurate valuations in uncertain environments and ensure compliance with all regulatory obligations. Emerging market transactions can offer tremendous opportunities but they also come with their share of risk.

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Market Update: M&A Activity in India and the Middle East/ North Africa

By Vijay Thacker, Mumbai

India

M&A activity in India remains in a state of flux, mirroring the nation's economic and investment outlook. Overall, M&A activity levels have declined: in Q1 2013, the aggregate value of M&A deals announced was US$7.32 billion, down 13.5% compared to Q1 2012.

According to VCCEdge Private Equity, the number of deals dropped marginally over the same timeframe (208 deals in 2013, compared to 215 deals in 2012), reflecting a lower average deal size. The biggest deal announced in Q1 2013 was the acquisition of Agila Specialties by US-based Mylan Inc. for US$1.6 billion in cash.

Private equity

In terms of private equity activity, the value of investments (including venture capital investments) dropped almost 40% to US$1.75 billion in Q1 2013, compared to US$2.5 billion in Q1 2012, according to VCCEdge. There was a significant drop in the number of deals – 122 deals in Q1 2013, compared to 199 deals in Q1 2012, reflecting a similarity of average deal size between the two years.

There were only 45 private equity investments in Q1 2013 with a total value of US$1.54 billion. This was less than half the number of investments in Q1 2012. Private equity firms are seeking exits from investments made in the 2007–2009 period. Crowe Horwath believes this situation will continue during the remainder of 2013.

Among the major private equity M&A deals in Q1 2013, Blackstone completed two large real estate deals in Pune and Bengaluru. It also acquired a US$100 million majority stake in Sree Jayajyoti Cements, a domestic cement manufacturer.

Singapore-based GIC invested US$337 million in the energy sector, including in Greenko Group, an alternative energy firm.

Domestic deals

Domestic M&A in Q1 2013 was extremely slow, with less than half the number of deals completed compared to Q1 2012. There was a notable absence of large-scale acquisitions. The most important deals completed in Q1 2013 were in the energy, pharmaceutical, healthcare, IT, and real estate (including hotels) sectors. Crowe Horwath believes these industries will continue to attract investor interest during 2013.

Etihad buys a stake in Jet Airways

Abu Dhabi-based Etihad Airways is taking advantage of liberalized foreign direct investment (FDI) regulations for India's airline industry. In April 2013, Etihad announced an agreement to purchase a 24% stake in Jet Airways, India's only full-service private airline, valued at US$400 million. Coupled with the acquisition of operating slots at London's Heathrow Airport and a stake in Jet Airways' frequent flyer program, the overall investment commitment reached approximately US$600 million.

Crowe Horwath believes that the successful conclusion of this deal (which is currently going through regulatory approvals) will encourage foreign investment in other private Indian airlines.

Unilever and others up the stakes

In May 2013, Unilever NV announced a US$5.3 billion offer to increase its stake (from 52% to 75%) in Hindustan Unilever Ltd, a listed blue chip company in India. The offer reflects the multinational's confidence and commitment to India. It also highlights the growth potential of India's consumer goods industry.

This growth potential is backed by other recent acquisitions. Doha-based Qatar Foundation Endowment is acquiring a 5% stake in Bharti Airtel, the world's fourth-largest mobile telephone company by customer numbers, for US$1.26 billion.

Reliance Infocomm has entered into multibillion–dollar deals with Reliance Communications and Bharti Airtel to acquire operational capacity in their fiber networks and international connectivity.

While the outlook for India remains upbeat, common problems such as delays to approvals and project delivery mean that some investors may struggle to achieve a positive return until project managers meet meaningful completion targets.

Middle East/ North Africa

The Gulf region continues to enjoy additional capital from continuing high oil prices, which supports outward investment.

The three main sectors for M&A activity between January and April 2013 were financial services (54 deals aggregating US$27.5 billion); telecommunications (10 deals aggregating US$2.3 billion); and the food and beverage industry (nine deals aggregating US$1.5 billion).

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Other sectors attracting M&A interest included agriculture, government, media, transport, and tourism and leisure services. Gulf banks also purchased Egyptian bank operations and helped fund transactions for Aluminium Bahrain (Alba).

The general consensus for Q1 2013 was that the region experienced healthy transaction inflow and solid outbound investments.

The Mergermarket Middle East and African Network estimated inbound investment at US$15.1 billion in Q1 2013. According to Zawya, this increased to US$16.5 billion at the end of April 2013.

Zawya also reported a massive increase in the combined value of merger deals in the Middle East and North Africa. Taken together, deal value tripled from US$10.5 billion in January–April 2012, to US$35.7 billion for January–April 2013.

In addition, according to Zawya, over the period January–April 2013:

- the number of transactions dropped 15% (164 transactions in 2012, down to 138 in 2013)
- the average deal size quadrupled to US$259 million in 2013 from US$62 million in 2012
- significant share of deals came from overseas investments, which totaled US$19.3 billion across 28 deals.

At US$3.3 billion, Qatar Sovereign Fund's investment in VTB, Russia's second-largest bank, was the single largest transaction in Q1 2013.

With strong M&A activity in the first four months of 2013, the overall outlook for the rest of the year remains positive. We believe investors will seek quality deals and opportunities in North Africa where attractive pricing can balance higher risks. Saudi Arabia and UAE will also continue to attract mainly inbound investment in the near term.

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