Crowe Horwath

The Global Corporate Advisor

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Welcome to the May 2016 issue of Global Corporate Advisor.

In this issue, from the US, we have an article on how to augment value in M&A in the current scenario where there is a huge resurgence in deal-making activity around the globe. The article draws on research based on market data and interviews with corporate executives addressing recent deals. The results of the interviews are collated into actionable intelligence, which addresses factors such as what the acquiring companies set out to achieve, the processes they used, and whether they deemed the deals successful or unsuccessful in terms of capturing value.

From Hong Kong we have fascinating on-ground insights on conducting development land valuation in Hong Kong. Looking at the prevailing market characteristics, the authors compare the use of direct comparison method and residual valuation methods, their limitations and how to overcome them to reach fair value.

We're confident that insights from the articles in this issue will add value to the world of global corporate M&A.

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Inside This Issue:

Contact Us

The GCA team is here to respond to your needs relating to M&A transaction support, valuations and 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 GCA team member to discuss your ideas.

Insights for Augmenting Value in M&A

By Chris Nemeth, Chicago

The past couple of years have seen a huge resurgence in deal-making activity around the globe. Fueled by a combination of cheap debt, increased boardroom confidence, and the return of growth after the financial crisis of 2008, mergers and acquisitions (M&A) in the United States reached highs not seen for almost a decade. After a period of self-reflection and consolidation, companies have been looking to inorganic growth again, and their executives were hoping their M&A efforts will spur innovation, capture synergies, and make up for lost time.

After a record 2014, deal-making continued to thrive in 2015. According to Mergermarket, a provider of M&A intelligence, 16,837 transactions worth US$4.3tn were announced globally. Total value rose 30.5%, breaking 2014's previous record of US$3.3tn, despite a drop in volume by 560 transactions from 17,397.

According to Mergermarket intelligence, this strong outbound trend is forecast to continue in 2016 mainly in sectors such as industrials, chemicals, and technology, media and telecom, and to a lesser extent in pharma, medical and biotech, and energy, mining and utilities.

With this growth in deal activity, however, comes increased pressure to ensure that the completed deals generate the maximum value as competition and pricing are running high. The growing appetite to spend, however, comes at a time when companies face major challenges. Macroeconomic factors – such as slow economic growth in Europe, a slowdown of emerging markets' economies, and falling oil prices – have spurred consolidation in some sectors, making the realization of expected synergies more important than ever.

In addition, the rise in the number of activist investors has increased the pressure on boards to maximize shareholder value through buybacks, dividends, and M&A. Corporate executives who don't respond adequately to this pressure could be grilled at annual shareholder meetings and even asked to resign.

Also, increased business activity among countries brings with it an increase in the challenges often associated with cross-border transactions, such as regulatory issues and cultural differences.

Deal-making levels will remain at record highs as long as companies are hungry for growth and have access to cheap cash. While these factors put pressure on management teams to do a deal, no business wants to turn a potentially big opportunity into a costly mistake. Making a merger or acquisition successful is one of the toughest tasks in business today; in such a competitive environment, it is also one of the most crucial.

The challenge is to understand what separates the deals that capture value from the deals that do not? With so many factors in play, how can companies have a better chance of consistently creating value from their mergers and acquisitions?

Crowe Horwath LLP teamed with Mergermarket to interview 100 US corporate executives about some of their most recent deals – looking in particular at what the acquiring companies set out to achieve, the processes they used, and whether they deemed the deals successful or unsuccessful in terms of capturing value. We used the collected data to identify some important differences between good and bad deals, to capture insights into the paths taken by successful acquirers.

We have collated this information in the report, Steering Successful Growth: Value Capture in M&A. This report seeks to examine how the characteristics of successful deals differ from those of less successful deals and why a specific deal either builds or loses value at particular points on the M&A transaction value chain as the deal moves toward completion.

Excerpts from the report form this article.

Everyone can improve

The survey shows that even the most experienced deal-makers, by their own admission, are leaving substantial value on the table. There appears to be room for improvement at all stages of the M&A transaction value chain – from M&A strategy clarification, deal targeting, due diligence rigor, and integration execution.

These findings confirm our belief that from being viewed as an ad-hoc activity, it is only recently, with the greater prevalence of M&A as a core growth strategy, that deal-making as a discipline has been formalized, with a more professional focus on the tactical aspects and those related to execution, such as targeting, due diligence, valuation and integration.

Strategic clarity and insight set the table for success

The more successful deal-makers performed more value-clarification processes than the unsuccessful companies did.

More time spent upfront on clarifying and understanding exactly how best to extract the value from a merger or acquisition is a hallmark of better deals.

Synergies are not created equal

Strategic deals focused primarily on commercial synergies – including market and channel expansion, new product offerings, and cross-selling – proved to be substantially more challenging and problematic than deals focused on goals such as consolidation, removing production capacity from the market, and economies of scale.

Contemporary due diligence transcends the financials

Expanded due diligence – incorporating areas like IT, operations, human resources, and culture – was reported to be in almost nine out of 10 of the successful deals cited by the respondents.

Conversely, it occurred in just 59 percent of the unsuccessful deals. Integration is crucial – and a particular area of opportunity. Surprisingly, many of the otherwise experienced deal-makers responding to the survey indicated that they had inadvertently neglected or underestimated the integration aspect of the M&A transaction value chain and lost value as a result. This finding holds for both pre-close integration planning and post-close integration execution.

By almost every integration execution dimension surveyed, the more successful deal-makers seemed to invest more in the integration activity. For instance, half of successful deal-makers used an integration scorecard, compared to only 37 percent of unsuccessful ones. The percentages were similar when successful and unsuccessful respondents (54 percent and 35 percent, respectively) were asked whether they consulted external expertise for executing the integration. In general, while most deal-makers seem to understand that integration is utterly critical to capturing value, integration is not consistently receiving the early attention and adequate resources necessary for the delivery of its full value.

Figure 1. The drivers of value creation

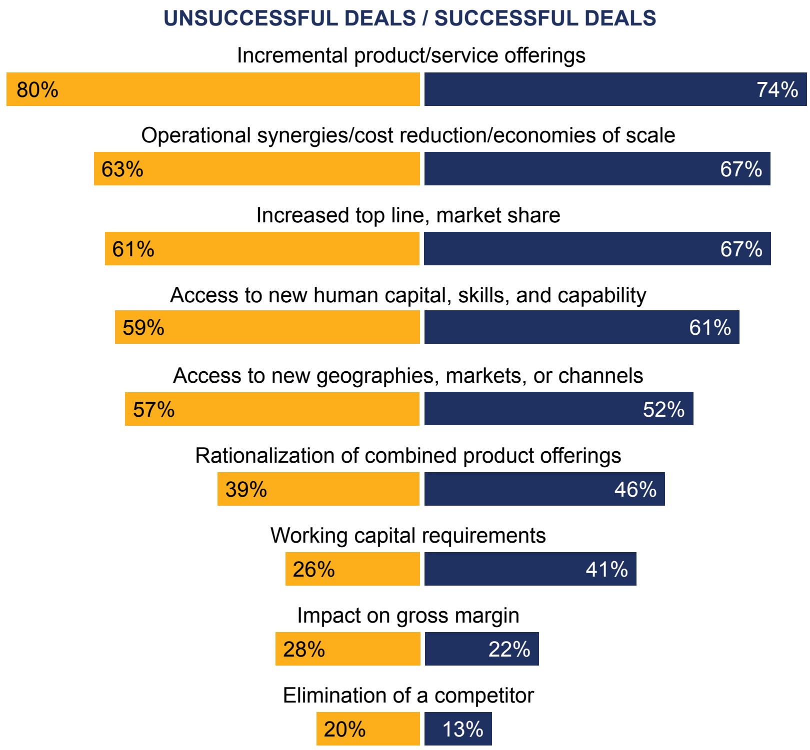
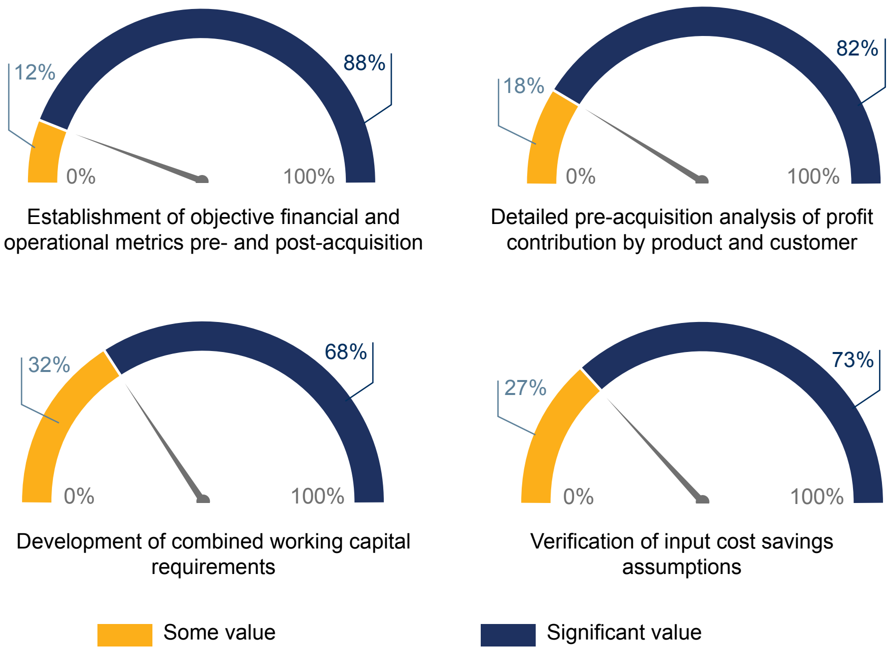


Figure 2. How facets of due diligence added value to successful deals



Good advice augments the internal team's capability and drives results

Virtually across the board, using qualified external advisers enhanced the value of the deals. Eighty-eight percent of the respondents whose companies executed successful deals and used an external consultant during the due diligence process said that having the adviser onboard generated significant value. By contrast, those in the unsuccessful deal category unanimously said that their companies should have used advisers during due diligence, integration planning, negotiation, and/or process management.

Deals abroad are even tougher

Cross-border deal-making is a large component of the recent uptick in M&A activity. Perhaps not surprisingly, the survey indicates that cross-border transactions present far more challenges and risks than domestic deals do. Thirty-three percent of unsuccessful deals (as opposed to just 11 percent of successful deals) crossed national borders. These issues are further compounded by companies' inability or unwillingness to deploy qualified internal resources for these transactions and the tendency not to supplement their teams with local knowledge.

M&A transaction value chain

Looking at the deal process as a value chain can help executives properly understand how each stage of the acquisition functions and, ultimately, is connected. The M&A transaction value chain model not only makes the steps of the deal explicit and clear, but it also speaks to the fact that the ultimate value of the deal can be either supported or undermined at each stage.

Figure 3. Areas of external eonsultant use

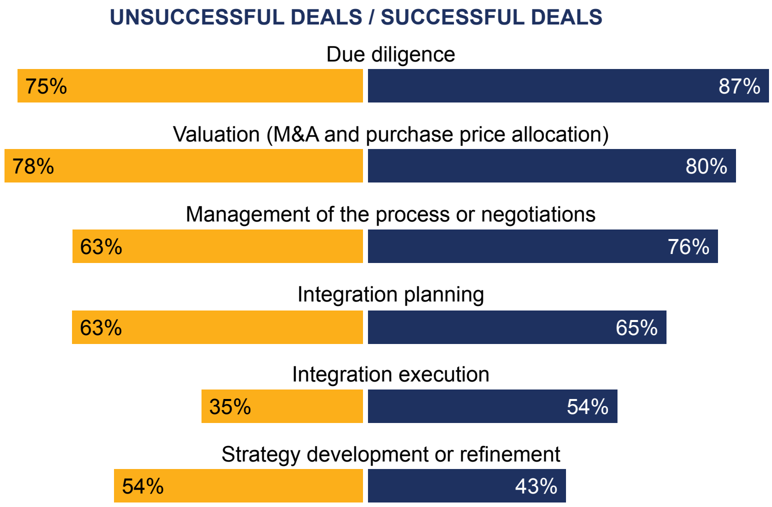
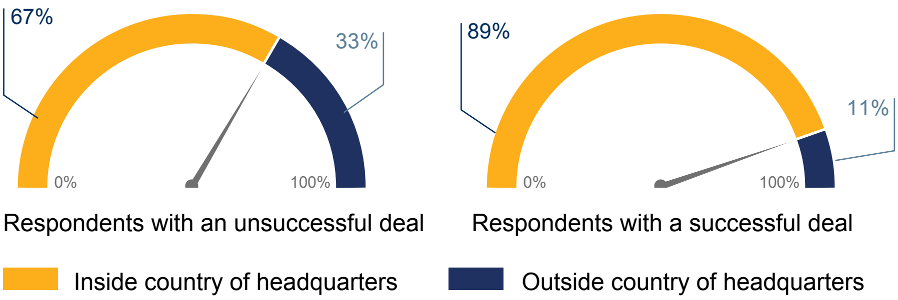


Figure 4. Cross-border and domestic deal success



The M&A transaction value chain comprises:

1. M&A strategy

Understand and articulate the deal rationale and its link to the underlying business strategy. It's all too easy to get caught up in the litany of transactional 'table stakes' issues and lose sight of the deal's value drivers.

2. Due diligence

Grasping the deal's underlying value drivers – the variables that affect the actual value of a company – should be at the heart of any due diligence process, as well as the financials. You need to understand what is driving the business by looking at what is driving the business value, not just completing a checklist. Good due diligence will look at these drivers.

At Crowe, we include members of the integration team in the due diligence; the integration team can begin to plan ahead for the integration.

3. Valuation

Valuation is part art, part science. As such, it can pay to work with an experienced, third-party specialist. At Crowe, we try to help the buyer understand where, why, and how they are getting value.

4. Integration planning

Despite having successfully navigated to this stage in the deal process, a company can irretrievably harm the deal's value by neglecting to prepare for the integration. And to make matters even more challenging, time is of the essence.

In particular, companies should focus on "bite-sizing" the integration into three basic areas: (1) vetting, prioritizing, and planning related to the key value drivers; (2) planning the functional transition in order to assume operational control and maintain operating continuity; and (3) laying out the change management and culture assimilation road map for the new, combined company.

5. Post-close execution

Even in modest integrations, there's an awful lot of work that has to get done. It's very useful to rigorously separate and prioritize tasks into near-term integration execution issues versus longer-term optimization issues.

6. Incremental optimization

The focus during this, the second post-close integration stage, is on attacking the deal's synergies and value drivers. In most deals, typically there are more projects with potential synergy than there are available internal resources – most of whom also have a "day job". The most important step is prioritization of resources and efforts, and aligning resources accordingly.

7. Capability upgrade

High-performing acquirers use each deal as a learning curve, working to incorporate those hard-won lessons into their M&A playbook. This can help minimize inefficiency, properly stage work steps and priorities, quickly bring new and inexperienced resources up to speed, avoid needing to reinvent the wheel with each new deal, and more.

The seven pillars of M&A success

Crowe has identified seven aspects of any merger or acquisition deal that constitute the foundation of good deal execution – aspects we call "the seven pillars of M&A success". These pillars are:

- Structure, governance and accountability
- Strategic clarity
- Execution efficiency
- Operating continuity
- Synergy capture
- People and culture management
- Scalable resources

They are not deployed on a sequential basis but rather apply continuously during all phases of the M&A transaction value chain, from strategy through capability upgrade.

As any weakness in a house's foundation can cause damage to the overall structure, each one of the seven pillars of a deal must be addressed effectively for the merger or acquisition to be a success – that is, for the acquiring company to realize the expected value that was the reason the deal was initiated in the first place.

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Development Land Valuation in Hong Kong
Is direct comparison method applicable in a volatile market?

By Alex Leung, Leo Lo and Stella Law, Hong Kong

Direct comparison method is the most common and straightforward method of valuation, especially for a mature and active real estate market such as Hong Kong. It's also considered the most reliable valuation approach when market transactions data are available. When dealing with development land valuation, however, some valuers tend to be reluctant to use the direct comparison method and instead prefer the residual valuation method.

Residual valuation method is more commonly used

Each piece of land in Hong Kong has unique characteristics. In some cases, two sites located next to each other might have a huge difference in value due to, say, difference in land size and street frontage, among other factors. The residual valuation method enables use of various valuation parameters that fit the characteristics of the site being valued. The method is therefore welcomed by valuers.

The direct comparison method requires the availability of comparable sites for reference. Since the real estate market in Hong Kong is volatile, some valuers would not consider a similar site that transacted over a year ago for comparison.

Time adjustment is another critical factor in the use of direct comparison. However, as no well-recognized land price index is published by the government, property agent/surveying firm, or universities in Hong Kong, it makes the application of direct comparison to land valuation difficult.

Overcoming the limitation

Solution 1: land price trend analysis

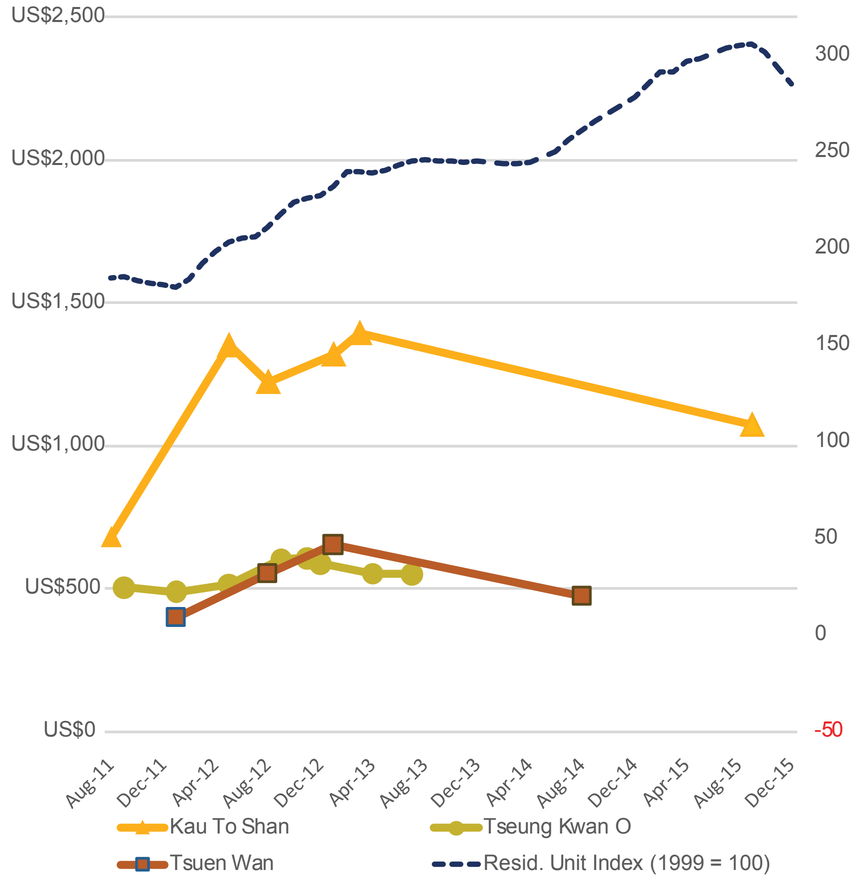
There are two ways which help overcome the limitation on time adjustment factors: land price trend analysis and key parameters sensitivity analysis.

For the land price trend, a good reference would be the government land sale/tender records. Different from private land sales, lands under government land sale programs are usually larger in area and contain a requirement for land buyers to develop (or redevelop) the land in near future. This means that the land buyers would not pay more for the possibility of renovating an existing building, and/or of holding the land awaiting joint redevelopment with neighboring site(s).

Figure 1 shows some government residential land sales in three areas: Kau To Shan, Tsuen Wan and Tseung Kwan O.

Kau To Shan is a luxury residential area at the upper level of Sha Tin new town. Tsuen Wan and Tseung Kwan O, on the other hand, are high density residential areas. All these areas are located in the New Territories.

Figure 1. HK government recent residential land sales and private residential unit price trends



Source: Lands Department; Crowe Horwath (HK) Consulting & Valuation (CHCV)

The three lines for the land price trend between mid-2011 and end of 2015 show that the land prices essentially moved in the same phases. Land prices were at a peak between late 2012 and early 2013, and then moved downwards. There is a divergence of the three trend lines against the price of completed residential units, which kept going up until it fell mid-2015, reflecting that the view of the developers, in general, was different from individual flat buyers.

From developers' perspective, they do not only consider future flat prices, but also the possible change in construction costs, future land supply, interest rates/cost of capital to alternative investment, inbound/outbound economic situation and government policies, among other factors. Different developers would have different expectations. The trend line analysis could provide a good indication on time factor adjustment.

Solution 2: key parameters sensitivity analysis

When handling a commercial land valuation, for example, the price from land sale may not be enough to generate a land price trend line. An alternative solution is to carry out a sensitivity analysis using key parameters in the residual valuation method.

In the residual valuation method, various costs of the development, together with a return on investment to the developer, would be deducted and income/receipt would be generated from completing a development to reach the residual value.

In the present situation in Hong Kong, changes in interest rate and professional fee would not materially affect the site valuation as their sums are relatively small. The key parameters are the GDV, construction cost and the developers' profit margin.

Figure 2. The flow using the residual model

Gross Development Value (GDV):	Unit price x GFA (or saleable area)
Less:	
1. Construction cost	Unit cost x GFA
2. Professional fee	
(i.e. Architects, Quantity surveyors)	% of item 1
3. Marketing and legal cost	% of GDV
4. Interest on costs	% on the summarization of items 1 & 2
5. Contingency	% of items 1 & 2
6. Developer's profit on costs above	% of items 1 to 5
Equal: Gross Site Value	
Less:	
7. Land acquisition cost	% of land value
8. Interest on land	% of land value
9. Profit on land	% of land value
Equal: Land Value	

Source: CHCV

Figure 3. An example of a hypothetical sensitivity analysis

Illustration: how to derive the time adjustment factor by sensitivity analysis				
	Comparable land sale say in Jun 2013 (1)	Valuation as at a date in Dec 201X (1)	Parameters changed over the period as observed from the market	Impact on Land Value
Gross Development Value	US$1,538	US$1,615	+5% in flat sale price	+9.5%
Less				
Construction cost	US$540	US$567	+5% in construction cost	-4.5%
Professional fee	US$36	US$38	(assume change in line with construction cost)	
Interest Cost	US$122	US$137	+0.5% percentage point p.a.	-1.9%
Marketing and legal cost	US$62	US$65	(assume change in line with GDV)	
Developer's profit	US$189	US$226	+2.5% percentage point in profit margin	-4.0%
Residual Land Value (Accommodation Value)	US$590	US$583	**Overall change in land value (2)**	**-1.1%**
Notes (1)	land price in accommodation value, i.e. value per developable GFA			
(2)	overall change refers various parameters changing at the same time, it could be slightly different from the sum of individual impacts			

Source: CHCV

Gross development value

This analysis shows that a small change in the GDV parameter would result in a larger change in land value. Assessment of the GDV change could be based on strata-title transactions of completed units in the first and secondary markets, or make reference to the price indices published by the government of HKSAR.

Construction cost

Unlike other well-developed cites such as Singapore, Hong Kong does not import many construction workers. This has resulted in a rapid rise in construction costs over the last decade (some examples are shown in Figure 4). Increase in construction costs becomes a main concern for the developers and has adversely affected the motivation of the developers to acquire development lands.

Developers' profit margin

Developers would require a higher return when they consider the higher risk in development of real estate. The developer's profit also depends on how they foresee the market, in particular, the economic and political issues. Valuers should observe the developers' land bidding behavior and interview active developers, in order to understand their current views.

In addition, more mainland China based developers have entered the Hong Kong development market in recent years. The keen competition has led to lowering the profit margin. Figure 5 shows some recent government lands acquired by developers based in Mainland China.

Having a good understanding of the changes in the above three key parameters, valuers could work out appropriate time adjustment factor(s) to facilitate their land valuation by using the direct comparison method.

Figure 4. Daily salary on selected construction jobs

Year	Concretor	Carpentry (Interiors fitting & decoration)	Painting	Plumbing
2013	US$231	US$128	US$128	US$131
2014	US$256 (+11.1%)	US$135 (+5.0%)	US$135 (+5.0%)	US$144 (+9.8%)
2015	US$295 (+15.0%)	US$145 (+7.6%)	US$144 (+6.7%)	US$160 (+11.6%)

Source: Hong Kong Construction Industry Employees General Union, Census and Statistics Department and CHCV

Figure 5. Recent government lands acquired by Mainland China-based developers

Date	Location	Land use	Transaction price	Mainland China-based developer
Mar 2016	Shan Tong Road of Lai Chi Shan in Tai Po	Residential	US$273m	China Overseas
Sep 2015	Castle Peak Bay on Castle Peak Road in Tuen Mun	Residential	US$222m	Poly Property
May 2015	Lok Wo Sha Lane in Ma On Shan	Residential	US$188m	CITIC
Dec 2014	Cheung Sha in Lan Tau Island	Residential	US$37m	Sino-Ocean Land
Dec 2014	Yiu Sha Road in Ma On Shan	Residential	US$274m	Partnership of China City Construction (CCC) & Chun Wo (HK developer)
Oct 2014	Tung Ching	Hotel	US$235m	Partnership of Shimao Property & Mingfa Group (International)
May 2014	Junction of Shouson Hill Road West and Wong Chuk Hang Path	Residential	US$235m	Partnership of Emperor International (HK developer), CEO of Shimao Property (Individual) & Mingfa Group (International)
Apr 2014	12-24 Luen Fat Street in Wanchai	Residential	US$110m	Vanke
Feb 2014	No. 3 Site in No. 1I District in Kai Tak	Residential	US$503m	Poly Property
Nov 2013	Castle Peak Road of Tsing Lung Tau in Tsuen Wan	Residential	US$64m	Metallurgical Corporation of China (MCC)
Jun 2013	Site 1H1 in Kai Tak	Residential (HK People HK Land Scheme)	US$291m	China Overseas
Jun 2013	Site 1H2 in Kai Tak	Residential (HK People HK Land Scheme)	US$291m	China Overseas
Jan 2013	No. 6 District in Tsuen Wan West	Residential	US$440m	Partnership of Ultimate Vantage Limited (Partially owned by Vanke) & New World (HK developer)
Mar 2012	Intersection between Praya Road & Ap Lei Chau Drive in Ap Lei Chau	Residential	US$325m	China Overseas

Source: Lands Department and CHCV

Summary

While performing land valuation, valuers usually rely too much on residual valuation method and overlook the importance of the direct comparison method. Direct comparison could act as a cross-checking tool for the residual valuation method. Direct comparison also has its own advantages in valuing the lands, particularly when fewer parameters are required.

Even though there is no time index for land transactions due to limited number of transactions and uniqueness of some development lands in Hong Kong, professional valuers should try to apply direct comparison method in land valuation. By analyzing the price trends, we could gain a solid understanding of the trends of land prices.

Auditors who review the working of land valuation, should ask the real estate valuers if they have collected land transactions and have used the direct comparison method. While there are a high number of parameters in residual valuation method, the use of only a single approach could result in an unfair value.

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