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The Global Corporate Advisor

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In this month's issue, we provide a round-up of Western Europe's M&A market in 2013 to date.

In January, we forecast that this year would be a turning point for Europe's M&A sector, with an increase in activity across the region. Indeed, a growing number of companies in the UK, Turkey and Germany appear eager to engage in M&A activity, particularly overseas acquisitions. While the outlook is more positive than it has been for a number of years, the market is still facing challenges.

This issue also includes insights from US-based advisor Robert Kollar. His article examines why excluding all elements of EBITDA can be a misleading way to analyze businesses. He illustrates how excluding amortization expense or interest expense when calculating EBITDA alters the true operating expenses of a company.

In the Dominican Republic, Juan Méndez Wolfschoon evaluates the appraisal methods investors should consider when looking to invest in existing or planned hotel projects.

Next month, our East Asian Regional Leader Antony Lam will bring you updates from China and Japan. If there are any topics relating to the East Asian region you would like us to cover, please get in touch to discuss your ideas.

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Contact Us

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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The European M&A Landscape

The M&A market in Europe was very weak in 2012. However, there are signs that the environment is slowly improving, with cautious activity returning in the current year to the German and UK markets. In this article, we provide our observations and outlook for M&A in Europe for the remainder of 2013.

France

The French M&A market performed poorly in 2012 due to the country's economic slowdown and the continuing Eurozone crisis. The presidential elections in mid-2012 contributed to uncertainty in the market, and both corporations and private equity firms were affected by the downturn.

According to Thomson Reuters, the volume of M&A mid-market transactions (less than US$500 million) decreased noticeably in 2012, from US$42.5 billion in 2011 to US$31.6 billion in 2012.

There were two significant cross-border transactions in 2012: GDF Suez's €11.2 billion acquisition of the 30% remainder of International Power Plc, and the €2 billion investment in Egyptian mobile operator Mobinil by France Telecom (Orange).

However, expected mergers including BAE Systems and the European Aeronautics Defence & Space Co., SFT and Free Mobile, and PSA Peugeot Citron and Opel did not happen.

There has been no noticeable improvement in the M&A market since the start of 2013. According to Thomson Reuters, the volume and value of mid-market transactions is in line with the first quarter of 2012. The Thomson Reuters sample identified approximately 475 transactions with a total value of approximately US$5.5 billion.

For the rest of the year, we believe that the French M&A market could be better oriented and benefit from cross-border transactions, venture capital outflows, and small and mid-sized transactions. Industries including energy, internet and e-commerce, medical technology, biotechnology, and personal services (nursing homes, clinics and nurseries) are seen as the most dynamic sectors.

Germany

According to the German M&A Association's mid-market index, the M&A market showed a slight upward trend in Q4 2012, but was still far below its all-time high. This trend was also supported by the ZEW-Zephyr M&A index, which expected a small recovery in the first half of 2013 and a much stronger increase in M&A activity in the second half of the year. But according to the Frankfurter Allgemeine Zeitung, the German M&A market has not yet shown any signs of recovery in the mid-market sector in the first four months of 2013.

However, the latest survey carried out by Finance magazine and lawyers CMS Hasche Sigle among private equity investors shows that banks are gradually providing more financing for buy-out transactions. According to these investors, since February 2013 the financing market has shown a robust positive trend, reflected in better availability of funds and better loan conditions.

As the private equity market has been very weak, this is a good sign for the months to come. The most attractive industries among private equity investors are services, food and beverage, and healthcare. The financial services, renewables and automotive sectors are rated the least attractive.

We believe an optimistic outlook for a livelier German M&A and IPO market in the second half of 2013 is justified, given that three large IPOs took place in the first four months of 2013: LEG Immobilien AG (real estate), Evonik Industries AG (industrial goods) and RTL Group S.A. (media). The stock market is also performing strongly and a number of significant IPOs were announced for June and July, including KION Group (industrial goods), Springer Science (media) and Deutsche Annington (real estate).

Spain

The 2013 outlook for corporate and M&A transactions in Spain is positive, especially in the middle market. There are attractive opportunities for both local and foreign investors.

The Spanish government has completed several structural reforms on a number of fronts, including fiscal, financial and labor market reforms; downsizing the public sector; and privatizations. These reforms were carried out in a balanced manner to drive growth in the medium to long term.

Turkey

Turkey has led the Central and South Eastern European regions in M&A transactions for the last two years, reaching US$15 billion in 2011 and US$30 billion in 2012.

There were 73 M&A transactions in Turkey from January–March 2013, with a total volume of US$8 billion. This high deal count is up by 40% compared to the same time last year, illustrating that Turkey's appeal remains strong for investors.

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Energy, manufacturing, financial services, and real estate rank as Turkey's most active M&A sectors. The previous forecast of US$25 billion for 2013 by the Investment Promotional Agency Turkey is achievable, provided that forecast privatizations and expected private sector deals go ahead.

2012: a strong year

While global markets struggled for recovery, Turkey's strong economic performance in 2011 led to a lively M&A environment in 2012. Total M&A activity continued to build momentum, reaching a record high of 259 transactions with a total deal value of US$28.1 billion, one of the highest volumes ever achieved.

This represented an 87% increase on 2011 (US$15 billion), primarily due to privatizations and several large private-sector deals. Excluding those deals, M&A activity was similar to 2011, with almost all deals occurring in the middle-market.

Turkey's M&A boom is underpinned by several key factors, including its relatively stable political and macroeconomic environments. In the past decade inflation has remained in single digits and the economy has grown by an annual average of 5.5%. These factors led to a spike in foreign direct investment to an average of US$10–15 billion a year, up from an average of US$1–2 billion in 2003–04.

The continued inflow of private equity into Turkey since 2006 resulted in strong M&A growth. Crowe Horwath believes we will start seeing those original investors exit their investments, which is likely to add more fuel to Turkey's M&A market in the remainder of 2013.

Finance sector

With an all-time high of 57 transactions and a total deal value of about US$1.6 billion – including estimates for undisclosed values – financial investors proved themselves a fundamental part of Turkey's M&A environment in 2012. E-commerce, retail, manufacturing, and services were the favorites of private equity firms.

Banking industry

Most large deals in the banking sector are now complete, which creates a more muted M&A outlook in that sector for the remainder of 2013. Most sizeable foreign banks are already in the Turkish market, and book multiples are quite high compared to local banks' European or global peers. However, according to Gokce Kabatepe, Country Head for Raiffeisen Investment of Bank Turkey, two local banks, Halkbank and Ziraat, may be privatized later in 2013 through an initial or secondary public offering.

Private sector

Turkey's largest private-sector transactions in 2012 included Allianz's acquisition of Yapi Kredi Sigorta, the insurance arm of Turkish–Italian partnered Yapi Kredi Bank; and the takeover of a majority stake in Turkey's Alternatif Bank by the Commercial Bank of Qatar.

Public sector

In 2012, privatization centered on Turkey's electricity distribution networks. The privatization of two state-owned utilities, Toroslar and Ayedas, and a natural gas grid, Baskent Gaz, topped the public transactions list in 2012. In 2013, Crowe Horwath expects to see tenders for the sell-off of Turkey's major tollways and sea ports. Another key infrastructure tender in the second half of 2013 will involve a build-operate-transfer concession for a third airport in Istanbul.

Telecommunications

In the telecommunications sector, Turk Telekom possesses a war chest of almost US$1 billion for acquisitions, which makes it likely the company will become a significant M&A player in the region. Turkcell is also very cash-rich; however, we believe that because of its shareholder issues Turkcell may not be in as strong a position as Turk Telekom.

Aviation

In Turkey's aviation sector, Turkish Airlines [BIST:THYAO] could be interested in doing deals outside of its home market. According to Gokce Kabatepe, Country Head for Raiffeisen Investment of Bank Turkey, Turkish Airlines is looking at Polish carrier LOT, while airport operator TAV and Celebi Ground Handling may also be interested in making some M&A moves abroad.

Conclusion

Despite the patchiness of the global economic recovery and pessimistic growth prospects, Turkey sustained its positive attributes well above average. In addition, the recent upgrade in the sovereign credit rating to investment grade is expected to improve investor confidence. Crowe Horwath believes the outlook for Turkey will remain positive for the remainder of 2013.

United Kingdom

2012 was a poor year for the UK M&A market; the values of inward, outward and domestic acquisitions appeared to be on a downward trajectory.

According to the UK's Office for National Statistics (ONS), in 2012:

- Expenditure on acquisitions abroad by UK companies (outward acquisitions) was £16.4 billion, down from £50.2 billion in 2011 and similar to the levels seen in 2009 and 2010.
- The value of acquisitions in the UK by foreign companies (inward acquisitions) was £16.7 billion, the lowest value reported since 2003 (£9.3 billion).

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- Mergers and acquisitions between UK companies (domestic M&A) fell to £3.3 billion, its lowest level since 1983 (current price basis).

The most recent ONS figures, released on June 4, 2013, revealed that the first quarter of 2013 saw a continuing decline in the number of transactions involving UK companies, although deal values appeared to be increasing.

However, the latter part of 2013 may prove to be a turning point, with numerous recent surveys indicating an increasing number of firms in the UK becoming eager to engage in M&A activity, particularly outward acquisitions.

UK corporates appear to be responding to a low-growth or no-growth domestic economy by looking abroad for opportunities. Many UK firms have been guarding their cash for the past few years, protecting their balance sheets through the hard years of recession. However, we believe they are now looking forward to pursuing growth through acquisition, particularly in emerging markets.

While the outlook for M&A in 2013 is more positive than it has been for a number of years, the market is still facing challenges. Raising finance remains difficult, particularly for smaller transactions by SMEs where leverage finance is hard to find. Asset-based lending, vendor financing or other alternatives such as peer-to-peer lending may have to be used to plug the gap.

Capital markets

The UK's capital markets have enjoyed a buoyant 2013 to date. The market rally that began in earnest towards the end of November 2012 has continued apace, with many indices such as the FTSE 100, FTSE All-Share and FTSE AIM UK 50 hitting highs of around 16% above their values on December 31, 2012.

Increases in trading volumes and values have encouraged a number of new companies to enter the capital markets. In addition to the overseas resources companies and funds that have been a feature of the markets for the past few years, we are seeing an increasing number of UK trading businesses deciding 2013 is the year of the IPO. Of the 10 new companies floating on the Stock Exchange's Main Market in the first four months of 2013, nine were based in the UK.

AIM (the London Stock Exchange's international market for smaller growing companies) has also seen a number of UK companies seeking new listings. In the last few months, we have witnessed the floats of an IP-owning media business, two IT managed service providers, a computerized psychological testing company, and a gaming hardware and software solutions business.

In May 2013, Crowe Horwath UK supported AB Dynamics plc on its successful admission to AIM. AB Dynamics is a UK-based group that designs, manufactures and supplies advanced testing and measurement products for vehicle suspension, brakes and steering to the global automotive industry. Our UK team has a number of other exciting businesses in the pipeline, which we expect to see list on AIM in the coming months.

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When Excluding Interest, Taxes, Depreciation or Amortization is the Wrong Way to Analyze a Business

By Robert Kollar, Atlanta, USA

In transactions ranging from acquisitions to financings, earnings before interest, taxes, depreciation and amortization (EBITDA) is often used to analyze and value a business.

EBITDA, which is not a generally accepted accounting principle (GAAP) financial measure in the US, reveals an entity's operating profitability before non-operating expenses and non-cash expenses. Despite carefully vetting of adjustments to EBITDA, preparers often accept the exclusion of interest, taxes, depreciation and amortization without a second thought.

Excluding all elements of EBITDA can be a misleading way to analyze businesses. The following two scenarios illustrate how excluding amortization expense or interest expense from an EBITDA calculation will alter a company's true operating expenses.

Amortization expense

In the first scenario, let's assume the company being analyzed has the following characteristics:

- It is a service provider with one-time implementation services and recurring monthly services.
- The company's new clients receive implementation services before the recurring monthly services commence.
- The company's service term varies by client and ranges from one to five years.
- The company earns one-time implementation revenue and recurring monthly service revenue. Implementation revenue is recognized on a pro rata basis over the service term.
- Conversely, the company incurs both implementation costs and recurring monthly service costs. Implementation costs relate to employee labor used in the implementation process. The company capitalizes these labor costs and amortizes them on a pro rata basis over respective client service terms.
- By recognizing implementation revenue and costs on a pro rata basis over the client service terms, the company matches revenue and expenses.
- The company's decision to recognize implementation revenue and costs on a pro rata basis over respective client service terms is consistent with GAAP.

The company determines that implementation amortization expense represents a true business expense because direct labor is incurred when acquiring new clients. Implementation amortization expense therefore consists of direct labor that is both a cash expense and a business expense.

As such, the company includes implementation amortization when calculating EBITDA. By including it in the cost of sales, the company's gross margin decreased nearly 10% over the reported gross margin in each of the periods analyzed.

Interest expense

The second scenario illustrates how excluding interest expense from EBITDA can omit a major operating expense. Let's assume the company being analyzed has the following characteristics:

- It offers channel finance programs for businesses to buy equipment from original equipment manufacturers for resale.
- It originates, underwrites, funds and services short-term, working capital financing transactions.
- Its working capital for financing transactions is from syndicated banks.
- Syndicated banks charge the company interest fees on outstanding facilities extended to resellers for equipment transactions.
- At approximately 41% of revenue, interest expenses represent the company's largest expense.

In this case, management determines that interest expense charged by syndicated banks represents the cost of doing business, similar to how material input costs are treated by a manufacturer. As such, the company includes the impact of interest expense in EBITDA and cost of sales.

Proceed with care

EBITDA can be an effective metric for analyzing and valuing a business. Before using it, however, preparers must consider the underlying nature of interest, taxes, depreciation and amortization as each relates to the operations of the entity being analyzed.

For more information

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Checking In: Evaluating Investments in Hotel Projects

By Juan Mendez Wolfschoon, Dominican Republic

This article sets out the investment considerations, valuation characteristics and appraisal methods investors should explore when looking to invest in existing or planned hotel projects.

Investment considerations

Location, location, location

Location is the most important aspect as it is integral to the success of a property. When undertaking due diligence, investors should examine important information such as access; visibility; distance to airport, bus and train stations; proximity to tourist and natural attractions, landmarks, shops and restaurants; the preservation and excellence of surrounding scenery; and the quality of infrastructure, including roads.

Due diligence must also consider any issues that may affect future profitability, such as nearby construction and the level of local competition from other hotel brands.

Which country?

The choice of which country to invest in is another important investment consideration. Many people use league tables or scores to determine which countries represent the most attractive opportunities. During this step, investors should source information on market share, growth in tourist arrivals, occupancy, tourist receipts, tourism investment and the availability of trained human resources in the local community. These statistics can help investors make informed decisions based on robust data.

Other factors that may influence choice of country include available tax incentives, political concerns, economic and credit risk, investment climate, potential hostile neighbors or terrorism, the risk of natural disasters and currency exchange rate risks.

The reputation of the country's legal system, estimated speed, and ease of and transparency of acquiring project permission are also important aspects to note.

Big brand or boutique hotel?

Internationally recognizable hotel brands are likely to be represent lower-risk investments as they typically provide experienced management and promoters to support the project.

For planned projects, it is also important to analyze the property performance and its potential EBITDA, before investment decisions are made.

Existing or planned investment opportunities: which is best?

When looking to become involved in hotels, investors face two choices: buying an existing property or creating a new hotel from scratch. To evaluate which option is the most promising, we have created the following scenario where an investor is choosing between two tourist projects worth US$12 million.

Option 1 is an existing internationally branded hotel with 240 rooms.

Option 2 is a planned mixed-use project that comprises 190 residential units, two 300-room hotels, an 18-hole golf course, and spa and meeting facilities.

Project appraisal methods

The investor must first decide which property appraisal method is the most reliable for obtaining an accurate project value: the discounted cash flow approach, market approach or cost approach.

1. Discounted cash flow (DCF) approach

The DCF method calculates the value of a project by converting future cash flows into a single present value by applying a discount rate (this demonstrates the anticipated profit generated from the asset over its life span). It is best used for valuing large income-generating properties.

Analysts suggest this approach is the most theoretically sound, as no other methodology focuses solely on determining the present value of the future income stream from the subject property.

Advantages

- Frequently used by financial entities and professionals to value assets and commercial real estate construction projects.
- Reliable at setting out the cash flow expectations for income-generating property.
- Illustrates the expectations and behaviors of typical assets in the market.
- Evaluates how much profit the business is likely to make and the associated risks.
- Reflects all the unique characteristics of the subject business, while deriving very specific conclusions.
- Most efficiently used when income streams are not expected to vary significantly over time.
- Discount rate is quick and simple to use.

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Limitations

- The discount rate is not reliable when income is expected to change in the future to a greater extent than generally expected in the market.
- May not take into account the property's condition, the exact neighborhood or financing concessions.
- The discount rate assumption relies on the market for competing investments at the time of the analysis, which would likely change over time.
- Will overvalue the asset if used during early years of a boom market.
- An incorrect discount rate can distort appraised value.

2. Market approach

The market approach considers the value of an asset on the basis of prices of comparable assets in the market, in close geographical position, that were available or sold within the previous six months. The method makes appropriate adjustments for differences in asset quality and size.

Advantages

- A very simple calculation method.
- Considers a wide selection of factors, including architectural style, property size, specific cultural or historic associations, permissible use, potential for extensions, legal protection and concentration of historic properties.

Limitations

- When appraising a unique project with no comparable market, the appraised value may be skewed.
- There may be a lack of information in certain geographical areas or lack of property sales.
- Adjustments for differences in risk and expectations of the comparable projects need to be made, which can be difficult to measure.
- No matter how comparable the land and the buildings are, the location will always be different.
- Less reliable when valuing income properties, as it doesn't include an income stream analysis.
- Requires the most up to date information.
- In the unlikely event of finding another comparable partially completed property, the value of a completed property would differ, affecting the current market value evaluation.
- Very little reliability during periods of rapid economic change.

3. Cost approach

The cost approach calculates property valuation by estimating the cost of replacing the property on the revaluation date with a modern equivalent, or replicating the building.

Advantages

- Often used when there is no evidence of transaction prices for a comparable property or identifiable income stream that could be attributed to the property.
- Most appropriate for valuing specialized property rarely sold in the market, such as marinas or amusement parks.
- Requires many detailed methods of application and inputs, increasing its reliability.
- Combines some elements of the market and the DCF approaches by including cost of labor and materials etc., and obtaining land values and depreciation from a comparable market analysis.
- More reliable for newer properties.

Limitations

- Less reliable for older properties due to the greater subjectivity in valuating depreciation.
- Very reliant on the appraiser's expertise and highly dependent on an accurate value of the site.
- Relies upon other valuation methods to derive the value of the land.
- It neglects the difference between cost and value, as one property might be cheaper than another but generate a much higher net income.

Benefits of DCF model over market and cost approaches

Although the DCF model has some limitations, it is the most reliable for investors and is a hotel industry norm. However, it should be noted that certain situations may require a combination of methods (or all three) depending on the market, to provide a wider view.

Taking the advantages and disadvantages of the three appraisal methods into consideration, in our example instance the investor selects the DCF model.

To calculate the operating performances of the two options, the investor estimated the projected financial analysis for five years of operation and produced an internal rate of return (IRR), which considers the commercial components of each property.

The results of the due diligence are as follows:

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	OPTION 1 Existing hotel property (US$ dollars)	OPTION 2 Planned mixed-use property (US$ dollars)
Total project cost	**$30 million**	**$95 million**
Investor equity (proposed)	$12 million	$12 million
Other property owners	0	$26 million
Entity equity	**$12 million**	**$38 million**
Financing (proposed)	**$18 million**	**$57 million**
Percentage of ownership	100%	31.6%
IRR	31%	76.6%
Investment recovery period	5 years	5 years*
Property appraisal DCF value	$43.1 million	$160 million
Debt paid period	7	7

*Including a two-year construction period

For Option 1 the existing project has a current value at the end of the fifth year of operation, owned by the investor, of US$43.1 million using the DCF model. This means that the investor will be the sole owner of the property but will incur all the property's risks with a lower IRR than Option 2.

For the planned project in Option 2 the current value at the end of the fifth year is US$160 million, of which the investor owns US$50.6 million, according to the DCF method. The mixed-use complex generated higher cash flows due to the sale of the real estate component, resulting in a higher IRR.

However the residual value will only be represented by the components operated by the promoter, such as hotel, spa, golf and meeting facilities, excluding the real estate compound. In this option, the investor is not the sole owner and will have to wait for two years of construction before reaching profitability.

This scenario shows that while the investor of the planned project has more risk, it will earn a higher return in the short term than investing in the existing property. However the IRR will decrease as soon as the real estate operation is completed.

Conclusion

An existing property is suited for the more risk-adverse investor, while planned hotel properties are more appropriate for the risk-seeking investors looking to make high returns.

In our view, the DCF model is the most reliable method of valuing income-generating assets. Its use continues to grow in many industries, particularly in hotel real estate.

For more information

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