thoughtpieces
Incisive analysis of topical issues

INTANGIBLE BUSINESS

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Merger and acquisition ("M&A") issues – financial forecasts

About this issue paper

This issue paper is designed for those involved in business M&A, to illustrate a range of processes available to assess financial forecasts and to consider some of the common pitfalls in forecasting. Generally, despite the inherent problems, such forecasts can and should be highly informative on a business and its value.

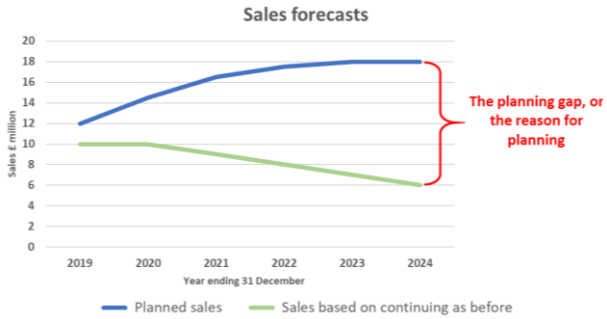
This paper is based on over 30 years of experience in the field of carrying out and advising on business mergers and acquisitions, beforehand and afterwards, (including post-acquisition disputes), for sellers and buyers. We give below examples and case studies based on our experience, but the reader should appreciate that (because of the confidential nature of our work) some client details are not given, nor are certain details disclosed.

1. Commercial due diligence, can it really cover sales forecasts?

On an acquisition, as in most circumstances, value is generally based on future cash flows. Therefore, forecasting is required to analyse such value, which is an inherently difficult task. But forecasting itself is a practical tool, which is widely used in managing businesses for many reasons.

Forecasting is widely used for managing businesses

One of the key reasons for this is that it informs and assists with planning. A commercial benefit of planning is well illustrated by the following planning gap, which in this case is based on a project where we helped an international group develop its plans for a sub-portfolio of consumer brands:



2. There are techniques for assessing forecasts

Generally, the most difficult (or subjective) area of forecasting is sales. It is also likely to be one of the most important areas given that sales are usually the primary driver of cash flows.

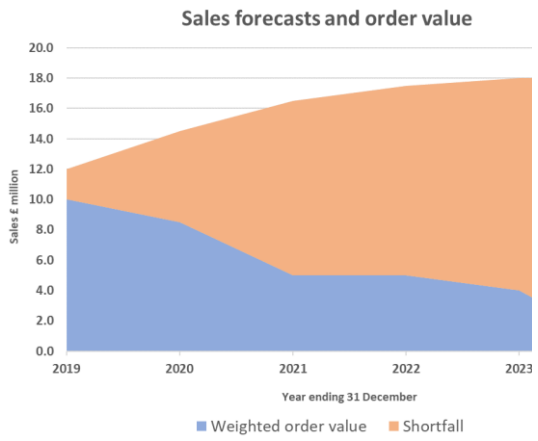
In practice, one of the conventional and widely used methods of assessing sales forecasts is:

- Assessing management's history and capability in forecasting. In one business, for example, where we were involved in forecasting the main purpose was to assess and deploy resources for investing in overseas expansion. It was therefore stressed by management that forecasts had to be as accurate and prudent as possible, so they were suitable as a basis for making investment decisions.

However, this is not the only way of assessing sales forecasts. We summarise below six further techniques for commercially compiling, assessing and understanding sales forecasts, all of which we have carried out many times and found useful and informative:

1. Comparing forecasts with inventory levels and profiling. On one of our commercial due diligence exercises we investigated and analysed spirits inventories to assess how much was left (after the angels' share where say 5% a year is lost as it literally evaporates) and the inventory's age profile. This was then mapped against forecast retail sales, which had implicit age profiles, or were described as having certain age profiles such as being a 15 year old whisky. This revealed significant discrepancies between sales forecasts and the inventory required to fulfil those forecasts, and so the sales forecasts had to be revised to match inventory levels.

2. Analysing orders received, and pitches made. Orders can be relatively strong support to sales forecasts, and sales pitches adjusted for the chance of success can also be relatively strong support. We developed a model for assessing this as part of ongoing management of forecast sales, which is illustrated as follows:



3. Obtaining and reviewing market research, forecasts, future market share and competitor activity. We have analysed this for post-acquisition disputes using research agencies, such as Euromonitor, where they have published market size and forecast information – sometimes as at a date in the past. Like all

research, this should only be used with knowledge of its limitations but can provide powerful analyses behind forecast sales.

4. Synergies. Acquisitions are often made to exploit synergies both in revenues and costs. This value can be separately quantified and may vary according to the opportunities that could be created by individual buyers. Such value in an acquisition can be used in different ways by, for example, rationalising residual goodwill once all acquired tangible and intangible assets have been recognised and valued.

Illustration of value synergy:
3 + 5 creates 12

5. Trade marks. It is often the case that mapping planned sales against trade mark portfolios reveals inconsistencies. This impacts the risks associated with such sales and the associated trade mark or brand value. This process can also assist in formulating trade mark strategy, for example trade marks may be retained to block competitors. However, if these trade marks are not actually used than they could be at risk of revocation.

6. Use of hindsight. If an assessment of sales forecasts, used at the time of acquisition, is being made later this might be able to use hindsight to some extent. Care should be taken to ensure that such analyses are reasonable.

So, these techniques taken together really can produce a clearer picture of the road ahead:

3. Analyses of forecast sales are useful

There are many useful techniques available for carrying out and assessing informative forecast sales for M&A purposes. We have set out a commonly used technique above (assessing management's ability and history of forecasting) and outlined a further six example techniques that are also often useful, depending on the circumstances. These techniques can also be relevant in other situations, such as when building a counterfactual model, for example, of profits that would have been made but for an event occurring. Such models are often used for resolving commercial disputes.

In practice, it will come as no surprise that sales subsequently made usually differ from earlier forecasts of those sales. This demonstrates the obvious inherent difficulty in forecasting , and it can be said that any plan must be wrong by definition. However, it does not follow that these analyses should not be carried out or used. Well thought through and compiled analyses can be extremely useful, and indeed necessary, for assessing value. The process should lead to better informed conclusions on value.

This whole process is not as impossible as the triangle below, from the well-known mathematician Sir Roger Penrose:

4. Proposed further thoughts on M&A issues

Intangible asset valuation is often based on a critical assessment, and an informed view, of financial forecasts. They are often valued in the context of a business acquisition, and from an accounting perspective this is most often linked to a rationalisation of goodwill. Based on our experience we are developing some further thoughts on the following M&A issues:

- Sales regulations and problems are often present.
- Unused trade marks – are they a liability or an opportunity?
- What can happen with warranties and indemnities?
- Are the accounting implications of an acquisition known?
- What if Intellectual Property ("IP") ownership is defective?
- Is licensing and franchising activity a strength or a problem?
- How to deal with unconventional valuation measures.
- The practical use of valuations in the M&A process.
- Do acquisitions create or destroy shareholder value?

Any comments or thoughts on any of these topics, particularly on which of these M&A issues are of the most interest, would be gratefully received.

For further information, please contact one of our experts on the next page below.

Consulting services offered by Intangible Business:

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- Business value
- Intangible asset and intellectual property value
- Share value
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- Related revenues and costs

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- Single joint expert

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- Contractual disputes
- Post-acquisition disputes
- Licence / franchise disputes
- Shareholder / stakeholder disputes
- Unfair prejudice / derivative actions
- IP infringement
- Other disputes

Our team of experts

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