



# Competing for growth in emerging markets

The Ernst & Young study of UK  
corporate outbound M&A





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## About this study

As the global economy gradually emerges from the recent downturn, many UK corporates are seeking growth opportunities, notably in overseas markets and increasingly in emerging markets. We have conducted this study of outbound M&A activity by UK plc to help businesses in all industries take well informed decisions on allocating their capital for outbound investment.

This study blends qualitative and quantitative research, and consists of three strands:

- ▶ An analysis of the comparative historical record of UK plc in outbound investment and acquisitions over the past two decades, examining the destination, type, structure and rationale of deals.
- ▶ A detailed study of current outbound M&A activity by UK corporates over a three-year timeframe from 2007 to mid-2010, examining trends both at a sector and country level. As part of this, we analysed the destination of investment and subjectively attributed the rationale for the deal, based on our evaluation of press statements at the time.
- ▶ A programme of in-depth interviews with the corporate development functions of 16 UK-domiciled corporates, to discuss their relative priorities in pursuing outbound deals, and their learnings and concerns as a result of their experiences. The corporates interviewed range from £1bn to £170bn in turnover, are mostly listed on the London Stock Exchange, and have all been active in outbound M&A over the past three years.

These interviews, though not intended to be statistically valid, do provide a directional view on the key themes and challenges influencing UK corporate behaviour, and are consistent with our ongoing interactions with our corporate clients.

Based on the findings from these three research strands, we have assessed the priorities for outbound investment going forward, and highlighted the key considerations for UK corporates involved in – or contemplating – outbound M&A transactions.

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# Executive summary

In the wake of the deepest recession since the 1930s, the dramatic slowdown in outbound acquisition activity by UK plc in 2009 and 2010 appears to reflect rising risk-aversion regarding overseas deals. While UK-domiciled corporates have been amongst the most active Foreign Direct Investment (FDI) players in the world over the past decade (punching far above their weight), they significantly cut back on outbound investment in 2009 - far more than their peers in other countries - from an average annual FDI outflow of \$134bn to just \$18bn. If it continues, then UK corporates may find themselves at a future competitive disadvantage on an increasingly global playing field.

Furthermore, UK corporates are at risk of missing out on the growth potential of the world's fastest-expanding emerging markets, by failing to target M&A and investment opportunities in them. Over the past decade, UK corporates have significantly under-invested in Brazil, Russia, India and China (BRIC), preferring the better understood, but slower growth markets of Europe and North America. For example, in the period 2004-08, the UK accounted for an approximate 10% share of global FDI flows, but only 5% of flows into Asia; by contrast the comparable shares for the US were both 18%.

UK corporates, in pursuing acquisitions in emerging markets, highlight challenges around:

- ▶ High valuation expectations built on difficult to substantiate revenue growth projections.
- ▶ An effective integration approach that balances the need to realise synergies quickly whilst preserving local know-how, relationships and entrepreneurialism.
- ▶ Deal structuring – especially with respect to the need for joint ventures.

These challenges must be overcome if UK corporates are to claim their share of the growth potential of emerging markets. We believe this is achievable through a carefully-planned and coordinated approach to each issue.

More positively, the consensus from our discussions with UK corporates is that having weathered the downturn, they are now leaner and fitter, and are more actively considering overseas investment and acquisitions. We believe they should prioritise the consideration of specific capital allocation strategies for Asia as a whole – and for China and India in particular – in order to capture critical market footholds before their competitors. The importance of doing this is underscored by the fact that the developed markets traditionally targeted by UK plc are likely to face combined headwinds of low growth, high private and public debt levels, and rapidly ageing populations. These conditions are in stark contrast to those in major emerging markets.

Winning back lost ground in emerging-market M&A will require many corporates to think and work differently – both to overcome the deal constraints and issues they have encountered in the past, and also to meet competition from resurgent private equity acquirers. This will require them to reconsider their approach to sourcing and structuring deals, and to adopt an 'issue-led' approach to deal negotiation and due diligence that focuses on the revenue growth potential, cost synergies and integration approach for their investment appraisals.



# UK plc's track record in outbound investment

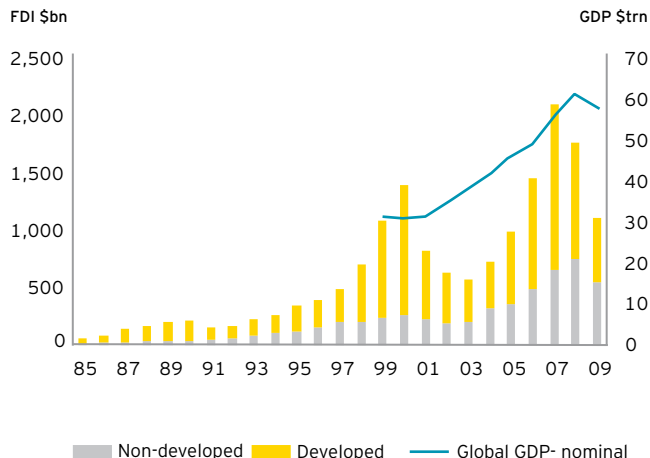
## The long-term macro perspective

### The rise of emerging markets

The past two decades have seen strong growth in global foreign direct investment flows (see Figure 1). Within this overall trend, emerging economies have become increasingly important recipients of global FDI, accounting for 38% of FDI inflows in the five years to 2009. However, it is also clear that economic downturns can have a significant impact on the overall scale of FDI activity, most notably in 2001 and during the current slowdown.

These strong and sustained inflows into emerging markets largely reflect a concerted drive by international corporates to seek out new sources of growth. This race to seize and capitalise on opportunities in emerging markets is consistent with Ernst & Young's 2010 *Competing for growth* study, which found that 85% of executives worldwide expect competitive pressures in their sector to intensify over the coming two years, such that their key focus is on winning growth from competitors.

**Figure 1: Global FDI inflows, 1985-2009<sup>1</sup>**



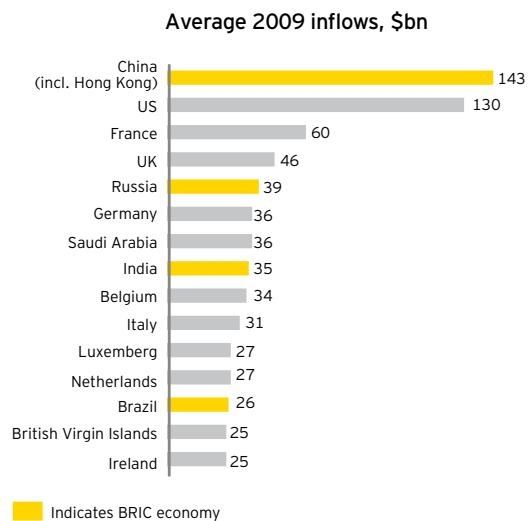
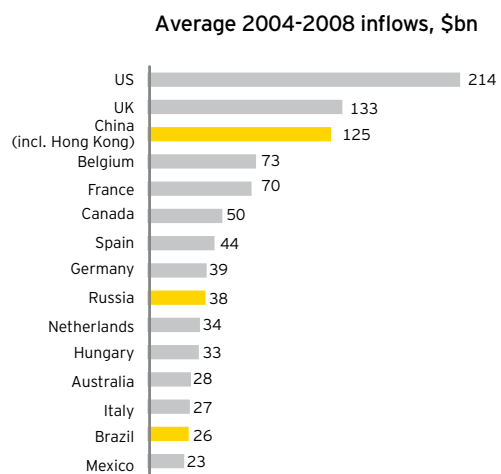
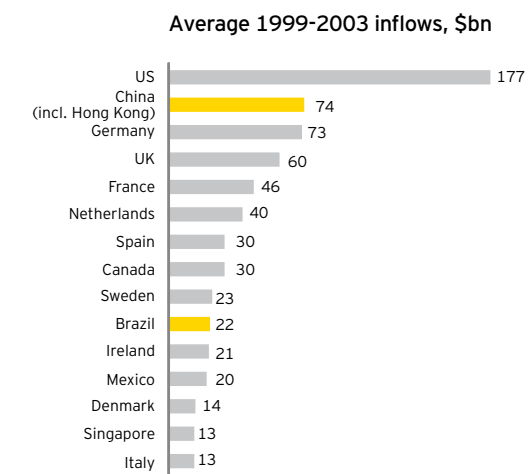
The 'high performers' we spoke to were significantly more optimistic about growth opportunities in China, India and other parts of Asia Pacific than other parts of the world.

Source: UNCTAD FDI statistics, Global insight

<sup>1</sup> a. Developed economies comprise the member states of the OECD (other than Chile, Mexico, Republic of Korea and Turkey), plus new EU member countries which are not in the OECD (Bulgaria, Cyprus, Latvia, Lithuania, Malta and Romania), plus Andorra, Israel, Liechtenstein, Monaco and San Marino.  
 b. FDI flows are nominal (US\$ at current price and current FX rate (as per the WIR website and report).



**Figure 2: Top 15 countries receiving global FDI inflows, 1999-2009**



Source: UNCTAD<sup>2</sup>

Of the emerging markets that have been capturing a rising share of FDI, China stands out as the biggest winner. As recently as 1999-2003, inflows into China were less than half those into the US, and only narrowly ahead of the UK. Today, as Figure 2 shows, China has caught up with – and overtaken – the US as the leading destination worldwide for FDI, and is attracting more than three times the UK’s total FDI.

The rising importance of emerging markets is emphasised by underlying GDP and demographic trends. At current growth rates, China’s nominal GDP will catch up with the US in around 2020 – by when both India and Brazil will have overtaken the UK. Developed countries’ higher debt burdens also reinforce the more attractive investment and growth opportunities offered by emerging markets. Furthermore, demographic trends suggest a deteriorating dependency ratio in many developed countries, with the proportion of the population that is of working age in 2030 projected to be just 62% in the US and UK compared to 69% in Brazil and India and 67% in China.

<sup>2</sup> FDI flows are nominal, with US\$ at current price and current FX rate (as per the WIR website and report).



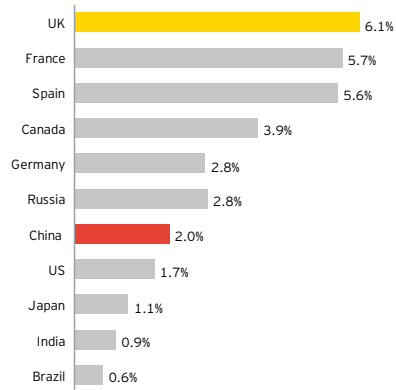
### The UK: from heavyweight to also-ran?

In terms of FDI outflows as a proportion of GDP, the UK has historically punched well above its weight in global terms. As Figure 3.1 shows, between 1999 and 2009 the UK's FDI outflows were equivalent to an average of 6.1% of GDP, making it a world leader in relative terms.

However, Figure 3.2 also illustrates the dramatic impact that the financial crisis and subsequent economic downturn have had on UK FDI. The country's annual FDI outflows have collapsed from an average of US\$134bn in 1999-2008 to just US\$18bn in 2009, well behind much smaller economies such as Sweden and Norway.

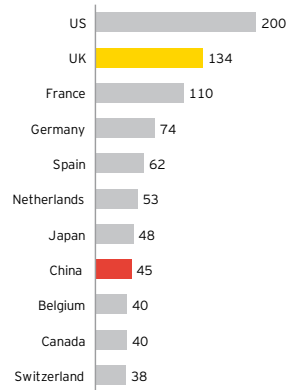
**Figure 3.1: FDI outflows as % of GDP<sup>3</sup>**

Average 1999-2009

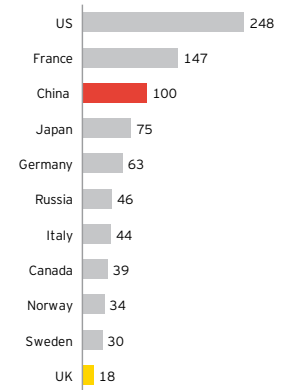


**Figure 3.2: Average annual FDI outflows, \$bn**

Average 1999-2008



2009



Source: UNCTAD, Global Insight

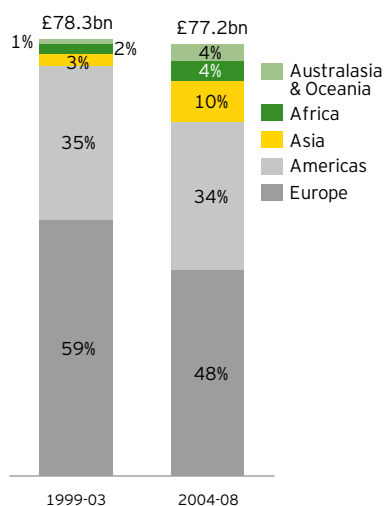
<sup>3</sup> a. FDI flows are nominal with US\$ at current price and current FX rate.

b. China also includes Hong Kong.



Of most surprise – and concern – is the fact that UK outbound FDI has been significantly underweight in Asia, including the emerging market giants of China and India (see Figure 4). In 2004-2008, Asia was the destination for just 10% of the UK's global FDI outflow; the vast majority of FDI was directed towards the developed markets of Europe and the Americas. This suggests that increasing the flow of FDI into fast-growing Asian markets should be a priority for UK corporates.

**Figure 4: Average UK outbound FDI by region, £bn**



Source: ONS

Over the 10 years from 1999 to 2008, transport and communications, financial services, and mining were the most active UK-based foreign direct investors. However, as developing economies become more oriented towards domestic consumption, the industries likely to become more important are food and beverages, retail and motor vehicles. To capture this growth, UK corporates in these sectors need to critically consider redirecting capital towards these countries.

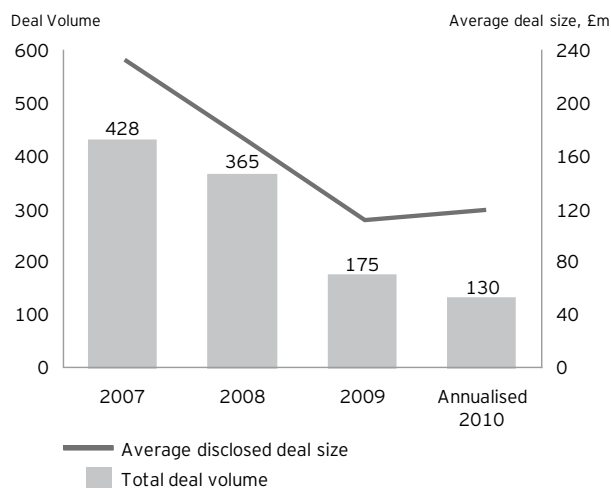


## An analysis of recent outbound M&A

### Declining activity, rising risk aversion

A closer look highlights the full impact of the sharp decline in UK FDI outflows on UK plc's level of overseas M&A activity. As Figure 5 shows, the volume of UK corporate outbound acquisition activity more than halved in 2009, and remained subdued in the first half of 2010.

**Figure 5: Volume of outbound acquisitions by UK corporates, 2007-2010<sup>4</sup>**



Source: Mergermarket

Ernst & Young's own programme of interviews with UK-domiciled outward acquirers helps to explain the speed and scale of the decline, by highlighting the extent to which UK corporates have been focusing on managing and reducing their cost base, as opposed to seeking top-line growth through acquisitions. Typical comments from respondents included:

- ▶ "We have focused on cost effectiveness, which included a programme of disposals – about 100 brands sold in the last 5 years – and organic growth in the identified core businesses." (Consumer products company)
- ▶ "Since 2007, our strategy has been more focused on margin improvement rather than top-line expansion, to provide a platform from which we can invest and grow going forwards." (Diversified industrial products company)

The slump in outbound M&A reflects not just the current preoccupations and risk aversion of large UK companies, but also their investors' attitude to outbound acquisitions. Of the companies we interviewed, only one-third believe that their investors were supportive of all M&A deals, while the rest feel that investor support is limited, especially for large deals. With the recession having exposed the operational and financial shortcomings of many companies, there is now a need to rebuild credibility as operationally effective organisations, before investors will endorse acquisition-led growth strategies.

Astute managers have focused on demonstrating operational efficiency and a long term track record of successful overseas organisations and integrations, to build trust in the investor community, before pursuing more significant deals.

Figures 6 and 7 set out the main outbound UK acquirers between 2007 and mid-2010. The largest acquisitions have been made by mining, consumer product and telecom companies, while the most active acquirers in volume terms are in diversified industrial products, pharma, and media.

**Figure 6: Top ten UK corporate outbound acquirers-cumulative deal value, 2007 – H1 2010<sup>5</sup>**

	Company	Sector	Deal value, £m
1	Rio Tinto Plc	Mining	22,007
2	Imperial Tobacco Group Plc	Consumer product	11,820
3	Vodafone International Holdings	Telecom	11,350
4	National Grid Plc	Power and utilities	6,795
5	AstraZeneca Plc	Pharma and biotech	6,722
6	Royal Dutch Shell Plc	Oil and gas	6,071
7	GlaxoSmithKline Plc	Pharma and biotech	4,575
8	BG Group Plc	Oil and gas	3,820
9	Xstrata Plc	Mining	3,824
10	British American Tobacco Plc	Consumer product	3,348

Source: Mergermarket

<sup>4</sup> 2010 deal volume is an annualised deal volume and 2010 average disclosed deal value is based on H1 2010 disclosed deal value.

<sup>5</sup> a. Deal value is based on deals with disclosed values.  
b. Mergermarket does not capture all deals.

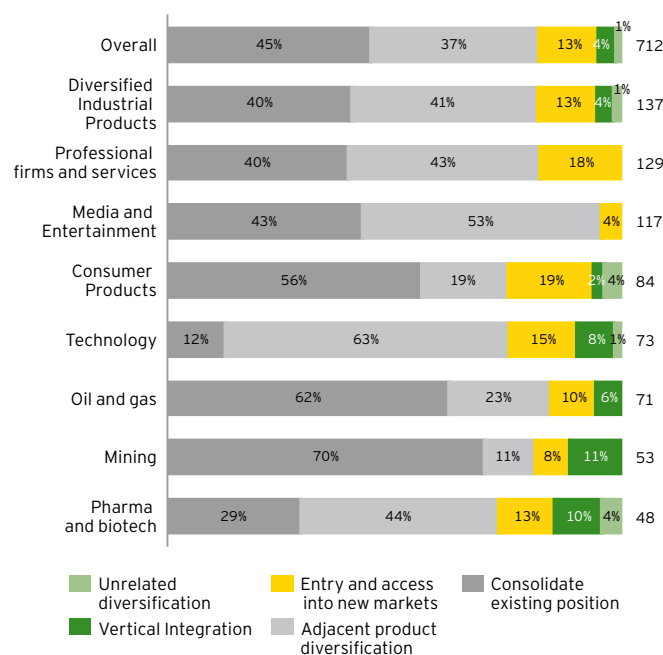


**Figure 7: Top ten UK corporate outbound acquirers-deal volume, 2007 – H1 2010<sup>6</sup>**

	Company	Sector	Deal volume
1	Bunzl Plc	Diversified industrial product	13
2	GlaxoSmithKline Plc	Pharma and biotech	13
3	United Business Media Limited	Media and entertainment	12
4	WPP Plc	Media and entertainment	12
5	G4S Plc	Prof firms and services	10
6	Aegis Group Plc	Media and entertainment	10
7	Amec Plc	Real estate	9
8	Intertek Group Plc	Diversified industrial product	9
9	BG Group Plc	Oil and gas	9
10	BT Group Plc	Telecom	8

Source: Mergemarket

**Figure 8: Deal rationale by sector (number of deals)<sup>7</sup>**



Source: Mergemarket, press releases, company websites

## Sector trends and characteristics

Our analysis of all overseas acquisitions by UK corporates between 2007 and H1 2010 highlights consolidation as the predominant deal rationale, rather than gaining access to new markets (see Figure 8). This is consistent with the developed market bias of UK acquisitions, and suggests a level of risk aversion of UK corporates.

There are often industry-specific drivers behind the differing rationales for deals in different industries. For example, consumer products multinationals are already present in most of their potential markets around the world, and therefore tend to undertake deals focused primarily on consolidating their position and increasing their share of existing markets – by extending distribution and buying leading local brands. This enables such companies to take a more comprehensive approach to integration.

Similarly, the extractive industries, such as oil and gas and mining, are overwhelmingly focused on consolidating their market positions, reflecting the fact that they are already global, and that they need to acquire assets such as rights to reserves and mines in their existing territories.

By contrast, people-based organisations such as media and entertainment, professional firms and services and, to an extent technology businesses, are more strongly focused on buying smaller operations, and preserving the target's existing local market relationships, knowledge and contacts. As a result the integration approach tends to be more hands-off. There is also an increasing focus on sourcing expertise in emerging markets and leveraging it worldwide.

Technology businesses stand out in using M&A primarily for adjacent product diversification.

<sup>6</sup> a. The number of deals also includes deals which have not disclosed their value.

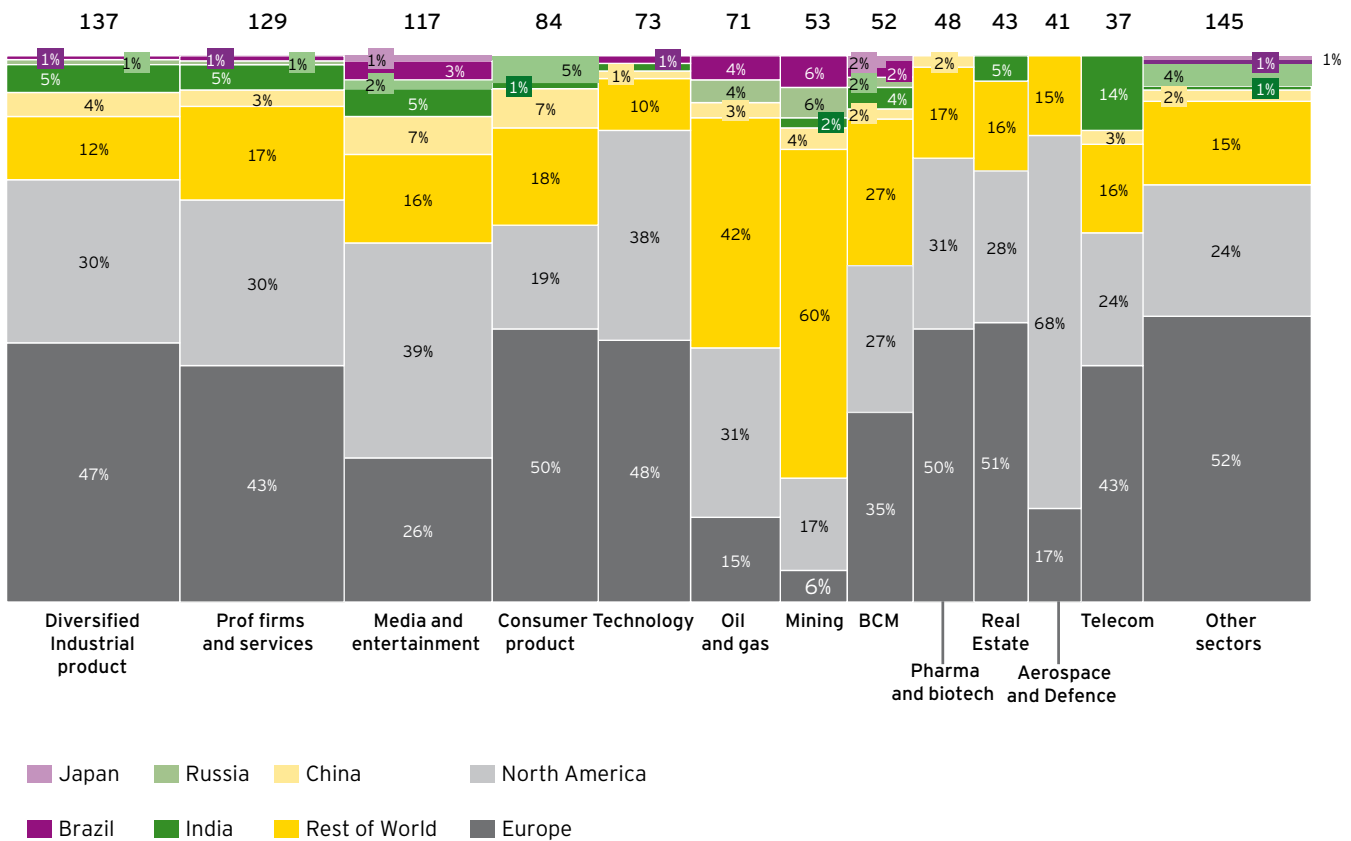
b. Mergermarket does not capture all deals.

<sup>7</sup> Overall comprises deal rationale of 74% of the deals during this period.



## Missing out on the BRICs

Figure 9: Deal volume by sector, cumulative 2007- H1 2010<sup>8</sup>



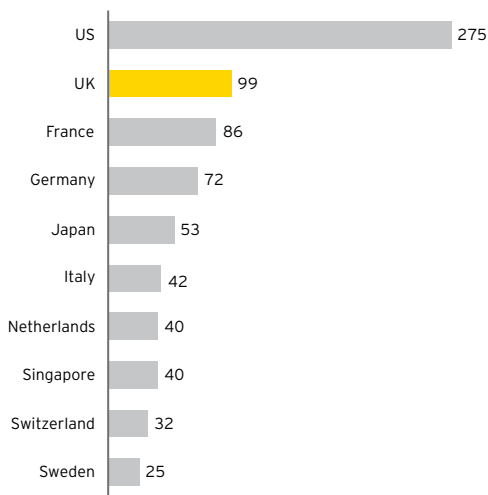
Source: Mergemart

This focus on familiar markets is evident from Figure 9. With the exception of the extractive industries (mining, oil and gas), the majority of outbound acquisitions by UK companies across all sectors have been concentrated in Europe and North America. The volume of activity targeted at China and India since the start of 2007 has been relatively small, despite those countries' much higher growth rates.

<sup>8</sup> 'Other sectors' includes retail and wholesale, insurance, power and utilities, airlines, chemicals, automotive.



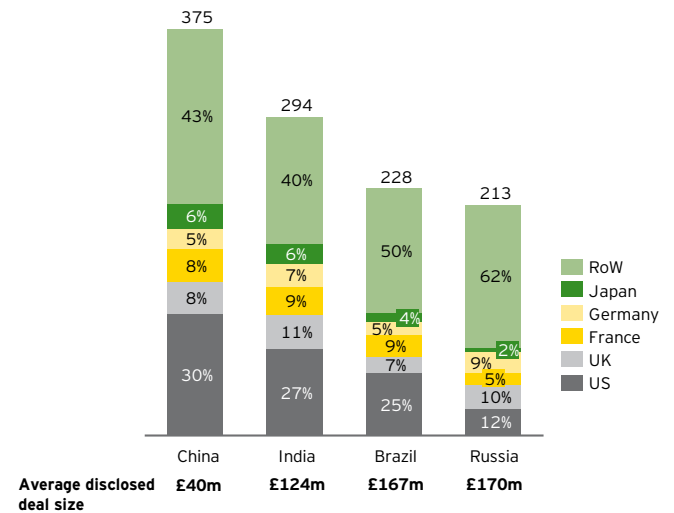
**Figure 10: Top 10 countries with corporates acquiring in BRIC economies, 2007 – H1 2010<sup>9</sup>**



Source: MergeMarket

Figure 10 shows that UK corporates have been far less active than their US counterparts in investing in the BRIC economies during the past three years – though they have remained ahead of other countries in this regard. Comparative analysis of the share of total FDI flows relative to the share of FDI flows into Asia confirms that the UK is under-investing in Asia relative to the rest of the world. Between 2004 and 2008, the UK had a 10.4% share of global FDI flows but only a 4.7% share of FDI flows into Asia, whereas the US had a 17.9% share of global and 18% share of Asian FDI flows.

**Figure 11: Deal volumes by country in BRIC economies, 2007 – H1 2010**



Source: MergeMarket

Figure 11 sets out an analysis of acquirer origin for deals in BRIC countries between 2007 and 1H 2010. This highlights the extent of M&A investment activity by US corporates into China and India. However, our research shows that UK acquirers in some sectors have been keeping level with or even outpacing the US – notably in the oil and gas and media and entertainment industries.

<sup>9</sup> Hong Kong corporate M&A activity into China has been viewed as domestic activity and therefore excluded from this list.



UK corporates are adopting a relatively cautious approach to acquisitions in the BRICs. As Figure 12 shows, their main focus during the past three years has been on the traditional markets of North America and Europe, well ahead of the BRICs. Typical comments include:

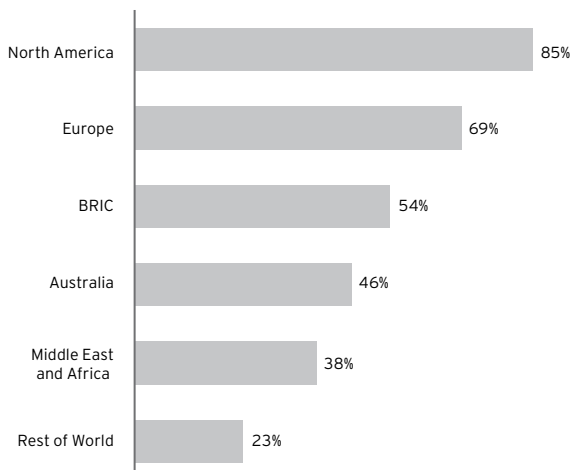
- ▶ *"We have invested in Western Europe, as we have less confidence in investing abroad and less experience in dealing with the 'cultural leaps'."* (Consumer products company)
- ▶ *"The US business provides an easy environment in which to invest, as the markets are familiar and provide good returns."* (Pharmaceuticals company)

Views on emerging markets are correspondingly more cautious.

- ▶ *"We acquired a number of small businesses in India and China a few years ago, but in general there is very little to buy out there that meets our criteria, particularly once the manager has taken his cut."* (Diversified industrial products company)
- ▶ *"We are present in former Soviet Union countries ... however, opportunities are inherently more risky."* (Global real estate company)

Taken together, our findings suggest that UK corporates are more wary than their competitors based elsewhere of acquisition risks in emerging markets, and are failing to seek out the right – and sizeable – deal opportunities in them. As the balance of global economic power and growth swings increasingly towards the BRICs, this caution risks undermining UK-based multinationals' future growth prospects.

**Figure 12: Respondents' M&A activity by region, 2007 – H1 2010**



Source: Mergermarket data on respondents, n=13

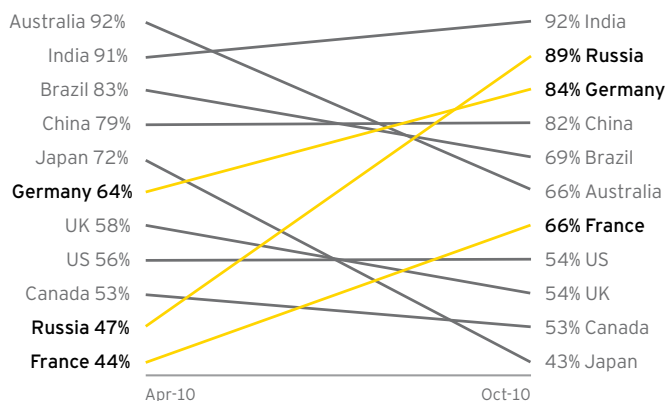




# Looking forward – emerging trends and future considerations

## Investment outlook

**Figure 13: Optimism by country April 2010 to October 2010**



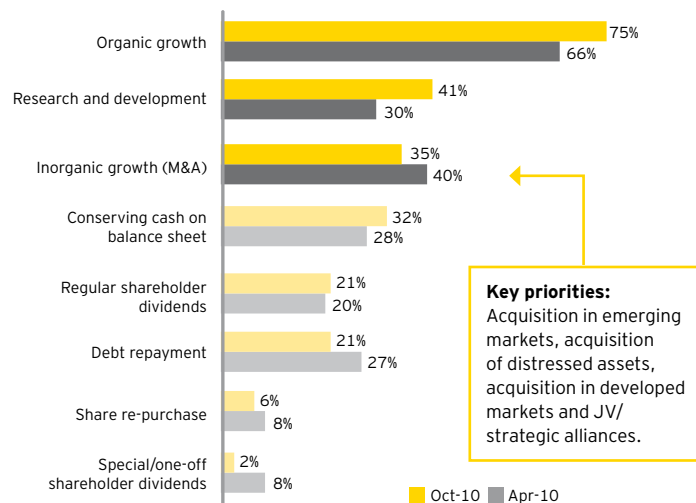
Source: Ernst & Young Capital Confidence Barometer, Q3 2010  
 Yellow indicates those where confidence has improved by more than 5%

Ernst & Young's *Capital Confidence Barometer* is a regular survey of senior executives from large companies around the world conducted by the Economist Intelligence Unit (EIU). The barometer gauges corporate confidence in the economic outlook and identifies boardroom trends and practices in the way companies manage their capital agenda. The latest barometer suggests that corporate optimism over the economic outlook is improving. However, as Figure 13 shows, UK executives were relatively pessimistic compared to their counterparts elsewhere. The barometer also showed that the priorities for capital allocation had shifted in the previous six months towards a focus on growth – including acquisitions in emerging markets.

## Waking up to the new economy

A study by Ernst & Young in 2010 of the most attractive regions for investment in the next 3 years highlighted China and India as top priority (see Figure 15).

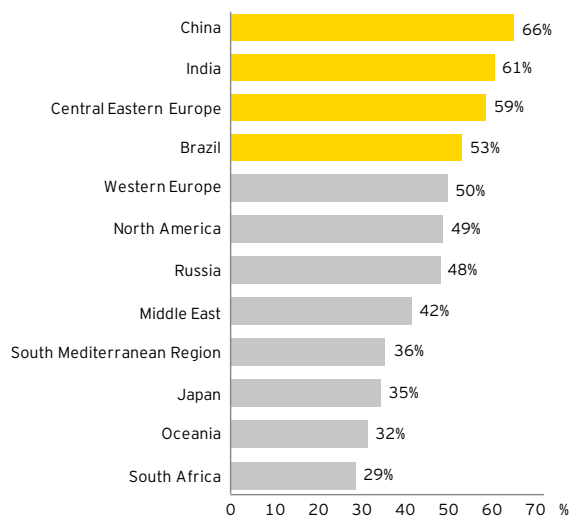
**Figure 14: What are your top three priorities for capital allocation?**



Source: Ernst & Young Capital Confidence Barometer, Q3 2010



**Figure 15: Most attractive regions over the next three years**



Source: Ernst & Young's 2010 European attractiveness survey, based on responses from our 800 decision-makers across the world. Respondents selected 3 possible answers.

### Varied opinions – but shared caution

Among the UK corporates participating in our study, some are positive about the opportunities in the more attractive emerging markets, while others voiced concerns. A respondent from a global media and entertainment company is especially upbeat about emerging markets: *“Driven by trends in GDP and demographics new capital allocation will be 80:20 in favour of emerging markets – key interests include China, India, Saudi, Kenya and South Africa.”* A pharmaceuticals company adds: *“Of the emerging markets, Brazil, Russia, Columbia and Iran have most potential due to demographics (the growth of the middle class) and leverage on the healthcare system.”* However, an oil company executive cautions: *“The speed of progress in China and India is frustrating.”*

Asked about their experiences of outbound M&A in the recent past, many respondents highlighted instances where they have been outbid by overseas competitors – reflecting differing approaches to valuation. *“We lost two deals – we weren't aggressive enough and our competitor outmanoeuvred us.”* comments a global testing company. A facilities management company says: *“We haven't missed many deals, but those that have been lost were those that went for much higher prices than we were prepared to pay.”*

Looking to the future, the UK corporates that we interviewed stressed that they will maintain their cautious approach to M&A. *“We will continue to undertake M&A at a similar level to the last few years – but we will be more cautious on valuation and the diligence that we undertake,”* says a global packaging company. Even where companies expect to increase their M&A activity, the focus is more on traditional markets than emerging ones.

Many of the concerns expressed echo the assessment of country risk factors in the M&A Maturity Index (see information panel) by the Cass business school.



### The M&A Maturity Index: mapping out the global M&A landscape

The M&A Maturity Index ([www.mandamaturity.com](http://www.mandamaturity.com)) is a global benchmarking study that analyses and summarises risks and opportunities for M&A transactions in 175 countries around the world. The index has been developed by MARC, the M&A Research Centre at Cass Business School, City University, London, of which Ernst & Young is a senior sponsor.

The study uses 36 factors to analyse M&A maturity, divided into six groups – economic, financial, political, regulatory, socio-cultural and technological. The greater the maturity, the lower the risk of undertaking transactions. The M&A maturity average scores are shown in Figure 16. This highlights the risks that emerging markets pose relative to developed markets.

China is the most mature BRIC market, in 29th place, well ahead of the others.

**Figure 16: M&A maturity rankings (top 10, leading “less mature” market countries and BRICs)**

Rank	Country	Maturity score	Economic factors	Financial factors	Political factors	Regulatory factors	Sociocultural factors	Technological factors
1	Canada	90%	82%	80%	100%	75%	100%	100%
1	United Kingdom	90%	75%	75%	94%	98%	100%	100%
3	United States	87%	79%	75%	94%	85%	88%	100%
4	France	86%	75%	75%	94%	73%	100%	100%
4	Japan	86%	82%	75%	94%	65%	100%	100%
4	Netherlands	86%	86%	75%	100%	83%	75%	100%
7	Denmark	85%	82%	70%	100%	85%	75%	100%
8	Sweden	85%	82%	75%	100%	78%	75%	100%
9	Germany	84%	82%	79%	100%	67%	83%	92%
10	Finland	83%	79%	60%	100%	83%	75%	100%
10	Norway	83%	75%	63%	100%	88%	75%	100%
23	Israel	73%	79%	60%	69%	65%	63%	100%
24	Chile	72%	75%	63%	94%	73%	63%	100%
24	Czech Republic	72%	71%	54%	75%	54%	92%	83%
24	Malaysia	72%	82%	79%	69%	71%	58%	75%
29	China	70%	82%	83%	50%	40%	67%	100%
49	Brazil	57%	54%	54%	44%	31%	75%	83%
49	Russia	57%	54%	55%	19%	38%	92%	83%
52	India	56%	64%	75%	38%	44%	42%	75%

Source: MARC - M&A Research Centre, Cass Business School



# Challenges and lessons learned

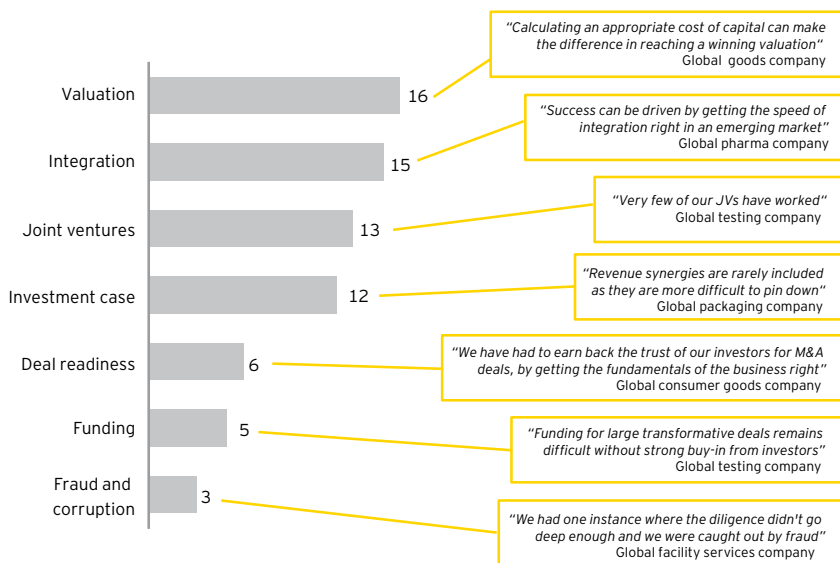
Our research interviews provide indications as to why many UK outbound corporate acquirers are currently holding back from seizing opportunities in emerging markets (see Figure 17).

Whilst fraud and corruption are clearly a concern, as might be expected, by far the most critical concerns were around investment appraisal (valuation and investment case) and integration challenges.

In the pages that follow we discuss the challenges and concerns raised by our interviewees and our view on how these can best be addressed, focusing on:

- ▶ Investment appraisal
- ▶ Post-acquisition integration
- ▶ Joint venture structures

**Figure 17: Prioritisation of M&A issues – number of mentions**



Source: Ernst & Young interviews



## Investment appraisal

### The risks of under-valuation

In our view, UK corporates need to gain a clearer and more accurate view of potential revenue growth and synergies to enable them to undertake more – and more value-creating – acquisitions in emerging markets. As we have seen, a number of our UK respondents say they are being outbid for deals. This indicates that they are being more conservative with respect to projected returns and/or weighted average cost of capital (WACC) relative to other bidders.

Our research confirms that this cautious approach is seeing UK corporates lose ground in the race to acquire businesses in emerging markets. It is impossible to say at this stage whether it is the UK or overseas bidders who have got their assessments of risks and return right. However, what is clear is that there are only a finite number of good acquisition opportunities – and a purchase that looks like a relatively poor deal in the short term may look like a winner in a few years, when emerging markets are more mature and consolidated. So an apparently high price today may simply reflect the justifiable premium to be paid for gaining a solid foothold in a high-growth market.

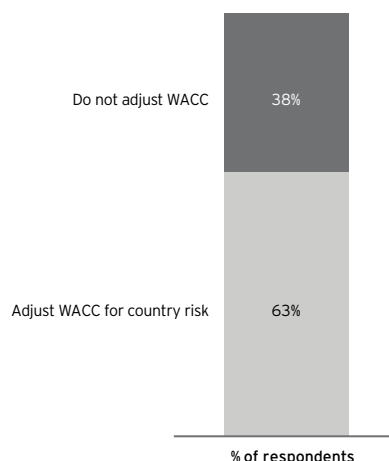
#### Five factors that can result in under-valuing a potential acquisition

- ▶ Assessment of cost structures too high
- ▶ Assessment of revenue growth too low
- ▶ Failure to take potential revenue synergies into account
- ▶ WACC adjusted to too high a level because of aversion to country and market risks
- ▶ Short-term view of value from the acquisition

## Risk levels and cost of capital

Most of the companies we interviewed say they find it difficult to calibrate risk for their hurdle rate calculation when assessing a potential acquisition in an emerging market. As Figure 18 shows, 63% of respondents adjust their WACC for emerging markets deals, while 38% do not.

Figure 18: Local market adjustments to the WACC



Source: Ernst & Young interviews

It could be argued that a global acquirer can apply a standard group cost of capital across its diversified asset portfolio, and absorb the variations in risk in different locations. However, this approach inevitably involves accepting potentially massive additional risks. So we believe it is important to adjust the cost of capital for local risks.



Those companies that adjusted their cost of capital for emerging markets have different approaches:

- ▶ *"WACC is very much dependent on the geography, political risk, capex requirement."* (Mining company)
- ▶ *"We typically have a differential of 7% to 8% between developed and emerging markets."* (Media company)
- ▶ *"WACC differs between top eight pharma markets and the rest of the world – a deal in China will have a 4% higher WACC than a deal in one of the big eight."* (Pharmaceuticals company)

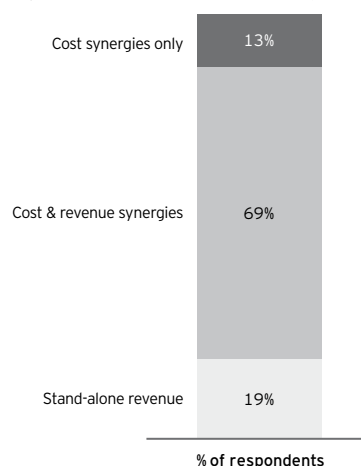
A simplistic approach based purely on sovereign risk premia derived from government bonds, will potentially ignore any risk mitigation already put in place by target management or as part of the deal structuring.

We believe that management should make an adjustment to the risk premium that addresses the local market and industry specific risk factors (including operational disruption, regulation, security of key resource inputs, government intervention) in the context of the corporate portfolio. A further complication is that the risk factors are evolving over time, and their impact may be affected by the strength of the local operation.

## Sustainable growth rate and synergies

As Figure 19 shows, our respondents' investment appraisal processes usually consider cost and revenue synergies in combination. However, revenue upsides are treated with a much higher degree of caution – an approach that can contribute to the widespread mismatches between the valuation expectations on either side of M&A deals in emerging markets.

**Figure 19: Investment case-aspects considered**



Source: Ernst & Young interviews

At one extreme, a minority focuses solely on costs:

- ▶ *"The investment case will include cost synergies; we never pay for revenue synergies."* (Global testing company.)
- ▶ *"Revenue synergies are rarely included, as they are more difficult to pin down."* (Packaging company)

By contrast, some others just focus on revenues:

- ▶ *"Most deals are revenue-led, hence we will leave the target as a stand-alone."* (Global engineering consultancy)
- ▶ *"The investment rationale is typically revenue/value-generation led rather than synergy-driven."* (Technology company)



Cost-related synergies are relatively straight-forward to assess and quantify. However revenue growth and revenue-related synergies are far more challenging to quantify.

### Five questions to ask in assessing growth potential

- ▶ How will local GDP growth of 8% to 10% feed through to sales growth in the product set?
- ▶ How long will growth continue at these levels?
- ▶ What shocks might emerge to throw it off track?
- ▶ How positive are the long-term demographic trends?
- ▶ How will the competitive environment evolve to affect the outlook for growth?

In a deal situation, high top-line growth expectations held by sellers can combine with limited market and competitor data to make it hard to reach an objective assessment of revenue potential. In such cases, detailed primary research conducted through local market due diligence can provide more robust inputs to the valuation assumptions.

### Issue-led due diligence

Emerging market deals clearly warrant rigorous and detailed due diligence, combined with a clear sight of the underlying deal rationale and objectives – especially for those buyers unfamiliar with the local market. In this context, a particularly valuable approach is 'issue-led due diligence'. This involves starting by identifying the major risk issues in the deal – not just financial but also commercial, operational, HR etc., – and then dissecting the due diligence process to focus specifically on those issues.

Our experience in applying an issue-led diligence mindset and methodology reflects the fact that, in many cases, financial considerations are not necessarily the dominant concerns in an emerging market M&A transaction. Instead – as discussed above – the major risks may lie in aspects such as local market knowledge and relationships, cultural issues, taxation, or political and regulatory factors.

Issue-led diligence zeros in on these factors on a case-by-case basis, to support a holistic and targeted diligence process focused on risks that really matter. This in turn provides a much sounder basis for formulating and executing the integration strategy. This holistic approach enables acquirers to develop a more realistic view of the financial potential of a target, taking into account all of the key risk factors.

### Five likely focus areas for issue-led diligence

- ▶ Local market position and supply chain relationships
- ▶ In-market growth and competitive intensity
- ▶ Taxation
- ▶ Cultural alignment
- ▶ Political and regulatory risks



## Post-acquisition integration

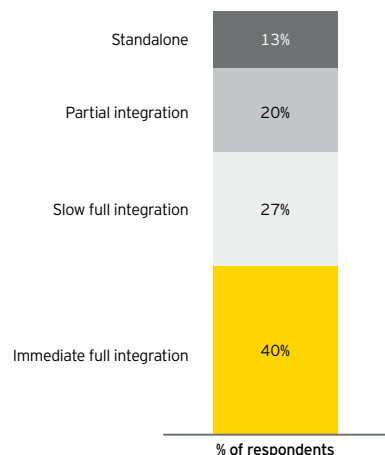
### Refocusing on integration

Deal integration, especially in emerging markets, needs to strike the right balance between capturing synergies, and preserving local market and cultural expertise.

It is evident both from our research and wider client engagements that integration has come sharply back into focus in the rationale for M&A deals. In a relatively lower-growth world, where financing is tight and investors are closely scrutinising the business case for every proposed transaction, acquirers need to seek out every possible source of value. This has put integration back at centre-stage.

With companies' integration strategies back under the spotlight, our research also illustrates the broad diversity of approaches that companies are taking. As illustrated in Figure 20, roughly one company in eight leaves acquisitions to operate as stand-alone entities, while 20% go for 'partial integration' – likely to involve some back-office synergies. The remainder aim for full integration, but at differing speeds.

**Figure 20: Approach to transaction integration**



Source: Ernst & Young interviews with 15 outbound corporate acquirers

The renewed focus on integration is all the more significant, given that a lot of post-merger integrations were not especially rigorously managed during the run-up to the financial downturn. Acquirers – especially when buying in developed markets – could often realise satisfactory returns without squeezing out every ounce of value from integration. However, with returns from acquisitions now under scrutiny by investors, integration is a source of value that managements can no longer afford to ignore.

### Consistent principles – different emphasis

Against this background, the rise of M&A in emerging markets has caused many corporates to go back and re-examine the approach and methodology that they apply to post-merger integration. In many cases, this exercise has shown companies that they could have realised more value from their previous acquisitions through a more disciplined approach to integration.

With this in mind, they are doing two things. The first is to consider opportunities to further integrate existing acquisitions to increase the returns from the initial investment. The second is to apply a more rigorous framework to all post-merger integration projects going forward, albeit with variations in emphasis on a case-by-case basis.

In fact, experience shows that the principles involved in integrating businesses in developed and emerging markets are very similar. The differences in the degree and speed of integration are more a question of emphasis rather than content – and reflect a wide range of issues, which are summarised in the accompanying information panel.



### Five factors impacting the approach to integration

- ▶ Deal rationale – cost synergies and/or revenue growth and synergies?
- ▶ Industry sector
- ▶ Existing local presence of acquirer
- ▶ Cultural fit
- ▶ Incentives and rewards for local management

### Fast or slow?

While every deal – and therefore every integration – is different, there are a number of trends that tend to hold true. In emerging markets integration tends to be slower and more gradual, reflecting the need to sustain the local brand and relationships.

- ▶ *“In new sectors we tend to keep the businesses separate, as there is not much to integrate. We typically co-brand for two to three years, and then move over as makes sense.”* (Global testing company)
- ▶ *“We don’t have any strict procedures for integration, but slower (2-4 years) is generally better – as cultures can merge at a slower and easier pace, preserving value and local management teams.”* (Global facilities management)

Within these overall trends, the deal rationale and type of synergies being sought also come into play. If the primary aim is to realise cost synergies, then integration of the back-office processes will probably take place quickly.

The general tendency in developed markets is to integrate quickly, given a focus on realising cost synergies in a mature and relatively slow-growing marketplace. This will often involve integrating back-office activities such as Finance and IT, possibly into shared service centres.

In contrast, seizing revenue synergies opportunities – which is generally the aim in emerging markets – requires more thoughtful front-office integration, which is a more complex task, and tends to be implemented more slowly. This can be further complicated by the incentives offered to local management as part of the deal.

Companies in different sectors tend to integrate at different speeds and to different degrees because of the nature of their business and strategies. A global media company comments: *“We like to move quickly to integrate acquisitions to capture synergies.”* A packaging company agrees: *“We undertake a very methodical and approach to realising synergies through rapid integration.”*

Others take a more hands-off approach – including this global speciality pharma business: *“We tend to do less integration than our peers as we tend to allow the newly acquired business to get on with developing their product.”* A defence company adds: *“It is very important to integrate slowly – the political aspect of defence means that sometimes integration is counterproductive.”* And a global engineering consultancy looks to drive integration in IT but not elsewhere: *“We leave targets as stand-alone typically, only bringing in the global organisation to supplement the target where it is weak, i.e., systems.”*



## Joint ventures

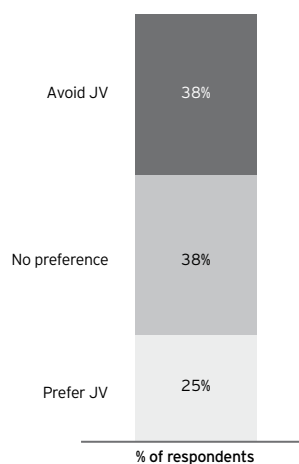
### Importance of flexible deal structuring in emerging markets

By their nature, many emerging markets require different types of structures from developed markets for international companies looking to establish a presence. In this regard, joint ventures can provide an attractive option – acting both as a way of sharing risk, and also of bridging the gap between buyers' valuations and sellers' price expectations, and between their respective views of the local target operation's revenue growth potential.

A further consideration is that some countries make a joint venture with a local party a regulatory requirement for entering the marketplace. Also in countries such as India and China, potential targets are often family-owned and –managed where the family wants to have a continuing interest.

Our respondents are fully aware that joint ventures can provide more rapid access to new markets, contacts and expertise, and can help to bridge a valuation gap. They also acknowledge that emerging markets require different types of entry structures from developed economies, and that joint ventures with local partners are often the only realistic means of entry.

**Figure 21: Use of joint ventures in emerging markets**



Source: Ernst & Young interviews

However, many of the executives we interviewed are wary of the risks posed by the complexity of joint ventures and the lack of control over the joint entity. As a result, only 25% positively prefer joint ventures as the entry method to emerging markets (see Figure 21).

Whilst 25% of our interviewees actively prefer a JV structure they are quick to stress the need to ensure expectations and interests are aligned on both sides, that there is a solid and preferably long-standing relationship with the local partner and that there is a clear path to control over a specified time period.

A global facilities management company comments: *"It is always better going into developing markets with a partner, providing you know that partner well."* A global information services company adds: *"The key to success is having realistic forecasts that both parties agree to, a clear break-up process, and an independent, politically astute CEO."* And, according to an oil multinational, the key attributes of a good joint venture include *"equal ownership with clearly different and defined contributions."*

As these comments indicate, the significant attractions of joint ventures are offset by the potential risks. A number of interviewees highlight the difficulty of making joint ventures work effectively because of their inherent complexity, the lack of control, the risk of cultural clashes, and the need to reconcile the interests of different shareholders.

As a result of considerations such as these, some 38% of the companies we spoke to actively avoid joint ventures altogether. *"Controlling acquisitions are preferable."* comments a global testing company. *"Very few of our JVs have worked, so we try to avoid them strategically."* A technology company agrees: *"We tend to avoid JVs as they tend to be unstable."* And a global consumer goods company says it only enters them when there is no alternative: *"We try to avoid JVs at all costs, but sometimes it is necessary, you have to weigh up the inconvenience factor with what the deal will bring."*



A further 38% of respondents take a balanced view of joint ventures, judging each opportunity on its specific merits. *“In some emerging markets a JV might make sense,”* comments a drinks company, *“but we would only consider a JV if it were a stepping stone to taking more/full control downstream.”* A global packaging company highlights the importance of a clear exit route to full control: *“We prefer JVs with a route to 100% ownership in emerging markets; in one case in China we lost 50% of revenue on acquisition because we didn’t fully understand the market.”*

### **Risk mitigation approaches**

There are several ways in which companies can mitigate the risks around joint ventures, and many of these were highlighted by our interviewees. The first – and most obvious – is to conduct full and detailed due diligence on any potential partner before entering the joint venture arrangement. Ideally, this should include having worked with the other party already on other joint projects.

Several of our research respondents say they have invested in the relationship in this way – often over a number of years – before forming a joint venture. This approach provides opportunities to get to know not just the business, but also its culture, the leadership and the individuals working there.

In cases where there is insufficient time or opportunity to build up the relationship in this way, it is vital to carry out as much in-market commercial and cultural due diligence as possible on the prospective joint venture partner.

It is important that both sides entering the arrangement are absolutely clear about their respective roles and responsibilities. For example, in a consumer goods joint venture, the UK partner may be bringing brand, marketing and IT capabilities, while the local partner will bring complementary elements such as relationships on the ground and distribution strength. This division of responsibilities should be made clear and explicit in the joint venture agreement

A further important component of a successful joint venture is a clear ‘exit’ route to majority ownership interest over a specific period of time if things go well – or, alternatively, to pull out of the venture entirely if things go badly. The timeframe to full ownership may vary widely depending on the industry and market environment.

### **Five success factors in making joint ventures work**

- ▶ Know the partner well, working together on other projects
- ▶ Full and detailed in-market commercial and cultural due diligence, especially if the relationship is new
- ▶ Clear division of respective contributions
- ▶ Clear and agreed exit route to majority ownership or withdrawal
- ▶ Independent, politically astute MD



## Conclusion

Over the next few decades, the global economy is likely to experience 'convergent incomes' through 'divergent growth', as Martin Wolf (*Financial Times*) succinctly puts it.

The inexorable growth of emerging markets has excited the interest of many investors. Inevitably, there will be successes and failures along the journey. However, UK plc seems reluctant to take the first steps to building a long-term presence in these markets of the future.

This may well be an astute, prescient choice by UK corporates, given the uncertainties and risks involved in investing in any early stage market. But we worry that UK businesses may be missing opportunities to take strategic footholds in – and to learn about – these new high growth markets. Developing and regularly revisiting a company's capital allocation strategy to emerging markets should be on every Board's agenda.



# Ernst & Young points of view



## Competing for growth

A study conducted by Ernst & Young with support from the Economist Intelligence Unit (EIU). Between September and October 2010 we talked to over 1,400 senior executives from companies around the world to hear their experience, test our thinking and understand more about the actions they are taking to help their companies thrive in a new competitive environment.

For more information about our findings, please go to [www.ey.com/competing-for-growth](http://www.ey.com/competing-for-growth).



## M&A maturity index

The M&A maturity index provides interactive high level insight into 175 countries around the world, helping to identify issues that might affect transactions and insight into how these can be managed.

It has been developed by MARC, the M&A Research Centre at Cass Business School.

For more information please go to [www.mandamaturity.com](http://www.mandamaturity.com)



## Capital Confidence Barometer

Ernst & Young's Capital Confidence Barometer is a regular survey of senior executives from larger companies around the world conducted by the Economist Intelligence Unit.

This snapshot of our findings gauges corporate confidence in the economic outlook and identifies boardroom trends and practices in the way companies manage their capital agenda.

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## European attractiveness survey

The Ernst & Young's 2010 European attractiveness survey is based on a twofold, original methodology based on analysis of FDI figures combined with a survey of foreign investors' perceptions of Europe.

For more information, please go to [www.ey.com/GL/en/Issues/Business-environment/2010-European-attractiveness-survey](http://www.ey.com/GL/en/Issues/Business-environment/2010-European-attractiveness-survey).



**Ernst & Young wins 'Accountancy firm of the year' at the 2010 European M&A Awards**

Ernst & Young were named 'Accountancy firm of the year' for mergers and acquisitions (M&A) at the prestigious Financial Times/Mergermarket European M&A Awards 2010.



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