



GUIDELINES FOR BUYER CLIENTS

The following guidelines have been prepared by NCG for clients and prospective clients contemplating an acquisition programme. NCG acts for buyer clients on the basis of NCG's buy side methodology, and an agreed project plan and schedule. The views expressed in these guidelines need to be tailored to the plan and schedule established for each assignment. These guidelines need to be interpreted and modified to meet the demands of each particular assignment, as each situation has its own particular characteristics.

In a recent study completed by IBM Corporation, IBM found that sector leaders were differentiated from their sector peers by their capacity to pursue on-going acquisition programs, and to successfully plan and execute each transaction – through to post purchase integration.

Timing and Environment

- The decision to embark on an acquisition programme is normally driven by events which include economic cycles, shareholder needs, perceived limitations to growth in existing markets, the need for cultural change, rapid changes in technology, the need for new skills, the desire to expand infrastructure and the need for new technologies. The decision to buy normally is driven by trading circumstances, and the stage of life cycle maturity of the buyer organisation.
- NCG's buy side methodology begins with front end advisory services focused on development of a target template. The target template describes in some detail the characteristics sought by the buyer client in targets. Targets can be rated against the target template on an objective basis, based on data collected by NCG from research sources, or from the targets themselves.
- NCG discourages buyer clients from pursuing opportunistic targets, that have "come in over the transom". Some buyer clients receive regular approaches from prospective sellers, directly or via their appointed advisers. Targets of opportunity may, or may not match the buyer's real needs and objectives.
- In providing advice to buyer clients, NCG works with the client to establish target criteria which meet the client's real needs, rather than just adding more volume to existing business streams. Very left field acquisition strategies tend not to be effective, for various reasons. Equally, just buying more revenue in an existing business stream, often motivated by a maturing market and reducing margins, may not be the best application of the client's funds. New, compatible business streams which provide the opportunity for sustainable growth in revenues and earnings are some times more productive.
- Typically, more sellers than buyers exist in the market at any one time. But quality targets which really match a buyers target template require careful research to identify.
- The majority of buy decisions are taken on a "reactive" rather than "proactive" basis. Prospective buyers often react to opportunities that arise, rather than pursuing a methodology based acquisition program approach. NCG believes that the most successful acquisitions are driven by proactive acquisition programs, based on needs analysis, strategic gap analysis and longer term planning and strategic market analysis.
- Buyers often limit the scope of acquisition activities to expansion ("bolt-ons") of existing businesses. Drivers for these types of acquisitions include expectations regarding synergy benefits and savings, existing knowledge bases, the desire to remove a competitor by

acquisition and so on. NCG encourages buy side clients to think carefully about strategic expansion of existing operations into new lines of business, which have the capacity to create cross-selling opportunities with an existing and acquired customer base, and faster growth and potentially higher earnings than can be achieved from existing lines of business. New line of business focused acquisitions can still benefit from "back office" synergies, but create long term growth and earnings opportunities. This style of acquisition was de riguer in the 1980's when most IT vendors drove to expand into the IT services sectors. In the ICT market of 2005 and beyond, many areas of the products and services markets are consolidating and commoditising, and new lines of business are important within any acquisitions program.

- Acquisition programs can be broadly segmented into 3 phases - needs analysis and planning, execution and lastly integration. Where organisations proactively embark on acquisition programmes, the most poorly planned and executed phases are almost invariably the first and last phases. Poor analysis and planning leads to "wrong fit" buys, and poorly planned and executed integration results in the leakage of much of the potential value that was available from the acquisition.
- NCG can participate in single or multiple phases of acquisition programs. NCG's preference is to participate fully in each acquisition programme, from conceptualisation through to detailed integration planning.
- An acquisition program typically takes from 4 to 6 months, or in some cases longer to execute, from the planning stage through to the completion of integration. Complex acquisition programs which involve multiple transactions and large target populations can take considerably longer to complete.
- Acquisition programs are typically planned by the Board and CEO, with support from other key executives - including legal, finance and line operations management. Acquisition programs that are for any reason distanced from the key Executive Directors and CEO are subject to high failure rates. In larger ICT organisations, typically the drive for an acquisition is generated by a line of business executive. The view is that the responsible line of business executive will have a strategic view of the existing business, the market, and areas where significant revenue and earnings growth opportunities exist. This may, or may not be the case.
- Acquisition programs are generally regarded as "offensive" initiatives, as opposed to defensive strategies. Being "offensive" initiatives, there is frequently pressure applied to the acquisition team to "cut to the chase", and initiate field work rather than spend time on analysis and planning. Poorly planned and conceptualized acquisitions typically produce poor results.
- Acquisition programmes which are based on inadequate planning and conceptualisation, and which involve approaches to multiple targets, very often become fragmented, and encounter difficulties in the completion phase. If a clear vision, motivation and will hasn't been established, then the act of completion - which crystallises risk - becomes difficult to execute.

Acquisition Planning

- Successful acquisitions are based on effective needs analysis, research and planning. Before embarking on an acquisition program, experienced buyers will conduct a detailed analysis of their needs, which identifies "strategic gaps" which targeted acquisitions are capable of closing. The starting point of needs analysis are the buyer's vision and mission statements, which then are reflected in medium to longer term business plans and financial plans. It is self evident, that if an organisational development plan is not available, it is difficult to identify strategic gaps, and then develop acquisition plans to close the identified gaps.

- NCG can't over-emphasise the importance of adequate market sector research before any field work is undertaken. The old carpenter's saying is very pertinent – "Measure three times, cut once".
- The fundamental building blocks of successful acquisitions are skills, knowledge and relationships, together with technology and products.
- Organisations are "collectives" of individuals, and the value add of the collective is measured in earnings. The value add of the collective derives from the skills, knowledge and relationships (internal, and particularly external) of the individuals that constitute the collective. Astute and experienced buyers focus in very strongly on the "human capital" aspects of target definition, rather than just the technology and financial aspects. Some of the most successful acquisitions in which NCG has been involved have been planned largely on the basis of a strong human capital, HR focus.
- Technology based acquisitions, supported by careful HR needs and skills analysis, are often motivated by perceived opportunities to market acquired technologies through extensive channel structures owned by the buyer. Australia is becoming recognised as a source of world class technologies, particularly software technologies, which have substantial potential in world markets. Detailed definition of how newly acquired technologies can be brought to market through extended channels needs to be examined. HR factors should and do play a large part in technology based acquisitions.
- When acquisitions are conceived as "offensive" initiatives, buyer organisations can allow the offensive nature of the execution process to flow through to the integration process. Acquired staff normally encounter some measure of post acquisition culture shock, but skilled buyers will plan and deliver integration management initiatives to ensure retention and maximisation of the real value of most acquisitions - skills, knowledge and relationships – "human capital".
- NCG has formed a strategic alliance with Highland Partners, a recognised leader in executive search and executive assessment. Highland Partners can supplement in-house HR resources in an acquisition program. Assessment of cultural fit, organisation design and integration processes form very important components of any acquisition programme, and have a major impact on value retention.

Valuation Parameters

- Inexperienced buyers will focus on the historic and projected earnings of an acquisition target, and then calculate returns on investment based on their own particular financial methodology - Returns on Assets Managed, Return of Funds Employed etc.
- Experienced buyers will focus on the value that can be derived from an acquisition, to the point of completing post acquisition integration planning prior to commencing acquisition pricing. It is of course possible that post acquisition plans will amount to maintaining the acquired vehicle as an independent business unit. Even in this case, the acquirer will almost invariably expect to add value to the acquired organisation. This added value may take the form of management inputs, financial inputs, product inputs, distribution inputs or many other forms of value add.
- Any acquisition needs to be based on reliable research and analysis. NCG's acquisition methodology includes two forms of pricing validation –
 - Recent comparable transactions. It is almost invariably possible to identify (relatively) recent true comparable transactions. Relevant comparables are very useful in validating acquisition pricing.

- Financial modelling, to produce a present value of future cash flows, with the current year as the base year. NCG has developed a sophisticated modelling tool which can be used to produce acquisition pricing parameters. The model uses weighted average cost of capital (WAAC) as a key ingredient of the modelling process.
- As a result of the post acquisition value added by the acquirer, the acquired organisation should clearly demonstrate the capacity to produce greater "value" under the ownership of the acquirer, than under current ownership. The pricing envelope that an acquirer will develop for use in negotiations will be taking into account the perceived value add post acquisition.
- Each acquisition needs to be based on an agreed negotiation strategy. The most commonly used negotiating strategy is to determine the level at which a buy is possible, and equally importantly the price point at which a transaction will fail. Between these 2 points is "The price". "The Price" however, is rarely "THE PRICE", because The Price is subject to "layering" and deal structuring. Layering involves "peeling the price" until the "core price" is identified. Deal structuring involves risk reduction and yield optimisation strategies, in which terms, conditions and time/step sequencing are as important as the quantum of the price.
- Most buy clients will seek to negotiate price parameters early in the buy process, arising from a natural desire to ensure that a transaction can be delivered within their established pricing parameters. There is great advantage gained from delaying pricing discussions until late in the process, at which time the buyer is equipped with full information on the target, which typically provides many points of available negotiating leverage.
- In buy transactions, the buyer is advantaged by entering into heads of agreement or term sheet based on very vigorous price and deal structure negotiations. Almost invariably, due diligence will result in identification of some undisclosed "negatives" which can be used to further layer the price and terms.
- Most acquirers want acquisitions to be value accretive. Measurement of value accretion can range from pay-back cash on cash analysis, post-acquisition earnings per share (EPS) calculations, internal rate of return calculations etc. However, particularly in the case of small cap listed ICT organisations, with low share prices, insistence on immediate accretive EPS results from an acquisition, particularly a valuable acquisition, will mostly prohibit viable pricing for the vendor. Opportunistic, reactive "bottom fishing" may result in acquisitions, but the value outcomes are seldom viable, and a "handful of dust" outcome is not unusual.

Seller Targeting and Strategic Fit

- In every case where NCG has been engaged by a buyer, extensive market research has identified prospective sellers of which the buyer was unaware. Thorough research is essential to buyer "comfort", through provision of an accurate and comprehensive perspective of market opportunities.
- Increasingly, sellers are adopting the view that there is always a price at which they will sell. Comparatively rarely do identified targets determine they are not available at any price. The simple objective of target searches is to identify sellers which rate highly on the buyer's acquisition template, and have a value perception which is below the buyer client's value perception. Seller value perceptions vary wildly, based on a lack of market transaction information. This is particularly the case with privately held organisations.
- The analysis and planning process ideally produces a template which can be used to evaluate and rank potential sellers. The quality of the template will be directly related to the quality of the analysis, research and planning processes. With the benefit of a well

constructed template, the process of seller assessment and ranking is greatly simplified, and the quality of the process is greatly improved.

- Strategic fit assessment will depend on the qualitative and quantitative aspects of the template developed by the buyer. The criteria which determine strategic fit will be identified in the analysis and planning phase, and will be reflected in criteria weightings in the template. Criteria which determine strategic fit will be buyer specific, and will transverse financial, technological, cultural, skills/knowledge and infrastructure elements.

Intermediaries Positioning

- Field work associated with sector research, target identification, target assessment and target qualification can be completed without direct involvement by the buyer client.
- It is critical to any acquisition process that the buyer be positioned as at worst "benign". If a buyer is positioned as "hostile", this will interfere with the process of acquisition. NCG always seeks to resolve conflict, and remove hostilities during the course of NCG's field work with targets.
- Some organisational cultures will result in hostility to NCG, particularly if initial approaches to targets are based on an undisclosed client. At times, targets will attempt to make direct approaches to the buyer client. In such situations, the motivations of the target need to be carefully assessed, based on best available information.
- In the case of publicly listed targets, protocols based on ASX rules and the Companies Code exist, and need to be observed. These issues are particularly important if the process involves a reverse takeover of a listed vehicle.

The List of "Don't Do" Items

- Don't embark on opportunistic, reactive acquisitions - without at least acquainting the buyer with available and potentially available targets.
- Don't engage buyer executives in early stage field work with targets.
- Don't apply significant efforts to establish the best fit acquisition. The best fit may be to grow an existing line of business, and achieve synergy benefits. Or the best fit may be to acquire an entirely new line of business which provides superior revenue and earnings growth opportunities.
- Don't initiate field work until an adequate target template has been prepared, derived from the buyers vision and mission statements, and established medium to long term plans.
- Don't enter into early price discussions with targets. Don't regard price discussions as a single point negotiation, but as an-ongoing "layering" process.
- Don't regard the "sticker price" of an acquisition to be the key transaction driver. Astute buyers recognise the terms of the sale and purchase agreement, and transaction structuring, can be as important - or more important than just the "sticker price".
- Don't proceed into final negotiations with a single target - always ensure that options exist, to generate a competitive environment. Don't abandon potentially viable targets until a deal has been concluded, and ensure that potential targets are regularly re-assessed vis a vis the preferred target.

- Don't proceed with a "process bound" due diligence phase. Due diligence is intended to provide risk identification and risk reduction, so before due diligence spend the time and effort to realistically assess the true commercial risks. Due diligence must be target specific.
- Don't provide targets with a detailed post acquisition plan view - at least until price, terms and transaction structure have been agreed in writing. Targets will use post acquisition plans, including the buyer's projected synergy savings, to negotiate and seek to improve terms.
- Don't establish detailed heads of agreement with the preferred target. Try to limit documentation to a "Terms Sheet" which broadly outlines the key elements of the deal. Heads of agreement should either be by-passed, or negotiated after due diligence.
- Don't take an offensive, aggressive approach to targets, as this will cost time and money.
- Don't proceed to final negotiations without clearly established negotiating authorities and approvals in principle.
- Don't agree to schedules or processes. Time is almost always on the side of the buyer. Don't "rush". Allow time to test the durability of relationships with key executives in the target organisation. Always track the financial performance (including actual cash flow) of the target over a reasonable current time frame.
- Always try to understand the vendors' drivers, which can vary from very positive to very negative – from a buyer's perspective.
- Don't rely on warranties in place of due diligence. Claims under vendor warranties can be very difficult if the claim is on a key executive on which the business depends.
- Always have a clear assessment of not only the actual funding for the acquisition, but also a clear assessment of the working capital that will be required to fund the acquired entity or operations. Working capital funding becomes particularly important if the acquired business achieves high growth.
- Don't create unreasonable or heightened expectations with targets. Honesty is always the best policy. If you prefer to say nothing on an issue, say nothing.
- Don't allow lawyers to negotiate the material commercial aspects of legal documentation in an acquisition. Lawyers can de-rail important acquisitions.
- Don't allow acquisitions activities to "leak" into line management. It is critical that acquisition activities be subjected to very tight internal and external security.

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