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The Global Corporate Advisor

The Corporate Finance newsletter of Crowe Horwath International

Welcome to the April edition of the Global Corporate Advisor (GCA) newsletter

In this month's issue, Mohamed Raoof from our Kuwait office examines the implications of the Capital Markets Law on Kuwait's M&A market which follows the Saudi laws. It's a fascinating look at this emerging market and the issues the Capital Market Authority has to address, including the need for greater clarity around regulations.

Raphaël Leveau from our Geneva office provides a practical overview of valuation methodologies for closely held companies. He notes that consideration must be given to a range of valuation approaches before deciding which methodology to apply.

You'll notice we have attached to your newsletter, the article, *Cost Savings and Synergies Abound in Healthcare M&A* (courtesy of US-based *Corporate Board Member* magazine). It features an interview with Ron Ralph and Brian Kerby from Crowe Horwath in the United States, discussing the effect of US healthcare reforms and M&A incentives in the healthcare M&A environment.

Please don't hesitate to contact me or the team to discuss any of the ideas in this issue, or for any needs relating to M&A transaction support, valuations, M&A advisory and related services.

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How the Capital Markets Law is Shaping Kuwait's M&A Landscape

By Mohamed Raoof, Kuwait

In February 2010, the Kuwait Parliament passed a law to establish a Capital Markets Authority (CMA), and in March 2011 the CMA issued the Executive Regulations of the Capital Markets Law (CML).

Before this, the Kuwait Stock Exchange (KSE) was self-regulated. There had been an increase in insider trading and other forms of market manipulation in the preceding years, and the CML was a step towards greater transparency and investor confidence. It aims to protect investors, enhance market performance, increase foreign interest, promote efficiency and fairness, and curb manipulative market practices.

Kuwait's CML largely replicates the Saudi Capital Market Authority laws, introduced in 2003, which regulate the Saudi Stock Exchange. Statistics by Capital Standards Rating – an independent rating agency for companies in the Middle East and North Africa – show that after Saudi Arabia introduced its Capital Market Authority laws, the number of listed companies increased significantly, driving market liquidity.[1]

This article looks at the implications of the CML on Kuwait's M&A market, and what has already changed.

How does the Capital Markets Law affect M&A activities?

The CML aims to protect minority shareholders during the acquisition process through a supervisory framework, and undertakes to regulate, supervise and monitor mergers and acquisitions. The CMA also has the authority to exempt any acquisition from the mandatory offer provisions if it considers it is not in the public interest or the interests of the remaining shareholders.

The Executive Regulations under the CML stipulate that any person making an acquisition offer to a Kuwaiti listed company needs to submit an offer document to the CMA for prior approval. The offer document must include details of the offering person, the total amount offered, the time schedule, and the financing method and source. The person making the offer and the target company must make relevant information available to all shareholders. The acquiring party must also appoint an independent investment advisor licensed by the CMA.

Once the CMA approves the offer document, the target company has seven days to publish its opinion and recommendation for its shareholders, and to make relevant documents available until the end of the offer period.

Where the acquirer already owns 5% or more of the shares of any listed company, and intends to increase his or her ownership to not more than 30% of the shares of the target company, the acquirer must disclose the interest and provide the company with whatever information is required. If the acquirer intends to buy more than 30% of shares with voting rights in a Kuwaiti listed company, they must make the same offer for all remaining shares of the same class. These must be cash offers for at least the weighted average daily price of the target company's shares on the exchange during the six months prior to the bid period. The price is calculated by the exchange.

During the bid period, the bidder, its subsidiaries and its associates cannot sell any shares in the target company without prior written consent from the CMA. The Board of Directors of the target company is restricted from issuing shares and other securities and disposing of assets without the approval of the shareholders' general assembly. A takeover bid is not accepted unless a majority of the shareholders of the target company approves the bid in the target company's general assembly.

How is the Capital Markets Law changing Kuwait's M&A market?

Prior to the introduction of the CMA, there were no effective laws regulating mergers and acquisitions, particularly from the perspective of small investors, as they could not always access the information necessary to make informed decisions.

While stakeholders are still coming to terms with the Executive Regulations and their implications, the CMA has started asserting its authority in several areas.

In September 2011, the regulation of investment companies shifted from the Central Bank of Kuwait (CBK) to the CMA. The CBK's role in this area is now confined to supervising the financial activity of investment companies.

The CMA announced in January 2012 that it had hired HSBC to help privatize the Kuwait Stock Exchange. In a move that will make Kuwait one of the few countries in the region to privatize its stock market, the government is planning to sell 50% of the stock exchange to listed companies and the remainder to Kuwaitis in an initial public offering.

1 Capital Standards Economic Report (October 2011).

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In February 2012, the CMA delisted nine companies, most of which were investment firms, from the stock exchange. It issued a new decision in April 2012 regarding these suspended companies and 10 additional companies. The CMA's resolution directives included instructions to the companies to write off losses, increase capital and submit delayed financial statements by a set deadline.

Looking ahead: issues the Capital Markets Authority must address

If the CML is to continue strengthening Kuwait's M&A market in the long term, the CMA needs to provide further clarity around some regulations. There are still a number of ambiguities, including whether there is a time limit for making an offer. The CMA regulations state that after an acquirer obtains prior written approval from the CMA, they can submit the offer at any time. However, it is unclear whether the CMA would grant a second approval when the first approval did not result in an offer. If there can only be one approved offer at any time, this could lead to a party misusing the provision to block others from making offers.

There is also uncertainty around the mandatory offer trigger when a person obtains equity of more than 30%. There could be situations where share ownership increases beyond 30% other than through intended acquisition. For example, in the event of a foreclosure, would a mortgagee receiving shares be required to extend a mandatory offer? Shares may also be given to someone who subscribes to a particular rights issue and others don't take up the rights to the shares offered; or when a target company increases its treasury shares, thus increasing a person's shares beyond the trigger level.

While certain issues, such as the appointment of the CMA Board, created some disarray in the market, it seems the CMA is on track to successfully implement new regulations. The Saudi experience indicates that an empowered and fully functional CMA can significantly boost market growth and credibility, thus increasing foreign investor and institutional interest. If developments in Kuwait over the coming years follow a similar path, we may see strong growth in Kuwait's M&A market.

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Commonly Used Methodologies for Valuing Closely Held Companies

By Raphaël Leveau, Switzerland

In most accounting and advisory firms, the valuation of closely held companies (also known as private companies) is a recurring and challenging project. The process may be difficult as the stock of such company is not traded in the open market, and the information available tends to be much more limited. In addition, these companies often have poor-quality financial and non-financial data.

Private companies that require professional valuation advisory services range in size from one-person or small family businesses, to larger companies competing in international markets. When it comes to estimating inputs for valuation, the industries in which companies operate are often significantly different.

Consider why are you conducting the valuation

When valuing a closely held company, the objective for the valuation is the key factor affecting the process. What is the final motive for valuing the business? Is it a transaction-related valuation process, such as a sale or acquisition, management buy-out or shareholder rotation? Alternatively, is it a compliance-related valuation for financial reporting, or for tax or legal assessment?

Because valuation methods and the reasons for transactions and compliance can differ greatly, the context of the valuation strongly influences the underlying assumptions. While synergies with potential investors and negotiation tactics will be highlighted in a sale process, compliance-related projects will focus on pure fair value elements using, for example, future incomes.

Ultimately, the basic principles of the valuation remain the same, but there are estimation issues unique to closely held businesses, which strongly depend on the final objective of the valuation.

Commonly used valuation approaches

Asset-based approach

The asset-based approach measures the value of a company using the net aggregate fair value (net asset value) of its underlying assets. The valuation of these assets and liabilities is based on economic criteria where estimated fair values are substituted for book values.

This approach is particularly appropriate when the company has tangible operating assets such as industrial companies; mark-to-market financial assets such as financial companies; and companies with a history of earnings instability.

An asset-based approach is less suitable for companies with intangible operating assets such as trading companies. A major drawback of the asset-based approach is the reliance of historical financial performance, due to the lack of comprehensive forward-looking elements.

Income-based approach

An income-based approach to valuation assumes that the value of a company's assets reflects its earning potential. A company's value is taken to be the current value of its future financial performance.

Value considerations are developed by capitalizing current earnings (capitalized earnings approach) or discounting prospective cash flows at an appropriate rate of return and a sustainable growth rate.

The most common method used to value a business under the income-based approach is the discounting of prospective cash flow, which depends on the availability of robust forecasted financials to derive meaningful value.

This methodology is widely used by professional services firms. Value estimates can be highly subjective if they are not implemented in a professional and educated manner; for example, using other economic operating cash flows and robust valuation assumptions such as terminal value, growth rate and cost of capital.

Market-based approach

The market approach (also known as a relative valuation approach) determines the value of closely held companies by comparing a company's transactions to those of similar businesses. Two types of comparisons are typically applied – publicly traded comparable companies and comparable transactions.

All variable data used for the valuation is extracted from market-derived, empirical data sources. The rationale behind this approach is based on the argument that the market prices of the stocks in quoted companies within an industry can be related (to a certain extent) to the stock of closely held companies.

A market-based approach to valuation is often used to corroborate results obtained using asset- and income-based approaches. This is because the market-based approach rarely captures company-specific risks and characteristics.

Market multiples should therefore be interpreted with care and, whenever possible, only for the purpose of corroborating results obtained through other valuation methods.

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Discounts and premiums

The inclusion of potential discounts or premiums would alter a company's value and must be considered during the valuation process, regardless of which approach is taken.

Discounts and premiums play a crucial role in assessing risks to the business, particularly in transaction-related valuations. For example, a company's owner may be the key client relationship manager and be intimately involved in the management of the company. This is a very different situation to a company with a strong and independent management team. There are many other control and marketability issues to be considered.

During the valuation process, quantitative and qualitative aspects must be reviewed to achieve a better understanding of the company-specific valuation drivers. This will also help the valuation team understand the weight of subjective criteria that can be used to justify an appropriate adjustment for a discount or premium.

Summary

The choice of valuation method for closely held companies should be driven by the characteristics of the company being valued – its business activity, level of earnings and growth potential, among other things. However, the income-based approach appears to be the preferred valuation methodology used by professional services firms, including Groupe Berney Associés.

As businesses derive their core value from earnings potential, asset value is implicitly based on forward-looking criteria. Caution must therefore be exercised when estimating future earnings and other valuation assumptions. Valuers must conduct sensitivity analysis to uncover the impact of change on certain critical assumptions.

Ultimately, the use of professional judgment and critical experience will remain the best way to conduct a professional company valuation.

This paper is not intended to provide a comprehensive analysis of the valuation standards, but rather a brief examination of some commonly used valuation approaches. There are numerous other value methodologies and key methodologies which merit further discussion, including Economic Value Added®, real options valuation, valuation of non-operating assets, impact of GAAPs, earnings normalization, cost of capital and scenario analysis.

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Cost Savings and Synergies Abound in Health Care M&A

By Ron Ralph, Partner and Brian Kerby, Director, Chicago

Health care reform in the US is the major contributing factor to increased health care M&A activity. A recent article in *Corporate Board Member* magazine, 'Cost Savings and Synergies Abound in Health Care M&A', features insights into health care M&A activity from two US-based Crowe Horwath principals, myself and Brian Kerby.

Heath care reform in the United States has divided critics and supporters. Most of the debate focuses on decreasing the cost and social burden of health care on the US Government, reforming the health insurance industry and increasing coverage for the underprivileged.

The stakes are high. According to the OECD, the US spends more of its GDP (17.4%) on health care than any other member country. This percentage is increasing at a rate of 6.8% to 7.1% per year.

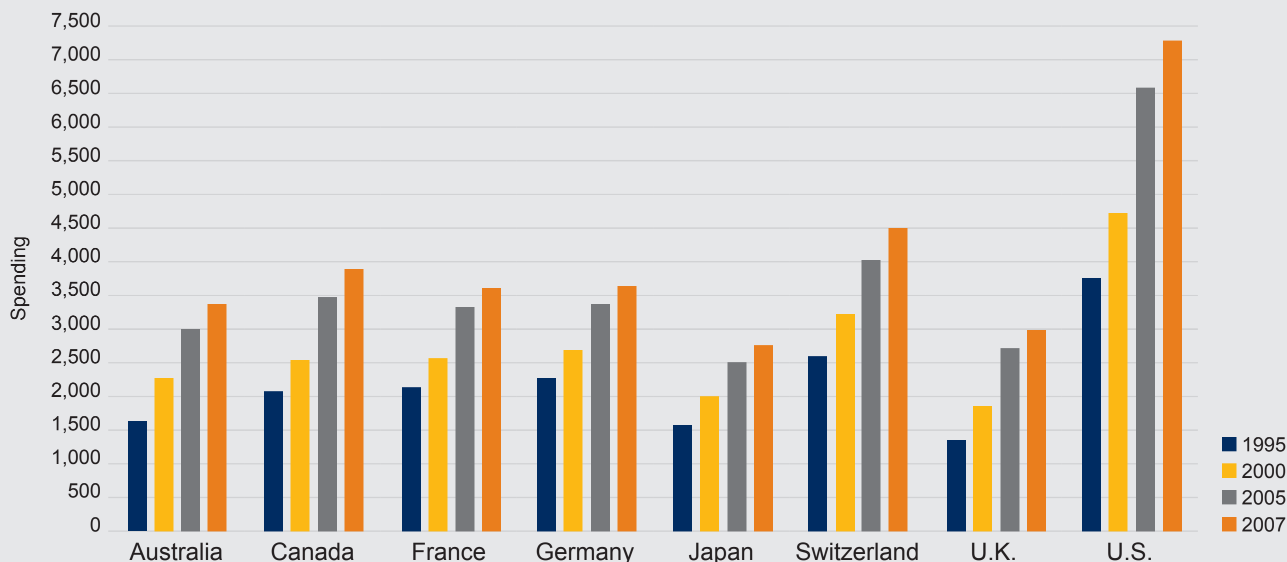
Furthermore, as the United States' population ages, its state and federal governments will be under even greater financial strain. The number of US citizens aged 65 and older will increase from 35.5 million in 2000 to 69.4 million in 2030. The Social Security Administration suggests that the country's elderly population will rise to 96.5 million by 2090.[1]

In the article, Mr. Kerby and I discuss the criteria investors should evaluate when considering which health care sectors to invest in. We argue that it is important to examine each sector separately to determine:

- the effect of health care reforms on reimbursement, payer mix and volume
- cost savings
- cost pressures
- quality of care and pay for performance.

We also share our thoughts on potential synergies for health care companies that are looking for possible mergers.

Figure 1: *Total Health Expenditure Per Capita, US$ PPP*



Source: Wikimedia Commons, and OECD Health Data 2011.

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1 http://www.economist.com/media/globalexecutive/coming_gen_storm_e_02.pdf

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Cost Savings and Synergies Abound in Health Care M&A

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What factors do you see driving the sustained increase in health care M&A activity and how does health care continue to remain dynamic, despite the lagging overall economy?

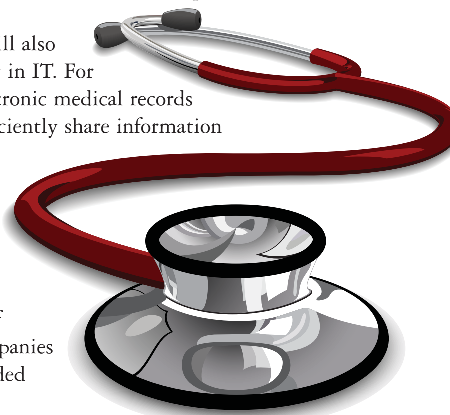
Brian Kerby: For health care payers and providers, as well as health care service companies, I believe health care reform is the biggest factor continuing to drive the sustained increase in health care M&A activity. However, I think the softening of the credit markets and a generally fragmented health care industry has also contributed to the sustained increase. Investors in these sectors are looking for target companies that will benefit from an increase in the insured population with limited direct reimbursement or pricing pressure and for companies that improve quality and reduce costs of health care delivery. Also, patents are expiring for the large biotech and pharmaceutical companies, which will need to fill their pipelines, and smaller capital-constrained medical device companies will need capital infusions, which will be the main drivers of M&A activity in these two sectors.

What has been the impact of health care reform and what are the ultimate goals as you understand them?

Kerby: Health care reform's goals include cost controls, pay for performance, and compliance, with an eye on expanding access to health insurance, modernizing health care, promoting public health, and prevention and wellness. There are around 32 million people who will be covered by Medicaid or some similar type of coverage, including insurance exchanges, Medicaid expansion, and individual and employer mandates. As a result, reform has also helped create an uptick in M&A activity across the various health care sectors, including health IT, Medicaid managed care, pharmaceutical companies seeking to fill their drug pipelines through acquisitions of early-stage drug companies, and medical device companies acquiring smaller, capital-constrained device companies. Health care reform has also provided certainty to the industry, which has allowed strategic and financial buyers to become more comfortable. For example, federal and state reimbursements per unit will remain flat or increase at rates lower than inflation, depending on the specific sector. As a result, costs are increasing at rates higher than revenue, which will continue to put pressure on companies that can't control costs. So that's also been driving increased M&A activity.

As I previously mentioned, health care reform's goals include cost controls, pay for performance, and compliance. We all know health care spending is out of control. Expenditures have been rising for the last several years and have surpassed $2.4 trillion, or more than three times the amount spent in 1990. This needs to be curtailed. Health care spending accounts for approximately 17% of the GDP and has been rising at a rate of 6.8% to 7.1% per year, although it has slowed down over the last couple of years. Major contributors to this increase have been technology and prescription drugs, chronic disease, and the aging population, as well as administrative costs. Health care worker shortages are also driving up labor costs, as are Medicaid shortfalls, where many state budgets are operating in the red as a result of fiscal pressure. As a result of all these factors, health care companies need to gain economies of scale, purchasing power, and clout with payers. These companies can then consolidate and integrate and spread costs. These will be the companies that survive.

Companies will also need to invest in IT. For instance, electronic medical records will more efficiently share information and reduce overhead costs and help manage and avoid unnecessary duplication of services. Companies will be rewarded



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for value and healthy outcomes, rather than volume of care, eliminating unnecessary care and decreasing costs.

The second goal of health care reform is quality pay for performance, which is sometimes referred to as value-based purchasing or pricing. For example, in the fall of 2012, CMS will begin withholding 1% of Medicare revenues to hospitals and will redistribute that 1% to the hospitals based on their performance under various measures.

"By combining two organizations, they hope to better navigate the ever-changing legislative landscape that's resulting from direct or indirect pricing and reimbursement pressures so that they can improve bottom-line performance and gain better or improved access to capital."

– Brian W. Kerby, Crowe Horwath LLP

The third goal is compliance. For example, physician-reported negative events must be reported on state websites, and health care companies have to prove compliance with laws and quality measures. Health care companies are also required to report quality measures to the appropriate governing bodies.

Ron Ralph: What health care reform did—whether you like it or agree with it or not—was provide stability. Business people in the M&A space see a lot of opportunity for improving the business side of health care, and I think a lot of this relates to the current inefficiency in the marketplace. You have business people saying, "I can make it more efficient and less costly, and there's a profit in that for me." Also, a big part of this is realizing the opportunity for M&A to help improve the business side of health care from a care-management perspective such as, for example, billing companies that are improving the process of billing claims, collecting money, and then reporting data. Most people understand that the need for technology and the need for accountability in reporting in order to manage the continuum of care across a patient's life is what's driving this. Reform injected a lot of energy into the business side of health care—a clearer understanding of the totality of the service-delivery cycle that needs to be given to the population—managing care before they get in the office or the hospital and managing the care afterwards.

I also see a lot of activity in the home health space, which has historically consisted of a lot of mom-and-pop type businesses. They just can't make the money they were able to in the past. However, the financial and strategic buyers see this as a terrific opportunity to acquire these businesses and put in processes, protocols, and management systems to deliver health care via a more franchised approach. In home health care, we're also seeing a trend to deliver physical therapy, speech therapy, and those kind of modalities to largely a senior population. As care moves more out of the very expensive in-patient settings and more into the home and ambulatory world, it puts the home health providers in a nice position to expand their services to those markets. So if you're talking M&A, you're talking business and profits and opportunities. That's what's driving everything.

What criteria need to be evaluated when considering what major sector of health care to invest in?

Kerby: There are probably four major areas. First, an investor will need to evaluate the effect that health care reform will have on reimbursement, payer mix, and volume in a specific sector. Does the specific sector face direct payment cuts per unit or will payment units stay flat? Will payer mix improve or not? Will volumes increase or decrease for that specific sector? Second, I think an investor needs to consider the cost savings for the specific sector. Does the sector reduce costs for customers and take costs out of the system? Third, an investor needs to consider the cost pressures on the specific sector. Will the sector benefit from scale and what is the market? What is the supply and demand for caregivers in that market and sector? For example, will the sector need to hire personnel or increase compensation? And then last, an investor needs to consider the quality of care and pay for performance. How will the care-delivery model change since the model is changing to quality pay for performance? Does the sector improve quality from a cost-effectiveness standpoint?

In summary, an investor or an acquirer needs to think about lower-cost access to care, such as retail clinics and outpatient clinics. That trend is already occurring with Walgreens and CVS opening retail clinics. Some proof of this is that hospital admissions across the country are down while outpatient activity is up, so we are seeing the shift to lower cost-of-care settings. Second, with an increase in the insured population, there will certainly be an increased demand for primary care and other

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ancillary services. So I think it will be important to note that this newly insured population will be covered by Medicaid or a similar type of payment. Third, investors need to think about the ancillary business and, indirectly, which health care service companies will benefit most from this increased volume. Fourth, there is a need for investors to focus on health care businesses or service companies that take costs out of the system. Again, some of this overlaps with what we discussed earlier, but there are four major sectors: biotech/pharmaceuticals; medical device manufactures and suppliers; health care providers/payers; and health care services. Of these four, I believe biotech/pharmaceuticals and health care services will be the hottest sectors, although there will continue to be good activity in all sectors of health care.

Ron mentioned home health and I completely agree with him. Health IT companies are reducing or eliminating costs and therefore taking costs out of the system. They also are improving efficiency and that's attractive to buyers. Under health care reform, companies are required to track patients and outcomes under pay for performance. So the IT infrastructure and investment will be required to track this. Another specific sector, and I'm drilling down into those four major sectors I discussed, would be disease prevention and management companies. So there will be a focus on preventive and wellness services, which will take costs out of the system and create M&A opportunities. Behavior health will be another fairly hot area. Health care reform also calls for increased reimbursement in the mental illness space, so states will be providing or expanding coverage for these services nationwide. Health plans are becoming more heavily regulated as a result of health care reform, and they've been impacted by mandated coverage requirements, removal of preexisting conditions, and limitations on premium increases. So I think there will be an increase in consolidation opportunities among health plans due to some of these factors.

Ralph: I agree. Investors are looking for entities that reduce the cost of delivering care, increase the efficiencies in the provision or the management of health care. As I mentioned previously, information technology providers and technology focused on care management will be attractive to buyers. I think the common ground is they all focus on the business side of health care.

What is the overall mood in the boardroom?

Kerby: I believe boardrooms are cautiously optimistic and prepared to do deals. Although we've heard of corporates being fairly active, more so than not, they have been sitting on the sidelines watching the market and really just boosting their balance sheets and cash levels and analyzing where the opportunities are for them. So they're ready to do a deal that makes strategic sense for them when it pops up. The economic recovery thus far has restored optimism, and M&A is at the top of the agenda in many corporate boardrooms.

I don't think the due diligence process has become more complicated, but I believe it needs to be well planned and thought out. That said, there are two major factors in due diligence that boards need to consider. Is it a strategic fit and how does the board and management evaluate the opportunity? Second, how do the board and management value the transaction and set the purchase price? In addition, seller motives need to be understood and the board and management need to consider whether it wants to build on current services and products or if it is an add-on of services and products.

Ralph: I don't know that due diligence is becoming more complex, but I do see it becoming more thorough. Where maybe a year or two ago companies would only conduct financial due diligence, they're now wanting clinical diligence and IT diligence. As far as the mood in the boardroom, the focus seems to be back on growing and being aligned with capital partners or strategic partners that can help you grow. I see a lot more activity, energy, and excitement now, as opposed to what it's been in terms of hunkering down, as Brian said. Companies are cleaning up their balance sheets and getting in a strong cash position, and certainly the mood is a lot more positive these days than it was in the last 24 months. Along those lines, I don't think diligence complexity necessarily deters risk taking, but I do think

> "Companies are cleaning up their balance sheets and getting in a strong cash position, and certainly the mood is a lot more positive these days than it was in the last 24 months."
>
> — **Ronald L. Ralph,** Crowe Horwath LLP

it is becoming a little more difficult to get over those hurdles than it was a couple of years ago. A single issue that a buyer can't get comfortable with is squelching some transactions right now. So I would probably have to agree that there is a little more sensitivity to risk areas, particularly when the buyer is a private equity

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group or a financial buyer as opposed to a strategic buyer. There's a lot of energy and talk about getting new capital partners to have money to grow, or selling to a strategic buyer in order to grow and get the economies of scale and market presence to allow that to happen.

What synergies are health care companies looking for these days in a possible merger deal?

Kerby: Without a doubt, improved efficiencies and effectiveness with the economies of scale are the most important incentives. When you have two organizations combining their operations and their resources, there is a lot of duplication, in capital and in operations, that can be saved. Organizations typically better leverage their purchasing power from vendors. They can eliminate redundant positions, consolidate employee benefits into one, etc. I think you've got to be cautious, though, because costs can result, too. You're talking about marketing and rebranding the merged organization, although those will mostly be one-time costs. Another point is that organizations can enhance access by providing a broader range of services and products, and perhaps even offering these services and products at a greater number of sites. Another synergy would be organizations that can enhance their financial position on a combined basis. They can enhance market share and be the sole or a dominant player in a market and increase their revenues. My last point would be for the organization to survive under health care reform. By combining two organizations, they hope to better navigate the ever-changing legislative landscape that's resulting from direct or indirect pricing and reimbursement pressures so that they can improve bottom-line performance and gain better or improved access to capital.

Ralph: Economies of scale, vertical integration, and an ability to corporatize and to really inject business principles and run and grow the merged entity based on those management skills are really the synergies. Money follows good management, and if you've got a good model with a good management team in place, that really gives an investor in the health care industry today comfort in the future because there's a lot of momentum right now. As Brian said, as far as the service industry providers, which are mainly home health, care management, and health care technology, we see a good opportunity to expand them and run them more efficiently.

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