Room for rapid growth in a virgin market

Daniel Denby highlights some of the practical considerations which must be taken into account when acquiring a Spanish company

Spain has experienced some quite impressive growth rates since 1987, ranging from 3.7% to 5.6%. Whilst many European countries are now experiencing serious recessions, Spain's GDP should grow by about 3.3% during 1991, with inflation being less than 7%.

Although labour costs have been rising in recent years, Spain still offers a low-cost manufacturing base. Furthermore, Spanish companies are generally interested in associations with foreign companies in order to obtain financial support, technology, brand names and trade marks, foreign distribution networks for their products, and new products to distribute within Spain.

The particular attraction of Spain as a target country for strategic acquisitions, is that most of its markets are still virgin. If one takes as an example almost any product, Spain's *per capita* consumption is almost always substantially less than the rest of the Common Market (except Greece and Portugal).

Foreign industrial companies that are continuously investing time, money, and manpower in their own countries merely to win trivial market share increases, consider Spain especially attractive. They find that by making well-planned strategic acquisitions, it is not unrealistic to hope for a medium-term doubling of one's sales turnover, simply through overall market growth, and without stealing business from competitors.

However, acquiring a Spanish company is not easy, and the traditional processes followed in other EC countries must be modified to suit the local situation. The following sections highlight some of the practical considerations one must take into account in trying to acquire a Spanish industrial company.

TAILORING BUYER'S CRITERIA

Frequently the buyer will have unrealistic aspirations for his ideal Spanish target, particularly regarding size. Spanish companies are significantly smaller than their European counterparts. For example, a ranking of all Spanish companies shows the 500th having a sales turnover of about US$ 150 million, whereas the 500th largest U.K. company has an approximate US$ 650 million sales turnover. Furthermore, most Spanish companies are family-owned.

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There are only about 400 companies listed on the Madrid stock exchange; and only half of these could be considered industrial companies, the rest being banks, property companies, investment funds, and insurance companies.

It is also common to find a Spanish industrial company with a sales turnover of say only US$ 10 million, but being the absolute leader in its market sector. But as mentioned earlier, the company could have significant scope for rapid growth, provided the buyer is willing to support it financially and technologically. It is worth noting that the largest industrial acquisition ever made in Spain, was last year's US$ 1 billion acquisition of La Cruz del Campo by Guinness. However, the preponderance of Spanish acquisition values are under US$ 25 million.

RESEARCH DIFFICULTIES

Target company research is extremely difficult in Spain due to the enormous number of small companies that exist, their reluctance to reveal financial data, extremely poor activity coding, the dearth of publically-available information, and the unreliability of that information which does exist. Furthermore, there is not yet a national "Companies House" as exists in most of the other EC countries.

Of course there are several research sources that can be used (Dun & Bradstreet, DICODI, KOMPASS, Fomento de Producción, industrial trade fair catalogues, trade association membership lists, the SPA Shareholder Directory, Telefonica's Yellow Pages, and even physical visits to retail shops and wholesalers), but the going is tough.

For example, poor activity coding caused a recent search for a certain type of packaging *machinery* manufacturer, to turn up several hundred candidates, an impossible number. After investigating, it was discovered that manufacturers of packaging *materials* were also included in the coding. In such circumstances, it is normally simpler to write all the companies listed, than try to weed out a-priori, those that don't seem to fit.

Our experience in initially contacting targets on behalf of clients has frequently given positive "hit rates" of 50%; but generally, only a small fraction of those responding are of interest. Initial telephone interviews usually determine which companies fit the acquisition criteria, which ones are serious, and which ones are merely curious.

After selecting by 'phone which companies *seem* to fit, the next difficult stage is gathering enough information on each target for the acquiror to evaluate. Apart from sales turnover, it is almost always futile to request detailed financial information without a personal visit. However, product information and literature, facilities information and locations, manpower, markets served, general sales methods, and channels of distribution, etc., can usually be elicited. This is normally enough for an acquiring company to determine whether or not it is worthwhile taking matters further and arranging an initial fact-finding visit.

SEDUCTION

It is our experience that out of those companies responding positively to the initial contact, and then subsequently to the request for more information, about three to five targets are usually identified as being of possible interest and worthwhile visiting. During these visits, the potential acquiror has an opportunity of seeing the factory, meeting the principals, and learning more about the company and its business. However, contrary to what one was initially led to believe, he also frequently learns that the owners are now only considering selling a minority participation, and that they have in mind a shockingly high initial asking price.

Side-stepping the issue of the high initial asking price until the target's financials can be studied, a great deal of time is spent trying to persuade the owners that it is not feasible for a large foreign company to take a minority holding in a small or medium-sized family-owned company. One will try to convince them that it would be much better for them in the long-term to sell, say, 75% of their firm to the buyer, who would then bring new products, technology, etc.; and that perhaps the 25% remaining in their possession would be worth more in, say, five years, than their 100% today.

If one (or more) of the companies visited does appeal to the potential acquiror, then the next step is to obtain detailed financial and operational data. Usually other visits by some of the acquiror's operational staff are organised, as well as a "public relations" (wined and dined) trip by the Spaniards to visit the potential acquiror's relevant facilities.

INTERPRETING A SPANISH COMPANY'S FINANCIALS

It must be kept in mind that until recently, many Spanish companies kept formal accounts merely for tax purposes, not for management or control. This is because most are family-owned and have never needed to report to a stock market, to outside shareholders, or even to lodge their accounts with a companies register.

To complicate matters further, very few Spanish companies have ever had their accounts audited. Until recently, only publically-traded companies were required by law to be independently audited. However, on 1st January, 1991, a new companies law came into effect requiring all companies to have their accounts audited that meet two of the following three requirements: sales turnover greater than 480 million Pesetas (US$ 5 million); and/or total assets greater than 230 million Pesetas (US$ 2.4 million); and/or more than 50 employees.

Furthermore, all companies, no matter what their size, must now register their annual accounts with their local companies registrar. The new law will *eventually* ease life somewhat. However, even if one leaves aside for the moment questions concerning the quality or rigorousness of these future audits, what about Spanish companies not required to be audited, or accounts for years previous to 1990?

In fact a "chicken and egg" situation frequently arises. On the one hand, it is not usually practical or cost-effective for a potential buyer to contract his auditors to audit the target company's accounts until some type of informal agreement on price and other conditions exists. On the other hand, the buyer is reluctant to make even a conditional offer without fully understanding what the seller's accounts really say. To complicate matters even further, one could never use a Spanish company's fiscal accounts in their raw format as a basis for negotiations, since they would most certainly give a completely distorted picture of the company's performance.

Therefore, the buyer's advisors must perform various adjustments to the target's accounts to come up with some indication of his past performance so that a *conditional* offer can be made subject to audit and subject to contract. Below are highlighted some of the points that one must consider.

Common (Legal) Practices

■ Property

Land and buildings are almost always carried on a Spanish company's balance sheet at their (net) historical cost. Under current legislation, if a company wishes to revalue its property, then the resulting profit would be taxed at the normal corporate tax rate of 35%. Therefore, only companies with substantial accumulated tax loss carry-forwards ever attempt to revalue their property. Every so often (the last time was in 1983), the Spanish government allows *all* companies to revalue their fixed assets for free, but this legal revaluation never really reflects the impact of inflation. In summary, a Spanish company's balance sheet usually has substantial hidden reserves in undervalued property.

It is very frequent in Spain for a family to own separately the land and buildings used by their operating company, and then rent this property to the operating company at a nominal or symbolic rent. However, because of the explosion in property prices since Spain joined the Common Market in 1986, if one were to impute a fair market rent, it would often force the operating company into a loss-making situation. Much ingenuity is therefore required when making an offer and structuring the deal, depending on whether the property is going to be included; and if not, what rental will be paid, under what conditions, and for what period.

■ Treatment of Financial Leases

Financial leasing is an extremely popular method for financing capital investments in Spain. Until the new companies law recently came into effect, most companies did not capitalise these leases as is the common practice in other EC countries. That is, all lease payments (capital plus interest) were written to the P & L (to reduce profits and hence taxes), and only the residual value of the asset (usually less than 10% of its cost) was capitalised.

Therefore, considerable care must be taken when examining a Spanish company's accounts that has acquired assets through financial leasing. Otherwise, too low estimates will be placed upon the value of its assets and profit history.

■ **Accelerated Depreciation**

In past years, the Spanish government offered some quite attractive incentives for companies to invest in productive capital equipment. One of these, was the ability to write the full amount off in the year of acquisition. Therefore, if a Spanish company that did take advantage of this incentive, presents its accounts without notes or explanations, too low estimates will be placed upon the real value of its assets, as well as on its past performance.

■ **Bills of Exchange *(Letras)***

Most Spanish companies' purchases or sales are transacted with promissory notes or bills of exchange *(letras)*, usually requiring payment in 30, 60, or 90 days. This is one of the least expensive forms of financing in Spain; and a common practice is to discount these notes before their maturity, to ease cash flow problems. Therefore, if someone unaware of this practice examines a Spanish company's accounts, he becomes totally perplexed to discover inordinately high finance charges on the profit & loss account, which do not seem to correspond to the level of borrowings on the balance sheet.

Common (Not-So-Legal) Practices

Tax evasion, like bullfighting and football, has always been somewhat of a national pastime in Spain. (In fact, the Spanish attitude towards taxation is really not too different to its Mediterranean EC neighbours).

However since Spain joined the Common Market, tax fraud has been steadily declining. This has resulted primarily from the introduction of VAT, an enormous investment in information systems by the Spanish tax authorities, and a concerted effort to bring fiscal attitudes up to EC levels.

■ **"Black" Transactions**

Until recently, many Spanish companies participated in various types of "black" transactions. The two most commonly encountered are:

Black Sales - where a company sells its products or services without an invoice and gets paid in cash.

Black Invoices - this is also a cash transaction where a company buys fictitious invoices for goods not received, or services not rendered. (The going rate for such an invoice is approximately 10% of its face value, plus reimbursement of the VAT).

Obviously, both practices have the net effect of artificially reducing the target's declared profits, and hence its taxes. The "black" cash generated from such transactions is either used to pay a supplier who also wants to sell in "black", or perhaps to pay a senior executive an undeclared salary supplement, or maybe to pay some employees for overtime work (which is strictly limited by Spanish labour law to create employment), or merely to enjoy as a "pre-tax dividend".

■ **Expensing Capital Assets**

Many privately-owned Spanish firms frequently pass off capital investments as current expenses, thereby effectively writing off the entire investment in one year, thus saving on taxes. The accounts of a company following this practice would obviously cause an unknowing buyer to place too low estimates upon the company's assets, or on its profit history.

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Independently discovering all such unofficial transactions without the target company's assistance is almost impossible, even during a full audit. Therefore, whenever one begins to perform an analysis of the target's financials, it is imperative that all such "black" transactions are revealed by the target company. Indeed, it is always in the target's best interest to do so. Otherwise, the company's profitability and net asset value would be understated, thereby yielding a lower offer. The key is knowing what questions to ask....and when, and how, to ask them.

NEGOTIATIONS

After the buyer has studied the target's adjusted financials (as of yet unaudited) and other operational data, and satisfied himself that he has a fair idea of the company's performance, the next step is to open negotiations with the sellers.

There is no general rule on where negotiations should take place, how long they will require, or the best approach to take. Each case is different. One thing which is certain however, is that the negotiating process is often more akin to horse trading, than esoteric arguments regarding company valuation techniques, or the proper discount rate to use in calculating the present value of the target company's future cash flows.

In spite of the high initial asking prices, it is our experience that the actual prices paid for Spanish industrial companies, are not significantly different from those paid for similar companies in other EC countries. The secret is structuring a tax-efficient deal to minimize capital gains taxes for the sellers (more about this later).

In recent years, there has been a marked tendency for Spanish sellers to accept the concept of an "Earn-Out". This is particularly true for companies experiencing rapid growth and where the sellers would not be satisfied with an offer based on historical earnings. An Earn-Out is also frequently attractive to a foreign buyer since such an arrangement will at least guarantee local management continuity for several years.

Assuming agreement is reached in principle on price and payment terms, experience has shown that it is also always best to negotiate *all* the other important matters that the buyer may desire (employment and non-competition agreements, the responsibility for tax and other contingent liabilities, rental agreements, etc.). Covering all such items at this stage will obviate expense and disappointment later.

The buyer will also normally ask for two or three month's exclusivity. During this period, the sellers will agree not to negotiate with anyone else, and the buyer can perform his various detailed investigations as well as have his lawyers draw up the definitive purchase contract. Although the sellers will frequently ask for some type of goodwill deposit, one can usually negotiate out of this situation by a plethora of logical arguments.

MEMORANDUM OF AGREEMENT

Once everything is agreed, a **non-binding** "Memorandum of Agreement" (MoA) is usually drawn up. This is a "Gentlemen's Agreement", generally about three to five pages long, putting forth everything agreed to verbally, and written in ordinary everyday (not legalese) language. This agreement is always subject to the definitive purchase contract, subject to legal and financial audits, and subject to the buyer's detailed due diligence. The MoA is usually *not* written by lawyers, although sometimes vetted by them. Nevertheless, the MoA serves as the basis for the definitive legal purchase contract.

AUDIT & DUE DILIGENCE PROCESS

The due diligence process in Spain is really no different to that in any other European country. The buyer will normally unleash the Spanish branch of his auditors to perform a financial audit, instruct his lawyers to undertake a legal audit and commence drafting the sale/purchase contract, and arrange for some of his operational people to meet their counterparts in the target company.

The sellers will usually provide enough information for the auditors to perform their random checks to satisfy themselves that the unofficial transactions did indeed occur. Once presented with the necessary information, auditors based in Spain are extremely adept at analyzing the situation, calculating its impact, and judiciously incorporating all such findings in their audit report.

Unfortunately, many deals fall apart in Spain at the audit stage.....*not* because of "black" transactions, *nor* because the vendors were trying to mislead the buyer, but primarily because the target company had not been particularly rigorous in maintaining its accounts. For example, first-time audits in Spain frequently turn up such items as unaccrued obligations to employees, obsolete stocks or incorrect valuation techniques, doubtful accounts receivables, etc., which either cause a re-adjustment to the offered price, or in extreme cases, dropping the deal completely.

One of the most difficult issues to handle is the calculation of contingent tax liabilities. Even with the Target's full co-operation, it is extremely difficult if not impossible to quantify exactly such contingencies. However, the auditors can usually be coerced into giving a "worst case scenario" by itemising all the various unpaid taxes, adding interest and estimated fines, and then classifying the total amount according to the probabilities of being detected during a tax inspection. Normally these categories are: "Remote", "Possible", and "Probable"; and the distribution of the total "worst case amount" among these various categories really depends on how sophisticated and creative the target company's owners or accountants were in concealing the unofficial transactions.

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Almost all sale/purchase contracts call for the vendors to be jointly and severally responsible for ***all*** tax liabilities resulting from operations prior to the sale. To simplify matters, either part of the purchase consideration is held in escrow, or the vendors are required to put up a bank guarantee usually for the total "Probable" and "Possible" amounts. Then over the next five years (the statutory period for tax liabilities), money is gradually released from escrow, or the bank guarantees are reduced, as the contingent liabilities expire.

DEAL STRUCTURE

One of the most important considerations in acquiring a Spanish company is structuring a tax-efficient deal for the vendors. This is because the present capital gains tax for amounts greater than US$ 100,000 is 56%. But worse still, the gain itself is calculated from a very low base.

For example, if the present owner started the company 40 years ago for, say, US$ 1,000, and if there were not any further capital contributions along the way, then the basis for calculating the capital gains is the original US$ 1,000 investment, multiplied by a sliding factor (which never surpasses 2.5), based on the number of years that have transpired. Apart from an adjustment which the tax authorities allowed in 1978, this method of calculation is used irrespective of the after-tax earnings retained in the company, or its present net asset value.

Therefore, if a fair price for the company today were, say, US$ 10 million, the capital gains tax of 56% would be applied to virtually the full amount. As can be imagined, Spanish tax experts and lawyers spend a considerable amount of their time in developing contorted deal structures (and there are many!) to circumvent such an onerous tax.

Frequently buyers will be asked by Spanish vendors to declare, say, only half of the transaction value in Spain, and to pay the rest outside. Our very strong recommendation is to decline politely this request because it is illegal; and the seller would essentially be passing ***his*** capital gains problem on to the buyer in case the latter ever wanted to sell the target in the future. In all the cross-border deals in which our firm has advised, one was always able to develop a legal deal structure to make the transaction attractive to the vendor.

One breath of fresh air on the horizon however, is a new tax law now being studied by the Spanish legislature, which hopefully will come into effect during 1992. If this proposal does become law, capital gains resulting from selling the shares of privately-owned companies, would be reduced by 6.67% for each year that the investment was held, essentially making all such investments tax-free, if sold after 15 years.

CONCLUSION

Whilst all the above may seem rather daunting to buyers accustomed to making acquisitions in their own countries, in practice, it is not as difficult as it appears. If there really is a desire to be a part of Europe's fastest growing economy, all that is needed is determination, and the advice of experienced professionals.

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