

## Super Return and M&A<sup>1</sup>

### M&A Super>Returns From 2010 Onwards?

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#### 1. Super-Return in Its Time: Returns and Values

Super Return and M&A – how does that ring in your ears? Does it ring a bell? At a time of “crisis”: an alarm bell perhaps? I don’t think it should. Yes, the next generation will look back to this word “super-return” as generations do look back to the words of an earlier generation and scratch their head and think “this must be something, I think, from the late 20<sup>th</sup> century, maybe a little bit later.” Because words have their times, like hairstyles, or hemlines, or first names preferred by parents of newborns. And you can tell the time from which a word derives. If born in 2010, this conference may not have been named Super Return.

Super-return hits crisis = crisis hits super-returns: also super-returns of M&A? The crisis does not really impair M&A and the returns from M&A because M&A has no return. M&A has no yield, M&A may produce gain or loss. Yes, gain derives from value, and value is calculated on real or projected returns of the underlying business or to the buyer. But M&A, like real estate and other transactions with other income-producing assets, M&A is based not on return and yield but on differences of opinion, of perception, of position. And obviously, there are more (not less) differences in times of change. So there should be more gain, and more loss. Crisis changes things. Crisis does not destroy value. Wars destroy value. Yes, nowadays, many assets are soft assets and therefore may be more fragile and may not need wars to be destroyed. But still, a crisis only changes things, restructures them, but does not destroy them. In line with that, M&A clearly is on the rise again.

#### 2. A Crisis Separates

A crisis separates one period from another. From which other period would that crisis separate the previous one? Do we know what the new phase, the new situation is? And as long as we don’t know what the new situation is, and I don’t think we know yet, so long the crisis is not over because it does not yet separate one old definable state of matters from a new definable state of matters.

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<sup>1</sup> Talk by Prof. Dr. Reinhard Pöllath at the P+P Pöllath + Partners’ Evening Reception at **Super Return 2010** International Conference in Berlin on February 8, 2010.

### 3. The? New? Reality? Is?

Now, it is a common way of talking about the crisis and the time before and the time after, to say “Don’t we live in the new reality now?” The new reality is the word all over in business. Isn’t there a new reality?

- a. First of all, obviously there is no reality; or rather: it is not directly relevant. At least when we talk about a “new reality”, we talk about perception. Perception is real, reality is only perceived. What we perceive is what really drives us in doing a transaction, for example. And the more complex the reality is which we perceive, the more differences of perception will there be and, therefore, the more change and the more transactions and the more movement and the more gain or loss. So, don’t focus too much on reality. And don’t believe you know what’s real.
- b. Second, is that purported reality new? We all know it is not new. Things are never new. They are rearranged. Rearrangements may be very important, but they are not new. There is the same cash around, actually there may be more cash around; so prices are forced to go up over time which is good for M&A. Yes, there is still a lot of cash, actually perhaps more cash; it may be sitting in banks or financial institutions, it may not go to industrial borrowers, that is what we hear being complained about from the other, the non-financial part of the world, the real economy. So there is cash or liquidity around for stock exchanges, for anything which is liquid but not enough for businesses and therefore not helpful for M&A. Since there is less credit for business, that’s not good for M&A. Credit to businesses, credit to private borrowers has been replaced by credit to public borrowers, that’s not good for M&A. So, in that sense, yes, the perceived reality has been rearranged. And the rearrangement is real and has an impact on M&A.
- c. Third, is there the new reality? Again, we all know there is never *the* reality, just as there is not *the* perception: there are several. Perceptions like realities are relative. The perception and the relative positions are important (“How are you?” – “Relative to what?”). Take the position of the bank sitting on the money and the position of the borrower not getting the money. Quite a difference, same cash, same situation. Take the position of somebody standing in the water and the water rises. Take any line for the water and for the man standing in the water. There are many perceptions to this rising or falling water, depending on its distance to the man’s chin.
- d. Finally, the new reality, is it? Again, we all know it isn’t, never is. It is always developing, in process, going on, becoming. For example, we have learned in the early parts of what is being referred to as the crisis that leverage in balance sheets is dangerous, and that was an early experience. As we now learn, leverage outside of balance sheets is just as dangerous. And I am not talking about leverage stored away somewhere, hidden. I am talking about, for example, fixed costs and profit and loss statements. A profit and loss statement, a statement of income is as dangerous as a balance sheet. It may even be much more dangerous. Actually, you may and need not even notice that there is no equity in the balance sheet as long as revenues go on. But as soon as revenues go on just a little bit more slowly, that changes the whole world. It is like what we see every day on the Autobahn: you drive along, you see a big traffic jam on your side, you stand for an hour, you go on, you come to the point which caused the traffic jam, and actually, it was an accident on the other side. There

was nothing on your road, nothing. Except perception. People being interested in what is happening, people getting a little bit more cautious. If everybody among our customers gets a little bit more cautious and we are selling coffee or machinery or whatever, then, we are losing a lot of sales in any week where our customers hesitate just a week, just a few days. A week of hesitation means that you have lost 2%, 3% of your business in that year. A month of hesitation makes you lose 10%, half a year 50%. Many businesses lost 50% or even 90% of order intake in 2009. Therefore, in short, a profit and loss statement is far more dangerous than a balance sheet.

#### **4. Change: Order: Discipline**

So, I am trying to say *the* new reality which is neither new nor real nor is it, and not *the* reality, it is going on all the time and we are becoming more and more aware of it. It is changing, which is good for M&A. Change in the past for people involved in M&A or in transactions often needed to be triggered, people needed to be induced to make a change. There was a need for a catalyst. In the new world, in today's world, there is no need for inducement, no need for a catalyst, there is force. Sheer, brutal, simple financial or business force which forces change. No need for M&A lawyers or advisors or anybody to induce change. Change is going on anyway. What is needed is not inducing change or pushing the change which is being forced upon people anyway, what is needed is what has been needed and what has been requested and required from professionals involved in M&A all the time: It is to provide a degree of order within the change. Order so as to understand what is happening and so as to do it. To create order by doing it, order in understanding, order in doing, there are rules, practices and usages, the rules of the art, the rules of the trade. But there is also discipline, discipline in people. I know discipline is what is referred to as a secondary virtue, but it is not less necessary than primary virtues.

Crisis, including this crisis, is being dealt with in a poem by Kipling. You remember, Kipling is the one who is always talking about Indian riots and the jungle and so on and not directly about the financial community, but the poem could be applied as well to our situation:

“If you can keep your head when all about you      If you can trust yourself when all men doubt you,  
Are losing theirs and blaming it on you,      But make allowance for their doubting too; ...”

And it goes on about riots and jungles, obviously. Kipling talks about discipline. Macho discipline, perhaps, but still: purposeful discipline, order. And that is what is requested from, and imposed on, M&A professionals.

#### **5. Transparency and Documentation**

Order rules all trades nowadays, in M&A and elsewhere, in particular: order by way of transparency – documentation, for example. If there is no documentation, that as such, the sole fact that there is no documentation, proves that there is a mistake. It is simply wrong or disorderly not to have documentation. At the same time, documentation documents mistakes. You are caught between the rock and the hard place. You should have documentation, if you don't, there is no need for inquiry, it is proven that there was something wrong. If there is documentation, you can be sure that it will document mistakes. Because human life is full of mistakes. No M&A transaction would happen if there were not mistakes.

Business, in general, everything in human life goes on only because people accept that there can be mistakes. Mistakes have been part of our life and of M&A. In times of rising asset prices, the rise covers mistakes. Remember real estate from 1950 to 1980. (Remember inflation?) The only mistake you could make then was to sell. In times of rising prices, even if there is a hot potato found in your hands, as the buyer, you will be able to pass it on to somebody. Declining asset prices uncover mistakes, unavoidably. They uncover big mistakes – maybe you even knew that they were mistakes at the time you made them. But also small mistakes, little shortcomings, little nothings which have big effects. The declining asset prices and the documentation in e-mails or otherwise, reflecting what you did or did not do, also uncover something far beyond mistakes: the little embarrassments. The way how you were talking about somebody else. The way how you were using first names or expletives or acronyms or whether you took the time to write something which at least was acceptable when read out loud in front of a court or a third person or the other party. I used to say to young associates: “Look, when we write this memo how would I feel if this memo was read out aloud in front of me or if I had to explain my memo to a tax agent, to a judge, how would I feel?” I am not talking about mistakes or being “sentenced” to something. Just if I feel embarrassed, I should not write the memo the way I otherwise would.

In the old time, actually not so long ago, mankind had to use a lot of effort, philosophical, religious and so on, to impress upon people that there is something or someone watching you all the time to help you to be disciplined. I am not saying this is no longer required, but it is no longer the only way of making you think that it might be better to be a little bit more disciplined.

Also, and more importantly or as importantly, the way how M&A has developed has created more order, more rules, more fixed practices, more usages. You can be certain that there is documentation. In the old times maybe there was none. If there was none, was it destroyed or did it never exist? Today you can be sure there will be documentation. If it isn't on your computer, it is on somebody else's. It is only a question to find it. And there is a very easy way to find, I will come to that. Also in today's time, and I am talking about times which have developed over the last two decades perhaps, in today's times there are more parties involved, more people involved. More people means more views, more memos, more memories. And always different and changing perspectives and perceptions. And you don't know which one will be played up and which one will be ignored, later, when push comes to shove.

## **Litigation**

Documentation helps litigation including arbitration. Litigation in the old time used to be something far away referred to by old men saying to young men: “Look, perhaps, this might go to litigation. Let's think about it more thoroughly”. Today, you can be sure there will be litigation. Maybe not in your case but maybe in the other one. Not one out of a hundred as in old times but – I am making up the figure, I did not count it – one out of three. A very statistically relevant proportion of cases will go to litigation. Therefore, the word boldness in taking a decision, boldness in giving advice takes on a new meaning.

Arbitration clauses take on a completely new meaning. They used to be ignored, used to be referred to as boiler plate. Nowadays, they – for example, their reach – may be the most important clause in the whole agreement. They may be the only really important clause in the

agreement. And you always ignored them. You who signed the agreement, you who advised the one signing the agreement, everybody ignored it because it was just boiler plate.

In the old times, there was paper, actually in the new times there is also paper, there is even more paper than before. But today, on top, there is e-mails, there is data stored. Data never get lost – papers get lost sometimes. They get misplaced. The sheer number of papers, 300,000 pieces of paper in a mid-sized transaction, make sure that most of these papers get “lost”, simply because, much later, you cannot find that piece of paper which you need. With data storage nothing gets lost. You only need to do a search. This is what you see when you get e-mails from people who try to get across your spam filter: they are putting in apostrophes or blanks or other things in their words in order to obstruct the search methods. Otherwise, everything can be found. Everything will continue to be stored, everything will be stored, forever, also in the wrong place. You think it is stored or destroyed in your place, it will be stored in twenty other places. It will be stored in the wrong place and in the wrong context, at least you think it is the wrong context. You will have to explain the context. What you wrote in that e-mail, was it a perfectly legitimate consideration in tactics about pricing and negotiating? Or is it actually proof of fraud? Or attempted, failed but still punishable fraud. I could not give you a hard and fast rule to distinguish one from the other. But you can be sure that there will be people out there afterwards who will take a view, the one you don't like.

There are e-mail chains. There may be a perfectly innocent e-mail at the end of a chain. If you went down the chain, you found a piece of e-mail which nobody would have liked to come out. I am not saying that it will be a disaster or anything, it may just be felt by the people who wrote it, you, afterwards, that it was embarrassing. And the fact that it was embarrassing may mean that you lose your case, that you lose in litigation, or that you lose a client or a friend. Life is not only about big, deep and analytical thinking. It is very often about very superficial things.

A final remark on documentation and e-mails and so on. There is access in almost every transaction. There is access by the buyer to data storage and e-mails and everything from the seller's side. Because a few days after the transaction, people may still have access to the old IT system. The same way the other way round. Through the managers, the buyer will have access to the e-mails or the other data storage on the part of the seller. There are not just two sides and a big rift in-between. Everything is linked to everything. And in today's litigation or arbitration, everything may be discovered. There is something very close to US-style discovery in a lot of non-U.S: litigation or arbitration. The other party just needs to ask for it, and you may have to open all your data storages. By the way, simply asking may be a sure and easy way to find something because no one wants to run the risk of being found (or suspected) to have lied later.

## **6. Relativity: Competition**

When I said perspective, perception, I am talking about relativity and competition. Always, there had been competition: the better against the good. This is why a venture capital idea did not play out because there was a better idea somewhere else, even though the one you invested in was perfectly beautiful. And the better versus the good plays out on a bigger scale in globalization, every idea against every idea everywhere, now. Plus, today, it is not only the better versus the good, it is also the bad and the worse against everything else. The

bad is dragging down something else which is perfectly good. Therefore, your piece of business, your piece of a transaction may get involved in a struggle, later, between other people further down the chain. And it comes back to you to haunt you.

## **7. Han Fei Tse: The Art of Horse Racing**

The word relativeness, the words “relative to what”, the word competition take on a new meaning. A Chinese writer, Han Fei Tse, two thousand years ago, explained very well what competition means and what it should not mean. It is the short story of a prince teaching the emperor to race horses. After much training, the emperor does races with the prince and loses two times and says: “Prince, you gave me a lot of teaching, however, I lost two times, so your teaching must be somehow imperfect.” The prince responded: “No, my teaching is quite perfect. You are doing it wrong. When you are chasing ahead of me you are thinking about me and fear that I may come up to you. When you are chasing behind me you are thinking about me and how to come up to me. In horse racing, you win by two things: one, by putting on the harness and gearing in the right way, and second, as the racer, the driver, by becoming one with your horses, and not thinking about anything else. Now, obviously, if you are racing with another party on the same horse track, the other party will always be either ahead of you or behind you. So, if you think about the other party, you will always think about one anxiety or the other. And that prevents you from becoming one with your horses, and so, you are losing.”

Yours, only yours, are the things which you control and which are meant to get you to win. And what you can control may be little, very little. But it is all, it is 100 percent of what you can control and by which you can add value. So, little as it may be, it is all you can do anyway. Therefore, the rule is: be afraid, be very afraid, there is good reason to be afraid, and go out all the same. Be afraid and do it. Be afraid and do something in order to win.

### **Be afraid and go!**

In the first crisis of mankind, to the extent we can believe the reports, in that first crisis the voice from above spoke to the earliest members of mankind, showed them the sword and the flame, talked about sweat and tears and the difficulties of life out there, outside of paradise, and then said, as you may recall: Go out and control it or conquer it or own it. The voice did not say, sit down and make an analysis, or consider what I said, or take advice or therapy to overcome your anxiety. The voice said: go out, in spite of everything, in spite of your anxiety. And therefore, being afraid is one half of what has saved mankind to a large extent up to now. The other half is: in spite of being afraid, doing something, that is what is required. Incidentally, Kipling’s poem about riots and chaos and jungle, ends with a line: “If you can fill the unforgiving minute with sixty seconds worth of distance run ...”. So, the voice meant and wisdom tells us: Go out now and run, starting this minute, this second.

## **8. Ownership**

When I said the voice told them to go out and own the world that obviously is an interpretation, it is not quite literal. What I am trying to say is this: from the beginning of times, in creation itself, ownership was created – not yet M&A. Ownership is made and held and developed and dies and falls away and is destroyed – without M&A professionalism. But by

doing M&A, we are bringing, we are trying to bring, order to the holding of ownership, the development of ownership, the change of owners to prevent or rather delay the death of ownership. (All life is entirely about delaying death.) The practice and art of M&A is about order, as I said. M&A is meant to be orderly. We may take comfort in knowing that ownership will die anyway. If we do something about ownership and its transfer, rightly or wrongly, we will not be the final cause for ownership of that asset to die. It will die anyway. But we have a chance of helping it survive in a different and orderly fashion.

With that I mean ownership in the true sense of the word, not in the sense we have all become used to as a synonym for any sort of responsibility, like in ownership of a project or to be the owner of a problem. That is inflation of the word, that is not ownership. True ownership is about value and the value created by the most absolute, extremist, radical lever which you can use to create value: time. Ownership is for indefinite times, it is not for a period of time, it is forever. In addition, human mind added on inheritance and other ways of extending the lever and in making the value leverage bigger. And value and change is what ownership is all about. Ownership is, for example, not about qualification. You do not need to be qualified to be the owner. There is no test for ownership (as there is no test for the right to vote). But there is change in ownership. And the whole creation of wealth since the early days of mankind up to now, that whole creation of wealth was done through the invention of the legal and societal and economic concept of ownership and of transferring ownership. M&A realizes that value which derives from the infinite time leverage deriving from ownership (as opposed to use).

### **Capital and No Return**

I am talking about ownership of assets, of things, whether soft assets or hard assets. I am not talking about capital and the ownership of capital. Capital as such does not create wealth. Nor value. Capital as such, therefore, financially has only nominal value. Assets depreciate, capital maintains its nominal value, hopefully. Capital should be returned, and for the very reason that it should be returned it does not merit producing a return. And actually, capital produces very little return, almost none. If you deduct the cost of storage and of air-conditioning and of watching it and guidance and monitoring it and so on, nothing is left, more or less, of the return on capital as such. And that is right, because capital does not create value. Risk taking produces value and earns a return. Work earns a return, ideas earn a return, innovation does, innovation in technology or marketing or financing or selling. Capital does not earn a return.

There is plenty of risk out there, plenty of ideas, plenty of workforce available including among M&A professionals. So there will be no shortage of super-returns, in or after the crisis.

Enjoy it, by doing.