THE CROSS BORDER M&A BUY SIDE PROCESS
IRAN’S CHALLENGES

TEAM

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INTRODUCTION

Corporate mergers and acquisitions ("M&A") represent a common and key strategic growth alternative for business owners in today’s business environment. Prospective investors are intrigued by the potential opportunities, but there are a lot of questions and lack of clarity about the Iranian market and how to enter. Iranian equity markets are dominated by a number of large institutional investors such as pensions funds and Para-governmental. We think it might be helpful to analyse challenges facing potential investors in this opaque market.

With a growing number of strategic and financial buyers seeking to deploy available capital towards Iran, and with investors applying increasing pressures on companies to accelerate growth, a company that is seeking to grow through acquisitions (i.e., a prospective acquirer) is often disadvantaged in uncovering and accessing acquisition opportunities compared to buyers that are visible to sellers and have established connections to sellers directly or through intermediaries.

Complicating the situation further, when a company gains access to attractive targets that are actively being sold, typically in a competitive managed sale process, a prospective acquirer is often disadvantaged in successfully bidding for the target due to limited insight into the business landscape, as well as into situational, legal and financial factors that provide an experienced buyer with leverage. As a result, a prospective acquirer may not be able to move quickly enough in a transaction process.
Because of these factors, engaging a qualified investment banker as a professional intermediary is usually the most proactive means for a prospective acquirer to successfully drive the acquisition of a target company. In these situations, an acquirer may exclusively engage the investment banker to execute a comprehensive "buy side" process for identifying, accessing and facilitating the successful closing of one or more M&A transactions. The investment banker will also act as a critical bridge to connecting with M&A opportunities while the management team can continue to focus on operations.

In other situations, an acquirer may choose to run its own buy side process without the assistance of an outside advisor. Regardless of whether or not an investment banker is engaged, it is important for an acquirer to thoroughly understand the process of buying a company, collectively referred to as “the buy side process”. This guide highlights the typical process of buying a company, with specific context for potential acquirers that may be new to the process in Iran.

Based on estimates about 45% of the stocks have been affected by domestic economic weakness resulting primarily from sanctions and banking restrictions. These companies have the potential to regain profitability and bounce back strongly as sanction relief works through the system. A further 20% have seen weakness due to lower global commodity prices. Aside from stock market investments, Iran is ripe for partnerships with external companies. Iran has a well-educated labour force, competitive labour costs, and access to locally produced raw materials for many industries. Combine this with a consumer oriented country with a population larger than that of France and one can see the potential. There are many opportunities for western companies to create partnerships with Iranian companies to combine external capital, product and business expertise, and local labour and raw materials to build successful and fast growing businesses.

As we discussed previously, currently the market is dominated by a few very large investment groups, with a smaller yet active retail market. As a result, the stock float for many companies is very low by Western standards. Most of these large shareholders have an incentive to reduce their large holdings, further diversifying their portfolios, and raising capital for new projects and investments. As investors come into the market, we expect more transactions to occur, increasing the stock float, overall liquidity, and trading volumes. Historically, the annual turnover rate in the stock market has been approximately 25% of the total market capitalization – we believe that turnover and the market cap will increase steadily.
BUY SIDE PROCESS OVERVIEW

The buy side process is generally comprised of the following four stages:

PHASE I:
Target identification and engagement

PHASE II:
Preliminary due diligence, valuation, and indication of interest

PHASE III:
Further due diligence and letter of intent

PHASE IV:
Final diligence, negotiations, drafting of the definitive purchase agreement, and completion of the transaction

We describe the typical activity and challenges for each stage below.

PHASE I: TARGET IDENTIFICATION AND ENGAGEMENT

The first stage of the buy side process is to identify and engage the acquisition target. The main objective of this phase is to uncover and pre-qualify an acquisition target as a potential strategic fit and as reasonably likely to be willing and able to consummate a transaction.

As described below, an acquirer will typically identify and engage an acquisition target in one of two ways: (1) by directly reaching out to the target or (2) by receiving an invitation to bid on a target, typically when the target is actively in a competitive auction process to sell its business.

1. Direct Reach-Out to the Target

This approach involves the acquirer researching the Iranian market for acquisition targets and then, once identified, proactively reaching out to solicit interest from the target to engage in exploring a potential transaction. The acquirer may reach out to the target directly or through a financial Advisor or other intermediary if the acquirer wishes to be anonymous.

Once interest is established, both the acquirer and target will typically submit, with the assistance of legal counsel, a Confidentiality Agreement ("CA") for the other side to execute, to enable in-depth bilateral discussions. The CA legally binds the parties from not disclosing confidential information regarding the target or the prospective transaction. At this point, once the CA is executed, the acquirer’s identity will be revealed if an intermediary is used.

For the acquirer, the main benefit of the direct reach-out approach is that the acquirer may pursue discussions with the target without the target necessarily being actively engaged in selling the company. Thus, opportunity exists to acquire the target outside of a competitive bidding situation, which may partially mitigate the risk of overpaying for the business as well as being forced to keep pace with local potential buyers in a formal managed sale process. Furthermore, the acquirer may have more flexibility and leverage in dictating the terms and pace of consummating a transaction.

For the target, a main benefit of the direct reach-out approach is a potentially shortened and more discrete transaction process, which may include minimal risk of confidential strategic or competitive information being leaked into the market. However, a challenge of the approach is potential concern from the target of lack of negotiating leverage and of “full” value potentially not being received since there are no other buyers actively competing for the business.

Often times, the target may engage the acquirer without strong intentions to sell the business. Alternatively, the target may simply be chiefly seeking to receive a “market check” on what the target’s business is worth in advance of potentially launching a formal competitive auction process to sell the business.

Given these factors, the likelihood of successfully consummating a transaction with a specific target through direct reach-out or on a direct one-off basis is usually considered lower probability compared to if the target initiates discussions with an acquirer and is actively undergoing a sales process. This is particularly the case if the acquirer does not have a relationship with the target before reaching out.

However, this risk can be partially mitigated by the acquirer by first developing a strong network of corporate executives and intermediaries – including of lawyers, accountants, investment bankers, private equity firms, commercial banks, wealthy investors and other capital providers.

Many of the most attractive target opportunities in IRAN are often uncovered through such an established network. It is common for acquirers to be introduced to
targets through individuals that are well-connected to IRAN businesses and offer inside perspective on potential targets, including through direct or indirect key relationships within the target organizations. Developing such a network can play a critical role in uncovering high quality target opportunities in IRAN that may not be readily found in the market. Such a network may also uncover situations where the target is a good faith seller with unique motivations to consummate a transaction with a specific acquirer.

In directing dialogue with such a network, it is value-added for the acquirer to first have conducted some research to determine the specific criteria that the acquirer desires in a potential target. Successful planning at this early stage can significantly increase the likelihood of a successful acquisition. Examples of certain criteria to consider include geographical preferences, industry or market niches, size of revenue, profitability, the stage and growth of the potential target and the nature of the potential target’s operations and facilities.

Importantly, the acquirer should have a clear understanding of its business objective and corporate strategy in pursuing acquisitions. While the acquisition criteria may be revised a number of times, it is often best to put it in writing as a formal benchmark to judge opportunities against as they become available.

2. Initial Discussions

In the event that the seller has engaged a sell-side financial advisor to run a formal managed sale process, the acquirer may receive a phone or email solicitation to participate in a formal process to bid on a target. This is usually done through the financial advisor that is acting as an exclusive intermediary to sell the target’s business on a confidential basis.

The financial advisor will most likely be executing a competitive “auction process” on behalf of the target. However due to recent removal of sanctions and lack of potential strategic and financial buyers, not many will be actively involved in bidding to acquire the target. Therefore a one to one approach is a better solution.

In order to establish interest from the acquirer to bid on the target, the financial advisor will provide a brief written executive summary to the acquirer that describes the target on a no-names basis or name basis. The summary, commonly referred to as a “teaser”, is reviewed by the acquirer and discussions are had with the investment banker to size up the target opportunity. This summary is often very difficult to write for the following reasons and its is a special local know how:

1. Accounting principles
2. Language barrier
3. Opaque ownerships
4. No access to market research
5. Stock market non transparent

Once interest is established from the acquirer, the financial advisor will submit a CA for execution to ensure that confidential information on the target is not disclosed by the acquirer during the transaction process. Upon executing the CA, the target’s identity is revealed to the acquirer by the investment banker. Before executing a CA, it is important for the acquirer to have qualified legal counsel involved in reviewing and advising the acquirer on modifying the document. Executing CAs in relation to participating in a bid process is a standard process and often involves ambiguous legal language that is company specific and may be heavily slanted in favour of the target. Furthermore, the target will typically require that disputes arising from any potential breach of the CA be handled based on the current laws of the jurisdiction where the target resides.

Once the CA is executed, the investment banker will send the acquirer a Confidential Memorandum ("CM"), which describes the target and its industry and the investment merits and growth opportunities of the target in great detail. A summary of the target’s financial statements and forecasts will also be included in the CM. Again at this stage given the Iranian market nature, a dedicated commercial due diligence is needed to better understand the growth potential of each company. There is not much market research available by sector and each case requires specific market research.

PHASE II: PRELIMINARY DILIGENCE, VALUATION, AND INDICATION OF INTEREST

After the acquirer has engaged the target and the acquirer and target have executed a CA and receives the CM (if participating in a bid process), the second phase of the buy side process begins. This phase involves the acquirer conducting preliminary due diligence on the target and, if interest remains in acquiring the target’s business upon completion of the diligence, determining a value for the business and
submitting a non-binding Indication of Interest ("IOI") letter that outlines the acquirer’s intention to purchase the target. Each of these steps is described below.

1. Information Gathering and Preliminary Due Diligence

The goal of this step is to better understand the target and its investment merits, as well as to identify any deal-breaking issues prior to committing substantial time, resources and expenses in exploring an acquisition. If the acquirer is participating in a competitive bid process, the target will provide the acquirer with a specific bid date by which the acquirer must have completed its preliminary diligence and submitted its IOI. The bid date is typically set at three-to-five weeks from the day that the acquirer receives the CM.

Given this short timeline, only a limited amount of diligence can be reasonably conducted on the target. Furthermore at this phase, the acquirer is only provided with limited access to information on the target, most of which is contained in the CM.

As a result, diligence should be executed quickly yet thoroughly and will typically focus on an “executive level” assessment of the business with a focus on uncovering key issues, opportunities, potential synergies and determining a preliminary valuation and deal structure for the target.

Issues that can immediately cause the abandonment of a potential acquisition may be based on how well the company fits the desired acquisition criteria previously outlined. Major items to be considered include size of the company, location, products, capabilities and customers; most of which can be garnered from the CM.

Other items to consider that this early stage include any materially negative trends in the target’s earnings and growth, pending legal litigation or potential lawsuits, lack of a sustainable and defensive competitive position, management retention or personnel turnover, customer concentration or retention concerns and other factors. The acquirer should also gain a reasonable level of comfort that the potential acquisition target is a strong strategic and cultural fit and that the likelihood of successfully integrating the company is high.

It is also important to look closely at the target’s financial statements and forecasts, typically found in the back of the CM. Most companies will provide a summary of their historical financial statements in Iranian language but it is crucial to have them translated into a Generally Accepted Accounting Principles ("GAAP") basis an in English. The financial statement should be audited and include full income statements, balance sheets and statements of cash flows. However, smaller companies, or companies that are being sold as divested units of larger companies, may not have complete or fully audited financial statements. This can be a challenge for an acquirer and a lack of audited financial statements heightens the risk that there could be a problem with the target’s quality of earnings.

As example, it is not uncommon for targets to not properly record all of their accrued expenses on a timely, consistent basis (e.g., payroll and vacation accruals, etc.). Furthermore, the target may not be fully expensing certain items as it would under GAAP, or it may use unconventional revenue reporting or capitalization methods compared to similar companies in its industry. Furthermore, if the target is a divestiture of a larger entity, certain assumption may be required to be made by the acquirer to layer in additional costs surrounding corporate overhead.

Given these potential issues and the limited visibility that the acquirer has into the company at this stage, it is important for the acquirer to properly consider these factors when it is submitting its bid. It is also important to “normalize” the target’s historical earnings, to adjust for certain non-recurring or owner discretionary expense items that may be flowing through the income statement, but are not expected to continue or are expected to be eliminated in the hands of a new owner. It is also important for the acquirer to consider the degree of potential synergies that may exist in the target, including potential redundancies of operations that can be eliminated.

By proactively attempting to quantify such synergies and perform a thorough "scrubbing" of the financials, the acquirer will be putting itself in the best position possible to submit a compelling valuation bid while minimizing the risk of over- or under-paying for the business. During this preliminary due diligence stage, it is also recommended that the acquirer actively engage with the target’s financial advisor and ask key financial and strategic questions to uncover important information in preparing the bid. It is also highly recommended for the acquirer to have familiarity with GAAP or engage an advisor that does to make certain that the true economic impact of the financial statements is ascertained.
2. Establish Preliminary Valuation

Once the acquirer has completed is preliminary due diligence, it is necessary for the acquirer to conclude on an initial view of what the acquirer believes the potential target is worth. It is important to note again that at this point in the process the estimation of value is preliminary and based heavily on the limited financial information provided by the potential target. A potential target is often hesitant at this stage to provide in-depth information without first gaining comfort that the acquirer can successfully complete the transaction and that the acquirer has a certain level of intent to complete the acquisition.

In order to establish a preliminary estimation of value for the potential target, the four most commonly used methods that are traditionally applied to assess value are: (1) discounted cash flow (“DCF”) analysis, (2) leveraged buyout (“LBO”) analysis (3) comparable public companies analysis and (4) precedent M&A transactions analysis. Acquirers will also use a fifth method, (5) underlying assets analysis; however, usually to a lesser extent and most often to confirm or dispute the indications of valuation derived from the other methods.

The value arrived at using these methodologies will be the Enterprise Value (“EV”) for the business. In the context of a transaction, the Enterprise Value will be based on assuming that the company will be acquired on a cash free (i.e., the seller keeps all the cash) and debt free (i.e., seller is responsible for paying off any bank debt) basis. Additionally, it is typically assumed that all operating assets are included in the purchase price as well as all operating liabilities (i.e., accounts payable and accrued liabilities).

3. Submit Indication of Interest (IOI)

After the acquirer has satisfactorily conducted preliminary due diligence and determined a preliminary valuation for the target, a formal IOI letter must be submitted by the set bid date if the acquirer continues to seek to acquire the target.

Note that the IOI is non-binding and that a definitive proposal to acquire the target will be requested to be submitted later in the process when selected parties are engaged in full due diligence. The purpose of the IOI is to provide sufficient details for the target to assess the acquirer’s level of readiness, willingness and ability to consummate and finance a transaction. The IOI should also provide sufficient picture on valuation for the target to determine if the acquirer should be moved forward to the next phase of the process.

PHASE III: FURTHER DILIGENCE AND LETTER OF INTENT

Shortly after the acquirer submits its IOI, the acquirer will be notified as to whether or not it has been selected to move forward to the next phase of the transaction process. This next phase typically involves being one of a small handful of acquirers to (separately) meet with the target’s management team, gain access to and diligence a greater amount of information, and submit a Letter of Intent (“LOI”) to acquire the target if interest continues. Similar to phase to, the target will provide the acquirer for a set bid date that the LOI must be submitted by.

The target will request and require the acquirer to meet with management in person, usually at the target’s main place of business. There, key members of the management team will conduct a presentation on the company and provide the opportunity for the acquirer to meet for several hours and ask and received answers to key questions that the acquirer may have.

Shortly after the management presentation is concluded, the target will typically provide the acquirer with access to an online information “datasite” where select legal, financial, operational and other information on the business can be found so that the acquirer can determine an appropriate valuation to submit a LOI.

The LOI highlights the acquirer’s intention to acquire the target and sets forth the proposed purchase price along with all relevant key terms, in much greater detail than did the IOI.

The LOI will also have an exclusivity clause, typically covering 60 to 90 days, so that the acquirer and its diligence and legal team has sufficient time to complete its diligence and consummate a transaction.

PHASE IV: FINAL DILIGENCE, NEGOTIATIONS, AND COMPLETION OF THE TRANSACTION

Shortly after the LOI has been submitted, the acquirer will be notified as to whether or not it has been selected as the preferred buyer to move forward with a transaction. If the acquirer is selected, the target will further negotiate the LOI with the advice of legal counsel. If the LOI is successfully executed, the next
phase of the transaction process will begin – final diligence, negotiations and completion of the transaction. As mentioned, the LOI will typically provide for 60 to 90 days to complete the transaction. During this period, the acquirer has exclusive access to the transaction opportunity, as well as complete access to the online dataset. However, if the acquirer is unable to complete a transaction by the designated deadline, an extension must be granted by the target (at its sole discretion) or the transaction process must be terminated.

1. Conduct Full Due Diligence

With exclusive access to the target, the acquirer now undertakes the formal due diligence process, which generally serves to confirm the consistency and material accuracy of representations made by the target company. The signing of the LOI by both the acquirer and the target typically grants the acquirer access to financial statements, operating reports and other private and confidential company documents (both financial and non-financial in nature), allowing the acquirer to perform a detailed, in-depth investigation of the target company.

During this step of the process, the acquirer will typically deploy a full independent outside diligence team to lead in the diligence effort. The diligence team will usually consist of a public accounting firm; an M&A transaction law firm; and specialist diligence firms for certain financial, human resources and benefits, insurance, tax and other related diligence needs. Together, the financial diligence team members will rapidly work to complete its diligence so that there is sufficient time to deliver diligence findings, including the financial condition of the business and its quality of earnings.

Some key considerations that the due diligence process seeks to validate include:

i. Should the acquirer make the acquisition?
ii. How much should the acquirer pay for the target?
iii. How should the acquisition be structured?
iv. How should the Acquirer handle any post-acquisition operating, accounting and legal issues?

More importantly though, the due diligence of the business seeks to confirm that all of the information provided throughout the process is in fact true and correct. In order to effectively perform this detailed level of research the due diligence process is typically divided into functional areas and disciplines in order to answer certain questions, as follows:

Business/Operations: What are the products and services offered by the target company? What is the nature of the target company’s customers? Are the customers diversified or concentrated in certain ways? Does the acquirer’s post-acquisition strategy line up with the target company’s existing customer base?

Finance/Accounting: Are the target company’s financial statements accurate? What are the major internal or external factors impacting financial results?

Legal/Regulatory: Are any legal issues anticipated in the post-closing process? Does the target company possess any potential legal threats? Does the target company maintain contracts with employees that will be impacted by the acquisition? Do any governance, regulatory, or cross-border issues exist?

Organizational: Should certain management personnel remain in their positions? Will any issues arise in integrating the culture of the target company with that of the acquirer? Are there plans for retaining key employees? Is a plan in place for a successful integration after the closing of the acquisition?

The biggest challenge in this phase is for financial advisor to coordinate due diligence officers and identify the right partners who are familiar with Iran market. Many years of sanctions have pushed the relationships to zero and therefore it is very hard to find western accepted officers.

As is evident, the due diligence process is no light undertaking, and it plays a vital role in the buy side process. Outlining strategic goals for the due diligence process is key and will lead to a better outcome. Additionally, enlisting the services of experienced due diligence professionals and familiar with Iran market conditions and regulations can help substantially ensure that this step of the buy side process is thorough and moves smoothly. Often during due diligence, the acquirer will uncover information that will warrant the acquirer to revise
its valuation (usually downward). In the sensitive situation where there is a downward revised valuation of the target, it is critical for the acquirer to consider all pertinent facts as well as cultural differences in order to determine how to best deliver the message. If the message is not well-received, the target or its advisors may suggest pursuing an alternative acquirer once the exclusivity period ends, which may jeopardize the entire transaction.

3. Deliver the Definitive Agreement
Typically around the same time that financing is being arranged for the transaction, the acquirer, with the assistance of its legal counsel, will submit a Definitive Agreement to acquire the company. If the acquisition is being structured as a purchase of assets, the agreement is referred to as an Asset Purchase Agreement. If the acquisition is being structured as a purchase of equity, the agreement is referred to as a Stock Purchase Agreement.

The Definitive Agreement is comprehensive and a binding legal document, and includes all details regarding the acquisition, including purchase price, target working capital and all other relevant details surrounding the deal. In addition to having the acquirer’s general legal counsel intimately involved in preparing the Definitive Agreement, it is also important to have tax counsel review the transaction and Definitive Agreement to ensure that all potential domestic and global tax consequences are assessed and managed and that the structure of the transaction is optimal for the acquirer and considered in the transaction price.

4. Negotiate, and Execute the Definitive Agreement and Close the Transaction
In the final stage of the transaction process, the acquirer and target continue to negotiate the finer elements of the Definitive Purchase Agreement. If the aforementioned steps were taken thoroughly and properly, all that is left is to sign the appropriate documentation, wire the funds and close the transaction, completing the buy side process.

However even at this stage where simple wire transfer can be considered as last closing phase, Iran lack of banking link to the west and lack of SWIFT and direct banking correspondences makes it hard for the acquirer to simply pay the funds. Indeed financial advisor has to assist during the wire transfer to find mechanism of compensations and escrow agreement to close the transaction.

Conclusion
A well-executed and thorough transaction process of a target will typically take between six to eight months to complete. However, in certain situations, the transaction process may take longer due to potential required regulatory approvals and other hurdles that may be unique to the specific transaction at hand.

Given these factors, is it highly recommended that the acquirer engage qualified legal counsel and other advisors with expertise in the target’s industry and regulatory environment, and do so early on in the process in order to identify and work to mitigate potential transaction issues. By being proactive in uncovering and addressing issues and hurdles, when the time comes for regulatory approval, the company will be best positioned to successfully execute the transaction in an expeditious manner.

In conclusion, by planning ahead, organizing the right team of advisors and being fully aware of the intricacies of the aforementioned buy side process, it is possible for an acquirer to not only find quality target opportunities, but also successfully win them. Even if the acquirer is participating in a competitive bid situation, with the right knowledge and team, a buyer can have an excellent opportunity to acquire the target, and at a fair price.
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