

Due diligence driving the Success of Mergers and Acquisitions in Macedonia

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Abstract

The act of due diligence is of vital importance when considering the possibility to enter the Macedonian market through merger and/or acquisition transactions. In this paper, I discuss that due diligence helps reduce potential risks or even results with curtailing the transaction as most of the Letters of intent never come to life. Many Macedonian entities, both public and private, operate in an environment considerably different to the European Union economies, a fact that inspires many questions with potential investors, especially in those who come from the European Union. If proper preparation takes place, and the expectations and processes are duly taken into account, successful merger and/or acquisition can be conducted in the Republic of Macedonia in spite of facing numerous difficulties. Finally, I discuss that several suggestions/factors can maximize the chances of success, demonstrated with the example of due diligence process set-up prior to the one. Vip merger that marked the Macedonian communications industry in 2015.

Keywords: Due diligence, Merger and acquisition, Macedonian market

1. Introduction

When considering the possibility to enter the Macedonian market through merger and/or acquisition transactions, due diligence helps reduce potential risks. Many Macedonian entities, both public and private, operate in an environment considerably different to the European Union economies, a fact that inspires many questions with potential investors, especially in those who come from the European Union. If proper preparation takes place, and the expectations and processes are duly taken into account, successful merger and/or acquisition can be conducted in the Republic of Macedonia in spite of facing numerous difficulties.

2. Setting up the Due diligence process in the Republic of Macedonia

The most common problem rests with unresolved land tenure rights and land under State ownership. Accordingly, the due diligence process reveals unsettled transfers of land use rights which entails major financial implications because the State may ask for title settlement before or after the completion of the desired M&A transaction.

Another problem arises from unsettled tax liabilities. Many enterprise have separate accounting for the purpose of tax evasion, Value added tax in particular, given its intake in total taxes payable. Income tax may be of lesser value because of various tax reliefs, especially connected to entities operating in the so-called free economic zones.

If proper preparation takes place, and the expectations and processes are duly taken into account, successful merger and/or acquisition can be conducted in the Republic of Macedonia in spite of facing numerous difficulties, which is the focus of this paper. Several suggestions/factors can maximize the chances of success (Ulrich and Kummer, 2007).

- **Engaging advisors in a timely fashion**

Engaging advisors prior to submitting the Letter of intent enables higher transparency of the target entity which enables faster execution of the Letter of intent. It is of uttermost importance not to introduce the counselors as inspectors to avoid negative resonance among the Macedonians involved in the process because the term inspectors is usually associated with inspection and control-related activities with negative or even daunting undertone. The initial stage should be defined as a preliminary process for data collection purposes that will ease the completion of the potential transaction.

- **Understanding the due diligence process differences between the EU countries and the Republic of Macedonia**

Initiating the due diligence process with solid expectations is of essential meaning for potential EU investors. The financial statements, financial infrastructure and the business processes are on a lower ladder than their EU counterparts, which necessitates higher attention towards several potentially risky operation segments and prolongs the due diligence duration. Part of the due diligence differences in comparison to the EU practices are presented in the table below.

Table 1. Due diligence process – European Union vs. the Republic of Macedonia

Due diligence process – European Union vs. Republic of Macedonia		
	European Union	Republic of Macedonia
1. Financial data transparency	High	Low
2. Due diligence duration	1-2 months	1-3+ months
3. Duration of the preparation process in the target entity prior to starting due diligence	Brief	May be prolonged considerably
4. Basis for preparation of the financial statements	IFRS or US GAAP	IFRS or local accounting standards applicable for tax filing submission
5. Revised financial statements	IAS	IAS, disputable quality at times
6. Transaction with related parties	Of different value, compulsory disclosure	Of high value, often inadequate/insufficient disclosure
7. Contingent liabilities	Transparent disclosure	Are of high risk, infrequent disclosure
8. Computerized accounting systems	Yes	Automation in progress, manual processes still present
9. Proper products/services warranties	Mostly yes	Mostly no
10. Realization of claims (financial compensation)	Yes - adequate court support	Imperfect, sluggish court execution

Apart from the general accounting process deficiencies, the local accounting standards are different than the standard accounting practices adopted by IFRS. Such an example is the

allowance for doubtful accounts which does not represent accurate evaluation of the quality of accounts receivable. Namely, the allowance is acknowledged for tax purposes only if the bad debt reserve is supported by enforceable court judgment for bad debt, a process which is far from perfect due to the inefficient court system. Therefore, the accounting practices due diligence should focus on early identification and evaluation of the income and working capital adequacy.

- **Dealing with internal expectations**

In the Republic of Macedonia, enforcing the transaction often becomes goal by itself and can become misleading given the initial targets and expectations. The internal expectations should be properly handled, which is a great challenge by itself. Hence, initiating early preparation is of vital meaning where no investment should be executed without prior analysis of potential deficiencies which may be detected upon due diligence.

- **Patience**

The presence in any market necessitates certain degree of patience. This is also valid for the Republic of Macedonia where the investor's motives are often put to test and only a small number of Letters of intent are completed with implementation of the desired transaction. There are three key reasons for failing the transactions on the Macedonian market – evaluation of the revenue quality, lack of transparency in due diligence, and timeframe of the process from the expression of interest until signing of the transaction papers which may often last longer than one or two years.

3. Stages of the Due diligence process in the Republic of Macedonia

It is recommendable to conduct the due diligence in several stages. Proper tasks should be defined prior to signing the Letter of intent. These tasks are normally segmented in the following fashion.

Table 2. Collection of data prior to signing the Letter of intent

Collection of data prior to signing the Letter of intent	
Potential tasks	Goals
1. Scanning historical audit reports	Understand the core operation drivers, revenue quality, working capital quality, etc.
2. Evaluation of the main accounting policies	Identify the potentially risky/sensitive areas that should be thoroughly inspected, evaluated and structured upon due diligence.
3. Analyzing the complete picture	Evaluate the financial data integrity and quality.

4. Evaluation of the financial and accounting environment	Highlight the deficiencies of the accounting software used, prepare expectations regarding the vital financial data that will be used for further analyses.
5. Revision of the internal management reports	Prepare information that will be used as basis for due diligence.
6. Understanding the operations	Analysis of the valuation impact and identification of areas that will be subject to detailed review.
7. Preparing a detailed list for request of information before initiating the due diligence process	Securing sufficient information for the purpose of better analysis.

Upon signing the Letter of intent, it is highly recommendable to conduct the analysis in two stages. Certainly, virtual data rooms on both sides support the purchasing entity's due diligence checklist demands and data organization, easing a smoother transaction.

Table 3. Due diligence procedures upon signing the Letter of intent

Due diligence procedures upon signing the Letter of intent	
Potential tasks	Goals
First stage	
1. Revising auditor notes	Identification of risk areas that need to be attended
2. Getting familiar with the assets and liabilities of the entity	Validate the book value of the assets/liabilities and evaluate the forthcoming revenue impact.
3. Analyzing financials statements fluctuations	Understand seasonality, assess the revenue quality.
4. Addressing potential pro-forma changes	Assess the historical profitability of the target entity.
5. Assessing additional areas	Evaluate the hidden expenses of the target

	entity.
6. Identifying contingent liabilities	Assess the impact on value and identify areas for due diligence.

The Firsts stage findings often indicate the need to reinvestigate the decision to implement the merger/acquisition transaction – the value of the deal drops leading to different expectations from the transaction driven by the new risk evaluation. Nonetheless, should the assessment continue, it is recommendable to proceed with a more thorough assessment of the following areas (i.e. Stage two).

Table 4. Standard due diligence procedures after signing the Letter of intent

Standard due diligence procedures after signing the Letter of intent	
Potential tasks	Goals
Second stage	
1. Evaluating the profitability per product/segment/geographic location	Detailed operations assessment, evaluation of revenue quality.
2. Analyzing price and quantity correlation	Detailed operations assessment, evaluation of revenue quality.
3. Identifying core cost drivers and cost variations	Detailed operations assessment, evaluation of revenue quality.
4. Reassessing historical capital investments	Assessment of the valuation impact.
5. Analyzing the sensitivity of working capital and seasonality patterns	Assessment of the valuation; assessment of the financials needs of the target entity.
6. Analyzing budget deviations	Assessment of the forecasted budget and profitability of the target entity.
7. Evaluating the human resources	Assessment of the valuation impact.
8. Quantifying the EBITDA	Assessment of the valuation impact.
9. Finalizing the due diligence report	Summarizing the key findings and observations, potential problems, if any, for

	the purpose of facilitating the acquisition/merger decision.
10. Analyzing warranty liabilities/receivables according to the purchase agreements from financial point of view	Support the target entity for the purpose of minimizing the investment risk.

Foreign entities willing to invest in the Republic of Macedonia are faced with language barriers, cultural differences, and unfamiliarity with the local business practices. This is why it is of utmost importance for foreign investors to apply a system of well-defined steps upon investigating the investment opportunities, taking into account the internal opportunity expenses as well as the expenses for engaging external advisors. The Republic of Macedonia is undergoing an active economic transition towards establishing a free market economy which is why the business environment is exposed to continuous changes. In this respect, the accounting milieu is undergoing fast development, and not all accountants are adequately trained. Understanding the core cultural differences, the potential difficulties, and the success factors is basis for conducting the due diligence process and for determining which areas need to be thoroughly examined while benefiting from the involvement of professional external advisors.

5. Case study: Due diligence of the Macedonian communications provider ONE prior to one. Vip merger

This paper will illustrate the importance of the acumen reached upon conducting due diligence in ONE prior to the merger with Vip operator dooel Skopje into one.Vip doo that took place in Q4 2015 (Telekom Austria Group Newsroom, 2015). The merger's core intention was to generate a new company with larger investment capacity and greater competitiveness. One.Vip was expected to be beneficial for residential and business customers, while also fostering competition in all affected sectors on products, quality, and prices.

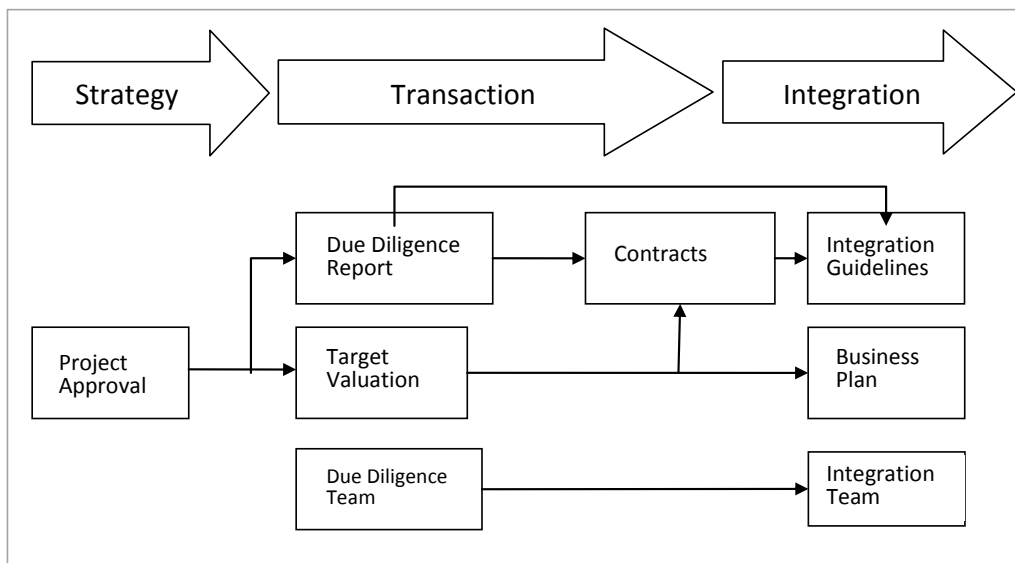
The Macedonian Commission for Protection of Competition approved the merger of Telekom Austria Group's Macedonian subsidiary Vip Operator (established in 2007) with Telekom Slovenije's subsidiary ONE (established in 2007), with 55% vested in Telekom Austria Group with sole control over the new company. The contract foresees call and put options for the exit of Telekom Slovenije Group within three years following the merger. MVNO access to interested operators was a basic condition to the merger approval in order to ensure competitiveness of products and prices should new market players embark on virtual operations.

Prior to merging, ONE occupied the third position in the mobile communications market of the Republic of Macedonia, with SIM market share of more than 26% at the end of Q3 2015 and customer base of circa 600k subscribers. In 2014, ONE achieved total revenues and EBITDA of approximately 75.7 mn EUR and 10.6 mn EUR respectively.

In the common practice of Telekom Austria Group, legal and financial due diligence are

outsourced to external experts where a reputed local law firm was engaged in the assessment of legal documents, while an internationally acknowledged audit firm performed the financial assessment. Given the sensitivity upon conducting business appraisals, operational Due Diligence Teams (especially technical and marketing teams) are staffed internally in order to benefit from the expertise of local experts from various departments (marketing, sales, controlling, customer service, technical, regulatory, HR and legal). Team members report to the respective Stream Leader, they report to the Project Manager. The Project Manager has to make sure that individual Streams are aligned.

Graph 1. Document Flow in one. Vip Merger Project (Telekom Austria Group, 2016)



Timing-wise, the due diligence project of ONE was stretched from the initially planned 4-6 weeks in the Data Room to more than 2 months due to processing of large quantity of questions and lack of resources needed to process data in ONE's Data Room. Once the Data Room step was completed, it took another week to run the due diligence report and complete the valuation phase.

The due diligence of ONE provided insight into financial and operational performance of the target entity. This paper will focus on the process organization and data collection phase necessary to avoid post-merger integration concerns. Prior to one.Vip merger transaction, several areas were prudently examined (Telekom Austria Group, 2014):

5.1 Accounting due diligence

The financial examination of ONE gathered details on operations and accounting approach behind financials. Core aspects subject to scrutiny were:

- Accounting policies and deferral practices,
- Capital and debt structure,
- Contingent assets and liabilities, especially if not properly disclosed,

- Employee and tax liabilities,
- Outstanding debt and reason for delayed or non-payment,
- Revision of all active Contracts especially the contractual conditions, prices and timelines – possibility to renegotiate the terms to generate savings (horizontal merger synergies due to overlapping of operational areas)
- Warranty liabilities and outstanding Bank guarantees,
- Existing internal control mechanisms,
- Historical internal auditor reports and notes,
- Annual stock taking reports and findings,

The accounting assessment had to anticipate and neutralize the financial risks from operations, thus enabling smoother post-merger integration. KPMG, the Vip operator auditor of that time, were engaged to perform the financial review. The auditor combined their knowledge of Telekom Austria Group and their wide international know-how, to complete the engagement.

5.2 Legal due diligence

The M&A team of Telekom Austria Group also focused on legal due diligence of ONE in order to ensure that no legal violations exist or that the violation amounts have been duly disclosed. The review encompassed access to:

- The Articles of association of ONE,
- License agreement with the Macedonian Agency for electronic communications,
- Register of ONE's statutory liabilities (status of dues like license and spectrum fees, profit and value added taxes, interconnection amount due),
- Intellectual property rights and infringements,
- Contracts behind capital investments,
- Assessment of key contracts (with network service providers, TV content services, collection companies, lessors for base station sites, sales channel partners and master dealers, roaming agreements, VAS service vendors, etc.),
- Status review of all legal cases filed by and against ONE,
- Minutes of Management and Supervisory Board meetings of the last five years.

Given the quantity of legal documents and contracts that had to be reviewed and properly evaluated, a renowned Macedonian legal firm (given the local law specifics) was engaged in the process. The legal revision helped value ONE's legal build and reveal problems before committing to merger.

5.3 Operations due diligence

The operations assessment had to ensure maximized financial worth of the new entity. This stage encompassed the business, technical, and HR appraisals.

5.3.1 Business and Marketing appraisal

As the targeted merger was of horizontal character, the examination focused on several operational performance indicators:

- ARPU/L per subscription and customer segment,
- Revenues per unit charged i.e. airtime revenue,
- Retail and wholesale revenue structure,
- Current market share vs projected market share(s) in both mobile and fixed operation segments,
- Customer base quality,
- Appraisal of brand perception and marketing strategy,
- Customer care approach,
- Sales channel ability to promote the products of the new entity to the detriment of competitors,
- Hard and soft synergies expected in the transaction aftermath,
- Potential emergence of new competitors in the Macedonian communications market,
- Strategic positioning to establish and preserve market leadership.

This aim is reinforced with the on-going hard and soft synergies tracking in the first two years following the merger event – cost reduction across operational segments being the hard synergies, followed by soft synergies through ARPU elevation, customer base upgrade via cross-selling, and higher RGU to subscriber ratio.

5.3.2 Technology appraisal

The technical review provided information on the quality of systems across all operational domains and the possibility for system integration between Vip operator and ONE:

- Network coverage and network assets quality,
- Maintenance and/or renovation stage of network assets,
- Potential incompatibility of Vip operator and ONE network assets with the target architecture and quantification of expected write offs,
- Billing system interface to the target financial system of one.Vip,
- Purchasing procedures and purchase order approval process,

- Database behind the customer care system, customer ticket/complaint resolution time and ability to support customers throughout their lifespan.

The technological assessment took the appraisal one step closer to system integration in the new entity.

5.3.3 Human Resource appraisal

With human resources being vital for the future performance of one.Vip, the review looked into:

- Number of employees in total and per department,
- Number of outsourced employees,
- Employee ranking and salary range in comparison to industry,
- Content of Golden Parachute contracts with ONE management to be transferred to one.Vip's books.

This information helped determine if ONE's staff size exceeded requirements. The due diligence data helped in valuing the target entity and revealing problem areas before signing the transaction, such as stating in public that workforce reduction is to be expected in the middle term.

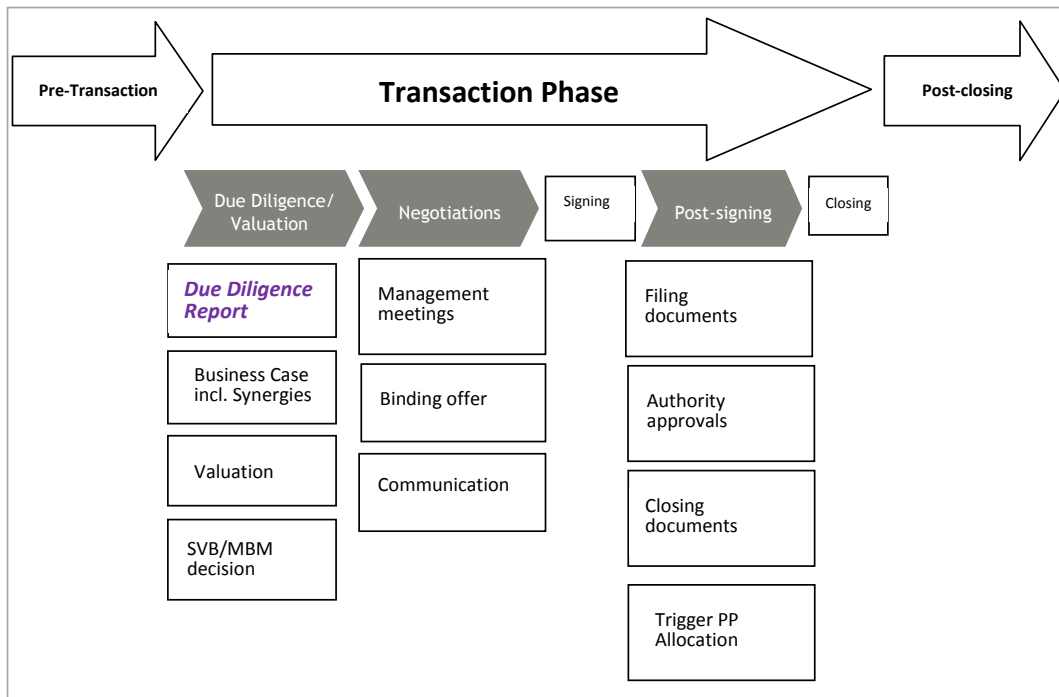
5.4 Due diligence Output: Completion of Transaction Phase

The main due diligence output of is the Due Diligence Report where all the findings, potentials and integration topics are presented. As demonstrated with the one.Vip merger transaction, this Report serves as a basis for:

- The decision to buy or not to buy (Board Presentation)
- The valuation of the asset (Valuation Model including Synergies)
- The ongoing negotiations with the target (Contracts)
- The integration planning (Integration Handbook)

The graph below presents the position of the Due diligence Report step in the merger and acquisition process.

Graph 2. One.Vip Merger Project Management, with emphasis on Due Diligence Process, Transaction Phase (Telekom Austria Group, M&A Process DD Team Briefing, 2016)



As demonstrated with the ONE due diligence, the Due Diligence Report takes into account that some topics are transferred to the seller, some are absorbed by the buyer, and some become part of the Valuation. Namely, topics presented as contingent liabilities normally remain risk for the seller within the negotiated M&A Contract timeframe, such as use of end-user software licenses by more than the nominated employees. Secondly, the risks that come in the form of synergies are absorbed by the buyer: Telekom Austria Group absorbed in the Business Plan the expected EBITDA post-merger benefits in the form of potential cost cutting, marketing and sales savings, lower subsidy expenses, and renegotiated supplier contracts. Finally, the third type of risks is absorbed in the Valuation model and is used to put the purchase price down, such as asset-related risks prior to one.Vip merger with end of life equipment that needs to be refurbished or replaced in the near future in order to maintain operations on the Macedonian market.

The Due diligence Report, accompanied by Business Case calculation including synergies (preliminary Business plan of the future entity) and Valuation of ONE operations, was followed by a joint Supervisory and Management board meeting where decision to invest was made. Should the outcome be acceptable for all parties involved like in the one.Vip case, Negotiations Stage and Contract signing wrap up the agenda of the Transaction Phase.

6. Conclusion.

On the 10-year road to EU accession, the Republic of Macedonia embraced EU's telecommunication regulations, leaning towards the establishment of a liberalized market supervised by an independent body, the Macedonian Agency for electronic communications.

The new framework spurred influx of capital investments in both, fixed and mobile communications networks, followed by multiple transactions of mergers and acquisitions. The M&A wave in the industry reduced the number of mobile carriers from four in 2014 to two by the end of 2015. In parallel, intense consolidation is reducing the number of fixed operators, enabling future capital focus on innovation and technological benefits for customers. Following the 2015 merger transaction, one.Vip certainly demonstrates this focus on innovation with the intense post-merger 4G and cable network rollout along with development of rich convergent portfolio for the Macedonian subscribers.

Certainly, further ownership structure rearrangements in the existing market communication licenses along with entry of new players will continue. Hence, communications industry continuous restructuring will help keep up the pace with novelties in the sector where revenue and cost efficiencies cannot be achieved without solid set-up of due diligence prior to any M&A transaction event. The due diligence of ONE provided insight into financial and operational performance of the target entity where process organization and data collection phase proved to be necessary to avoid post-merger integration concerns. But, this due diligence depicted some of the local market specifics that should be improved to approach the European Union practices, given the prolonged due diligence duration, with more than 2 months spent only in the ONE data room, incomplete disclosure of contingent liabilities, and Macedonian judicial system deficiencies resulting with slow realization of claims in ONE's case as across all local industries.

Acknowledgement

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