

# 4 The merger situation and the companies involved

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## Introduction

4.1. This chapter deals with the events leading up to the referral of the proposed merger of H+H Celcon and MBM. It also describes the parties involved, their financial performance, the rationale for the proposed merger, the justification for the price to be paid, the synergies arising from the proposed merger, and how the proposed merger would be funded.

## Events leading up to the referral of the proposed merger

4.2. H+H Celcon is the UK subsidiary of H+H International, which has conditionally agreed to acquire MBM from Etex. The companies are described more fully later in this chapter. However, in effect, the proposed merger forms part of a series of transactions by both parent companies, which were aimed at refocusing their respective businesses on particular activities.

4.3. Etex is a privately-owned, diversified, international building products company based in Belgium. In 1999 it acquired MBM along with the rest of Marley, and early in 2001 it acquired the pipe systems business of Glynwed International plc. These two major acquisitions meant that Etex decided to embark upon a series of disposals in order to reduce the level of group debt. MBM was both profitable and, unlike most Etex companies, was not active on a pan-European scale. Hence, MBM was an obvious candidate for disposal. Accordingly, in July 2001, MBM was put up for sale.

4.4. H+H International is a Danish company, which in 1998 took the decision to specialize primarily in the manufacture of aircrete products and instigated a planned disposal of its other interests. When it was offered the chance to buy MBM it was attracted to the opportunity to expand significantly its UK aircrete operations already being carried on by H+H Celcon, thereby reinvesting the proceeds of its earlier disposals and rebuilding its turnover and asset base towards their 1998 levels.

4.5. Etex engaged Dresdner Kleinwort Wasserstein Limited (DrKW) to prepare an information memorandum describing the business of MBM to prospective purchasers. DrKW drew up a list of 29 potential purchasers (trade and financial), whom it approached in order to find out if they would be interested in purchasing MBM. However, MBM told us that since Etex wished to retain the senior management of MBM, the business being sold was perhaps unlikely to be of interest to financial buyers.

4.6. In the second half of July 2001 the information memorandum was sent to [§] of the parties contacted. These included [§] trade buyers ([§] based overseas) and [§] financial buyers. One of the trade buyers was H+H International, which already owned H+H Celcon; another was Tarmac, which also manufactured aircrete products.

4.7. In the first week of August 2001 DrKW received [§] indicative offers for MBM, [§]. The offers ranged from a bid of £[§] million to a bid of £[§] to £[§] million. H+H International bid £80 million. [§] potential buyers went through to the next round of the bidding process, which included the provision of further information and presentations by the management of MBM. Following this, a second round of bids was submitted in October 2001. This time H+H International submitted the highest bid of £82 million, the second-highest bid was for £[§] million and the third-highest bid was for £[§] million.

4.8. It was apparent to Etex that H+H International was more committed to buying MBM than [ *Details omitted. See note on page iv.* ]. As a result of this Etex agreed to enter into exclusive negotiations with H+H International, following which, on 21 December 2001, H+H International announced that it had entered into an agreement whereby H+H Celcon, its UK subsidiary, would acquire MBM for a consideration of £81 million.

4.9. Some time before this Tarmac had entered into an agreement to acquire Durox, thereby potentially reducing the number of principal suppliers of aircrete products in Great Britain from four to three. Durox had been put up for sale by its owner, RMC, as part of an asset disposal programme designed to reduce group borrowings. That transaction was subsequently completed following clearance by the OFT.

4.10. Along with other conditions, the agreement between H+H Celcon and Etex is conditional upon satisfactory clearance of the proposed merger by the UK competition authorities. Following consider-

ation by the OFT and on the advice of the DGFT the merger was referred to the CC by the Secretary of State on 13 February 2002.

## The companies

4.11. The companies involved in the merger and their financial performance are considered in the following paragraphs.

### H+H International

4.12. As stated in paragraph 4.4, H+H International is a Danish company specializing primarily in the manufacture and supply of aircrete products in northern Europe. It has a partial listing on the Copenhagen stock exchange (see paragraph 4.14). H+H Celcon is its only UK operating subsidiary and is engaged solely in the manufacture and supply of aircrete products in Great Britain.

4.13. H+H International has aircrete operations in Denmark, Norway, Sweden and Finland, as well as the UK. It also has a 50 per cent share in a joint venture with a German cement company which produces lightweight concrete precast wall elements that are sold in Germany and Denmark. This business may be bought out in 2004 by H+H International's partner under the terms of the joint venture agreement. The group has around 1,050 employees. Its headquarters are in Ølsted in Denmark. In the year ended 31 December 2001, roughly 50 per cent of group turnover of DKR1.2 billion (£102 million) was accounted for by H+H Celcon, its UK subsidiary.

4.14. H+H International has two classes of share capital. The A shares, which account for a majority of the voting rights, but a minority of the share capital, are held by descendants of the original founders of the company. The B shares, which account for a minority of the voting rights, but a majority of the share capital are publicly held and are listed on the Copenhagen stock exchange. The market capitalization of the B shares on 30 April 2002 was around DKR584 million (£49 million).<sup>1</sup>

### Financial performance of H+H International

4.15. Profit and loss accounts, and balance sheets for H+H International for the five years ended 31 December 2001 are set out in Appendices 4.1 and 4.2 respectively. Some of the more significant figures derived from the accounts, together with various measures of performance, are analysed in Table 4.1 and considered in the following paragraphs.

TABLE 4.1 H+H International: profitability, 1997 to 2001

	Years ended 31 December					£ million*
	DKR million					
	1997	1998	1999	2000	2001	2001
Net turnover	1,918	1,851	2,072	1,672	1,223	101.9
Gross profit	656	678	866	744	558	46.5
Operating profit	108	128	165	183	130	10.8
Profit attributable to shareholders	44	69	81	188	252	21.0
Average capital employed	887	843	830	771	580	48.3
						<i>per cent</i>
Return on sales†‡	5.6	6.9	8.0	10.9	10.6	10.6
Return on average capital employed†	12.2	15.2	19.9	23.7	22.4	22.4

Source: H+H International published accounts.

\*Using an exchange rate of £1 = DKR12.

†Based on operating profit.

‡Based on net turnover.

<sup>1</sup>Using an exchange rate of £1 = DKR12.

4.16. Between 1997 and 1999 net turnover fluctuated between DKR1.9 billion and DKR2.1 billion. Thereafter, it fell to DKR1.2 billion (£102 million) by 2001, following a number of disposals as H+H International concentrated on its core business.

4.17. Operating profit increased from DKR108 million in 1997 to DKR183 million in 2000 and then fell to DKR130 million (£10.8 million) in 2001.

4.18. Average capital employed has fallen each year from DKR887 million in 1997 to DKR580 million (£48.3 million) in 2001, reflecting the disposal of non-core businesses.

4.19. Return on sales increased from 5.6 per cent in 1997 to 10.9 per cent in 2000, before falling slightly to 10.6 per cent in 2001. Return on average capital employed (on a historic cost basis) also rose from 12.2 per cent in 1997 to 23.7 per cent in 2000, before falling slightly to 22.4 per cent in 2001.

## ***H+H Celcon***

4.20. Celcon was established in 1949 by a Danish company called Christiani & Nielsen and originally produced lightweight concrete products. H+H International acquired a shareholding in Celcon in 1958 and helped it to start aircrete production. Further funding was provided in 1961 by venture capitalists 3i, which first took an equity stake and then bought out Christiani & Nielsen in 1963. H+H International acquired sole control of the company by buying out 3i in 1998, at which time the corporate style was altered from Celcon, to include H+H in the company name and branding.

4.21. H+H Celcon currently operates three factories in the UK producing aircrete blocks. The factory at Westbury in Wiltshire was opened in 1974, followed by further factories at Pollington, near Goole, East Yorkshire, in 1978 and at Borough Green, near Sevenoaks, Kent, in 1993. The company is in the final stages of commissioning a second factory at Pollington capable of manufacturing reinforced autoclaved aerated concrete, for use in its Jämerä construction concept (see paragraph 3.75). The company's head office is at Borough Green, Kent, and it employs around 385 people, of whom around 290 are involved in production.

## ***Financial performance of H+H Celcon***

4.22. Profit and loss accounts and balance sheets for H+H Celcon for the five years ended 31 December 2001 are set out in Appendices 4.3 and 4.4 respectively. Some of the more significant figures derived from the accounts, together with various measures of performance and operating statistics, are analysed in Table 4.2 and considered in the following paragraphs.

TABLE 4.2 **H+H Celcon: profitability, 1997 to 2001**

	<i>£ million</i>				
	<i>Years ended 31 December</i>				
	1997	1998	1999	2000	2001
Turnover	46.7	51.3	58.5	56.7	55.7
Gross profit	24.1	27.3	32.6	31.0	29.6
Trading profit	4.9	9.3	12.1	11.5	9.7
Average capital employed	17.4	19.7	20.7	21.4	20.4
					<i>per cent</i>
Return on sales*	10.5	18.1	20.7	20.3	17.4
Return on average capital employed*	28.2	47.2	58.5	53.7	47.5
<i>Operating statistics</i>					
Capacity volume ('000m <sup>3</sup> )	[ <i>Figures omitted. See note on page iv.</i> ]				
Sales volume ('000m <sup>3</sup> )	923	925	1,033	974	968
Revenue per m <sup>3</sup> (£)	50.60	55.46	56.63	58.21	57.54
Profit per m <sup>3</sup> * (£)	5.31	10.05	11.71	11.81	10.02

Source: H+H Celcon statutory and management information.

\*Based on trading profit.

4.23. Turnover rose by 25.3 per cent from £46.7 million in 1997 to £58.5 million in 1999, before falling by 4.8 per cent to £55.7 million in 2001. Management attributed the drop in sales volume in 2000 to earlier changes in taxation and interest rates affecting the housing market in the second half of the year, compounded by the impact of bad weather. Foot and mouth disease and bad weather in the first part of 2001 disrupted the movement of materials and the opening of sites. In the latter part of 2001 an initial loss of confidence following the terrorist attacks on 11 September in the USA was offset by reduced interest rates so that some of the sales volume deficit compared to the previous year was redressed.

4.24. Trading profit has followed the same overall trend as turnover, but increasing by 146.9 per cent from £4.9 million in 1997 to £12.1 million in 1999, before falling by 19.8 per cent to £9.7 million in 2001. The high level of fixed costs in the business means that changes in sales volume will generally have a disproportionate impact on profits.

4.25. Average capital employed increased by 23.0 per cent from £17.4 million in 1997 to £21.4 million in 2000, before falling slightly to £20.4 million in 2001. These figures do not take into account the new factory under construction at Pollington, which had not entered production and has therefore been excluded from the capital employed calculation.

4.26. Return on sales increased from 10.5 per cent in 1997 to 20.7 per cent in 1999, before falling to 17.4 per cent in 2001. Return on average capital employed (on a historic cost basis) also rose from 28.2 per cent in 1997 to 58.5 per cent in 1999, before falling to 47.5 per cent in 2001. We consider H+H Celcon's returns on its depreciated replacement cost of capital in paragraphs 4.39 to 4.47.

4.27. Revenue per m<sup>3</sup> rose from £50.60 in 1997 to £58.21 in 2000 then fell slightly to £57.54 in 2001. Profit per m<sup>3</sup> more than doubled from £5.31 in 1997 to £11.81 in 2000 and fell to £10.02 in 2001. The changes in H+H Celcon's profitability around this time are considered further in paragraphs 4.45 and 4.46.

## **Etex**

4.28. As stated in paragraph 4.3, Etex is a diversified international building products company, registered in Belgium with its headquarters in Brussels. It is a private company, which is itself controlled by another private Belgian company called Fineter. MBM is one of Etex's UK subsidiaries and is engaged in the manufacture and supply of aircrete products in Great Britain.

## **MBM**

4.29. MBM now produces only aircrete products, which are sold under the Thermalite trading name. In the following paragraph describing the history of the business we have used the name Thermalite to identify the aircrete business subject to the proposed merger, since it has passed through a number of corporate manifestations prior to its present one.

4.30. Thermalite was founded in 1951 by Laing, a building products and construction company, to produce aircrete blocks using technology imported from Sweden. In 1983, Thermalite was subject to a management buy-in, which lasted for three years. Then in 1986 the business was bought by Marley, which supplied a number of products to the construction industry. In 1992, several Marley businesses, including Thermalite, were brought together in one company to form MBM. MBM supplied concrete and clay roofing tiles, bricks and paving, as well as aircrete products. However, Marley was itself acquired by Etex in February 1999. Since its acquisition by Etex all of MBM's other businesses, with the exception of Thermalite, have been divested or transferred elsewhere within the Etex group, so that MBM's only activity now is the manufacture and supply of aircrete. MBM was put up for sale by Etex in July 2001 (see paragraphs 4.2 to 4.8).

4.31. MBM operates from three factories in the UK at Newbury, Berkshire, which was built in 1987; at West Thurrock, Purfleet, Essex, which was built in 1976; and at Hams Hall, Sutton Coldfield, West Midlands, which was built in 1955. All of the plants have been extended and modernized since their original construction. MBM's head office, which is not included in the proposed merger, is located at Coleshill, Birmingham. MBM has approximately 366 employees, of whom 236 are involved in production and maintenance.

## Financial performance of MBM

4.32. Profit and loss accounts for the Thermalite business of MBM for the three years ended 31 December 2001 are set out in Appendix 4.5. Profit and loss figures prior to 1999 are not comparable with subsequent years due to the introduction of recharges for group services in that year and changes in accounting policies and classifications. No balance sheets relating solely to the Thermalite business of MBM were prepared prior to 31 December 2001, since before that date the company carried on other activities as well as aircrete production, and the assets and liabilities of all its businesses were amalgamated. Furthermore, the land and buildings used in the Thermalite business have always been held by different group companies. Accordingly, for the purposes of the proposed merger the management of MBM carried out a special exercise to extract a statement of the net assets of MBM relating to Thermalite as at 31 December 2000 and 31 June 2001. The net assets at 31 December 2000 and 2001 are set out in Appendix 4.6.

4.33. Some of the more significant figures derived from the accounts and the extraction from the accounting records, together with various measures of performance and operating statistics, are analysed in Table 4.3 and considered in the following paragraphs.

TABLE 4.3 MBM: profitability, 1998 to 2001

	Years ended 31 December		
	1999*	2000	2001
	£ million		
Turnover	( <i>Figures omitted.</i> <i>See note on page iv.</i> )		
Gross profit			
Operating profit			
Capital employed†			
	per cent		
Return on sales‡	( ✂ )		
Return on capital employed‡			
<i>Operating statistics</i>			
Capacity volume ('000m <sup>3</sup> )	( ✂ )		
Sales volume ('000m <sup>3</sup> )	969	1,029	1,062
Revenue per m <sup>3</sup> (£)	51.8	51.8	52.1
Profit per m <sup>3</sup> (£)	10.0	11.4	9.2

Source: MBM management accounts and extraction by management from accounting records.

\*Figures prior to 1999 are not comparable with subsequent years due to the introduction of recharges for group services in that year and changes in accounting policies and classifications.

†Capital employed is only available as at 31 December 2000 and 2001.

‡Based on operating profit.

4.34. Turnover rose from £[ ] million in 1999 to £[ ] million in 2001. These movements mirrored changes in sales volume over the same period.

4.35. Operating profit rose from £[ ] million in 1999 to £[ ] million in 2000, before falling to £[ ] million in 2001. The figures for 1999 and 2000 have been distorted by the absence of a normal charge for pension contributions in the accounts in those years. The 'pension holiday' came to an end in 2001, when a charge of £[ ] million was incurred. In the absence of that charge the operating profit in 2001 would have been £[ ] million.

4.36. Return on sales rose from [ ] per cent in 1999 to [ ] per cent in 2000, before falling to [ ] per cent in 2001, reflecting in large part the recommencement of pension contributions.

4.37. Capital employed figures are only available for 31 December 2000 and 2001, since prior to 31 December 2001 the underlying balance sheet figures were not available from the accounting records of MBM and had to be manually extracted from various different sources, which was done at 31 December 2000 for the purposes of the merger. In Table 4.3 we have shown the actual capital

employed figures for 31 December 2000 and 2001 and the resultant returns on capital employed (on a historic cost basis) of [ 38 ] per cent and [ 38 ] per cent respectively. If capital employed at 31 December 1999 had been the same as at 31 December 2000 then the return on capital employed in 1999 would have been [ 38 ] per cent.

## **Returns based on the depreciated replacement cost of capital**

4.38. In view of the high levels of return on capital employed exhibited in recent years on a historic cost basis (see Tables 4.2 and 4.3), we asked H+H Celcon and MBM separately if they could provide us with data supporting a revised calculation of return on capital employed covering a longer time period and based on capital employed substituting the depreciated historic cost of fixed assets with the depreciated replacement cost of fixed assets. The purpose of this was first to examine to what extent, if at all, returns were greater than normal (ie significantly above the weighted average cost of capital) when considered over a longer period; and second to eliminate the distortion caused by comparing profits at current prices with assets at historic prices.

### ***H+H Celcon***

4.39. H+H Celcon carried out its analysis in three stages. First, it made a number of accounting adjustments to normalize some of the figures in its accounts over an 11-year period from 1991 to 2001. These adjustments related to exceptional profits and losses, to assets used in the business and held by other group companies, and to services provided by other group companies and not recharged to H+H Celcon.

4.40. Second, H+H Celcon calculated the depreciated replacement cost of fixed assets in each of the years 1996 to 2001 by indexing individual assets from the date of their acquisition using the RPI. It then derived the consequential annual depreciation charge using the rates of depreciation in force. Where assets were already fully depreciated but still in use, their lives were extended by a further three years, thus creating a depreciation charge.

4.41. H+H Celcon's fixed asset records did not give sufficient information to carry out this procedure prior to 1996. Accordingly, the figures for the years 1991 to 1995 were estimated based on the later years and on known movements in fixed assets in the period. H+H Celcon also revalued freehold land, which is not depreciated, to open market value in each year. By these means H+H Celcon was able to derive values for the return on adjusted indexed capital employed in each of the years in question.

4.42. Third (as a means of cross-checking the results of the above calculation), H+H Celcon assessed the current replacement cost of the fixed assets used in their business (plant, land and buildings). It made the assumption that, given a rolling capital replacement programme, at any point in time in a steady state those assets (with the exception of land) would on average be 50 per cent depreciated. The resultant depreciated value of fixed assets was then indexed back over the 11-year period in order to provide an estimate of indexed capital employed in each year. In order to distinguish this calculation from the previous one, we refer to the resultant values as pro-forma indexed capital employed.

4.43. H+H Celcon's analysis, together with details of sales volumes, capacity, capacity utilization and average realized prices (average revenue per m<sup>3</sup>) covering the same 11-year period, is set out in Appendix 4.7. Certain elements of the data are summarized in Table 4.4.

4.44. Over the 11-year period the average return on average indexed capital employed was 14.3 per cent, and the average return on average pro-forma indexed capital employed was 12.1 per cent. H+H Celcon argued that these average returns were reasonable in comparison with its stated (post-tax) weighted average cost of capital of 12.6 per cent (see paragraphs 4.53 to 4.55) and that the 11-year analysis demonstrated the cyclical nature of the business. Within that time period, whichever measure of capital employed is used, it can be seen that in the first three years returns were either negative or zero, in the next four years returns were modest, and in the last four years returns were high, ranging from 22.9 to 36.5 per cent.

TABLE 4.4 H+H Celcon: returns on indexed capital employed, 1991 to 2001

per cent

	Years ended 31 December										
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Return on average indexed capital employed	-2.5	-5.3	0.0	6.9	7.0	8.2	16.0	29.5	36.5	33.2	27.7
Return on average pro-forma indexed capital employed	-1.4	-3.4	0.0	5.0	5.6	6.9	12.7	24.9	31.4	28.7	22.9
Operating statistics											
Capacity utilization (	<i>Figures omitted. See note on page iv.</i>										
Revenue per m <sup>3</sup> (£)	47.34	46.92	44.06	47.21	51.44	52.69	50.60	55.46	56.63	58.21	57.54

Source: H+H Celcon analysis.

4.45. We asked H+H Celcon to explain the very steep rise in profits that had occurred around 1997/1998, although part of the explanation would appear to be that levels of capacity utilization were much greater from 1996 onwards than previously and also that there was a significant increase in average realized prices of 9.6 per cent in 1998.

4.46. H+H Celcon told us that there had been a number of significant efficiency gains achieved over the period, which had seen the closure of two older plants at Rugeley, Staffordshire and Grays, Essex, and the commissioning of a new plant at Borough Green. In particular, increases in haulage costs had been contained below inflation by renegotiating contracts with hauliers from a per tonne basis to a per lorry basis, by the use of larger vehicles and by increasing the load factor on deliveries. Materials costs had been reduced by investing in plant at Westbury to eliminate production bottlenecks and generally by increasing autoclave capacity. Both of these measures had allowed for a reduction in the amount of cement and lime needed in the mix for any particular strength, by optimizing the process and timing by which the blocks hardened. In addition, expenditure to relieve bottlenecks in packaging lines and to reduce energy wastage had brought further savings. Finally, greater automation of production and rationalization of overhead functions had enabled H+H Celcon to cut its staff numbers over the period from 565 to 385, leading to greater productivity and significant cost savings. These cost savings had had the effect of significantly increasing H+H Celcon's profits.

4.47. We also questioned H+H Celcon about the extent to which they had revalued freehold land in performing their analysis. Of the total revaluation in 2001 of £[ ] million, £[ ] million related to H+H Celcon's site at Borough Green in Kent. H+H Celcon argued that this was a fair value based on an open market value of the site, which had been derived from a valuation of an adjacent piece of land that it owned and had recently had valued. It also said that, given the scope of their operations, it would always wish to have a factory in the South-East of England, near to its major market, and that inevitably land prices were much higher in that part of the country.

## **MBM**

4.48. In response to the same request, for data supporting a revised calculation of return on capital employed covering a longer time period and based on capital employed substituting the depreciated historic cost of fixed assets with the depreciated replacement cost of fixed assets, MBM was unable to provide us with any data prior to 1999, because of the significant changes in accounting policies and treatments that had occurred following the takeover by Etex (see paragraph 4.32). However, MBM did provide us with estimates of the current replacement cost of fixed assets, which enabled us to derive figures for the return on pro-forma indexed capital employed in a similar manner to that adopted by H+H Celcon in its second methodology (see paragraph 4.42).

4.49. The results of the MBM analysis are set out in Appendix 4.8. Clearly, in view of the short time period analysed, there are no discernible trends that may or may not relate to the wider business cycle in the economy. The average return on pro-forma indexed capital employed over the three-year period (1999 to 2001) was 19.1 per cent. Although this is lower than the comparable returns for H+H Celcon for

the same period (average of 27.7 per cent) this difference is largely attributable to the high value attributed to freehold land by MBM (£[ ] million per factory). H+H Celcon's analysis incorporated an average freehold land value per factory of just over half this (£[ ] million). If this lower value had been used, it would have increased MBM's average return on pro-forma indexed capital employed to around 23.3 per cent, which is more in line with the returns of H+H Celcon for the same period.

## **Rationale for the proposed merger**

4.50. From the 1980s until recently, H+H International had been a diversified company with some divisions supplying concrete products and others offering very different products, such as furniture and gravel. In 1998, the decision was taken to focus the business on aircrete and (through a 50:50 joint venture) on lightweight concrete panels, and accordingly the other businesses were sold or closed. As a listed company on the Copenhagen stock exchange, having refocused its business, H+H International felt that it should demonstrate that it was moving forward and expanding the business.

4.51. Accordingly, when it was approached by Etex as a possible purchaser of MBM, H+H International identified a strategic opportunity to grow the UK part of its business significantly. Moreover, the acquisition of MBM and its subsequent integration with H+H Celcon would result in significant synergies and cost savings, initially estimated at £7.7 million a year (see paragraph 4.56). H+H International's advisers calculated that the net present value of those synergies to H+H International's shareholders would be around £[ ] million or more than [ ] per cent of the current value of the whole company (both the A and B shares), which was estimated at around £[ ] million.

## **Justification for the price to be paid**

4.52. H+H International has entered into an agreement with Etex whereby H+H Celcon will buy MBM plus the land, plant and machinery used in MBM's business, and certain intellectual property rights, for a consideration of £81 million. In addition, H+H International estimates that it will have to pay transaction costs of around £3 million. The purchase consideration of £81 million was apportioned between the estimated book value of the net operating assets and working capital being acquired (free of debt), valued at £24.5 million, and goodwill (before accounting adjustments) of £56.5 million. To the extent that the net operating assets and working capital at the date of the transaction differ from £24.5 million the purchase consideration will be adjusted accordingly.

4.53. H+H International assessed the amount that it was prepared to pay for MBM after considering its own valuation of MBM using a discounted cash flow model in order to arrive at the stand-alone net present value of MBM and the net present value of the various synergies that were expected to arise from the merger. This was done using a discount rate of 12.6 per cent, which was stated to be equivalent to H+H International's weighted average cost of capital (see paragraph 4.54). The discounted cash flow model assumed annual revenue growth at MBM from 2002 of 1 per cent and from 2005 of 2 per cent. The resultant stand-alone valuation of MBM was around £80 million (ie broadly equivalent to the purchase price) and the net present value of the synergies arising from the proposed merger was calculated to be around £[ ] million. Those synergies are discussed further in paragraphs 4.56 to 4.59.

4.54. We questioned H+H Celcon about the methodology that had been used to calculate H+H International's weighted average cost of capital of 12.6 per cent, as we were concerned that the cost of capital might have been overstated, and hence the valuation of MBM understated. The calculation had been based on market values of equity and debt, which were assumed to be in the proportion of [ ]. This seemed rather high, since it appeared to us that after the acquisition the relative proportions of equity to debt would be approximately 2:1. However, H+H International's advisers explained that in their valuation model it was the long-term capital structure of the company that should be taken into account. Although immediately after an acquisition the level of debt would be relatively high, in the longer term the debt would be repaid out of cash generated by the business and the capital structure of the business would therefore tend towards pure equity.

4.55. Whilst it is true that a higher proportion of debt will lead to a lower cost of capital (since debt is cheaper than equity) we accept that any calculation of the cost of capital will always be dependent on the underlying assumptions about capital structure, which can be challenged. H+H International's advisers pointed out that the methods and assumptions they had employed were well established within investment banking and so we decided not to pursue alternative scenarios.

## Synergies

4.56. H+H International initially estimated that cost savings from synergies arising from the proposed merger would amount to around £7.7 million a year after three years, with 74 per cent of annual synergies being realized by the end of one year. The cost of achieving these synergies was estimated to be around £4 million.

4.57. The synergies were attributed to a reduction in head count of around 100 in shared functions such as sales, accounting and management, lower material costs as a result of greater purchasing volume, improved logistics within distribution, better production scheduling, improved capacity utilization and greater economies of scale.

4.58. The estimated annual cost savings from synergies drawn up by H+H Celcon are summarized in Table 4.5.

TABLE 4.5 H+H Celcon and MBM: synergies arising from the proposed merger

	<i>per year</i>
	£m
Reduction in headcount Cheaper raw materials Lower transport costs Improved production efficiency and capacity utilization	$\left( \begin{array}{c} \gg \\ 7.74 \end{array} \right)$

Source: H+H Celcon business plan.

4.59. The estimated synergies were subsequently revised downwards publicly by H+H International, in its announcement of the proposed merger to the Copenhagen stock exchange, to cost savings of £7.5 million a year after four years, with 60 per cent of synergies being realized in the first year.

## Funding of the proposed acquisition and gearing

4.60. The precise funding arrangements for the proposed acquisition remain flexible. However, it is H+H International's current intention to finance it using £15 million out of their own resources and £20 million of mezzanine finance,<sup>1</sup> with the remainder of the £81 million on term loan from the bank. The mezzanine debt would be at an interest rate of LIBOR plus 3 per cent, whereas the bank debt would be provided out of a syndicated loan facility at an interest rate of LIBOR plus 1.75 per cent. The providers of the mezzanine debt would also receive warrants entitling them to subscribe for B shares in H+H International at current market prices representing around 7.5 per cent of the combined share capital of the company.

4.61. The impact of the proposed acquisition and funding on H+H International's balance sheet would initially be to raise the level of gearing (debt divided by equity) from 54 per cent to 200 per cent. Interest cover would fall from a very high level to around 2.6 times.

4.62. When we asked whether the level of gearing after the merger might be considered excessive, H+H International explained that the capital structure of the company after the merger would be considered normal in accordance with commonly accepted practice in Denmark. This was because its solvency ratio (equity divided by total assets), which was currently too high, would fall from around 50 per cent to 27 per cent. An optimum level of solvency ratio was considered to be between 25 and 30 per cent.

<sup>1</sup>Mezzanine finance is generally subordinated to ordinary bank debt and has no security attached to it. Consequently, it commands a higher rate of interest than bank debt. It also typically carries some form of conversion rights to equity.