Mitigating risks: Top 5 strategies for successful acquisitions in emerging markets

A proven playbook for emerging markets

The decision to enter a new country is often driven by the need to access new markets, eliminate intermediaries, connect with local consumers, or acquire new technologies or products. Emerging markets are attracting attention from investors due to their growth potential, large youthful populations with growing purchasing power, and, in many cases, abundant natural resources. Industrials, materials, and financials are the leading sectors for M&A in these regions according to LSEG.

Acquiring an existing local company provides immediate access to an established customer base, distribution networks, local expertise, and existing assets. However, breaking into emerging markets is no easy task. There are numerous hurdles including regulatory bodies, tax intricacies, complex business cultures, legal deadlocks, regional differences, inflation, and currency risks. Identifying high-quality targets is further complicated by the lack of reliable public data. Private companies in these regions are not always required to publish their financial statements, and even their websites may be rudimentary.

Merely determining the right party to engage with at a company can prove difficult. "Family-owned businesses dominate many emerging markets in southeast Asia and the real decision maker is often a family patriarch or another figure who holds no formal shares or directorships but wields significant influence," says Tawikarn Kingthong, manager of Clairfield in Thailand. "Identifying and convincing this individual is crucial for deal success." In Turkey, for example, some 95% of enterprises are family-owned, according to the Turkish Corporate Governance Association, further underscoring the importance of understanding family dynamics in emerging market transactions.

Adding to these challenges, many business owners in emerging markets are unfamiliar with M&A. Carefully educating sellers or identifying those with at least a baseline understanding of such transactions goes a long way to smooth the process. Deals may falter due to issues such as unrealistic price expectations or disputes over tax liabilities without such preparation.

Sifting through the competitive landscape and identifying the best available targets requires thorough understanding of the market, a personalised approach to individual players, and early-stage non-disclosure agreements to access even minimal information. While the path is fraught with pitfalls, Clairfield advisors have extensive experience in emerging markets in Africa, Asia, and Latin America and a strong track record of advising buy-and-build strategies in these promising but challenging regions.

Below we outline five strategies to mitigate key risks when pursuing acquisitions in emerging markets, drawing on our years working alongside international buyers.

1 Prioritise early detection of red flags.

Mid-sized companies in emerging markets are rarely audited, and financial statements often omit relevant liabilities. Changing legislation can lead to unknown contingencies or inappropriate practices uncovered in due diligence that even the owner may be unaware of. The cost of failure is high once the acquisition process has begun.

Strategy: Focus on critical areas early to determine deal-breaking risks.

Conduct initial red flag assessments before full due diligence. Key areas to review include compliance with tax regulations, labour practices, regulatory documentation, and environmental liabilities.

In Mexico, while federal legislation is relatively uniform across states, managers sometimes miss minor updates that can impact compliance. Brazil, in contrast, features heavier regional legislation that varies significantly from state to state, increasing the complexity of due diligence. In Southeast Asia, carefully framing questions and repeating inquiries can help uncover hidden issues. Evaluating the seriousness and motivation of the seller early on, by assessing their background, reasons for selling, responsiveness, and even their body language, can prevent costly misunderstandings later.

When such issues arise on the sell side, we advise the company to address internal issues before proceeding with a sale. As Dung Chau, Clairfield deal advisor in Vietnam, explains, "We usually advise sellers to use phased bridging, that is, to bridge the gap gradually over a period of about three years." On the buy side, he notes, "The key isn't just identifying risks. Ultimately it's about advising our clients to either mitigate them or walk away early if necessary."

2 Check the sustainability of commercial agreements.

Mid-sized companies often operate with informal business contracts tied to personal relationships. Such agreements may not withstand the transition to new ownership and can lead to revenue loss post-acquisition. However many acquirors are so focused on financial statements that they fail to notice the problems lying underneath: weak commercial partnerships, evolving regulation, and concentration of revenues in a small number of clients.

Strategy: Structure the transaction so that payments are contingent upon migrating informal agreements into formal, commercially sound contracts. Formalising agreements linked to personal relationships with transparent and sustainable terms will mitigate risks and strengthen post-acquisition integration.

In many emerging markets, non-arm's length transactions are prevalent. These may include underpaid CEO salaries, real estate leases between shareholders and the company at non-market rates, or intercompany transactions designed for tax optimisation or personal gain. Addressing such issues requires extensive due diligence to map the company's group structure, evaluate related-party transactions, and assess the nature of these relationships.

Governance gaps also complicate matters. Many older-generation entrepreneurs and executives in emerging markets are not well-versed in corporate governance best practices. This makes it essential to identify and formalise any informal or non-standard arrangements that could pose risks post-acquisition.

Transitioning informal contracts to market-based terms helps ensure that the business can operate independently of prior owners' personal networks and shows long-term stability and integration.

3 Resolve conflicting risk assessment and synergy assumptions.

Complex and shifting regulatory environments in emerging markets often also lead to discrepancies in risk assessments. Buyers and sellers may have differing perceptions of the likelihood or severity of liabilities, particularly when local regulations are subject to frequent change or lack alignment with international standards. These differences can complicate negotiations as assumptions about risks and synergies may diverge significantly. Generalist due diligence teams may struggle to accurately evaluate such risks, resulting in flawed assumptions about synergies and costs.

Addressing these discrepancies requires careful negotiation and tailored mechanisms to mitigate perceived risks.

Strategy: Consult independent experts outside the core due diligence team to assess specific liabilities, and implement tailored mechanisms to address these concerns and provide additional comfort to both parties.

These experts, who may include specialists in law, taxation, technology, or industry-specific issues, can provide critical insights beyond the capabilities of generalist due diligence teams. For instance, in Argentina, industry-specific advisors are essential to understanding complex risks, such as the alignment (or misalignment) of national and international standards in sectors like technology, agriculture, and manufacturing. Similarly, in Thailand, transactions often involve IT or antitrust specialists to address specific regulatory or technical issues.

Once the risks are identified they can be addressed. Tailored mechanisms can mitigate the impact of identified liabilities and provide additional comfort to buyers without undermining deal value. Mechanisms such as indemnification clauses, holding periods, and escrows are effective tools for bridging gaps in risk perception. In Brazil, indemnification clauses are a common solution for managing potential liabilities without reducing the purchase price. In Mexico, mechanisms such as holding periods and escrows are frequently employed to manage buyer concerns, especially for experienced international acquirors.

The risk perception of potential liabilities plays a crucial role in negotiating final contracts, and expert insight is key to avoiding misjudgements. Final negotiations often hinge on how these liabilities are perceived by both parties and the mechanisms proposed to manage them.

4 Bridge the valuation gap between acquiror and seller.

One thing is true for transactions all over the world, and that is the tension between high price expectations on the part of the seller and the search for a bargain on the part of the buyer. In emerging markets, the valuation gap between buyer and seller is often exacerbated by local capital costs and tax liabilities. Tax liabilities are particularly common in smaller deals and can represent a substantial portion of the total transaction value. In some regions, expected taxes upon closing are so high (30-35%) that sellers demand prices over market value to offset the tax burden, often refusing to sell otherwise. This is a frequent dealbreaker in Thailand, according to Tawikarn. In many regions, the acquiror is legally bound to the target company's liability for past tax obligations (typically with a five-year statute of limitation). Structuring deals to protect the acquiror while remaining attractive to the seller is therefore critical.

Earnout structures, where part of the purchase price is tied to the target's future performance, may seem like a solution but can generate conflicting incentives and create serious discord post-transaction. If there is a lack of clarity regarding what the parties consider satisfactory performance or other valuation metrics that trigger the earnout, costly and time-consuming disputes may occur. This mechanism is not universally used.

Strategy: Employ flexible deal structures to align value expectations.

Consider flexible deal structures such as vendor financing or holdback structures to align incentives. "It is important that 'base-case' sell-side business plans are credible and that a track record of delivery can be established through a due diligence process to anchor valuations at appropriate minimum/reserve levels. 'Upside' cases are useful ways of demonstrating out-of-

plan growth opportunities to provide further support for more favourable valuations," says Dipeel Parbhoo, a transactor at Clairfield in South Africa. "Additionally, in many instances, sellers might prefer providing warranties or indemnities in respect of key risks as opposed to accepting outright price reductions." Dipeel further advises considering not only the headline enterprise value, but also the components of the enterprise value to equity value bridge. "Focusing solely on a headline valuation level without considering how that valuation is adjusted for either other balance sheet items or the passage of time can lead to sub-optimal pricing outcomes for sellers."

Solutions such as escrows, holding periods, and deferred payment structures are often employed to manage buyer concerns without reducing the price. Vendor financing, particularly common in regions with high capital costs, allows sellers to achieve an attractive nominal transaction value while meeting buyers' cash flow needs. For instance, deferred payments and escrows are standard in Thailand to mitigate risk, while in Mexico, vendor financing can succeed when buyers provide strong guarantees to reassure sellers. These approaches bridge valuation gaps, protect against liabilities, and ensure deals remain attractive to both parties.

5

Adjust accounting data before making an offer.

Preparing a non-binding offer based on sellers' unadjusted accounting or managerial figures can be tricky. Many mid-sized companies' financial statements do not reflect the true state of their operations. We have observed some common and easily identifiable missteps, such as reporting employee compensation as dividends, not reporting all revenues and expenses to avoid taxation, which can both overstate or understate the profitability, and using company funds for personal expenses. These practices can distort profitability and lead to inaccurate valuations.

Making an initial offer based on unadjusted figures can create friction with the seller if the price is later reduced following due diligence. Conversely low initial offers can result in the buyer being excluded from negotiations, even when they might be willing to pay more if accurate data were available.

Strategy: Apply the necessary adjustments to the target's financials before indicating a price.

"We typically present an offer together with a clear breakdown, including the valuation multiple applied to a specified earnings amount. By specifying the earnings value on which the offer is based, we articulate any adjustments made to the financial information provided by the sellers in respect of the target," says Dipeel.

Looking ahead: turning challenges into opportunities

Emerging markets do not remain in this category forever. As regions mature, they align more closely with international standards and become more stable business environments. Look at the robust M&A markets in Eastern Europe as an example. Similarly, the Indian market has matured over the last decade due to its alignment with international regulations in areas such as banking, intellectual property rights, insolvency, tax, and country-to-country treaties on repatriation of dividends and proceeds, says Abhijeet Biswas, partner in India. Similar reforms have made business environments more predictable and attractive in several emerging regions.

While challenges persist as these markets evolve, the five strategies outlined here provide not only practical tools for mitigating risks but also a guiding philosophy of dealmaking applicable wherever local complexity meets global ambition.

There is no substitute for working with in-country advisors who possess the local knowledge and expertise to guide critical judgment calls. Clairfield's partners in these regions are specialists in managing the unique difficulties of emerging markets. Consistently ranked among the top financial advisors by LSEG, Mergermarket, TTR, and other financial press, our emerging market teams have a proven track record of delivering successful outcomes. With their expertise, Clairfield ensures that acquisitions are both strategically sound and value-accretive. ■

This article is adapted from "The Brazilian M&A Handbook." For more information contact Luiz Penno: lpenno@clairfield.com.