FORSight Resources, LLC

The FORSight Resource

Volume 2, Issue 3 August 1, 2005

Upcoming Events...

International Perspectives on Forestry II. Sept 12-13, 2005
Portland, OR
www.wfi.worldforestry.org/ipf.htm

SAF National Convention
Oct 19-23, 2005
Dallas Fort Worth, TX
www.safnet.org/natcon/

Inside this issue:

Post-acquisition Due Diligence

Acquisition due diligence (ADD) is a discipline that has evolved steadily over the past several decades. It is basically a validation of the assumptions and facts upon which a purchase price for an asset or group of assets is determined. ADD deals primarily with tangible assets and values.

Perhaps most critical **post-acquisition** task is identifying human capital risk, an intangible. In most circumstances, except for the most senior leadership of the target company, acquisition risks related to people are lumped into the broader culture category and often ignored until performance suffers. This common practice represents a false belief that such risks can be easily mitigated once the transaction is completed and the two organizations are combined. The reality is that except for external market conditions, the most difficult risks to mitigate are 1) the potential loss of critical talent on both sides of the transaction and 2) resistance of the acquired workforce to change.

The folding in of the acquired company's workforce is akin to mixing oil and water. These people have just been through a traumatizing experience and continue to have anxiety about how or if they will fit into the new company's structure.

The task at hand it to determine how combining these two organizations will create a level of economic value that is significantly greater than their combined stand-alone values. This will occur through either 1) **economies of scale** or 2) **economies of scope.** Scale-based acquisitions seek to leverage economies through increasing the scale of a common line of business (doing more of the same activity). Acquisitions within consolidating industries are the traditional example of scale-based acquisition logic.

Scope-based acquisitions aim to leverage economies through the spread of common resources across related but distinct activities. For example, combining distinct and complementary customer bases from the

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Old Data...Hold or Discard?

Is maintaining old data more trouble that it's worth? The answer is...it depends. With regard to timber inventory data, the answer is yes in most cases. Often times old inventory data are discarded and only the most recent set of cruise data is maintained. This appears to be due to a perception that the older data are no longer useful or no longer relevant to the current management of a forest. We disagree.

Old data can provide a link to site quality estimates or site evolution, or can help examine treatment effects across rotations. If the data can be linked to an existing stand, they are of great value. They can be used for growth model testing and evaluation. Companies often invest significant time and resources to find the growth model that's best suited to their property. It is best to compare model predictions against actual growth data taken from the same plots/stands at multiple points in time.

The question then becomes, how do you know if your old data are useful? There are many ways to answer this. First, do you know If

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Old Data...

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the data have a reference to when they were collected, the value increases dramatically particularly when inferences about forest change are going to be made. Once a data age has been established, information on how the data were collected is helpful. From windshield cruises to permanent plot installations, an understanding of how reliable the data are will determine what types of things can be done with them. Basic tree level information is the building block for the forest inventory. If individual tree records, data age and method of collection are maintained, raw tree data can always be worked up a variety of different ways. Estimates of basic stand parameters such as TPA, BA, SI, volume can also be determined through time. With changes in technology, sampling designs are often evolving. This should not inhibit data usefulness, especially if the portion of the forest targeted for sampling has not changed between designs.

In nearly all cases, old data will prove useful to save. Whether it's simply to understand site history, or whether there's enough information to run individual-tree models, the data will help to understand current stand dynamics and provide the ability to better predict what may happen in the future.

So, what should be done with the data? Congress has been wrestling with this question for the base decade and has devoted millions of dollars to determine the best solution. In the 'digital' information age, technology is growing by leaps and bounds. On the down side, lack of standardization is the norm whether it relates to formats, storage devices, media types or software versions.

A high quality book can be placed in a dark environment and as long as moisture is not present, it can be preserved for decades and possibly centuries. Can the same be said about a CD? Even if the data are preserved on a CD, will the software be able to read the format the data are in? Digital data, while convenient can be erased with a single keystroke! This issue has implications well beyond the storage of forest inventory information. In the next issue of the FORSight Resource, possible solutions to data storage will be discussed.

In the meantime, storage devices and media are relatively inexpensive and available. With regard to old data, trend information can be developed which is infinitely more valuable than a single snapshot in time...best to store it!

Post-acquisition Due Diligence...

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two organizations is a scope economy benefit. In most large M&A transactions, both scale-based and scope-based economies are involved.

Given a basic understanding of the post-acquisition organizational form and the high-impact operating activities, the acquirer can **identify the factors that will impede performance**. These risk factors are all created by the need for change. Changes tend to come in two forms - required changes in the underlying business processes and changes in how decisions are made.

It is important to draw upon the basic understanding of prospective changes in the operating model to identify two basic types of integration risk factors. First, there are factors that represent employee behaviors that impede successful integration. Second, there are factors that may lead to the turnover of critical talent. Of course, there are other important risk factors that are less employee-driven, such as the difficulties in integrating distinct IT platforms. However, while these operational risks may require more attention, employee-driven risks are much more difficult to control and mitigate.

Behavioral risks reside at two levels: Senior management responsible for each of the organizational activities, and more generally, critical talent within both organizations who have the greatest affect on high-impact activities. There are four fundamental behaviors that create the greatest risk within a partially integrated operating model:

- Unwillingness to share tangible resources
- Unwillingness to share information and knowledge
- Unwillingness to adjust organizational processes
- Unwillingness to allocate time and energy to critical integration activities

All four of these behaviors represent a general resistance to changes required under the acquirer's operating model.

Why does this resistance occur? Consider what each of the newly acquired employees have been through since the announcement of the sale. The announcement likely came as a surprise reducing their trust in senior management. They likely are not able to seek other employment within the selling company as much of the value of the asset is reliant upon them staying. Fear of the unknown pervades their thinking (financial security, downsizing possibilities, etc.).

"The measure of success is not whether you have a tough problem, but whether it's the same problem you had last year."
John Foster Dulles

Note that the question is not whether some level of employee resistance will takes place, but how severe will the resistance be. The acquirer should anticipate significant resistance when employees are expected to change the way they perform their jobs and/or are expected to relinquish control over resources they believe to be critical to their individual performance. In the

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extreme, this resistance leads to turnover, which is the second category of risk factors.

Viewing the employment relationship with critical talent as a long-term exchange relationship between a buyer (employer) and seller (employee) is an effective way to assess the degree of turnover risk. In the pre-acquisition environment, the existing benefits of the exchange are sufficiently high to prevent either party in the relationship from exercising their alternative options-that is, the employee will not seek employment elsewhere and the employer will not fire the employee. From the employee's perspective, the exchange relationship includes benefits outside of pure monetary exchange, such as affiliation to the organization and the quality of the work environment. These non-monetary factors are often associated with a long-term employment relationship and in many cases are as important, or more important than the monetary rewards. This more complete set of benefits has become known as the employee value proposition (EVP).

If the success of the acquisition requires a significant change in important features of the EVP, then the employee has an incentive to reconsider his or her employment options. Most notable here are the non-monetary factors that are greatly diminished in the context of an acquisition. In the extreme, from the perspective of the critical talent of the acquired firm, the acquiring firm is on a level playing field with all potential alternative employers. The "clock" on the employment relationship has been reset to zero. Note that this reality does not go unnoticed by the competition. **Opportunistic Recruitment** is abundant in today’s market.

The acquirer needs to assess the degree to which the prospective EVP will be sufficiently attractive to the critical talent to prevent significant turnover. Note that beyond the senior leadership of the target company, the focus is not on incremental turnover, which is inevitable. The focus is on the potential for a "turnover tipping point," where dissatisfaction with the new EVP accompanied by the departures of the senior leadership, leads to the turnover of a large group of critical talent.

Once key risk factors have been identified, the likelihood of bad outcomes and the potential magnitude of those outcomes must be assessed.

Unfortunately, there are no hard and fast answers in this situation. A prudent course of action in this case would be to use the risk factors to construct a reasonably plausible low-performance scenario, and then judge the likelihood of this scenario occurring. Note that while the low-performance scenario may appear to be a worse case scenario, it is not unlikely.

Translating the risk factors into actual low-performance scenarios can be a powerful way of raising the importance of integration risks within the high-level strategic and financial discussions that tend to dominate the pre-deal process. First, it forces the acquirer to articulate how value will be created, or not created, by the acquisition. Second, traditional sensitivity analysis conducted on the valuation of the target tends to be a mechanical exercise in which various value drivers (e.g. sales) are adjusted up or down by some small percentage. Generating an explicit low-performance scenario that has clearly stated and plausible performance outcomes will provide a much more robust sensitivity analysis. Finally, it allows the senior leadership to answer the following question: "Why might this acquisition fail and how can we prevent that from happening?"

Lightening strikes on the horizon. Flagstaff, AZ. Courtesy of Mike Wanblat.

In summary, this acquisition risk analysis framework is designed to enable the leaders of the acquiring firm to assess the major integration risk they face prior to making the decision to invest in a comprehensive due diligence process. First, it requires understanding the prospective operating model and the critical operating activities that will be the primary source of the value creation.

The next step is to identify the primary organizational and human capital risk factors that will impede the performance of these critical operating activities. Perhaps the most distinctive element of this due diligence framework is the emphasis on human capital risk. In most deal situations, only the risks surrounding the most senior leadership are considered. As many acquirers have learned, this can be a profound mistake. A basic understanding of the prospective operating model should allow the acquirer to recognize significant human capital risks, and hence, avoid making this sometimes costly mistake.

FORSight Resources has considerable experience in assisting clients in the due diligence process and post-transaction integration. For more information or specific requests email us at: info@FORSightResources.com

A comprehensive review of the ORGANON growth model including new functionality will be included in the next issue of the FORSight Resource.

Letter from the Editor

This is the fifth issue of the FORSight Resource. When we decided to publish a newsletter, we hoped it would provide useful information to our clients and prospective clients. Today our subscription list is over 400 and grows daily.

We will continue to provide quality, timely information on topics of interest to the industry. Much of the information contained in the newsletter is based upon our experiences and the insight we've gained as a result. Thank you goes out to our subscribers from everyone at FORSight Resources!

Feedback or suggestions for articles from our readers is always appreciated...

"It is better to be approximately right than precisely wrong."
Warren Buffet

FORSight Resources is a leading provider of decision support services for natural resource management. The company's offerings include forest planning, inventory, growth and yield modeling, GIS analysis and custom programming, acquisition due diligence, wood supply analysis, forest finance, forest economics, and a host of other decision support services geared specifically towards natural resource management.

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Short-Term Harvest Schedule Sensitivity to Future Stumpage Price Assumptions

ABSTRACT

Forest planning models have long been used as an analytical tool for providing information to facilitate effective decision making and planning. Inherent to the financial analyses conducted with these models are assumptions concerning key financial parameters contained in the model such as discount rates, future costs, and future stumpage prices. While projecting timber prices into the future with any accuracy is an extremely difficult exercise, price forecasting is nonetheless a critical part of forest planning analyses. The ramifications of these assumptions over a long planning horizon can be significantly different product flows, activity levels, and cash flows. The purpose of this study is to investigate the impact of different future stumpage price assumptions on the short-term (5-year) timber harvest schedule for a southern pine forest, and to examine how much of the schedule is financially driven. The findings indicate that the short-term harvest schedule is sensitive to different price projections. This result is significant especially with respect to the timing of short-term timber harvest decisions to take advantage of market prices.

In Press: Bevers, Michael; Barrett, Tara M., comps. 2005. Systems Analysis in Forest Resources: Proceedings of the 2003 Symposium; October 7-9, Stevenson, WA. Gen. Tech. Rep. PNW-GTR-000. Portland, OR: U.S. Department of Agriculture Forest Service, Pacific Northwest Research Station.

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Data Storage Solutions

Growth Model Review - ORGANON

Effect of Exchange Rate on International Forest Products Trade

The FORSight Library

Letter from the Editor

"Advice is what you ask for when you already know the answer but wish you didn't."
Eric Jong, writer

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