MERGERS AND ACQUISITIONS:

THE ULTIMATE GUIDE

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Mergers and Acquisitions: The Basics

“Mergers and acquisitions” (“M&A”) are terms often used interchangeably to describe transactions involving the purchase of all or part of a one company by another. M&A is a tool or “tactic” used by companies to pursue a specific corporate strategy involving growth, expansion, contraction, or change in competitive position to achieve value enhancement. The buyer and seller each pursue their own specific set of strategies (likely involving growth, contraction, alignment or other change in competitive position). These strategic goals lead them to the transaction with its perceived value. The merger and acquisition process can be complex, requiring special technical expertise and assistance from outside resources. Attorneys, financial experts, industry experts, and business advisors are typically engaged to assist in the process, manage risk, and mitigate the seemingly high number of transaction failures.

Mergers and Acquisitions: Defined

Merriam Webster defines “merger” as follows:

1. *the act or process of merging*
2. *absorption by a corporation of one or more others; also, any of various methods of combining two or more organizations or business concerns*

In the transactional arena, “merger” is a term used to describe the process whereby two or more companies become one. In this case, the target company/business ceases to exist as it had in the past, as it becomes part of another company (Exhibit 1). Companies can combine tactically through a variety of structures and methods. Merger transactions are usually structured as the purchase of all the business assets or the majority of the stock of a target company. In most cases, the acquiring company survives, and in some, the target survives in what is called a reverse merger (Exhibit 2). Sometimes two companies come together in a joint venture to create a third company (Exhibit 3).

Three merger types and post-merger results are the presented below.

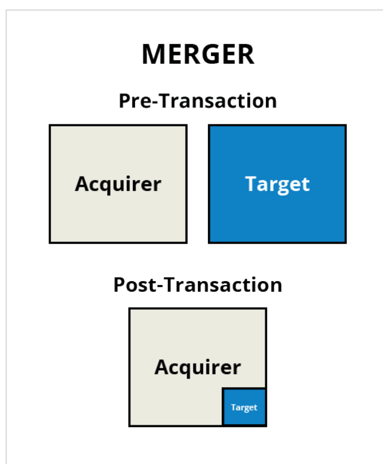

Exhibit 1

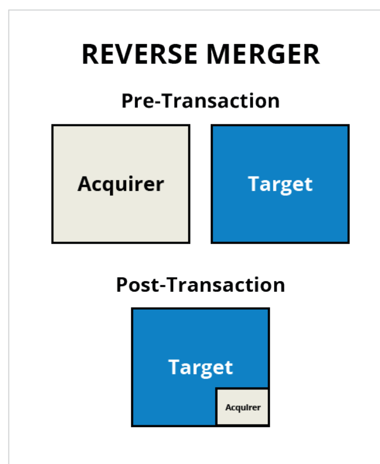

Exhibit 2

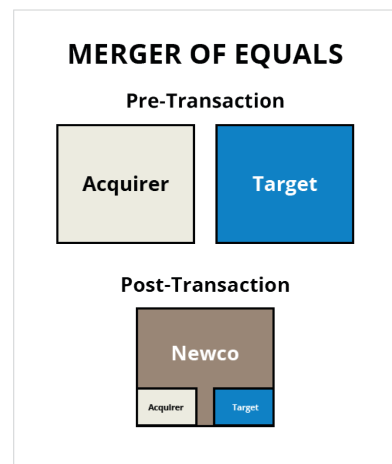

Exhibit 3

Investopedia describes the financial term "acquisition:"

> *"An acquisition is a corporate action in which a company buys most, if not all, of another firm's ownership stakes to assume control of it. An acquisition occurs when a buying company obtains more than 50% ownership in a target company. As part of the exchange, the acquiring company often purchases the target company's stock and other assets, which allows the acquiring company to make decisions regarding the newly acquired assets without the approval of the target company's shareholders. Acquisitions can be paid in cash, in the acquiring company's stock or a combination of both."*

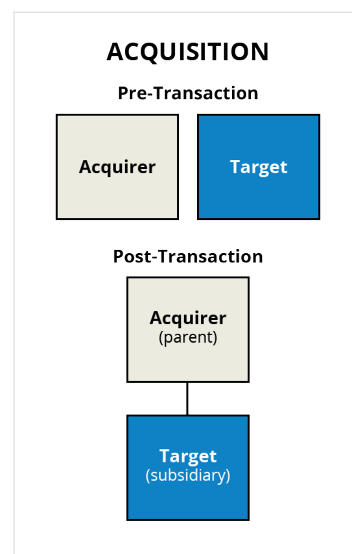

Exhibit 4

Acquisition is sometimes used as a term for merger or transaction; however, acquisition technically describes when the buyer takes control of the seller and retains the corporate entity immediately following the transaction. Commercially and economically the terms are used interchangeably, and the distinctions are less clear. Exhibit 4 above shows the majority of stock of target (greater than 50%) acquired to result in a post-transaction parent-subsidiary relationship.

Buyer Types

Two basic types of buyers participate in a transaction—strategic and financial.

Strategic Buyers

Strategic buyers are typically companies intending to enhance their business through acquisition. The strategic investor usually has a long-term time horizon. The strategic buyer is current on the industry, competition, growth prospects and trends.

The strategic buyer is pursuing M&A to accomplish any of the following strategies:

- Access synergies to accelerate growth
- Fill market or complementary service gaps
- Strengthen and speed the supply chain
- Exploit market conditions
- Address government regulation
- Enhance technology
- Supplement human resources or management
- Strengthen the acquiring company's core business

Strategic buyers may be competitors (horizontal integration strategy) or may be suppliers or customers (vertical integration strategy). Strategic buyers can also be unrelated to the target company, but the transaction achieves the goals of diversification, revenue and profitability growth. Strategic buyers desire synergy and ability to seamlessly integrate the target business.

Financial Buyers

Financial buyers include investors such as private equity funds, family office investment groups, venture capital firms, and hedge funds who have a goal of generating a return as a result of buying or investing in a business. The financial buyer usually brings capital along with business and and financial acumen to the table. The financial buyer is interested in helping the business scale up to the next level and make significant growth in revenue and profits. In return, the financial buyer expects the business to provide returns in the form of increased valuation upon a monetization event of a later transaction and oftentimes in cash flow from ongoing operations. The financial buyer has a preferred investment timeline of 4–7 years. The financial buyer often leverages the purchase with debt; therefore the target's ability to generate sufficient cash flow to service post-transaction debt is critical.

To ensure adequate understanding, the financial buyer evaluates the industry, competition, growth prospects, and trends as an integral part of the due diligence process before completing a transaction.

Many financial buyers seek well-managed companies with a solid history of earnings and earnings growth. Other financial buyers partner with industry experts such as an independent sponsor to identify undervalued businesses to participate in a transaction. Together, they invest business expertise to help take the company to the next level by adding infrastructure and professionalizing the company.

Sometimes, a strategic buyer morphs with characteristics of a financial buyer. Likewise, there are instances where a financial buyer decides the timing or target is right to grow in the space. This may be accomplished by adding-on a business, for which the financial buyer looks and behaves very much like a strategic buyer.

Resources Required to Complete a Transaction

Multiple resources are typically required to affect a successful transaction. Experts in legal, accounting, finance, tax, operations, information technology, and other specialists are involved in most transactions. Consultants or in-house staff can serve as subject matter experts. In using consultants, investors seek out teams with experience and track records of servicing M&A transactions.

Stages of a Transaction

Each transaction will pass through the various stages listed below.

1. Transaction Shopping – When a buyer decides to pursue growth through acquisition, it dedicates a team of resources to execute the plan. The team spends time researching the markets and the opportunities. The team will seek out and evaluate potential target companies. Once a solid opportunity is discovered, a team of internal and/or external resources are assembled to pursue the transaction.

Financial buyers have funds available to invest and seek out targets to invest in that meet their pre-defined investment criteria. Financials buyers typically employ highly specialized teams who identify opportunities, negotiate transactions and serve on the board once the transactions have closed.

Sometimes targets seek out buyers or investors by producing and distributing an "teaser" or Confidential Information Memorandum ("CIM"). These documents include background on the company, financial and forecast data, and details of the ideal transaction. Potential suitors respond with questions about purchase price, governance, transaction structure, and other items important to framing terms of a transaction.

The seller usually picks finalists or a finalist from the various suitors. After signing a non-disclosure agreement ("NDA"), some level of preliminary diligence to firm up an offer occurs which is memorialized in the execution of a letter of intent.

2. Letter of Intent – A letter of intent ("LOI") is a non-binding legal document which describes the preliminary terms of a transaction, usually includes exclusivity and due diligence terms as well as the timing in which the deal needs to be closed. Exclusivity is an agreement to the seller cannot shop the deal to other buyers during the term of exclusivity.

3. Due Diligence – Due diligence is the process by which the buyer can "kick the tires" of the company it is buying. The buyer has the opportunity to confirm the value proposition, assess the risks, and validate that the offered purchase price is reasonable and appropriate. The transaction team performs the due diligence by assigning responsibilities for completion among subject matter experts and consulting resources. The diligence team review and analyze financial and legal documentation to ensure that the claims the seller has made about the company are supportable, to search for unknown liabilities, explore risk factors, discover synergies, and to firm up transaction structure and deal points.

A key part of financial diligence for buyers, especially those obtaining outside financing, includes a Quality of Earnings ("Q of E") review. Many lenders require this report prior to funding a transaction. In a Q of E, the buyer engages a third-party expert to perform a financial evaluation of the target. The Q of E report discusses just that—the Quality of the reported Earnings. Because the value in most transactions is based on historical and future earnings and cash flows, it is important to understand the company's Earnings before Interest, Taxes, Depreciation, and Amortization ("EBITDA") on a normalized basis following the transaction.

The Q of E report discusses factors that include both positive and negative indicators of "quality" earnings. The Q of E reviewer begins evaluation of the company's EBITDA reported in its financial statements. The Q of E diligence team will review and vet management adjustments and adjust for any deviations from Generally Accepted Accounting Principles ("GAAP"), out-of-period, non-recurring, and pro forma items. In addition, the report might also provide some commentary on the projections associated with the target company. Other items commonly addressed in the Q of E report include working capital requirements, capital expenditure needs, and assessment of the significant balance sheet accounts and contingent/off balance sheet liabilities, if any. The Q of E assessment is not an audit but does help mitigate risk associated with target financial statements/earnings representations. The Q of E evaluation specifically focuses on recurring EBITDA and cash flows, which represent the primary basis for valuation and the proposed purchase price.

4. Transaction Negotiation and Documentation – This phase happens concurrently with diligence. The information gathered during the diligence assists in negotiating details surrounding

the framework of the LOI and eventual purchase agreement. The significant deal terms include such items as purchase price and payment components, closing date, purchase price adjustments, working capital methodology and expected amount, earnouts, representations and warranties, and other important deal points. It is important to note that the management team working on the transaction is empowered by the board or controlling ownership to negotiate the transaction. Authority for final approval of an acquisition lies with the controlling equity or its board of directors. Thus, before the transaction closes, both the buyer and the seller require approval of their respective Boards of Directors or post-transaction ownership.

5. Integration Planning and Execution – Post-transaction planning and execution are critical components of every transaction. No matter how well conceived, the expected outcomes of a deal will not be achieved in terms of financial pro forma, synergies, revenue enhancement, infrastructure, and expense right-sizing if integration planning and its execution are defective.

Post-transaction integration planning and implementation require a team will carefully consider and manage each detail of the business to ensure a smooth transition. Key components and questions to be addressed include:

1. Are the revenue contracts assignable/transferable?
2. What must be done to communicate with the customer base to ensure maximum retention?
3. What should employee communications entail?
4. How will employee benefits, compensation, and job descriptions be transitioned?
5. How will differences in company culture be managed or blended?
6. What will be the organizational and management structure—centralized, decentralized, bottom up, top down, matrix?
7. For significant organizational changes, how will the staff be transitioned to help them be successful?
8. What are considerations to ensure satisfaction of strategic suppliers and critical vendors?
9. How are facility issues addressed such as consolidation, divestiture, or shutdown?
10. What compliance and government regulation are pertinent?
11. How are tax benefits maximized and risks mitigated?
12. What needs to be addressed in the first day, week, 100 days?
13. Who will do what and be accountable to whom?

The considerations are multiple and complex. But, the primary goal is to be proactive rather than reactive—to shape circumstances rather than be a victim of them.

Why Do Transactions Fail?

The first question: *How does one define a successful transaction?* For financial investors this answer is objectively defined by the answer to the question: "How close did we get to our expected return in our expected timeframe?" Financial buyers have investment return expectations and timeline horizons. The closer the investment meets those criteria the greater likelihood the transaction is considered a success. Financial investors may experience many of the same challenges as a strategic investor; however their evaluation of success is unchanged.

For a strategic investor, success will be evaluated in a multitude of both objective and subjective ways depending on the company's priorities. Some pressure points causing risks and challenges to the success of an investment include:

1. Unclear alignment with strategy
2. Inadequate leadership
3. Inexperience
4. Failure to engage qualified, experienced outside advisors (e.g., legal, financial, IT, and human resources)
5. Unrealistic or overly optimistic expectations
6. Inadequate Board involvement and buy-in
7. Overvaluation/overpayment
8. Excessive financial leverage
9. Poor legal or financial diligence
10. Inadequate financial diligence
11. Incompatible corporate cultures
12. Failure to exploit synergies
13. Poor integration/transition planning and execution
14. Inadequate consideration of workforce as valuable asset
15. Lack of accountability for accomplishing objectives
16. Poor communication
17. Failure to transition customer base/contracts
18. Insufficient evaluation and disposition of risk issues
19. Seller issues, e.g., improper motivation or competition
20. Transaction fraud
21. Inadequate working capital

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