Merger & Acquisition Focus

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Ask the Advisor

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Making a merger of rivals work

What happens when two companies that have spent years battling each other for customers and market share suddenly join forces? Such a merger of rivals can be disorienting for both employees and customers. Because such deals add a degree of difficulty to the already complicated M&A process, both parties need to plan for special integration and cultural challenges.

Common deals, common problems

Mergers of rivals are actually very common. Consider CNBC's acquisition of the Financial News Network, AT&T's ongoing purchase of T-Mobile and the union of J.P. Morgan and Chase. But while these deals worked on paper, they encountered integration difficulties and mixed financial results.

Set the stage for a postcompetition future by presenting a new mission statement that emphasizes unity.

One of the more common problems with such deals is employee resistance. For example, when Credit Suisse First Boston acquired Donaldson, Lufkin & Jenrette in 2000, it imposed its own culture on the investment bank. Former Donaldson employees left in droves, which many feel reduced the deal's long-term value.

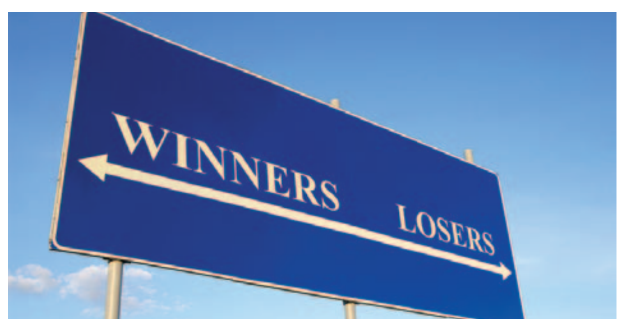
Another common problem involves difficulties surrounding corporate identity. Companies often define themselves by how their products or services are superior to those of their competitors. When competitors merge, employees at both companies must suddenly shift gears and not only accept, but sing the praises of, the combined organization.

Not surprisingly, customers may receive mixed messages. If they've been hearing for years that your competitor has inferior products, customers may question how a merger with that company will affect quality and service. They may decide to take their business elsewhere.

Banish negative messages

To minimize the potential for negative repercussions, outline action plans with your deal partner. Start by banishing negative messages. Even if your company is the buyer, you must actively discourage the idea that you're the "victor" and that your acquisition is the "vanquished."

Many employees will nevertheless feel that they belong to a "winning" or "losing" side. So instead of sweeping the issue under the rug, acknowledge your history of rivalry in meetings with employees. Try to keep these discussions lighthearted with a liberal dose of humor.



Then set the stage for a postcompetition future by presenting a new mission statement that emphasizes unity. This mission must be more than words on a page. Articulate how what were formerly known as your rival's weaknesses have been eliminated and how you're capitalizing on its strengths. For example, your former rival's understaffed customer service department will be bolstered by your excellent service team, and your sales department will be gaining a dozen crack salespeople.

Respecting culture

You and your merger partner also should pledge to respect each other's corporate culture. This doesn't mean that each company will retain every aspect of its current culture. But each group should state which qualities, such as an informal environment, it considers critical to the merged company's future success.

Although some mergers of rivals are made between equals, most have a clear buyer and seller. Buyers, understandably, need to make some changes to realize cost synergies and other acquisition objectives. But they should seek to retain as much of the seller's culture as possible — which can range from allowing the acquired company to operate as its own self-sufficient unit to simply letting it keep its name.

Sense of fairness

The consolidation of facilities and positions is inevitable when rivals merge. To head off accusations of unfairness, determine how you'll allocate jobs to ensure the right person remains in — or moves into — each position. If you're the buyer, don't plan to retain all of your own employees and only cherry-pick the seller's talent. Resignations of valuable key players could soon follow.

To ensure you understand the talent you have and the talent you're getting, interview employees of both companies and review their personnel records. Stress that each employee will be evaluated on his or her own merit and isn't necessarily competing against a counterpart in the rival organization.

A new team

To build a new culture that combines the strengths of each former rival company, try to minimize differences while preserving those qualities that made each business successful. And if you're still having trouble creating unity, focus on a *new* corporate rival. Nothing fosters teamwork like competition. ■

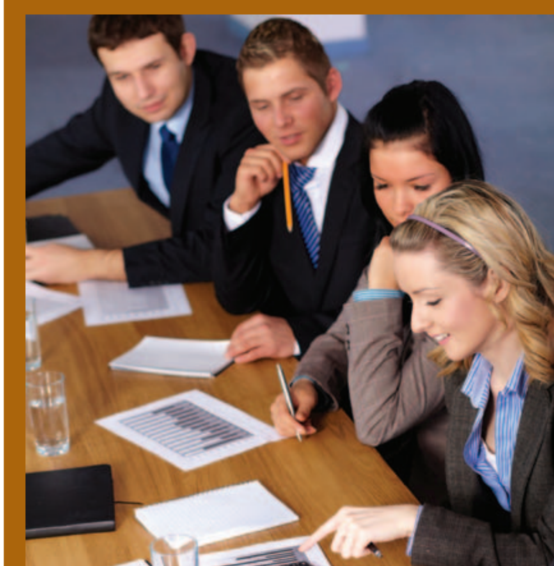
Compare corporate culture to predict clashes

Former rivals that decide to merge can predict certain integration challenges before they occur by comparing corporate cultures. Most corporate cultures follow one of the following models:

Power- and personality-based. Here the culture centers on top managers, their personalities and the loyalty of their subordinates. This "cult of personalities" culture can be hard to integrate — even if the other party's culture is similar.

Rule-based. In this case, the corporate culture has clear divisions of labor and places great emphasis on rules and procedures. Two rule-based companies can enjoy a relatively smooth integration.

Consensus-based. This culture emphasizes teamwork, with considerable give-and-take between management and employees. While the integration of two such organizations is likely to work, serious transition efforts will be needed if a rule-based buyer is integrating a consensus-based company.



The ins and outs of seller checklists

Before embarking on a sale, companies should try to visualize the kind of buyer they want. At the same time, they need to determine whether they're capable of attracting that ideal candidate.

Seller checklists, one internal and one external, can make this process easier. Although the two lists complement each other, they offer different perspectives: One helps you focus on buyers' qualities, the other on your own company's.

External: Finding the right buyer

Your company should take between three and six months to assess your buyer preferences. Basic considerations that belong on your external checklist include:

Strategic or financial buyer. Strategic buyers target companies that will enhance and expand their current product or service lines and help them to achieve cost synergies. Financial buyers typically look for businesses that they can purchase and then resell several years later at a higher price.

As you list your company's competitive advantages, think of how you can emphasize these to prospective buyers.

Same-size or larger company. The size of your buyer could affect everything from its offer price to its ability to fund future growth to its corporate culture. Are you seeking a similar-size buyer from within your sector or a larger multi-industry buyer that wants to expand into a new industry?

Location and workforce. Would you consider an offer from a company that's located in a different

geographic region? If so, the sale could result in layoffs or relocations, dramatically affecting employees and your local community.

Once you've determined these and other qualities you want in a buyer, list some prospects and rank them by category. None is likely to offer everything you want, but your M&A advisors can help you weigh the merits of each and suggest other potential buyers you may not have considered.

Internal: Sizing up your company

As you're making your external checklist, conduct a thorough self-evaluation. Put yourself in a prospective buyer's shoes: What advantages does your company offer and, conversely, what qualities might raise red flags?

Among the items to evaluate on your internal checklist are:

Growth potential. Does your company boast a record of consistent growth? Could a buyer add value that would enhance its financial performance? Do you pose a competitive threat to a potential buyer's market share? Any or all of these might attract a good offer.

Unique offerings. Do you have proprietary products, valuable intellectual property (such as patents and trademarks), hard-to-access markets or exclusive customers? Such qualities are becoming increasingly important for buyers.

Debt. What kind of debt burden do you offer potential buyers? List all outstanding obligations and their amounts, terms and dates of payments. Do what you can to reduce what you owe because large debt loads can turn off many buyers.

Personnel. Is your company adequately staffed? Or would a buyer consider you overstaffed (requiring layoffs) or understaffed (requiring new hiring)? Are management positions held by the best-qualified people who add strategic value to the business, or would a new owner need to overhaul your organization?

As you list your company's competitive advantages, think of how you can emphasize these to prospective buyers. At the same time, try to minimize disadvantages. In some cases, this may mean waiting a year or two before entering the M&A market.

Combining the two strains

By running your internal and external checklists concurrently, you can narrow down the list of potential buyers to the most appealing prospects. At the same time, your internal survey will help determine how best to attract these candidates and allow you to find — and potentially eliminate — flaws that could turn them away.

For example, if your top buyer candidate has a history of being debt-phobic and your internal checklist reveals you have an above-market-average debt load, you've located a potential deal-killing conflict. If the buyer is still your top choice, your company now has a direct incentive to improve its debt ratio before contacting the company for a potential deal.

What's important

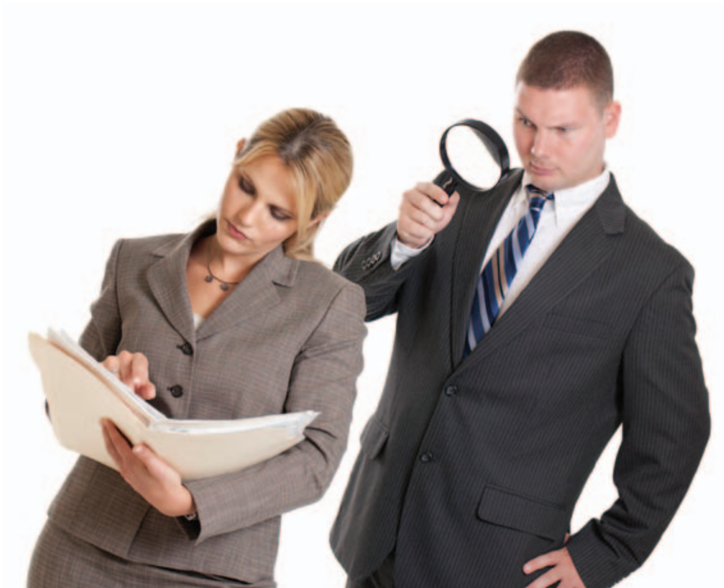
It's one thing to create a buyer wish list and another to find the ideal candidate ready and willing to acquire your company at a fair price. But internal and external checklists can help you focus on the deal process ahead and identify what's important to you — and to potential buyers. ■

CASE STUDIES

When due diligence findings threaten a deal

The due diligence stage of an M&A deal allows business buyers to make sure they're getting what they bargained for. In most cases, sellers make accurate financial and legal representations to potential acquirers. But what should buyers do when they uncover a serious — and previously undisclosed — issue that threatens the value of their deal?

The following describes four due diligence scenarios and how buyers acted on their findings.



1. The case of the criminal owner

Everything about the company seemed perfect — until the buyer's attorney performed a litigation search and discovered that the selling company's owner had been convicted of a felony 12 years earlier, before he founded the business. The owner had planned to stay on to run the company after it was sold, but the buyer believed his presence would be too risky. The buyer also worried about the accuracy of the seller's financial statements.

It called in a forensic accountant to review the seller's financials for signs of fraud. After determining that the statements were clean, the buyer renegotiated the deal so that the owner would have no further association with the company once it was sold. Although many buyers require the continued involvement of key personnel after an acquisition, the buyer in this case decided it could be successful with new management.

2. The case of the not-so-key employees

The buyer needed an experienced management team that would continue growing the business after the deal closed. But when a member of the buyer's due diligence team interviewed the company's chief financial officer, chief operations officer, and sales and marketing director, their answers to basic questions seemed tentative and lacking in substance. Digging further, she discovered that all three had been hired in the past six months to bolster the company's image.

A new management team that lacked in-depth knowledge of the business represented too much risk for the buyer. It decided not to move forward on the deal.

3. The case of the lost customer

When a buyer's representative interviewed its target's biggest customer — responsible for 25% of the company's sales — it learned that the customer would be withdrawing its business due to a change in strategic direction. The customer had informed the seller four months previously, yet the seller hadn't disclosed this development, which would adversely affect future profitability.

Buyers typically protect themselves from this type of scenario with a material adverse change clause in their purchase agreement. Such clauses cover events that occur between the signing of a letter of intent and closing. In this case, the buyer was spooked by the seller's dishonesty and decided to take advantage of the clause and walk away.

4. The case of the missing COBRA

While reviewing documents related to employee benefits, a buyer discovered that the seller had neglected to inform terminated employees of their rights under COBRA. Federal law requires employers to give former employees the option to keep their health insurance — if employers don't, they can face severe penalties. In this case, the company's exposure was estimated to be several million dollars.

Instead of abandoning the deal, the buyer asked the seller to indemnify it against any future claims related to COBRA. The buyer also asked a benefits expert to go over the company's employee benefits program with a fine-tooth comb to ensure there were no other irregularities.

End of the deal?

As these cases illustrate, due diligence can uncover a wide variety of potentially damaging issues. It's important for buyers to work with their financial and legal advisors to determine whether such problems are surmountable — or signal the end of the deal. ■

Ask the Advisor

Q. Should I consider a "handshake" agreement?

A. Although most M&A transactions involve multiple phases and extensive negotiations, some companies turn handshake agreements into actual deals. Typically made between two CEOs or owners, this type of agreement can be a viable option for certain types of companies. But the timing and conditions must be right.

Niche is best

In most handshake agreements, the seller is a small private business that isn't officially for sale. After brief negotiations with a potential buyer that forgoes extensive upfront due diligence, the business agrees to sell. Because such transactions can be risky, they're best made between similar companies. Participants in same-sector deals are more likely to already understand one another's business, which improves the odds of compatibility and makes for easier integration.

In 2010 and 2011, hazardous goods transporter Odyssey Logistics & Technology successfully executed four such transactions. A specialized business within a narrow market niche, Odyssey targeted only those companies that would support its existing operations. Among the targets its CEO approached were a rail transport business and a packaging logistics company, and the deals have since closed successfully.

Why do it?

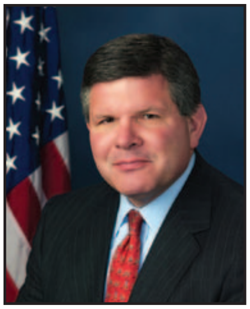
Speed is an obvious selling point for handshake agreements. After informal talks and a brief exchange of information — such as providing the buyer with recent financial statements — the buyer offers a price and the seller accepts. This doesn't mean that the buyer skips due diligence. Although simplified deals reduce the need for a large team of advisors and extensive negotiations, smart buyers always examine the selling company's legal and financial documents before the transaction closes.

Handshake agreements often allow sellers autonomy in continuing to run their businesses. After their deals closed, Odyssey's sellers retained their current employees, management and facilities. Impromptu sales tend to be more agreeable for both parties when they're essentially a transfer of ownership that doesn't affect the company's day-to-day operations.

Sellers also enjoy strong negotiating power. Most don't have to sell, so there's no pressure to accept an unappealing offer. And if the buyer wants to close the deal quickly, it may need to provide incentives such as a higher price or better terms.

Unusual but intriguing

Handshake agreements remain relatively rare, but in the right circumstances they can benefit smaller companies. If you're approached by a buyer with a great offer, it may be worth taking a chance on a handshake. ■



Gilbert A. Herrera founded Herrera Partners in 1992, a private investment banking firm that provides acquisition advisory services including allocation of purchase price and fairness opinions, SEC and FASB compliance services, impairment studies and valuations to our corporate clients; damage, proximate cause and expert testimony services to our legal clientele and restructuring services including the sale/disposition of non-core assets as part of debt restructuring and pre-packaged plans. He formerly served as director of Coopers & Lybrand's Southwest region corporate finance group. Previously, he was the senior investment banker for Underwood, Neuhaus & Co.

Mr. Herrera graduated from the University of Texas at Austin in 1978, where he is a member of the Dean's Council for the McCombs School of Business, MBA Investment Fund, Ex-Students' Association board of directors, Littlefield Society and Executive Committee of the Chancellor's Council of the University of Texas System. By appointment of the Texas Supreme Court, Mr. Herrera served two terms as a public member of the Commission for Lawyer Discipline from 1993 to 1999 and Chaired their Budget Committee. In 2001, Mr. Herrera was appointed by Governor Rick Perry as Chairman of the General Services Commission and its transition to the Texas Building and Procurement Commission. He currently serves as on the executive committee and board of directors of Neighborhood Centers, Inc., Chairman of CHRISTUS Health Gulf Coast, Chair-elect of the Houston Hispanic Chamber of Commerce, Vice Chair of Business and Financial Affairs for UTMB's Development Board and Chairman of the Investment Committee of the Texas Exes Scholarship Foundation. He is a past President of the Houston Chapter of the Turnaround Management Association, the leading education and advocacy group dedicated to the corporate renewal industry.

In 1995, he received the Outstanding Young Texas-Ex award from the Ex-Students' Association and previously served on the University of Texas at Austin's Commission of 125, *Planning for the Future*. In 2008, he received the Chairman's Award for Distinguished Service to the Houston Hispanic Chamber of Commerce.