# Merger & Acquisition Focus

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Ask the Advisor

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# Working the table

## NEGOTIATION TIPS FOR BUSINESS SELLERS

No matter how well an M&A deal seems to be progressing, it can meet a swift demise in negotiations. Deal negotiations may be the single most important — and the most challenging — stage of a transaction. If both buyer and seller aren't committed to serious, dispassionate and productive discussions, a minor disagreement can lay waste to the parties' work leading up to that point.

Deal negotiations can be particularly difficult for first-time sellers. If you're selling your business, prepare for possible disagreements and determine how you'll try to resolve them *before* you sit down at the negotiation table.

### Prep work

If it took you years to build your business and you consider your employees part of your family, you may get emotional when it's time to negotiate with a buyer. But if you do your homework and get to know your buyer, you'll feel more comfortable negotiating sale terms — and eventually handing off your company.

Although due diligence is generally considered a buyer's responsibility, sellers concerned about the future of their company and its people also need to conduct substantive research. Ensure your prospective buyer has a good reputation and stable operating history and that its principals have never been convicted of fraud-related or other crimes. If the buyer has made previous acquisitions, find out how successfully they were integrated and whether they flourished postmerger.

Most important, ensure that your prospective buyer is capable of financing an acquisition. If the buyer doesn't have adequate cash, has it lined up bank loans equal to the amount you're asking? Some buyers ask sellers to help with financing by accepting a portion of the purchase price out of future cash flows. If that's the case with your deal, thoroughly research your buyer's ability to grow a business.

*Be sure that any concessions you make mean something and that you receive concessions of equal value from your buyer.*

Establishing a negotiation "calendar" can also help both you and the buyer focus — and avoid conflict — when talks begin. List the critical topics of discussion and assign rough times or dates that will keep your meetings on course.

Also draw up ground rules. For example, to circumvent impasses, you and the buyer may want to agree to temporarily set aside contentious issues to work on more productive ones.

## Game day strategy

When you finally enter negotiations, keep some time-honored negotiation strategies in mind:

**Don't concede anything for nothing.** You're not going to win every battle — nor should you expect to. But be sure that any concessions you make mean something and that you receive concessions of equal value from your buyer. If you accept a lower price than originally discussed, for example, you might ask for payment in cash. (See "Beyond price" at right.)

**Always move strategically.** Every round of negotiations should move your interests forward in some way. For example, the Harvard Business School has found that when sellers propose a high opening price — even one that's unrealistic — buyers tend to counter with higher initial offers than they would otherwise.

**Know when to fold.** If negotiations drag on for weeks and don't seem to be getting anywhere, don't feel that you *must* complete the deal simply because you've already exerted time and energy on it. Establish an absolute price floor (or other "must have" concessions) and, if the buyer won't accept it, be ready to walk away.

## Experience and objectivity

M&A deal negotiations can be intense situations in which a seller's personal pride and a buyer's ambition may easily collide. So you need to expect some turbulence. Your advisors can be particularly helpful at this stage of a transaction because they have extensive negotiation experience and are better able to remain objective through the process. ■

## Beyond price

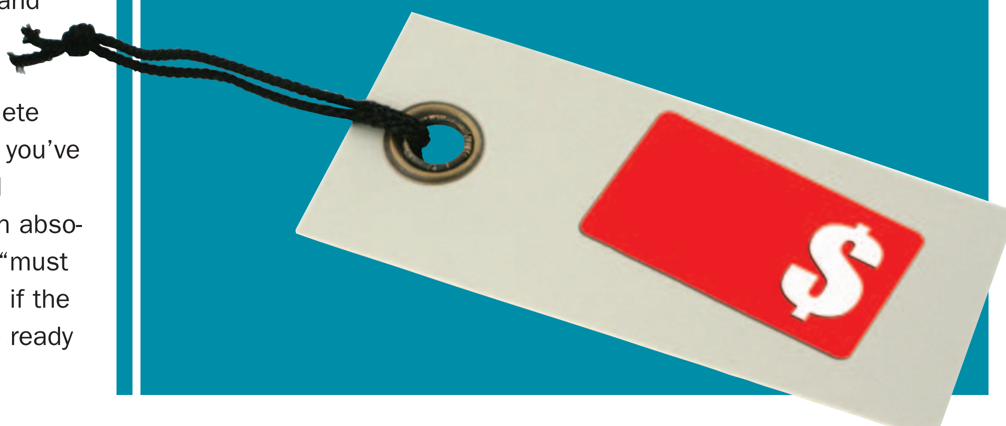
Business sellers tend to get tunnel vision when it comes to price: They have a number in mind and fixate on it. But if you demand the highest possible amount — and refuse to budge during negotiations — you're probably missing the forest for the trees.

On the other hand, if you're willing to bend on price, you may be able to win substantial concessions on other fronts and ultimately realize a better deal. Such concessions include:

**Type of compensation.** You might accept a lower price if it's delivered in an appealing format such as cash. Or, if you have longer-term investing goals and believe in your buyer's ability to increase share value, you might lower your price in exchange for stock options.

**Extra protection.** You might be more flexible on price if your buyer agrees to some seller-friendly deal protections — for example, substantial financial penalties if the buyer pulls out of the deal after a certain stage.

**Lower taxes.** At first glance, your deal's tax structure may seem like a second-tier priority. But if the proposed structure exposes you to higher taxes, you may be able to negotiate a better one — that will result in *more* in your pocket posttax — by lowering your asking price.



# Financing your second business venture

Jeff and Elaine spent 15 years building their technology business, and when the time was right, the married couple sold it for more than they'd expected. While Elaine enjoyed her early retirement, Jeff decided — within 12 months of leaving the business world — to acquire another technology company. Almost immediately, he learned that buying a business is very different from selling one.

Entrepreneurs like Jeff often believe the second time around will be easier. In some respects, that's true. Product development, leadership, money-management, marketing and sales skills are all likely to translate to running a new venture. But second-time owners first must surmount major financial obstacles.

## Leveraging experience

Entrepreneurs are rarely able to afford to buy a business the size of their former one. Jeff, for example, was certainly qualified to run a company as big as the one he'd sold. But after paying capital gains tax and setting aside enough to allow Elaine to enjoy a long, comfortable retirement, he didn't have the resources to buy one that large.

*Private equity groups apply rigorous valuation methods to calculate price and will walk away from a deal rather than overpay.*



Most entrepreneurs must borrow money at some point, generally from commercial lenders. A loan applicant's accomplishments and prior banking relationships can be critical to getting in the door. But banks rarely loosen their rigid lending guidelines, no

matter how good the entrepreneur's previous performance. If you've tried and have been unable to get adequate bank financing, consider applying to junior or mezzanine lenders, or ask whether your target's owner is willing to partly finance the deal.

Regardless of the types of lenders you're approaching, it's rare to get a deal done with less than 25% equity. Even if you can get the loans you need, beware of operating a company that's overburdened with debt. It leaves you a razor-thin margin for error.

## Teaming up

Another financing option is to take on additional investors. Private equity (PE) groups often partner with experienced entrepreneurs, favoring those who know how to grow a business and are willing to put some of their own money on the line.

These investors tend to deal with mature companies and usually will give you the operational autonomy required to run the company while providing you with board-level advice and support. Look for a PE group that buys businesses in your industry that are approximately the same size as the one you sold. PE deals may range from a few million to billions of dollars.

There are benefits beyond additional capital when working with professional investors — including price. PE groups apply rigorous valuation methods to calculate price and will walk away from a deal rather than overpay. And they perform thorough due diligence to uncover any company issues that may affect future performance. Having completed many acquisitions, such partners understand M&A transactions' complex terms and conditions and are more likely to remain emotionally detached when the "perfect" target comes along.

### Protecting yourself

While a PE partner's interests in making a fair, reasonable acquisition may parallel your own, pay close attention to how the pie will be sliced. Be sure to ask:

- ❖ Will my investment be on the same terms as theirs?
- ❖ Will I get additional stock options for successful operational results?
- ❖ What are my compensation terms?
- ❖ Will I maintain enough autonomy to implement my growth ideas?
- ❖ What happens if major disagreements arise?

It's important to have a knowledgeable M&A advisor working for you on these issues. In addition to locating and screening target companies, your advisor will know the PE groups investing in your area and can match you with compatible ones. Most important, your advisor can negotiate with investors to secure the best terms for you.

### Moving on

With the help of a bank loan and a PE partnership, Jeff eventually bought a company comparable to the one he'd previously sold. And after five years of impressive growth, he decided to sell that one, too. His experience buying company No. 2 was invaluable in acquiring his *third* business. ■

# Why startups pose special M&A risks

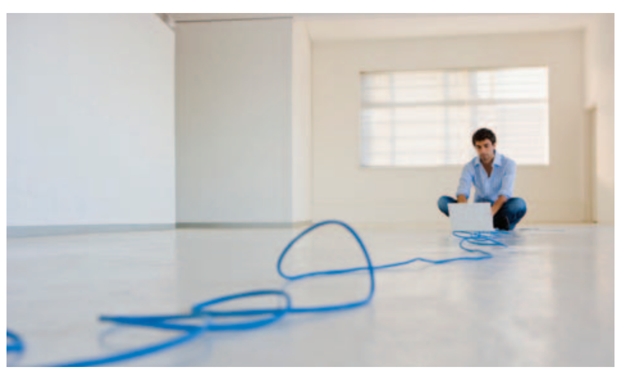
Hoping to enter booming new markets, a large, diversified company decides to acquire a small, innovative startup. What could possibly go wrong? A lot.

Startup acquisitions often are doomed from the beginning because buyers' expectations are too high. For their part, sellers frequently fail to consider how their nimble operation will fare once it's integrated into a large corporate structure. All too often, these seemingly promising marriages end in disappointment.

### Fatal missteps

Going into any merger with unrealistic expectations is a recipe for regret. But when the deal is made between a tortoise and a hare, it's generally fraught with special risks.

The classic example from the past decade is Yahoo!'s acquisition of photo-uploading site Flickr in 2005. The deal was intended to make Yahoo!



the dominant player in online photography. The reality has been less impressive: According to Quantcast, Flickr's monthly usage fell from a high point of roughly 21 million in May 2011 to an estimated 14 million in March 2012. Flickr has lost share to Facebook, the social-media Goliath, as well as to relatively new market entrant Instagram and its popular smartphone apps.

*Ensure that the new unit can continue to do what it does best: innovate and grow.*

According to various analysts, Yahoo! tried to integrate Flickr into its overall corporate development strategy too quickly. The smaller company's managers were required to spend so much time and energy meeting internal engineering integration deadlines that they missed out on innovation opportunities.

With little social-media experience of its own, Yahoo! also made decisions that alienated Flickr users and injured its online reputation. For example, it began requiring Flickr users to sign on to the site with a Yahoo! ID.

## Buyers beware

Most buyers, understandably, want to integrate an acquisition into their overall operations quickly. But it's worth going slow to ensure that the new unit can continue to do what it does best: innovate and grow.

Buyers also must exercise caution when they're novices in a market. The Internet, for example, is notoriously difficult for more-established companies to penetrate. If you've purchased a startup for its Web savvy, make sure you take seriously its managers' advice regarding future business strategies.

## Advice for sellers

Startup sellers also must be wary. Inflated expectations of postmerger autonomy can make the reality of integration a jarring experience. Owners may know their product and market and resent outside interference. But once they've accepted a buyer, they must be prepared to make compromises.

Instead of resisting every suggested change, principals who remain with the startup postmerger must pick their battles. Before the deal is final, owners and managers need to identify the company's core components that generate value and the areas that will provide the most future growth. Then they should focus on defending those interests above all others.

## Match game

Whether you're a startup buyer or seller, pay close attention to compatibility and other issues that could derail your deal in the long run. For example, is the acquisition being spearheaded by one unit — such as the buyer's business development team — but then being turned over to another unit that may have far less enthusiasm for the purchase? Is the buyer making the acquisition simply to quash a competitor or does it plan to provide resources and support that will enable the new unit to grow?

Buyers should ensure that their acquisition meets the company's greater strategic objectives and that all relevant managers are on board with the decision. Sellers must research the buyer's record with previous acquisitions and meet with the buyer's managers who will actually oversee the unit.

## Gem of a deal

Startup acquisitions can work. In the best scenarios, the buyer expands its product lines and market share and the seller grows bigger than it ever would have on its own. But a deal that preserves the spark of what made the startup shine in the first place is a rare gem and requires care and attention. ■

# Ask the Advisor

## *Q. Should I be concerned about hostile bids?*

**A.** Sometimes buyers make unsolicited offers to companies that aren't planning to sell or aren't yet ready for the market. While most unsolicited buyers take "no" for an answer — or improve their offer until the target company says "yes" — some attempt a hostile takeover.

### 2 approaches

Hostile takeovers primarily concern public companies, and their objective is to acquire enough shares to control management decisions. Typically, buyers directly appeal to shareholders using one of two approaches:

**1. Making a tender offer.** The buyer offers a fixed price per share that's higher than the target company's current trading price. Tender offers generally have time limits and come with a list of provisions, such as noncompete clauses, that the company must abide by.

**2. Starting a proxy fight.** Here the buyer tries to convince a majority of the target's shareholders to vote in new directorial and management teams that will be amenable to the buyer's offer.

Privately owned businesses can experience something similar when unsolicited buyers convince one or more owners to sell in opposition to the wishes of one or more other owners. If, for example, a company is partly owned by a private equity group, these outside investors could decide they want to accept the unsolicited offer. If they own more than 50% of the business, management may not be able to stop them.

### Defensive moves

If your company is the target of an unsolicited bid that's unacceptable, you'll need to prepare yourself for a fight. Fortunately, you have several built-in advantages.

Hostile bidders have no right to conduct the customary amount of due diligence that a solicited buyer would receive. So the buyer goes into battle armed with only public information. In the case of a public company, this might be a lot. But a private company can keep wavering investors in line by using its exclusive information about market share and future growth plans to argue that a hostile offer is too low.

Hostile bidders generally also have capital constraints. Banks are less willing to provide financing for a deal in which one party is unwilling — particularly when competition for scarce credit is fierce. Holding the line on price can force a hostile bidder's hand.

### Know when to fight

Keep in mind that resistance isn't always prudent. If your company had planned to sell in the near future, an unsolicited bid could be an easy way to jump-start the process. But if the situation devolves into a hostile takeover, know your options and enlist the help of experienced advisors. ■

**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, 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 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 Chair of the Houston Hispanic Chamber of Commerce, Chair of the Greater Houston HealthConnect and on the board of directors of CHRISTUS Health Gulf Coast and Community Health Choice, Inc., a Medicaid HMO serving 250,000 members throughout Southeast Texas. 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. He has authored numerous articles and publications (http://www.herrera.com/newsletter.html) on the financial industry and has spoken at numerous conferences and forums on various topics including debt restructuring, operational turnarounds, bankruptcy and financing alternatives.