Merger & Acquisition Focus

Year End 2012

Convincing companies to stop saving and start buying

Express ride
Tuck-in mergers take a direct route to integration

Keep your M&A deal's details under wraps

Ask the Advisor

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Convincing companies to stop saving and start buying

It's no secret that M&A activity has been sluggish in the past year. What many owners trying to sell their business might not know is that corporate buyers are responsible for much of this inactivity. Continuing a five-year trend, companies are hoarding cash rather than using it to finance acquisitions.

The challenge for sellers is to convince buyers to climb down off their mountains of cash. Although there's nothing you can do about the economy, you can minimize perceived risks and enhance your company's profile.

Cash cushions

It's easy to understand why buyers are wary. The recovery of the U.S. economy has been glacial, and a new contagion — such as the European debt crisis or Middle East political instability — could possibly send markets plunging again. For risk-averse companies, cash provides a safety net.

In the latest annual *Liquidity Survey* by the Association for Financial Professionals (AFP), 77% of the 391 U.S. and international respondents said safety is their most important short-term investment objective.

The numbers back them up: 41% of survey participants held larger cash balances in the first quarter of 2012 than in the first quarter of 2011, and 78% said they expected their cash balances to stay the same or increase in 2013.

Determine how your business can help buyers achieve specific strategic objectives, including increasing their market share in a particular sector.

Smart selling

In such an environment, you need to be well positioned and ready to approach potential buyers with a convincing sales pitch. Be prepared to make the case that even in a flat economy your company is valuable and won't remain on the market for long.

With that in mind, consider doing the following:

Get lean and mean. The last thing risk-averse buyers want is an acquisition that will raise expenses and add debt to their balance sheet. If possible, pay down outstanding debt or take advantage of current rock-bottom interest rates and negotiate more favorable terms from your lenders. You might also extend payable terms, speed up receivables or liquidate aging inventory and equipment.

Target strategic buyers. Financial buyers (for example, many private equity funds) are more likely to stay on the sidelines if they don't spot low-priced opportunities. Strategic buyers, on the other hand, may be willing to move quickly for the right company — and pay a good price for it.

Look for companies in your industry that have made acquisitions in the past. Then determine how your business can help them achieve specific strategic objectives, including increasing their market share in a particular sector or expanding an internal division with new products such as complementary services, intellectual property or niche technologies.

Appeal to market sense. When talking with potentially interested buyers, highlight any increases in profitability your company has experienced in recent years. Point out that buying your business is a more lucrative investment than sinking cash into low-yield bonds — which is where three-quarters of the AFP survey respondents reported they've stashed at least part of their cash. Counter concerns about risk by pointing out the steady nature of your profits, as opposed to the volatility of the general stock market.

Keep your options open

It's a buyer's market, so it's probably unrealistic to assume you'll sell your business right away for your asking price. If you've found an appealing buyer and want to expedite the deal, consider nontraditional options. You might, for example, offer to finance part of the deal yourself. (See "Making seller financing work" at right.)

Or, if a buyer doesn't have the appetite for a full-company purchase now, propose a partial sale in which you spin off a unit or division. Ideally, such a divestiture would be made contingent on a buyer's commitment to purchase your entire company at a later, specified date or if your company meets a set of agreed-upon performance benchmarks.

A simple argument

As an owner, you know that a buyer's fear of committing cash isn't irrational. The entire business community is anxious to see the economy fully recover. But that doesn't mean putting growth initiatives on hold. Companies that are confident they'll succeed in the current adverse conditions will strike when they find the right deal. Make the case to potential buyers that your business is just that. ■

Making seller financing work

Seller financing is intended to bridge the gap between what a business buyer is able or willing to pay and what the seller believes its business is worth. It can help parties of an M&A transaction to break an otherwise impossible impasse by delivering the price sellers want while reducing the amount of up-front cash.

In a typical deal, the seller accepts interest-yielding promissory notes for the unpaid portion of the purchase price — anywhere from one-third to as much as two-thirds of the total. So for a $1 million acquisition, the buyer might give the seller $500,000 in cash and $500,000 of the payment in medium-term promissory notes, which it then repays over a five- to seven-year period.

It's likely that both parties will request protections. For example, sellers want to know that buyers will make the purchased business a strategic priority and may retain rights to the business if the buyer fails to fulfill the terms of the agreement. Buyers might ask that their promissory notes be voided if the acquired business underperforms according to a mutually agreed-upon set of benchmarks. To be comfortable with these terms, both parties should be confident in the company's long-term prospects.

Express ride

TUCK-IN MERGERS TAKE A DIRECT ROUTE TO INTEGRATION

One of the most efficient types of mergers is the "tuck-in" or "bolt-on" acquisition. In these types of transactions, a buyer purchases a business that provides a core competency at a relatively low cost and quickly integrates it into an existing or new division.

For business sellers, these deals offer potential advantages. For example, a tuck-in can be an ideal next step for a start-up that's expanded as far as it can, given current capital constraints. But tuck-ins can require tough adjustments — particularly for entrepreneurial business owners who are accustomed to independence.

Express acquisition

By acquiring a company that's already established in a market or technological capability, buyers can quickly roll out the new business, offer a new product line or enter a new geographic region. In many cases, this strategy is less expensive and faster than generating new business internally.

Buyers typically seek to acquire specific assets such as a single product line, a manufacturing plant or a trademark.

By the time a tuck-in buyer approaches a seller, it has already determined how the business will integrate into its own operations and how much it can afford to pay. This can cut down on due diligence, negotiation and integration time. Often buyers simply "airlift" particular operations or intellectual property (IP) holdings into an existing division.

Cherry-picking

Tuck-in buyers typically seek to acquire specific assets such as a single product line, a research

and development team, a manufacturing plant, or a trademark at a cost lower than it would take to develop it themselves. Buyers intend to realize cost savings with greater economies of scale and other synergies that can be achieved when the company integrates the acquisition's assets with existing assets.

This means, of course, that the buyer may dispose of the seller's other assets. The buyer of a software company, for example, may keep the company's developers but lay off its marketers because it already has a well-staffed marketing team.

On the other hand, if a buyer is using a tuck-in to enter a new market, it may make its acquisition a separate division, retaining most of its original assets and management. Such was the case when, in May 2012, slot-machine maker WMS Industries acquired online gaming developer Jadestone Group to replace WMS' underdeveloped online operations.

Best candidates

Several types of sellers can benefit from a tuck-in deal — for example:

- ❖ Fast-growing start-ups that can use the resources of a larger company to expand,
- ❖ Financially troubled companies looking for a last-chance deal, or
- ❖ Entrepreneurial owners, such as software designers or other IP creators, itching to move on to the next project.

Although tuck-in buyers typically prefer deals that enable them to buy specific assets at a value price, sellers can still benefit from such transactions. For example, a buyer may be willing to raise its offer substantially if its target has received other acquisition offers. The buyer may also offer attractive financial incentives for the selling owner to maintain an active role in the business.

However, for owners concerned about preserving their business's culture and workforce, a tuck-in deal may not make sense. At a minimum, your business will lose some strategic flexibility. And you'll likely need to bring everything from your IT network to benefits package to office dress standards in line with that of your buyer. Even if a buyer keeps your business intact as a separate division, the unit will have to compete for attention and resources with the company's well-established other divisions.

Look before you leap

For sellers, particularly small start-ups, a tuck-in deal could be an option. Keep in mind that accepting such a deal means, in some cases, that only the assets and personnel your buyer deems valuable are going to make the transition to the new ownership. ■

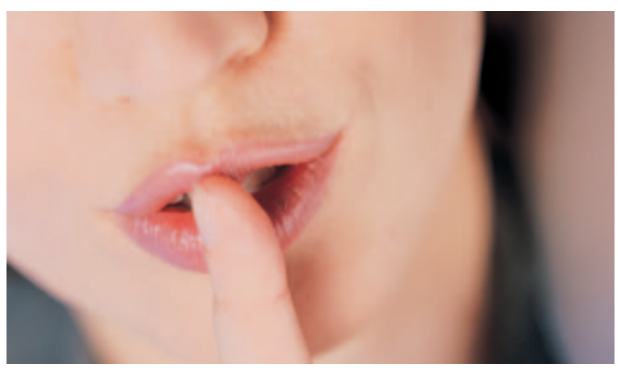
Keep your M&A deal's details under wraps

Less than 50% of all leaked M&A deals close successfully, compared to 72% of all nonleaked deals, and leaked deals take longer to complete. These were the findings of a study conducted by technology solutions provider IntraLinks and London's Cass Business School and released a few years ago.

Whether intentional or inadvertent, leaks can hurt a deal — even one among privately owned middle-market companies. Take steps now to ensure confidential information stays that way.

Informing employees

Leaks aren't necessarily intentional or malicious. In many cases, employees may not fully understand that they've acted improperly — particularly if they're



new to M&A negotiations. So you need to make sure they understand what's expected of them.

Everyone involved in sensitive discussions should sign an agreement promising not to disclose information. Each participant also should receive an explanation of the agreement's key terms, including

what constitutes a confidentiality breach. Be sure to explain that confidentiality agreements apply even to discussions with family members and friends.

Unfortunately, there may be employees who leak information intentionally for personal gain. To protect against such disclosures, stress the serious ramifications of leaks. Those who use inside knowledge for financial gain, for example, can face criminal penalties, including jail time.

Limiting access

One way to keep the lid on confidential information is to limit access to it. The smaller your M&A deal team, the better — though the team should include enough people and skill sets to evaluate and negotiate the transaction and prepare for the integration stage.

Once your team is set, require that its members be personally accountable for the information they receive. Consider designating one or two individuals as "gatekeepers" to make it easier to keep track of who has access to certain information. To enable your company to easily trace the source of any pages that leak, gatekeepers should keep track of sensitive documents and limit the number of copies that are released. If you're distributing electronic documents, make sure they're password protected. For extra security, use digital rights management software.

Pay attention to details

Even if your team is tight-lipped, you may inadvertently reveal that a deal is in progress with your movements and behavior. Your office, for example, may seem like a convenient place to meet with deal partners, but meeting on your home turf may lead to unwanted attention and rumors. Instead, meet at a secure facility, such as your M&A advisor's office. And be sure the buyer understands your concerns and takes steps to prevent leaks on its end.

Deal team members also need to be careful about technology use. Mobile phone calls can be overheard or intercepted and computer networks hacked. Public wireless connections, such as those available in hotels and cafes, are particularly vulnerable, and deal team members should avoid using them.

Leaks aren't necessarily intentional or malicious. In many cases, employees may not fully understand that they've acted improperly — particularly if they're new to M&A negotiations.

Finally, don't forget to properly dispose of or store confidential documents. Keep a document shredder in your meeting location, and avoid delegating the task of shredding to assistants. Ask a trusted IT manager to ensure electronic files are properly managed and destroyed when they're no longer needed.

Don't take chances

Leaks aren't always dealbreakers, but they can harm a transaction. Information that two large public companies are merging can send their stock prices soaring — or tumbling. Leaks about the terms of a small, private company transaction can create employee resistance or alert competitors to a strategic move before it's complete. Because you can't predict how deal information will be used, ensure it doesn't get out until you're ready to release it. ■

Ask the Advisor

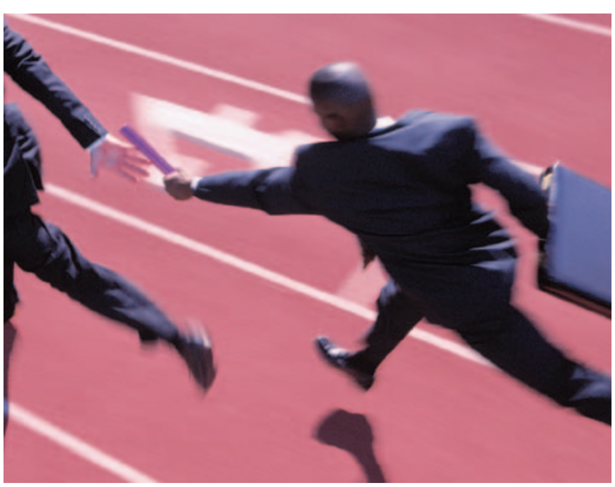
Q. How fast is too fast when selling a company?

A. There's nothing more frustrating for business sellers than a deal that's bogged down in due diligence or negotiations. In many cases, the faster a transaction is completed the better. That said, sellers need to be cautious when a deal seems to be moving too quickly.

Need for speed

Buyers have their own reasons for expediting M&A deals. They may, for example, want to close the transaction within their current fiscal year, or use the deal as a springboard into a new market. Many buyers prefer to close their deals within weeks or even days of announcing them publicly.

Analysts commonly refer to this strategy as keeping "the ice cube from melting" — or minimizing stakeholder uncertainty. Ideally, by the time investors, market analysts and customers learn about the deal, it has closed and integration is underway. This can also help minimize anxiety among employees who might otherwise worry whether the deal will go through and speculate how it may affect them.



Bumps in the road

But M&A parties that move too fast on a deal risk skipping steps or ignoring important details. Beware of the following signs:

Inadequate due diligence. Has the buyer fully explored the seller's financial statements, contracts, company culture and seemingly minor details that could later become major issues? For example, a company may play a significant role in its local economy, and the community is likely to react negatively — even challenge the deal — if the buyer plans to move operations elsewhere.

Ambitious integration. Some small acquisitions can be integrated swiftly. But when companies are, for example, trying to merge large workforces, overlapping sales teams, or two divergent IT networks, ambitious integration deadlines can cause costly mistakes that may actually extend the time it takes to join forces.

Skimping on strategy. Has the buyer mapped out its strategic objectives for the acquisition, including its specific market focus, and determined how long it might be before it expects the deal to be profitable? Or is it devoting all of its energy to closing the transaction first? Failure to plan at the purchase stage bodes badly for the long-term success of any deal.

In perspective

Owners who've carefully prepared their company for sale often are eager to find a buyer and get paid for their years of hard work and dedication. Just make sure your transaction doesn't burn so fast that it flames out before it closes — or before the buyer achieves its objectives. ■

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.