Merger & Acquisition Focus

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Sharing synergy value with sellers

When a business acquisition results in postmerger synergies — such as reduced operating expenses — the savings typically are considered the buyer's reward for negotiating a good deal. However, buyers may want to consider cutting sellers in on their synergy-derived savings. Not only could "sharing the wealth" improve price negotiations, but it also might ease the postmerger integration process by providing sellers with incentives to assist in the transition process.

Add it up

Savings can be derived from a number of postmerger synergies. Some of the most common are:

- Staff reductions, including downsizing offices and consolidating positions,
- Strategic reassessments, such as spinning off product lines or closing down poorly performing divisions, and
- Achieving better economies of scale by, for example, buying more supplies in bulk or reducing IT expenses by consolidating networks.

Simple cost-cutting decisions can add up to substantial figures. Stanley Works' purchase of Black & Decker in 2010 reportedly led to $500 million in savings over three years — thanks in part to Stanley Black & Decker's streamlining of manufacturing processes and cutting of overhead expenses.

Advantage of sharing

Understandably, buyers may be reluctant to share such wealth. But here's why dividing synergy value with sellers can be advantageous — particularly for public companies. By showing investors that both of the deal's parties have a stake in ensuring a smooth transition and quickly realizing cost savings, a sharing strategy can boost the stock price of the newly merged company.

You might concede on price but request a percentage of synergy-related savings over a specific period.

Some buyers already share synergy value with sellers. According to a recent study by Boston Consulting Group and Technische Universität München, the average seller's share of M&A synergies has risen between 2000 and 2011, with sellers now collecting about 31% of deal synergies on average.

Sellers on the offense

What's enabling sellers to get a larger piece of the action? During the recent recession, when bank loans became difficult for buyers to obtain, many sellers stepped in to help finance their M&A deals. In the process, sellers became accustomed to accepting a lower

purchase price at closing for a share of future profitability. For their part, buyers are expected to be more amenable to "creative" financing solutions as interest rates rise in coming years.

Not all deals are created equal, of course. Sellers with a strategic advantage are more likely to ask for — and get — a piece of the pie. A seller in a market or industry in which the buyer has little or no experience (for example, a company located in a foreign country where the buyer is unfamiliar with local business customs and regulations) is in a better position to negotiate. By contrast, a financially distressed or heavily leveraged seller is more likely to be rebuffed.

If you're planning to sell your company and want in on synergy-related savings, start preparing now. Obtain a thorough analysis of your future annual growth potential and accurate estimates of savings that could be achieved from consolidation. Armed with this information, you'll be in a good position to ask for a percentage of any potential synergy-related savings on top of the agreed-on sale price.

Or you might concede on price but request a percentage of synergy-related savings over a specific period (one to three years is typical). Buyers find this latter proposal appealing because it reduces the price *and* lowers their risk. If the merged organization fails to save on synergies, the buyer has no further obligation to the seller.

Two-way street

Sharing postmerger integration savings won't appeal to every business buyer. But if you're on either side of the negotiation table, you need to understand the potential benefits that might be derived from sharing the postmerger wealth. ■

First step: Find the savings

Before making any synergy-savings-related concessions, parties to an M&A deal must first identify and value potential synergies. Such synergies typically break down into two broad categories:

1. Cost. These are simple to visualize and predict. For example, a buyer and seller can easily come to terms on the amount likely to be saved by consolidating accounts payable. When steelmakers Arcelor and Mittal merged, for example, they reportedly reaped millions of dollars by consolidating marketing and trading operations, optimizing manufacturing processes, and reducing administrative costs.

2. Revenue. These are harder to quantify and are affected by many other factors, such as interest rates and market conditions. For example, a buyer might be able to cross-market its acquisition's products to its own current customers and vice versa. Lower costs might also enable the company to offer more competitive pricing, which can increase market share. However, coming up with an accurate estimate of such future revenue is difficult.

In fact, deal negotiations might go more smoothly if revenue synergies are taken off the table. However, such synergies can be quite lucrative — which is why many sellers push to include them.

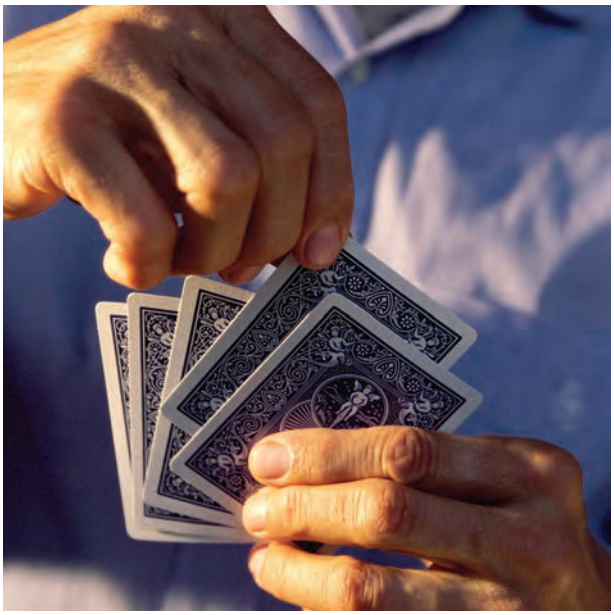
Merger not in the cards? Consider a strategic alliance

Deborah's small automobile-parts company was growing quickly. But when the company landed a contract with a large Detroit factory, she realized it wasn't growing quickly enough. Deborah considered selling her business, but neither the strategic buyers nor the private equity groups she talked to offered what she considered a fair price.

That's when her M&A advisor suggested she look for a strategic alliance partner — a company with a similar market focus that offers complementary products, new markets, or supply chain efficiencies. When chosen carefully, such alliances can enable businesses to assume projects otherwise out of their reach — not to mention increase revenue and market share.

Joint risk, joint rewards

Let's look at another scenario: Bill wants to raise capital to better compete in his software company's market, but he also wants to retain ownership and control of the business. A strategic alliance — a joint venture in particular — may be the perfect solution.



Though joint ventures can face many of the same integration challenges of standard mergers, they allow businesses to share some of the risk. They also can potentially generate valuable synergies; for example, they can yield more robust product lines, greater geographical reach and cost reductions related to scale. Meanwhile, the participating companies get to manage their own core competencies.

Most joint ventures are limited in scope to a single project or product, but they can also operate indefinitely.

Pooling resources in a joint venture may enable companies to take on projects that are larger than they would normally accept and increase their ability to raise capital. In addition, a joint venture can boost a company's bidding power and bonding capacity and allow it to tap the unique skills and ideas of a different organization.

Joint ventures require participating companies to create a separate legal entity (generally a corporation, limited liability company or partnership), of which all participating companies are partners. Joint business is conducted via the new entity under strict operating agreements, and the joint venture's accounting records and financial statements are independent of each participating company. Most joint ventures are limited in scope to a single project or product, but they can also operate indefinitely.

Possible alternative

A potential alternative to a joint venture is a contractual arrangement. These short-term collaborations may be appropriate when participants don't

require a formal management structure or single project entity to win bids.

The contract's specific provisions will depend on the complexity of the business arrangement, but it typically addresses:

- Duties and responsibilities of each party,
- Confidentiality and noncompetition,
- Conflict resolution,
- Financial obligations,
- Accounting procedures,
- Intellectual property ownership and rights, and
- Contract termination and exit strategies.

Two businesses might make a contractual alliance to distribute products, but share few financial resources. For example, the partners might both make significant financial contributions to fund capital-intensive investments, such as those in facilities and equipment.

A contractual alliance can grow into a more significant business for its participants. So both companies should seek expert advice to assess their initial legal, financial and operating risks, and benefits, as well as those that potentially come into play down the road.

Keys to success

Before entering into a strategic alliance, carefully consider the risks, including corporate culture clashes and loss of control over operations and proprietary information. To help ensure success, choose a company that shares similar values and business philosophies. For example, if you have an entrepreneurial spirit, partnering with a company that follows a more conservative, risk-averse approach is likely to lead to disagreements.

During the screening process, investigate your potential partner's financial and labor resources, strengths and weaknesses, bonding capacity, and production output. Request copies of the company's financial records for the past five years, interview its clients, and research records for litigation and other legal proceedings in which the company may be involved. You may also want to check legal records for civil actions such as a divorce. An ex-spouse or creditor could attempt to claim your joint business revenue.

Sale or alliance?

Even if selling's an option, your company may decide that a strategic alliance remains the better choice. But don't enter into this type of agreement lightly: Work closely with legal and financial advisors to screen potential partners and to draft a contract that will be to your company's advantage. ■

Tug of war

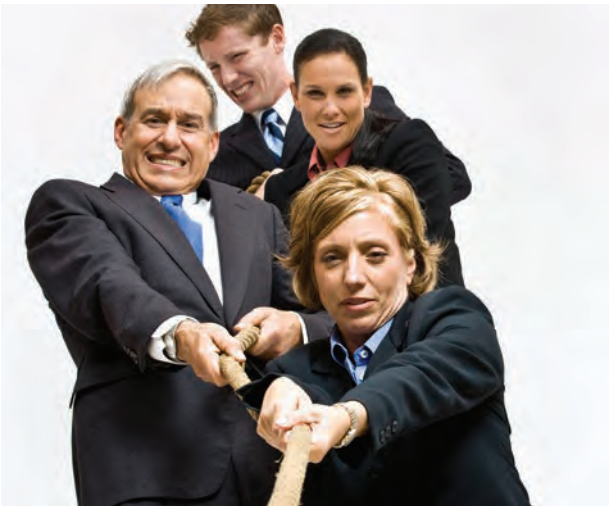
NEW REGULATION AIMS TO PREVENT VALUATION DISPUTES

Determining the fair value of a company can be cause for contention between buyers and sellers. To prevent discord during M&A deal negotiations, sellers need to understand how their company will be valued. This includes knowledge about recent fair-value accounting regulatory changes. Since they went into effect on Jan. 1, 2013, many companies' fair-value assumptions have become subject to buyer challenges.

Fair value defined

Regulators define fair value as the price that an asset would sell for in a transaction between market participants on a given date. This is primarily a *market-based* calculation — meaning that an asset could be overvalued or undervalued depending on how its seller values it internally.

To help avoid disputes, sellers generally should determine fair value by identifying the asset, its



uses and whether it can stand alone or should be valued in conjunction with another asset; deciding the type of market in which the asset could be sold; and determining which valuation methods could be used to appraise it.

IFRS 13

The newly effective International Financial Reporting Standard No. 13 (IFRS 13) provides more detailed guidance on measuring an asset's fair value. IFRS 13 applies to any corporation that's required to disclose fair-value assessments for M&As and other investment transactions.

Companies now have to disclose their assets' fair value by separating them into three tiers:

1. Assets whose prices are determined "objectively" by trading in an active, public market,
2. Assets that trade in less-active markets and may require additional pricing inputs from the company, and
3. Assets whose value is undeterminable via any market context, and so is entirely derived from the company's inputs.

What these new rules mean for sellers is that a prospective buyer could potentially challenge assets in the two tiers that derive value from more subjective factors rather than from current market performance. Using IFRS 13 as a tool, buyers might ask for more "calibration" or concrete explanations of the techniques that a seller has used to arrive at the asset's fair value.

Take a selling company that claims its intellectual property (IP) is worth $3 million — even though the IP has been used only internally and has never been sold to customers. A buyer could ask the seller for a detailed explanation of how it derived this IP value by, for example, comparing the asset with similar products currently in the marketplace.

Recipe for failure

A proposed buyout of Dell Computer by the Blackstone Group demonstrates why sellers should support and communicate their value claims, even when they're not required to do so. While asking its shareholders to approve Blackstone's buyout offer, Dell declined to make short-term growth projections or disclose other internal pricing information. Some shareholders became concerned that the company was being undervalued and were considering rejecting Blackstone's offer as too low even before Blackstone pulled its bid.

During this period, Dell released its disappointing first-quarter operating results. Based on this release and Blackstone's own due diligence research, Blackstone decided that Dell wasn't worth what it had initially thought it was. On April 19, the private-equity firm withdrew its original offer.

To help avoid situations such as this, be sure to retain advisors to value your company and provide supporting evidence to prospective buyers. Your buyers are more likely to accept that your numbers are reasonable.

Alleviate headaches

Disagreement over a selling company's value is part and parcel of M&A deal negotiations. But the process runs more smoothly and the transaction is more likely to close successfully when sellers are realistic about value and able to support their claims. Smart business buyers have always closely scrutinized their target's price. But regulatory rule changes now provide buyers with the tools to demand greater transparency. ■

Ask the Advisor

Q. How might rising interest rates affect my merger?

A. The Federal Reserve has held interest rates at rock-bottom levels for more than four years, but there's growing economic pressure to boost them again. So if you're considering a business purchase or sale, you might want to move relatively soon to avoid the effects of possible rate upticks.

That said, interest rates aren't likely to rise dramatically in the next six months. Last December, the Fed said that it would keep rates near zero percent so long as the U.S. unemployment rate remained above 6.5% and inflation grew modestly. However, if you're looking forward to 2014 and 2015, economic and political developments could boost rates and affect your M&A deal.

Politics and policy

Since 2008, the Fed has held the Fed Funds rate below 1%, but some critics in Congress are urging moderate rate hikes. A recently proposed bill would "establish a commission to examine U.S. monetary policy" that could require the Fed to set rates based solely on inflation. If the bill becomes law, the Fed may have more incentive to raise rates at signs of inflationary activity, regardless of other conditions.

When Fed chairman Ben Bernanke's current term ends in January 2014, he isn't expected to be nominated again. His successor could face serious congressional opposition and it's possible the President will nominate a more inflation-minded successor.

Pushing back on price

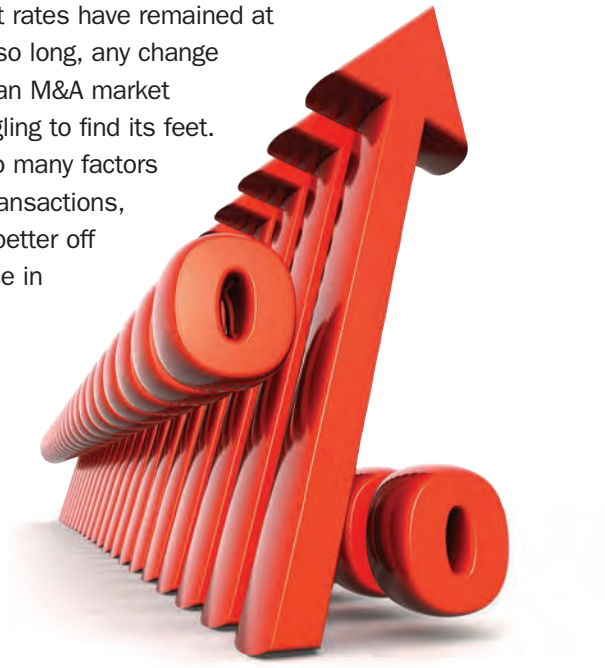
How exactly could these changes at the Fed alter the M&A deal landscape? Buyers may accept a higher-than-expected acquisition cost in a low interest rate regime because they can cheaply finance the deal. But in a rising-rate period, buyers might push back sharply on price if capital is more expensive.

When rates rise, deal financing becomes trickier, too. Buyers have benefited from relatively cheap bank loans this year. Selling companies have profited as well, refinancing their outstanding debt at low rates to polish their balance sheets.

But a rising-rate environment could produce more conservative, cost-minded buyers. When banks finance part of a deal, sellers may be pressured to concede on pricing and other deal terms. The overall M&A deal rate could once again decline, or sellers increasingly could have to finance part of their deals and recoup earnings from future operations.

One of many factors

Because interest rates have remained at rock bottom for so long, any change could shake up an M&A market that's still struggling to find its feet. However, with so many factors affecting M&A transactions, you're probably better off focusing on those in your control. ■



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 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 Chairman of the Houston Hispanic Chamber of Commerce, the largest Hispanic business-oriented, membership organization in the country; a Mayoral-appointee to Rebuild Houston Oversight committee charged with providing oversight regarding the dedicated street and drainage fund; and Vice Chairman of the Business and Financial Affairs committee of the Development Board for the University of Texas Medical Branch. 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.