

ANDREW J. SHERMAN

MERGERS & ACQUISITIONS

FROM A TO Z

Third Edition

- Best practices for structuring profitable deals during turbulent markets
- Effective ways to raise the capital needed to get deals done
- New due diligence rules and strategies in the age of Sarbanes-Oxley
- Guidelines for keeping deals on track and managing post-closing challenges
- Valuable tools, checklists, and sample forms

MERGERS & ACQUISITIONS

— FROM A TO Z —

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Andrew J. Sherman

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Introduction to the Third Edition

“It was the best of times, it was the worst of times.”

When Dickens first shared this quote with the world, he was not referring to the merger and acquisition (M&A) market from 2005 to 2009, but he might as well have been. In the time between the publication of the second edition of this book in 2005 and today, the overall financial markets and the levels of M&A activity have experienced both polar opposites and everything in between. From the seemingly insatiable appetite for middle-market companies that private equity firms and other buyers had in 2006 and 2007, thereby driving valuations through the roof, to the fast ending to the party and the sobering effects of a virtual halt in 2008 to 2009, sending valuations on a downward spiral, this was not a good time if you prefer merry-go-rounds to roller-coaster rides at the amusement park.

According to mergermarket, the total number of deals announced worldwide in the first half of 2009 numbered 3,873, with a total value of \$709 billion. These figures represent the worst six months on record since the end of 2003. While merger and acquisition activity in the United States increased slightly in terms of the number of deals from the first quarter of 2009 to the second quarter of 2009, the total deal value fell from \$183 billion to \$171 billion, according to Bloomberg.

Mergers and acquisitions are a vital part of both healthy and weak economies and are often the primary way in which companies are able to provide returns to their owners and investors. Mergers and acquisi-

tions play a critical role in both sides of this cycle, enabling strong companies to grow faster than their competition and providing entrepreneurs with rewards for their efforts, and ensuring that weaker companies are more quickly swallowed or, worse, made irrelevant through exclusion and ongoing share erosion.

Mergers and acquisitions have played a variety of roles in corporate history, ranging from the “greed is good” corporate raiders buying companies in a hostile manner and breaking them apart, to today’s trend of using mergers and acquisitions for external growth and industry consolidation.

During the 1980s, nearly half of all U.S. companies were restructured, more than 80,000 were acquired or merged, and over 700,000 sought bankruptcy protection in order to reorganize and continue operations. The 1980s featured swashbucklers and the use of aggressive tactics to gain control over targets. The 1990s were equally dynamic in terms of companies evolving through upsizing and growth, downsizing, rollups, divestitures, and consolidation, but focused on operational synergies, scale efficiencies, increases in customer bases, strategic alliances, market share, and access to new technologies. This period, however, came to a crashing end with the bursting of the tech bubble and the global recession that followed.

The wave of M&A activity seen from 2004 to 2007 was driven by the more general macroeconomic recovery and several key trends. First, many companies had exhausted cost cutting and operational efficiencies as a means of increasing profitability and were looking to top-line growth as a primary enabler of shareholder return. The increased pressure to grow turned the spotlight on the opportunity to achieve growth through acquisition. Second, the M&A market had been supported by the return of corporate profits and, with them, improved stock price valuation. The improved valuations enabled corporations to leverage their internal currencies to acquire target companies that were willing to swap their illiquid private stock for valuable public-company shares. Third, interest rates were hovering at historical lows, enabling firms to cost-effectively utilize debt to finance acquisition-based growth.

From 2008 to late 2009, the most recent wave of M&A activity was driven by weak economic conditions around the globe. The strong, cash-rich companies and firms began bargain shopping, picking off distressed and downtrodden competitors at a fraction of their market value compared to expectations just a short 12 to 18 months earlier. Large and midsize companies began to refocus on their core business lines,

triggering divestitures and spin-offs of underperforming divisions or subsidiaries. Private equity firms and even hedge funds, under pressure to provide returns to their limited partners, turned stepchild investments into small buckets of cash in order to hold off a tyranny or management overthrow.

Yet, although so many dollars have been changing hands, the number of readily available resources for business executives and professional advisors to turn to for strategic and legal guidance on mergers and acquisitions remains very limited. This book is intended to be such a resource.

There is no more complicated transaction than a merger or acquisition. The various issues raised are broad and complex, from valuation and deal structure to tax and securities laws. The industries affected by this rapid activity are also diverse, from banking and computer software companies to retailers and health-care organizations. It seems that virtually every executive in every major industry faces a buy or sell decision at some point during her tenure as leader of the company. In fact, it is estimated that some executives spend as much as one-third of their time considering merger and acquisition opportunities and other structural business decisions. As we will see in the chapters to follow, the strategic reasons for considering such transactions are also numerous, from achieving economies of scale, to mitigating cash flow risk via diversification, to satisfying shareholders' hunger for steady growth and dividends.

The degree to which the federal government intervenes in these transactions varies from administration to administration, depending on the issues and concerns of the day. During the Reagan-Bush years, the government took a passive role, generally allowing market forces to determine whether a given transaction would have an anticompetitive effect. During the Clinton years, regulatory bodies took a more proactive approach, with more intervention by the U.S. Department of Justice and the Federal Trade Commission, such as a refusal to provide the necessary approval for the proposed merger of Staples and Office Depot in mid-1997. The second Bush administration took a more laissez-faire approach, only to have the European Union take a more aggressive role in preventing potentially anticompetitive mergers. The European Competition Commission's landmark rejection of GE's proposed acquisition of Honeywell in 2001 signified a shift in the role that the EU played in the global M&A marketplace. Under the Obama administration, we are likely to see an increase in antitrust and regulatory

oversight, but also an anxiousness to facilitate transactions that will be beneficial from an economic recovery perspective.

Recent years have also seen a significant increase in merger and acquisition activity within industries that are growing rapidly and evolving overall, such as health care, information technology, education, infrastructure, and software development, as well as in traditional industries such as manufacturing, consumer products, and food services. Many of these developments reflect an increase in the number of strategic buyers and a decrease in the amount of leverage used, implying that these deals were being done because they made sense for both parties, which is very different from the highly leveraged, financially driven deals of the late 1980s.

The small- to middle-market transactions have clearly been the focus of this book in each of its editions since the 1990s. Fortunately for this audience, middle-market transactions continue to attract compelling valuations.

Companies in the small- to middle-market segment need to understand the key drivers of valuation, since they are often able to focus their operating goals in order to maximize the potential valuation range. Therefore, it is important to know that the multiple a company achieves for its business is directly correlated with the following seven characteristics:

1. Strong revenue growth
2. Significant market share or a strong niche position
3. A market with barriers to entry by competitors
4. A strong management team
5. Strong, stable cash flow
6. No significant concentration in customers, products, suppliers, or geographic markets
7. Low risk of technological obsolescence or product substitution

Successful mergers and acquisitions are neither an art nor a science, but a *process*. In fact, regression analysis demonstrates that the number one determinant of deal multiples is the growth rate of the business. The higher the growth rate, the higher the multiple of cash flow that the business is worth.

A study of deals that close with both buyer and seller satisfied shows

that the deal followed a sequence, a pattern, a series of steps that have been tried and tested. This book focuses on conveying this process to the reader, as we seek to understand the objectives of both buyer and seller in Chapters 2 and 3, move through the process of negotiations and closing in Chapters 4 through 10, and focus on closing and beyond in Chapters 11, 12, and 13.

For example, when a deal is improperly valued, one side wins big while the other loses big. By definition, a transaction is a failure if it does not create value for shareholders, and the easiest way to fail, therefore, is to pay too high a price. To be successful, a transaction must be fair and balanced, reflecting the economic needs of both buyer and seller, and conveying real and durable value to the shareholders of both companies. Achieving this involves a review and analysis of financial statements; a genuine understanding of how the proposed transaction meets the economic objectives of each party; and a recognition of the tax, accounting, and legal implications of the deal.

A transaction as complex as a merger or acquisition is fraught with potential problems and pitfalls. Many of these problems arise either in the preliminary stages, such as forcing a deal that shouldn't really be done (i.e., some couples were just never meant to be married); as a result of mistakes, errors, or omissions owing to inadequate, rushed, or misleading due diligence; through not properly allocating risks during the negotiation of the definitive documents; or because integrating the companies after closing became a nightmare. These pitfalls can lead to expensive and protracted litigation unless an alternative method of dispute resolution is negotiated and included in the definitive documents. This book is designed to share the pitfalls of such transactions, with the hope that buyers and sellers and their advisors can avoid these problems in their future transactions.

Finally, with merger and acquisition activity continuing to grow at rapid rates, and entrepreneurs and venture capitalists continuing to form new entities and pursue new market opportunities, it is critical to have a firm grasp of the key drivers and inhibitors of any potential deal. With so much money on the line, it is essential to understand how to maximize price and valuation goals while ensuring that the transaction is successfully consummated.

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