

MERGER AND ACQUISITION OVERVIEW

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1.1 INTRODUCTION

Historically, mergers and acquisitions (M&As) have always been a factor in the expansion and consolidation of the modern industrial base of the United States and other advanced economies. However, over the last decade or so, M&As have emerged as a particularly significant market force. This trend is reflected in the volume of M&A activity, measured in terms of both dollars and the number of transactions consummated. The dollar volume of M&A activity in the United States exceeded \$1 trillion in 1998 and has reached or exceeded that benchmark almost every year since. During that same period, the number of announced M&A transactions has consistently exceeded 7,500 annually.

Understandably, the largest of these transactions, large public company combinations, have been the most visible. These large transactions typically entail enormous transfers of value and affect thousands of employees and hundreds of thousands of investors. However, smaller transactions, such as those involving the sale of closely held businesses and the divestitures of business units—usually to larger, publicly traded companies—dwarf the number of combinations involving publicly traded entities.

Although these smaller transactions generally fall under the radar of the financial press and the casual business observer, they have consistently accounted for over 90% of all transactions by volume for the last several decades. They are clearly an important source of growth for publicly traded companies and, more relevantly, they are the types of transactions that are very likely to be encountered by business professionals, especially financial professionals, in the course of their careers.

Not only do these transactions differ in terms of size and visibility, they also differ significantly in terms of dynamics and process. The remainder of this chapter discusses these differences and other important factors that provide background and context for the more fulsome discussions of the acquisition and sales process that appear in the chapters that follow. This initial foundational discussion focuses on:

- The role of M&A activity in the context of overall corporate strategy
- Important definitions of, and distinctions among, the various types of M&A transactions
- Descriptions of the various types of transactions, highlighting differences in the nature of their execution
- An overview of the central role the financial manager generally plays in the various types of M&A transactions

1.2 CENTRAL ROLE OF STRATEGIC PLANNING IN THE MERGER AND ACQUISITION PROCESS

(a) **GENERAL.** Any meaningful discussion of M&As should start with an understanding of the role of strategic planning in the corporate decision-making process. Most companies reinforce or update their business development strategy annually. Typically, the end product of this planning process is the articulation of a limited number of strategic objectives whose implementation begins with translating them into concrete investment activities. The categories of the investment options available are limited. They take the form of internal development (build), acquisition (buy), or strategic partnership (ally).

It should also be understood that, even in those cases in which a formal, structured strategic planning process is not employed, a company will still be guided by a stated or implied business strategy that is broadly understood within the organization. That strategy may result

in a planning document, or it may simply be a shared understanding within a business of the need and intent to fill important gaps in the company's portfolio and infrastructure.

An expansive description of the strategic planning process is beyond the scope of this discussion. Suffice it to say that companies typically chart a strategic direction that is expressed in the form of long-term objectives and that the realization of those objectives must be driven by specific investment activities. These objectives typically fall into these broad categories:

- Developing or acquiring new products for current markets
- Expanding the distribution channels for existing products
- Developing or acquiring new products for new markets
- Achieving economies of scale in order to lower production costs
- Increasing brand recognition of products and/or services
- Developing or acquiring new technology, intellectual property, or research and development (R&D) capability
- Establishing control over sources of supply by expanding operations toward suppliers' markets (backward integration)
- Expanding operations toward customers' markets (forward integration)

(b) INVESTMENT CONSIDERATIONS. Frequently, the approach employed to accomplish strategic objectives is purely acquisition-based, but, as noted, acquisitions are just one of the three broad investment options (build, buy, or ally) available to further these objectives. These options are significantly different from one another in terms of risks, benefits, advantages, and disadvantages. The differences revolve around the trade-offs among a number of variables, particularly those of strategic fit, speed of implementation, cost of implementation, and anticipated synergistic benefits.

(i) Strategic Fit. It is axiomatic that the investment option must support the entity's strategic objective. Internal development generally provides the greatest potential for control and customization, and often the greatest assurance of strategic fit. Acquisitions and strategic alliances, when they can be implemented, generally will provide an *approximate* fit. However, occasionally the assets needed to accomplish a key strategic objective are unique, that is, truly one of a kind.

If such an asset does not exist in the marketplace (e.g., customized infrastructure technology), then acquisition can be automatically ruled out as an option. Alternatively, the unique assets coveted (e.g., intellectual property assets) may be owned by another entity, and acquisition of that entity or strategic partnership with it may be the only options available.

(ii) Speed of Implementation. One of the primary factors an enterprise must consider when making an investment decision is the importance of speed in accomplishing the strategic objective at hand. If speed is a primary consideration, acquisition is likely to be the most attractive alternative, assuming some or all of the assets acquired are a good strategic fit. This is particularly the case when market entry or market expansion is the objective. Internal development may provide a more precise fit, but the market opportunity may have passed by the time an internally developed initiative is implemented. Strategic alliances may also be a viable option, but execution can be difficult and time-consuming and, by definition, requires a sharing of the benefits derived.

(iii) Cost of Implementation. Cost is clearly a key consideration. Strategic alliances can be attractive because their costs (as well as their benefits) are shared. Acquisition, however, is generally the most expensive option, because it will often entail paying a premium over the cost of internal development.

(iv) Synergistic Benefits. When acquisition or strategic alliance is the option exercised, there is generally a presumption that, by combining assets and/or capabilities, benefits can be realized that are greater than what would be expected if the two companies operated independently. In the case of an acquisition, these anticipated synergies must be considered in the context of any purchase premium paid by the acquiring company. (Purchase premiums are discussed in greater detail in section 3.2(c).)

The investment option chosen will involve the weighing of these, and perhaps other, variables specific to the facts and circumstances of a given situation. Frequently, acquisition is the favored option, because it best satisfies the company's objectives in the context of these decision variables—or at least appears to do so.

(c) **IMPACT OF GLOBALIZATION.** The recent, accelerated pace of globalization has had a significant impact on strategic thinking and strategic plan implementation in the corporate world. Driven primarily by technological innovation, competition has intensified in many industries. To a greater extent than ever, this has led to strategic initiatives that focus on more aggressive market expansion and on rapidly attaining economies of scale and substantially enhanced efficiencies. This in turn has placed increased emphasis on the rapid implementation of strategic initiatives.

(d) **ENHANCED RISK.** Arguably, the interplay of the factors just noted has given primacy to speed of implementation and provided significant impetus to acquisition as an investment option in many cases. In situations where acquisitions are the chosen path to achieving strategic objectives, this choice is generally accompanied by increased risk. That risk derives from the likelihood of imperfect strategic fit, the high probability of paying a premium for the assets acquired, and the exposure inherent in integrating the purchased properties into the fabric of a separate business. *For these reasons, a thoughtful, well-planned, and disciplined approach to acquisitions is critical, if these risks are to be mitigated.*

1.3 TYPES OF M&A ACTIVITY

(a) **GENERAL.** M&A transactions can be characterized in a number of ways. These different characterizations provide important context for discussions of the transaction process, regulatory compliance, and the strategic and financial impact of the different types of transactions. The major categories of transactions are described in sections 1.3(b) through (g).

(b) **MERGERS VERSUS ACQUISITIONS.** The term “merger” technically means the absorption of one corporation into another corporation. Typically, in a merger, the selling corporation’s shareholders receive stock in the buying corporation. However, the term “merger” is frequently used more loosely—for example, to include a consolidation that is technically the combination of two or more corporations to form a new corporation.

In a true merger (as opposed to an acquisition), the acquirer becomes directly liable for all the liabilities of the acquired corporation,

often an undesirable result. In a pure stock purchase or *acquisition*, the acquired company can be kept as a separate subsidiary and, while its liabilities continue to exist, they do not become legal claims against the assets or earnings of the acquirer. However, assumption of liabilities by the acquirer can be avoided by a special structure known as a *triangular merger*, in which the acquirer sets up a subsidiary and then merges it with the acquired company. The more significant issue is often not whether the transaction is a merger or a stock acquisition, but whether it qualifies for tax-free treatment under Section 368 of the Internal Revenue Code. (The tax treatment of M&As is discussed in greater detail in Chapter 9.)

(c) LARGE PUBLIC VERSUS SMALL PRIVATE ACQUISITIONS.

Arguably, the most important distinction among types of acquisitions revolves around size. Mergerstat data confirms that a reasonable dividing line between large, public company acquisitions and small, nonpublic acquisitions, as determined by magnitude of purchase price, is \$500 million. This is because the vast majority of transactions that are larger than \$500 million involve the sale of a public company, and those falling below that benchmark are sales of private companies or divestitures of business units by larger companies. This distinction is important because large transactions have dynamics and requirements that are substantially different from those of smaller transactions, and those differences have a significant impact on the acquisition process for each. These differences and their impact are briefly described in the paragraphs that follow and are illustrated in Exhibit 1.1.

(i) Strategic Impact. Large public transactions are almost invariably transformational in nature. They involve the combination of two large entities that can be expected to have strong positions in the same or adjacent markets. Such combinations generally result in an entity of great size, with substantially expanded product breadth and depth, market reach, and overall capabilities. In contrast, smaller transactions are generally nontransformational in nature and fulfill important, but limited, strategic objectives. While they may materially advance the strategic position of the acquirer, they rarely are significant enough to *transform* the acquirer's business.

CHARACTERISTICS	LARGE TRANSACTIONS (\$500 MILLION OR GREATER)	SMALLER TRANSACTIONS (LESS THAN \$500 MILLION)
Parties to the Transaction	Predominantly two publicly traded companies	Predominantly a private company acquired by a large (frequently publicly traded) company
Strategic Impact	Transformational, resulting in a quantum leap in size, product breadth, market reach, and other capabilities	Usually nontransformational, improving strategic position but rarely significant enough to change business fundamentals
Regulatory Requirements	Substantial, including SEC filings, Hart-Scott-Rodino filings	Minimal under \$53 million; Hart-Scott-Rodino filings over \$53 million
Stock or Asset Purchases	Almost invariably stock	Both stock and asset purchases common
Leverage of the Parties	Tilted toward seller and reflected in premiums paid over preacquisition market price	Tilted toward buyer, especially when there is a thin market for the company being sold
Risk Profile	Substantial, due to premiums paid, the lack of recourse on breaches of representations and warranties, and challenges of integration	Moderate, due to ability to conduct in-depth due diligence, greater leverage on price, occasional ability to purchase just selected assets, and greater recourse on breached of reps and warranties
Volume of Transactions	Less than 10% of transactions executed	More than 90% of transactions executed

EXHIBIT 1.1 COMPARISON OF DEALS BY SIZE OF PURCHASE PRICE

(ii) **Regulatory Requirements.** The acquisition of a publicly traded company is heavily regulated by the Securities and Exchange Commission (SEC), state law, and federal antitrust statutes, specifically the Hart-Scott-Rodino (HSR) Act. (See section 11.5 for a discussion of relevant SEC regulations and a summary of HSR provisions.) Nonpublic transactions, in comparison, are minimally regulated. However, those with a purchase price of more than \$53 million (periodically adjusted for inflation) may be subject to the provisions of the HSR. In any

event, the greater the need for regulatory compliance, the greater the need for additional expertise and resources and the greater the length of time needed to execute the transaction.

(iii) Stock or Asset Purchases. As noted, when publicly traded companies are acquired, it is the shares of those companies that are almost invariably purchased. As a result, all the liabilities of the acquired company are assumed as well. Although the acquirer may be able to shield itself from direct exposure to those liabilities, the acquired entity is still liable for all obligations known and unknown to the acquirer. Frequently, in contrast, selected assets of nonpublic companies are acquired, in lieu of stock. This may enable the buyer to pay for only those assets it truly wants and to avoid assuming many of the target company's liabilities.

(iv) Leverage of the Parties to the Transaction. In acquisitions of publicly traded companies, pricing leverage will generally reside with the seller. Even as rumors that the target company is being pursued by a suitor emerge, the value of its stock will invariably increase. This among other factors will affect the negotiated price of the shares. If successful in executing a transaction, the acquirer will pay a premium that historically has been within a range of from 30 to 40% above the preacquisition price. In contrast, transaction leverage is generally tilted toward the buyer at the small end of the market, particularly when the field of potential buyers is small. This has significant implications regarding price as well as other major terms of the transaction.

(v) Risk Profile of the Transaction. There is an inverse relationship to leverage and risk. Accordingly, the risk profile of the acquisition of a publicly traded company is quite high. A large body of research has been conducted that indicates that a high percentage of public transactions never generate returns that would justify the price paid. This fact is generally attributable to two factors: synergies generated from the combination are not sufficient to justify the purchase premium paid, and the challenges of integration associated with a transaction of this magnitude are frequently not fully anticipated, adequately prepared for, and effectively executed. In addition, transaction risk is elevated because the acquirer has no recourse for breaches of representations

and warranties subsequent to the consummation of the transaction. (For a more detailed discussion of representations and warranties, see section 5.2(b).) Private transactions generally allow for a much greater mitigation of risk. This includes measures such as the ability to negotiate price and minimize premiums, the possibility to purchase only selected assets, the ability in many cases to perform more intensive due diligence, and much greater recourse in the case of breached representations and warranties.

It is particularly noteworthy that less than 10% of the transactions executed are those in which a publicly traded company is purchased, with smaller, private transactions accounting for the rest. The differences cataloged in the preceding paragraphs make it clear that transaction characteristics are strongly influenced by the size and nature of the entity being acquired. They potentially impact most major aspects of the acquisition process—ranging from negotiation of terms, to regulatory compliance, financing, due diligence, and contract and close.

(d) STRATEGIC VERSUS FINANCIAL ACQUISITIONS. The discussion to this point has focused on strategic acquisitions, those involving a buyer motivated by strategic considerations, such as the objectives listed in the introductory section of this chapter. However, when investment capital is plentiful, venture capital firms (i.e., financial buyers, to be distinguished from strategic buyers) are very likely to become major competitors in the acquisition arena. Rather than buy with the intent to build an enterprise for the long term, these private equity firms acquire properties for the short to midterm and, after investing, repositioning, and combining them with other synergistic assets, will resell them to strategic buyers. Although the discussion herein is biased toward strategic acquisitions, many of the same principles and procedures presented have equal application to financial acquisitions.

(e) PORTFOLIO ACQUISITIONS OF HOLDING COMPANIES. Acquisition-based holding companies buy companies in diverse industries, based more on the quality of the company, its products, and its management than any overriding strategic approach to a specific market. Although more common in the 1960s, a time when the concept of the “conglomerate” was in vogue, such organizations are relatively rare in the current environment. By definition, such organizations make

acquisitions with no expectation of realizing synergies and no intent to integrate operations. The properties are generally acquired along with their management teams and are run with the intent of building value over the long term. A notable (and extremely successful) example of such an organization is Berkshire Hathaway, the company founded and built by Warren Buffett.

(f) OTHER CHARACTERIZATIONS OF ACQUISITIONS. Other characterizations of acquisitions cross the lines established by the distinctions just made. There are “roll-up” strategies employed by both strategic and financial buyers wishing to expand size and reach, and realize greater scale and efficiency, in a particular niche market. Similarly, there are also “fold-in” strategies employed by buyers, whether strategic or financial, wishing to fill gaps in their offerings by acquiring relatively small companies (or their assets) that can be easily assimilated into the buyer’s operation, while shedding the support infrastructure of the company being acquired.

(g) DIVESTITURES VERSUS SALES OF AN ENTIRE BUSINESS. It is important to distinguish between divestitures and sales of entire enterprises, because they have substantially different transaction dynamics. Divestitures entail disposals of a segment of a business such as a business unit, a product line, or even an individual product. They are made either for strategic reasons or for financial reasons. In the case of the former, the unit being sold is deemed by the parent company to no longer be compatible with its strategic direction and therefore not a candidate for continued investment. In the latter case, the sale is invariably made to generate needed cash and is generally executed by a parent that is under financial duress. The sale of a business in its entirety is simply the sell side of an acquisition of a standalone company as described in section 1.4.

1.4 TRANSACTION OVERVIEWS

(a) GENERAL. This section provides overviews of the transaction process for acquisitions, for sales of an entire business, and for divestitures (i.e., sales of portions of a business). Chapters 2 through 6 discuss the various phases of the acquisition process in great detail, and Chapter 8 provides a similarly detailed discussion of the sales process. This summary provides a view of the staging, process flow, and event

sequencing of these transactions as well as overall context for those more detailed accounts.

(b) ACQUISITION PROCESS. The acquisition process begins with the search for, and identification of, a target company that will fulfill certain strategic objectives of the acquirer and ends with the acquisition and integration of that company into the acquirer's operation. The entire process is made up of a number of discrete steps that can be grouped into five major phases:

1. From process initiation through target qualification
2. From valuation through preliminary agreement
3. From due diligence through approval to finalize the transaction
4. From contract to close
5. Postacquisition integration

(i) From Process Initiation through Target Qualification. This initial phase of the process begins with the creation of a core team to manage the process and the identification of a target company and confirmation that the targeted company is a viable candidate for acquisition. The actual process by which this is accomplished can vary significantly from company to company and from one situation to the next. It may be readily apparent that a target company provides an excellent strategic fit and is the optimal candidate to fulfill the acquirer's objectives. Alternatively, a screening process may be employed to identify potential candidates before they are approached. In still other cases, a candidate may make its availability known either through an intermediary, such as a business broker or investment banker, or through direct contact with executive management of the acquirer's organization. Assuming that the process proceeds, the core team would ensure that a confidentiality agreement is executed; it would arrange a formal meeting with the principals of the target company to confirm their interest; and it would request sufficient preliminary information to perform a meaningful analysis and valuation of the target company.

The identification and qualification process for both public and private company acquisitions is similar but can differ in a number of important respects. When a public company is the target, the direct involvement of the acquiring company's chief executive officer (CEO) early in the process is almost a certainty, whereas with a smaller, private company acquisition, there is a much greater probability that the

CEO would delegate negotiations to a core team of senior managers who will keep him or her informed on an as-needed basis. In addition, the board of the acquiring company is likely to be advised by its management of its intentions to pursue a transaction. Smaller transactions generally do not warrant early board notification, especially at more acquisitive companies, where there may be many such preacquisition discussions in progress at any given time. Although relatively rare and often unsuccessful, an acquirer of a publicly traded company may pursue a transaction on a nonnegotiated basis, that is, a hostile bid that is opposed by the target company's board, an option generally not available in private company acquisitions.

(ii) From Valuation through Preliminary Agreement. Based on the information provided, the acquirer will perform a preliminary analysis of the potential acquisition. This analysis would be used as the basis for internal discussions about the advisability of acquiring the target company and would include a preliminary valuation as well as the consideration of acceptable terms under which the acquirer would execute a transaction. Once internal agreement is reached on price range, other major terms, and negotiating strategy, the core acquisition team under the leadership of the CEO would negotiate basic terms of the transaction with the target company principals. These terms would generally be documented in the form of a letter of intent (LOI). It is during this phase of the process that the acquirer would also determine whether it needed outside financing to consummate the transaction and, if so, would initiate the process to raise the necessary capital.

If the transaction involves publicly traded companies, the agreement to pursue a transaction puts into motion a number of additional activities. The boards of both companies would most certainly be apprised of discussions and, typically, a host of legal, business, and financial advisors would be brought into the process in anticipation of drafting a definitive agreement (contract) and a fairness opinion (a letter that will eventually be sent to shareholders opining on the fairness of the purchase price and other aspects of the transaction). The valuation arrived at will invariably result in a share price that is substantially higher than market value prior to these discussions. This premium assumes that the performance of the combined companies will yield synergies materially in excess of that premium. The extent of the typical premium paid in the acquisition of a public company is

one of the features that set it apart from a private company purchase. That does not mean that purchasers of private companies do not pay premiums. However, whether one is paid and its magnitude is much more of a controllable variable in a private transaction.

(iii) From Due Diligence to Approval to Proceed to Contract. Once the parties have agreed to the basic terms of the transaction, the acquirer would proceed to the due diligence phase of the process. This would entail fleshing out the core acquisition team with additional internal staff and external experts to assist in due diligence, thoroughly briefing team members, developing a due diligence program, conducting the due diligence review, and reporting on its results. Assuming that no evidence of material impairment of the value of the target company is uncovered, the process would proceed to the contract phase. If major issues affecting value are uncovered, the transaction may be terminated or the purchase price may be renegotiated.

This would be a period of particularly intense activity if the transaction is between two public companies. The boards of both companies would be actively involved in discussions with their respective managements and their advisors, and the drafting of the definitive agreement and fairness opinion would have commenced.

(iv) Contract and Close. Negotiation of the granular terms of the agreement would follow successful due diligence. Private company acquisitions may involve the sale of stock or the sale of assets. The form of the transaction would have a significant impact on the content of the contract, specifically the nature of the representations, warranties, covenants, and conditions contained therein. If the transaction is for a purchase price of more than \$53 million, there will almost certainly be a need for an HSR antitrust filing with the Department of Justice (DOJ) and the Federal Trade Commission (FTC). Assuming that the transaction will not result in an anticompetitive combination, the HSR filing will generally delay closing for about one month. In addition, a large private company acquisition may require the approval of the acquiring company's board; even if it does not, management may still present the transaction to the board for comment.

If the transaction involves public companies, the process from due diligence to close is much more complex and lengthy. The definitive agreement will require the affirmative approval of the target

company's board and usually the approval of the acquiring company's board. Securities regulations would require public disclosure of the impending transaction. In addition, a combination of this size and nature will undoubtedly require an HSR filing and may, in fact, require the divestiture of selected properties to satisfy the anticompetition concerns of the DOJ and the FTC. Shareholder approval will also be required, and steps leading up to such approval (possible prospectus preparation, SEC approval, proxy statement preparation, and proxy solicitation) will generally take several months to implement. Once all of these requirements are met and approvals are obtained, the transaction would proceed to closing.

(v) **Postacquisition Integration.** There is virtually universal agreement among students and practitioners of M&As that poorly planned and executed postacquisition integration is one of the primary causes of acquisitions not meeting pretransaction expectations. Integration planning should begin at the early stages of the acquisition process, and those who are charged with integrating the businesses should have strong representation on the acquirer's due diligence team. Aggressive timetables for accomplishing integration objectives should be set in advance of close, and the integration process should start immediately after the deal has been finalized.

The challenges associated with integration are the same for large and small companies, and any differences generally lie in the order of magnitude of those challenges. Integration is predominantly about the realization of synergies and the standardization of policies, processes, and procedures. The areas of synergistic opportunity are generally distribution, operations, systems, facilities, and infrastructure personnel.

Timely implementation is a key to the success of integration efforts. Implementation should be substantially accomplished within the first three to six months following the close of the transaction. Effective implementation is enabled by establishing clear objectives and assigning unambiguous accountability and authority to a team leader whose efforts are regularly monitored by an engaged CEO. However, clear and thoughtful objectives and rapid implementation are necessary, but not sufficient, components of a successful integration plan. Employee buy-in is also a critical factor in maintaining productivity, retaining talent, and ensuring that the integration is effective in the long term. Key to establishing buy-in is clear, candid, and continuous

communication. To the greatest extent possible, employees must be made to feel as if they are part of the process and the future vision of the organization.

(c) **SALES PROCESS.** In contrast to an acquisition, the process associated with selling a business is considerably more reactive. However, it too can be broken down into several distinct phases, specifically:

- Prenegotiation preparation
- Negotiation
- Due diligence
- Contract and close

(i) ***Prenegotiation Preparation.*** The seller of a private company often has no prior experience in navigating the issues encountered in such a sale. Once serious discussions with a prospective buyer begin, the seller should enlist the assistance of a number of advisors. This should include an attorney with M&A experience and some combination of business, tax, and financial professionals who are skilled in the M&A field. The primary area of focus for the inexperienced seller should be an understanding of the value of the business being sold, the tax impact of the terms of the sale, and how the transaction will unfold. Accordingly, the professionals engaged should provide expertise in these areas. In addition, the seller will want to mobilize a limited number of internal managers to assist in early-stage discussion and data assembly. To minimize the potential for business disruption and reduced productivity, it is generally advisable to keep this group small and to impress upon them the importance of strict confidentiality. One other potential member of the seller's team may be a business broker or investment banker. Their understanding of the market and the sales process can be of significant value. However, the seller must determine whether that value is likely to be in excess of the commissions paid for their services.

Public company sales, as noted earlier, are considerably more complex than private sales. Similar to the private seller, the management of a public company will seek out M&A expertise. However, at this stage of the process, management will also maintain an ongoing dialogue with its board as the transaction takes shape.

(ii) Negotiation. There are a number of major elements to be considered in structuring the transaction: price, the form of the sale (stock or assets), the form of the consideration (cash, debt, stock, or a combination), tax implications, the ongoing role of the seller (if any), and, possibly, the impact of the sale on the seller's employees. As a result, the negotiation process can be expected to be iterative and protracted. Expert input in the areas of greatest importance and an understanding of interrelationships (e.g., tax and valuation implications on the form of the transaction) are critical. From a strategic perspective, the seller, with the assistance of his or her team, should identify deal breakers and establish a walkaway position and be prepared to discontinue discussions if issues critical to the seller cannot be resolved.

The negotiation process is not necessarily different in concept for a publicly traded company. The major difference lies with the number of individuals involved in the process. A public company will enlist a substantial number of advisors and will involve the close participation of board members as well as the most senior members of its management team. In sharp contrast to a smaller transaction, especially one in which there is owner management, the communication and decision-making process can be quite byzantine.

(iii) Due Diligence. The parameters of due diligence are negotiable but, under any circumstances, preparation for and administration of due diligence requires the dedication of a substantial amount of company resources. Due diligence consists of extensive document review and analysis, management presentations, interviews of key personnel, and tours of facilities. Creation of a data room (the locus of document review) is a labor-intensive activity, and preparation of management presentations can be expected to tie up key managers and their staffs for substantial periods of time.

The length of the formal on-site due diligence process varies but will generally span several days to several weeks, depending on the size and complexity of the company being reviewed. Clearly, review of large public companies with multiple locations will require more time and staffpower than review of small closely held businesses. In addition, there is a vast amount of historical financial and business information available in the public domain for publicly traded companies. In the broadest terms, due diligence includes analysis of such information outside the framework of formal on-site diligence.

Although these activities have no impact on seller's resources, it is worth noting that, from the buyer's perspective, they may in fact dwarf the efforts associated with the formal, on-site due diligence review.

(iv) Contract and Close. Negotiation of the final contract (or definitive agreement) can be a lengthy, iterative process. Even for small deals, the final contract may take in excess of a month to negotiate. Typically, the seller is supported by his or her M&A attorney, a financial advisor, and/or the company's chief financial officer (CFO). This is the point in the process where the attorney is of greatest assistance and value. Negotiation of the granular detail of the transaction requires someone who is intimately familiar with the process, the associated documents, and the issues. By virtue of training and experience, a good M&A attorney will have mastered the first two of these items. Participation in the acquisition process from the beginning will have provided the attorney with the basis for dealing with the issues. That said, the active participation of the seller and his or her financial advisor is critical to ensure that business and financial issues are quickly and properly resolved.

In the case of private companies, contract and close can occur simultaneously, unless there has to be an HSR filing. As noted earlier, closing on public company acquisitions is more complex, and the time from contact to close is substantial and requires an affirmative vote by the board and, ultimately, the approval of the stockholders.

(d) DIVESTITURE PROCESS. Divestitures are sales of a segment of a company's business, such as a business unit, a product line, or even an individual product. Divestitures historically have accounted for a sizable percentage of all M&A transactions executed (estimated to be about 25% in recent years). Decisions to divest or dispose of a segment of a business generally originate once it becomes evident that the unit in question is no longer compatible with the strategic direction of the parent company. Divestitures are generally proactive initiatives that lend themselves to detailed planning and execution. Management of these transactions can be broken down into three distinct phases:

1. Divestiture planning
2. Transaction preparation
3. Transaction execution

(i) Divestiture Planning. Divestiture planning begins with the development of a paper that lays out the rationale for disposal. That document becomes the basis for corporate approval (from the CEO or the board), which is the trigger event for launching the initiative. Approval will be followed by the development of a retention plan (with incentives) for key personnel associated with the property being divested, to minimize business disruption and loss of productivity. At about the same time, a team charged with responsibility for the transaction should be assembled. The first priority of that team should be to develop a detailed divestiture plan that would identify objectives, assign responsibilities, outline the sales process, and establish a timeline for implementation. The final element of the planning process should be the creation of a communication plan for announcing the prospective sale and its rationale to the employee populations (those of the parent company and those of the business being divested) and external constituencies, such as customers, suppliers, contractors, and, if appropriate, shareholders and the investment community.

(ii) Transaction Preparation. The vast majority of divestitures are made by large businesses, frequently publicly traded companies. These companies usually opt to use a business broker or investment banker to assist in the sale. In these situations, the first step in this phase of the process will be to engage the broker or banker. If the business unit to be sold is of substantial size and is integrated into the infrastructure of the parent company, the seller might also engage an accounting firm to “carve out” dedicated financial statements that fairly represent the historical performance of the unit being sold.

With assistance of the broker or banker, and under the direction of the divestiture team, the key managers of the business being divested would develop an offering memorandum or prospectus that would eventually be sent to possible buyers. In a similar manner, management presentations would be developed to be used by the management team to describe the business to a limited number of qualified, potential buyers after the field is pared down. Concurrently, business, legal, and financial documents of interest to a buyer would be assembled in a data room, a location where the information would be stored and indexed awaiting buyer review. During this phase, a list of potential buyers would be created by the broker or banker and vetted by

the divestiture team. Once all of these tasks have been completed, the process would be ready to move to the execution stage.

(iii) Transaction Execution. The execution phase of the process begins with the announcement of the prospective sale. This announcement is essentially the implementation of the communication plan. Shortly thereafter, the seller would solicit initial bids from the list of potential buyers. Generally, a limited number of qualified buyers would be invited to participate in due diligence, and, ultimately, the field would be narrowed down to the final buyer. The parties would then proceed to contract and close.

(e) IMPORTANCE OF PROPER PLANNING AND DISCIPLINED IMPLEMENTATION. The transactions just outlined are generally of a material nature and entail significant risk for the participants. Although proper planning and disciplined execution cannot eliminate the risk inherent in such transactions, attention to preparation and execution can serve to substantially mitigate that risk. Although there is tremendous variability among and within the types of transactions described, several principles worth noting should be adhered to by those who manage M&A activities. They are:

- *Leave as little as possible to chance.* Establish clear objectives and develop detailed plans to attain them.
- *Ensure that transactions are properly resourced.* Draw on internal and external capabilities as needed and consider them investments, not expenses.
- *Respect the importance of staging and event sequencing within a transaction.* Transactions may differ in many respects, but they all follow a logical and natural process. Remember the adage, “Nine women can’t make a baby in a month.”
- *Do not be afraid to walk away from a transaction.* Do not give in to the temptation to salvage a transaction that does not make strategic or financial sense. At any point in time, the costs—both financial and psychological—should be considered sunk costs.

1.5 ROLE OF THE FINANCIAL MANAGER IN MERGERS AND ACQUISITIONS

(a) GENERAL. Financial professionals play a critically important part in all M&A activities. Often CFOs, controllers, and their functional

equivalents (throughout this chapter referred to as financial officers) are logical candidates to play a central role in the acquisition process, and invariably should be involved in the transaction from beginning to end.

Although executed for strategic purposes, acquisitions are essentially financial transactions. As such, a fundamentally sound acquisition process typically draws on these skills and expertise of the financial manager:

- The ability to apply rigorous financial analysis to ensure sound decision making
- An understanding of the tax implications associated with the various forms a transaction may take
- An understanding of the applicable regulatory requirements
- The ability to model and/or critically evaluate business valuations
- Familiarity with the various financing options available as well as the ability to take a leadership role in structuring a financing package, if necessary
- Familiarity with the principles of acquisition accounting and their application
- The ability to plan, coordinate, and execute an efficient and effective due diligence review

In addition to these financial/accounting capabilities, the senior financial officer involved in the acquisition process should also have strong leadership, organizational, and communication skills. A successful acquisition requires a substantial amount of cooperation and coordination among professionals and experts, both financial and non-financial, within and outside the acquiring company. It is imperative that those providing leadership ensure that the process is rationally structured (i.e., that the steps in the process are properly sequenced) and that the efforts of all those involved are not compartmentalized (i.e., that individual efforts are integrated and that all valid inputs are synthesized).

Capabilities the financial officer should bring to the acquisition process are discussed in detail in sections 1.5(b) through (e).

(b) COORDINATION. As a member of the core team managing an acquisition, the financial officer will have responsibility for coordinating much of the planning and execution of internal and external team

members. This includes various line managers within the acquiring organization, as well as accounting, tax, and legal and other specialists who may reside outside the organization and/or in corporate headquarters in the case of larger, multilayered organizations.

(i) Internal Coordination. The financial officer within the acquiring organization will generally be a co-equal partner with the business executives tasked with evaluating the merits of a transaction, making recommendations whether or not to proceed, and developing a plan of action, if the transaction is to be pursued. Additionally, he or she would play an important role in determining what internal resources would be needed to further evaluate the target company, to perform due diligence and, ultimately, to execute the transaction.

(ii) Coordination of External Experts. The financial officer is the logical point of contact in dealing with a wide range of accounting, tax, legal, and regulatory issues and processes. Outside accounting and auditing resources may be accessed to conduct preliminary assessments and financial due diligence. The financial officer must also interface with the target company's internal and outside accountants. And, he or she will have responsibility for ensuring that acquisition accounting is properly implemented.

The financial officer is also the logical coordinator of input from internal tax professionals or external tax advisors. Tax expertise is drawn on early in the acquisition process to determine the tax ramifications in structuring the transaction and is involved in the post-due diligence stage to ensure optimal tax treatment prospectively.

Financial and legal considerations intersect frequently throughout the acquisition process. The financial officer is the logical individual to coordinate with legal counsel to ensure compliance with regulatory requirements and coordination of tax and legal issues, including the drafting of the Letter of Intent, ensuring compliance with SEC regulations, state law, and antitrust statutes, and negotiation of the final Purchase Agreement.

The financial officer also has a role to play in the financing process. This can range from the simplest type of involvement for a large company, such as notifying the corporate treasury function that money has to be wired to the bank of the sellers at closing date, to very

complex negotiations with those funding the acquisition for a smaller organization.

(c) **FINANCIAL ANALYSIS.** Not surprisingly, the financial officer plays an important role in analyzing the transaction and modeling the target company's business. This includes, among other things, evaluating the target company's business model and financial dynamics in the context of the acquirer's investment objectives and establishing the value of the target company.

(i) **Financial Criteria and Metrics.** The financial officer provides critical input on the appropriateness of strategic fit, the reasonableness of projections of growth and profitability and assumed synergies and efficiencies, as well as comparisons of the acquiring company's projected performance before and after the proposed acquisition (to measure such things as potential accretion and dilution). These are important judgments and measurements for establishing a basis for a preliminary decision to proceed with a transaction.

(ii) **Valuation.** Establishing a preliminary view of value and updating that view as additional information becomes available is a major role of the finance function in the evaluation of an acquisition. There is a variety of valuation methods used in the acquisition process, but larger, acquisitive organizations generally have a standard approach and models that are used to determine value, returns on invested capital, and other investment hurdles. Smaller, less acquisitive organizations may engage a valuation expert on a consulting basis. In either case, development of a credible valuation model requires a detailed understanding of the financial dynamics of both the acquiring and target companies and how synergies and efficiencies can be realized (and quantified) by the two. The financial officer is, unquestionably, in the best position to make these determinations.

(d) **DETERMINATION OF DEAL STRUCTURE.** The financial officer is a key player in determining how the transaction can optimally be structured. Some of the major aspects of the potential structure he or she would consider are:

- Assets versus stock
- Earn-outs
- Working capital adjustments

(i) **Assets versus Stock.** Almost invariably, the buyer will prefer to buy specific assets (vs. the stock) of the target company, because it enables the buyer to be selective about which assets are purchased and reduces the buyer's exposure to hidden liabilities and generally reduces its tax liabilities. Conversely, the seller will prefer a sale of stock, so that unfavorable tax treatment can be avoided and all assets and all liabilities are included in the transaction. There are special situations in which the seller can treat a stock sale as an asset sale and the buyer can realize some of the benefits of an asset sale. The financial officer, often in combination with tax specialists, can determine the range of acceptable options and quantify their costs and benefits.

(ii) **Earn-Outs.** Earn-outs are an approach to risk sharing between the buyer and the seller. They provide the seller with upside potential in the form of additional consideration tied to company's post-acquisition performance above a defined level (usually measured by revenue and/or profit). The financial officer is in the best position to determine if the use of an earn-out makes strategic and economic sense and, if so, how the earn-out should be structured.

(iii) **Working Capital Adjustments.** Letters of Intent will frequently require that sufficient working capital is left in the business at the point of the acquisition to fund ongoing requirements. In such cases, if the working capital falls below that level, then the purchase price would be adjusted downward accordingly. These adjustments are designed to offset any unusual removals of cash from the business. An analysis of the working capital dynamics over time by the financial officer is necessary to determine a fair and suitable working capital target, if a working capital adjustment is contemplated.

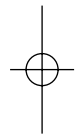
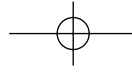
(e) **DUE DILIGENCE.** Clearly, the lead financial officer involved in the acquisition should have responsibility for financial due diligence. This would include establishing due diligence objectives, managing the process, and reporting on its results. These functions are briefly discussed below.

(i) **Establishing Due Diligence Objectives.** Although the due diligence process varies from transaction to transaction, there are some aspects of the process that are standard, regardless of the size and nature of the transaction. This includes the overarching objectives

of the review, which are to verify historical results and to validate forecasts and key assumptions (such as synergies, growth rates, and anticipated efficiencies) related to the valuation that the acquirer has established. The financial officer should be the primary architect in establishing these objectives.

(ii) Managing the Due Diligence Process. By virtue of expertise and experience, the finance function is a logical one to take a lead role in structuring the due diligence program and process. A due diligence review is by no means the same as an audit. Constraints on time and resources limit the depth of the evaluations conducted. However, a due diligence review is analogous to an audit, and the types of procedures that should be reflected in the program are not unlike what one would find in an audit program. The financial officer and his or her staff will generally have the experience and expertise to shape the program and coach non-accountants in performing the review.

(iii) Reporting on Results. Finance professionals are co-equal commentators, along with the business managers involved in the process, on the results of the due diligence. Because an acquisition is fundamentally an investment decision, recommendations to proceed or to disengage will largely be based on whether due diligence supports or contradicts the valuation that has been established. The financial officer is clearly in the best position to make such determinations.



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