Chapter 1

The Acquisition Process

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An *acquisition* occurs when a buyer acquires all or part of the assets or business of a selling entity, and where both parties are actively assisting in the purchase transaction. If the buyer is doing so despite the active resistance of the other party, this is known as a *hostile takeover*. A *merger* occurs when two companies combine into one entity. The vast majority of all business combinations are handled as an acquisition, where one entity clearly takes over the operations of the other.

In this chapter, we will address the basics of the acquisition process—why buyers acquire, why sellers have an interest in selling, and the process flow for both a basic acquisition and one conducted through an auction process. The chapter also addresses a variety of other issues, including acquisition strategy, risks, target criteria, and hostile takeovers.

WHY WE ACQUIRE

Why do companies feel compelled to acquire other businesses? After all, the typical buyer knows its own market niche quite well, and can safely increase its revenues over time by continual, careful attention to

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internal organic growth. Nonetheless, thousands of acquisitions occur every year. Here are some reasons for doing so:

- *Business model*. The target's business model may be different from that of the buyer, and so generates more profits. For example, a target may operate without labor unions, or have a substantially less burdensome benefits plan. The buyer may not be able to re-create this business model in-house without suffering significant unrest, but can readily buy into it through an acquisition.
- *Cyclicality reduction*. A buyer may be trapped in a cyclical or seasonal industry, where profitability fluctuates on a recurring basis. It may deliberately acquire a company outside this industry with the goal of offsetting the business cycle to yield more consistent financial results.
- *Defensive*. Some acquisitions take place because the buyer is itself the target of another company, and simply wants to make itself less attractive through an acquisition. This is particularly effective when the buyer already has a large market share, and buying another entity in the same market gives it such a large share that it cannot be bought by anyone else within the industry without anti-trust charges being brought.
- *Executive compensation*. A buyer's management team may be in favor of an acquisition for the simple reason that a larger company generally pays higher salaries. The greater heft of the resulting organization is frequently viewed as being valid grounds for a significant pay boost among the surviving management team. This is not a good reason for an acquisition, but it is a common one.
- *Intellectual property*. This is a defensible knowledge base that gives a company a competitive advantage, and is one of the best reasons to acquire a company. Intellectual property can include patents, trademarks, production processes, databases that are difficult to re-create, and research and development labs with a history of successful product development.

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- *Internal development alternative*. A company may have an extremely difficult time creating new products, and so looks elsewhere to find replacement products. This issue is especially likely to trigger an acquisition if a company has just decided to cancel an in-house development project, and needs a replacement immediately.
- *Local market expertise*. In some industries, effective entry into a local market requires the gradual accumulation of reputation through a long process of building contacts and correct business practices. A company can follow this path through internal expansion, and gain success over a long period of time—or do it at once through an acquisition. Local market expertise is especially valuable in international situations, where a buyer has minimal knowledge of local customs, not to mention the inevitable obstacles posed by a different language.
- *Market growth*. No matter how hard a buyer may push itself, it simply cannot grow revenues very fast in a slow-growth market, because there are so few sales to be made. Conversely, a target company may be situated in a market that is growing much faster than that of the buyer, so the buyer sees an avenue to more rapid growth.
- *Market share*. Companies generally strive toward a high market share, because this generally allows them to enjoy a cost advantage over their competitors, who must spread their overhead costs over smaller production volumes. The acquisition of a large competitor is a reasonable way to quickly attain significant market share.
- *Production capacity*. Though not a common acquisition justification, the buyer may have excess production capacity available, from which it can readily manufacture the target's products. Usually, tooling differences between the companies make this a difficult endeavor.
- *Products*. The target may have an excellent product that the buyer can use to fill a hole in its own product line. This is an especially important reason when the market is expanding rapidly, and the

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buyer does not have sufficient time to develop the product internally before other competing products take over the market. Also, acquired products tend to have fewer bugs than ones just emerging from in-house development, since they have been through more field testing, and possibly through several build cycles. However, considerable additional effort may be needed to integrate the acquired products into the buyer's product line, so factor this issue into the purchase decision.

- *Regulatory environment.* The buyer may be burdened by a suffocating regulatory environment, such as is imposed on utilities, airlines, and government contractors. If a target operates in an area subject to less regulation, the buyer may be more inclined to buy into that environment.
- *Sales channels.* A target may have an unusually effective sales channel that the buyer thinks it can use to distribute its own products. Examples of such sales channels are as varied as door-to-door sales, electronic downloads, telemarketing, or a well-trained in-house sales staff. Also, the target's sales staff might be especially effective—in some industries, the sales department is considered the bottleneck operation, and so may be the prime reason for an acquisition offer.
- *Vertical integration.* To use a military term, a company may want to "secure its supply lines" by acquiring selected suppliers. This is especially important if there is considerable demand for key supplies, and a supplier has control over a large proportion of them. This is especially important when other suppliers are located in politically volatile areas, leaving few reliable suppliers. In addition to this "backward integration," a company can also engage in "forward integration" by acquiring a distributor or customer. This most commonly occurs with distributors, especially if they have unusually excellent relationships with the ultimate set of customers. A company can also use its ownership of a distributor from a defensive perspective, so that competitors must shift their sales to other distributors.

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No matter which of the reasons previously mentioned are central to a buyer's acquisition decision, it ultimately involves enhancing the price per share of the buyer's stock. This may not be immediately apparent, especially for smaller acquisitions where resulting share price changes are trifling, but a long-term acquisition strategy should gradually build a company's price per share.

WHY A TARGET SELLS

The general assumption is that a target's shareholders are willing to sell strictly so that they can be paid the maximum price. This is not necessarily the case. A target may have a strong preference for remaining independent, but a variety of factors may require it to search for a new owner. The buyer should be aware of the principal reason for a sale, so that it can tailor its bid accordingly. Here are some reasons why a target may be interested in selling:

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- *Anemic profits.* If a target has minimal or no profits, it cannot sustain itself. In this scenario, a buyer may complete an acquisition for a low price, but also find itself having to restructure the acquiree in order to dredge up a profit.
- *Competitive environment.* The number and aggressiveness of a target's competitors may have increased substantially, resulting in a current or impending revenue and profit decline. While a buyer can certainly obtain such a business for a small price, it must also question whether it wants to enter into such a difficult environment.
- *Estate taxes.* The owner of a target may have died, and his estate must sell the business in order to pay estate taxes. The deceased owner's relatives may not have a clear idea of the value of the business, so a prospective buyer may have a relatively easy time negotiating with an inexperienced counterpart.
- *Patent expiration.* A target may be selling in a protected environment, using a key patent that keeps competitors at bay. However,

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that patent is now close to expiration, and the target is not sure if it will be able to compete effectively. Due to the increased competitive environment, the target may lose a great deal of value, and the buyer can acquire it for a low price.

- *Rapid growth*. A target may be growing so fast that it cannot obtain sufficient working capital to support the growth. This scenario is a good one for the target, since it has proof of strong growth, and so may be able to negotiate a high price.
- *Retirement*. The target's owner wants to retire, and needs to cash out in order to do so. If the owner has established a long timeline for the sale, he can sort through a variety of offers and negotiate at length, resulting in a higher price. Conversely, a rushed retirement timeline can force down the price.
- *Shareholder pressure*. If the target is privately held, then its shareholders will have a difficult time selling their stock. A buyer can provide complete liquidity to these shareholders, either through an all-cash offer, or by issuing shares that can be registered for sale to other investors. This is an especially common reason when the management team does not hold majority ownership of the target's shares, and so cannot control its direction.
- *Stalled growth*. A target may find that its growth has stalled, for any number of reasons. Maximized revenue is a logical point at which to sell, so the target puts itself up for sale, on the assumption that a buyer can re-invigorate growth.
- *Technological obsolescence*. The target may have based its core business on a technology that is now becoming obsolete, and it cannot afford the massive overhaul required for replacement. If the buyer is already operating under newer technology, it may be able to snap up such a target for a low price, and quickly convert it to the new systems.

All of the points above make it appear that sellers want to do a deal because of external forces that are not under their control, and which result in decreased value to them. However, a canny seller will have

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the sale transaction in mind for a number of years in advance of the actual event, and will position his company for sale at the time when its value is properly maximized, and he has stripped out as many risks as possible. For example, the seller should settle lawsuits and any government regulatory actions in advance, shorten the terms of any asset leases, and avoid launching any major, capital-intensive activities. These actions yield a clean, profitable enterprise for which a buyer would willingly pay top dollar.

Knowing why a target wants to sell is not just an input into the pricing process—it is also a very good question for the acquisition team to ponder. If the target's management is essentially giving up, and they are the ones most knowledgeable about their company, then why should the buyer want to acquire it? In many cases, examining the issue from the perspective of the seller may cause the buyer to back out of a prospective deal.

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ACQUISITION STRATEGY

A surprising number of buyers do not consider the total corporate strategy within which they conduct acquisition activities, if indeed they use any formal strategy at all. Instead, they simply look for modest extensions of their current core business. Given the large investment of funds and management time needed to buy and acquire another company, a buyer should instead spend a great deal of time formally pondering why it wants to make acquisitions in a particular market niche, and of an identified target in particular. The details of this analysis will vary considerably by company; several of the more common strategic issues are noted in this section.

The single most important strategic consideration is the size of an acquisition. It is much better to complete a series of small acquisitions than one or two large ones. By doing so, a buyer learns a great deal from each successive acquisition, so that it develops a significant experience base. If it buys a number of these smaller firms, a buyer can hone its acquisition skills remarkably. Conversely, if it only acquires

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large companies, it will not have such a skill set, and will therefore have a higher risk of failure. Also, a buyer can impose its own systems more readily on a small acquisition, whereas it may have a substantial tussle on its hands with a larger one. Finally, some acquisition efforts will fail, so it is better to have one or two small deals fail than one large one.

The buyer should always acquire a business that supplements its strongest business segment, and ignore acquisitions that would bolster its weakest segment. By doing so, it is concentrating its management efforts on that part of its business that generates the highest revenue or profit growth, and so builds the most long-term value. The buyer would be better off divesting a weak segment than adding to it.

A *bolt-on acquisition* is a direct add-on to the buyer's existing business; it is very similar to the operations the buyer already has. In this case, the buyer should have an excellent idea of what synergies can be obtained, so the acquisition is more of a mundane, tactical nature than a strategic one. However, the buyer must give a great deal more thought to strategy if it is contemplating an acquisition located in an entirely new business area. Since the level of uncertainty over a bolt-on acquisition is greatly increased, the buyer must be prepared for a broad range of outcomes, from serious losses to outsized gains. The buyer should also factor into its planning a proper retention plan for the target's management team, since it cannot reasonably expect to manage a business itself in an entirely new business arena.

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One of the more likely strategic issues faced by a buyer is the reactions of its competitors to an acquisition. They may buy a company themselves, or jump into a bidding war for the buyer's current acquisition foray, or file an anti-trust lawsuit, or enter into a protective alliance with other competitors—the list of possible reactions is substantial. This does not mean that the buyer should back away from an acquisition because of its fears of competitor reactions, but simply that it must be aware of how the deal will lead to a restructuring of the competitive environment in its industry. There may even be cases where the buyer deliberately backs away from an acquisition, leaving it to a competitor to acquire. This can be an excellent ploy when the

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target has several known flaws, and there is a strong possibility that the competitor may stumble in its integration of the target.

Another strategic concern is the avoidance of competitors. If a buyer has thus far subsisted in areas away from ferocious competitors, then it would do well to continue down the same path, and find unexploited niches that those competitors have not addressed. The worst possible strategy in a great many cases is to make an acquisition that places the buyer squarely in the path of large, well-run competitor; the result is usually an acquisition whose results rapidly head downhill.

If a buyer is publicly held, it may report in its quarterly and annual financial statements the key metrics upon which it relies (such as changes in revenue or backlog). If these metrics are properly communicated, the investment community also will focus on them, which means that changes in the buyer's stock price will be tied to those specific metrics. Thus, the buyer should focus on acquisitions that can help it improve those key metrics. For example, if the investment community focuses on increases in a company's revenue growth, then it should focus more on target companies with the same characteristic, rather than entities that perform better under other metrics.

If a buyer intends to pay for an acquisition with stock, then it should be mindful of the impact that a group of new shareholders may have on its ability to conduct business in the future. For example, this new voting block could interfere with the buyer's intent to sell off pieces of the newly acquired company. It could also contest director elections and oppose a variety of actions requiring shareholder approval, such as the creation of a new class of stock. Thus, a buyer may prefer to pay cash for an acquisition, strictly to avoid activist shareholders.

The strategic issues noted here include the size of the target, business segments to support, industry niches to invest in, and the reactions of both competitors and the investment community. None of them directly involve the purchase of a specific company, but rather the framework within which the buyer competes. A buyer should constantly test acquisition targets against this framework, and also test the veracity of the framework itself on a regular basis.

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THE BASIC ACQUISITION PROCESS FLOW

The buyer usually initiates contact with the target company. The best method for doing so is a direct call between the presidents of the two companies. This allows for a brief expression of interest, which can be discreetly broken off if the target's president is not interested. If there is some interest, then the presidents should meet for an informal discussion, after which their management teams can become involved in more detailed negotiations. If the buyer's president has difficulty obtaining access to his counterpart, then it is best to only leave a message regarding a "strategic transaction" or "strategic alliance," and wait for a response. Offering to buy someone's company through a lengthy voice mail may not be considered a serious offer, and will be discarded. A formal letter containing a purchase offer can be misconstrued as notice of a hostile acquisition, and so is to be avoided.

If the buyer wishes to contact a target but does not want to reveal its identity, it can use an intermediary to make the initial contact. This can be an investment banker, consultant, attorney, or some similar individual who can discreetly represent the buyer. The intent behind using an intermediary is to see if the target has any interest in a potential buyout. If not, the buyer can quietly depart the scene, with no one learning of its acquisitive desires. This is a useful ploy when the buyer is scouting out an industry for possible acquisitions.

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If there is an agreement to exchange information, then both companies must sign a non-disclosure agreement (NDA). Under the agreement, they are obligated to treat all exchanged information as confidential, not distribute it to the public, and to return it upon request. Otherwise, even if the acquisition does not occur, the buyer will retain all information about the target, and could use it for a variety of purposes in the future. In a worst-case scenario for the target, its confidential information could be spread around the industry, with adverse consequences. There are occasional cases of one-way NDAs, where the buyer signs it but the target does not. This is to be avoided, since there is an increased chance that the target is simply trying to publicize the deal, in hopes of attracting other bidders.

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The target may hire a professional negotiator, or proxy, to represent it in any discussions with the buyer. Though expensive, the proxy allows the target to create a buffer between itself and any of the more strident negotiation disputes. This allows relations between the buyer and target to remain cordial, with any ire being deflected onto the proxy.

A reasonable way to begin discussions between the parties is to avoid any mention of the target's financial or operational condition. This information will shortly become almost the sole topic of conversation, in order to see if the target meets the buyer's purchasing criteria. However, buyer's initial objective is to foster a sense of trust among the target's executives. Not only does this sometimes result in more willingness by the target to divulge information, but it may also mean that the target will be more likely to sell to the buyer, rather than some other bidder who has taken less time to build relations. Consequently, a good first step is complete avoidance of numbers, in favor of "softer" discussions about the needs, concerns, and operating styles of both companies.

In general, the target has more negotiating power at the beginning of the acquisition process, while the buyer has more control at the end. This is because the buyer has inadequate information about the target until it has completed the due diligence process, after which it will use that information to attempt to lower the proposed purchase price. Thus, a common scenario is for the buyer to initially agree to a high proposed price by the target, and then gradually whittle that number down through a variety of adjustments. The target is more likely to agree to these changes near the end of the negotiations, when it has become more firmly committed to concluding the sale.

If the buyer makes an offer, the target may be tempted to shop that offer among other potential bidders in hopes of attracting a better offer. Though common, this practice represents a considerable breach of good faith with the original buyer. Thus, the target should first consider the adverse impact of losing the original bid from a now-irate buyer before engaging in bid shopping.

Irrespective of how the two parties position themselves in regard to pricing, the ultimate price paid will be founded upon a detailed

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valuation analysis that is conducted by the buyer. As a baseline, this valuation uses a five-year discounted cash flow analysis, as well as an estimated termination value for the selling entity at the end of that period. However, it is best to supplement the analysis with a low-end breakup valuation, as well as a valuation that is based on prices recently paid for comparable companies. The later valuation works best for a high-growth target that has minimal cash flows. By creating and comparing a range of these valuations, a buyer can derive a reasonable price range within which it can negotiate with the target. This topic is covered in more depth in the Valuing an Acquisition Target chapter.

Under no circumstances should the buyer allow the target access to its valuation models. If it were to do so, the target would likely alter its figures for the numerous variables and assumptions in the models, resulting in a significantly higher price. Instead, the buyer should consider this to be a closely guarded secret, and only offer the target a final price, with no supporting documentation.

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As an interesting sidelight, the buyer can estimate in advance the selling president's reaction to a purchase price by estimating its impact on the president's outstanding stock options. If the president's options will not be exercisable at the offered price, then a certain amount of indifference can be anticipated. However, if the exercise price is greatly below the offer price, the buyer may find itself with an inordinately cooperative counterparty.

Alternatively, there are situations where the buyer is not likely to meet with a favorable reception. For example, if the target has just obtained significant funding or brought in a new president, it may have major growth expectations, and would prefer to wait until a later date, when it will presumably have a higher valuation.

The target may insist on an excessively high purchase price, or else it will not proceed with the acquisition. The buyer can work around this problem in two ways. One is through an earnout provision, where the target has the opportunity to be paid substantially more if it can generate significant revenue or profit increases in the near future. Alternatively, the buyer can offer to pay at least a portion of the price

with a long-term, low-interest note. The face value of the note makes it appear that the buyer is paying full price, but the low-interest nature of the instrument actually results in a substantial discount over its term.

The buyer can depress the purchase price by making it clear that it is evaluating several alternatives to the target company. By doing so, the negotiating power shifts to the buyer, who is now in a better position to obtain a more reasonable price. Also, many negotiations fall through, for any number of reasons. Because of these pricing and closing problems, it is extremely important for a buyer to constantly be searching the industry for targets, and to always have a number of potential deals in various stages of completion.

After the parties have discussed the acquisition and arrived at the general terms of a deal, the buyer issues a *term sheet* (also known as a *letter of intent*), which is a non-binding summary of the primary terms of what will eventually become a purchase agreement. The term sheet is discussed later in the Term Sheet chapter.

Many buyers do not have access to sufficient funds to complete an acquisition, but wish to continue with acquisition talks in hopes of obtaining the necessary funding prior to closing the deal. They can make the seller aware of this difficulty with a *financing out condition*, which allows them to abandon the deal in the absence of funding. The point at which this condition is brought up is a delicate issue. The seller will want to address it in the term sheet (preferably with a clause requiring the buyer to pay a predetermined penalty in exchange for breaking off negotiations). Conversely, the buyer would prefer to avoid the issue until nearly the end of the acquisition discussions, so that it can avoid a penalty.

The next step in the acquisition process is due diligence. Thus far, the buyer has developed a valuation based on information supplied by the target, and which the target represents to be accurate. The buyer must now ascertain if this information is indeed accurate, and also investigate a variety of other financial and operational issues. This important area is discussed in greater detail in the Due Diligence chapter, with many review topics itemized in Appendix A.

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Due diligence should be conducted by a large group of specialists with skills in such areas as accounting, human resources, legal, operations, and information technology. Not only does this allow for an extremely detailed and well-qualified review, but it also makes it easier to send informal messages to counterparties working for the target. This gives the buyer multiple channels of communication for an array of messages. In particular, it allows the company presidents to maintain cordial relations, while others engage in more difficult negotiations.

Based on the additional information collected in the due diligence process, the buyer can now construct a pro forma financial statement for the combined companies, so that it can see the net impact of the acquisition. The pro forma shows the income statements of both companies separately, and then adds or subtracts quantifiable additional costs or synergies to arrive at the most likely results of the combined entities. Some factors may require considerable additional analysis before inclusion in the pro forma. For example, the target's capitalization limit may differ from that of the buyer, so depreciation will vary. Also, the tax rate of the combined entity may differ from the individual ones of the separate entities. Further, the buyer may be able to refinance the target's debt at more advantageous rates. For these reasons, the pro forma requires considerable effort to attain a reasonable degree of accuracy.

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If flaws or weaknesses in the target's finances or operations were found during due diligence, the buyer must decide if it should further negotiate the terms initially described in the term sheet. It is also quite possible that the problems discovered are of a sufficient level of severity to warrant abandoning the deal entirely. This is an excellent time for the buyer to stop and have the senior management team conduct a high-level review of the acquisition team's work, with the intent of making a go/no-go decision. The review should dig into the assumptions used for valuation modeling, the level and types of identified risks, competitor reactions, and so on. This is a valuable exercise, because too many buyers become caught up in the bureaucratic process of completing an acquisition, and do not stop to think about whether it still makes any sense to do so.

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If the buyer elects to proceed, then the parties must negotiate a *purchase agreement*. This document, which is described in the Purchase Agreement chapter, describes the form of the acquisition, the price to be paid, and the representations of both parties regarding their condition and obligations prior to closing. Also, if the target is concerned about deferring income-tax recognition, then the purchase agreement can be structured to achieve that goal. This issue is addressed in detail in the Types of Acquisitions chapter.

If both parties prefer to conclude an acquisition with utmost dispatch, it is possible to simultaneously conduct due diligence and create the purchase agreement. However, both parties must be aware that problems found during due diligence will likely result in alterations to the purchase agreement of an iterative nature. Thus, what the parties save in time may be expensive in terms of additional legal fees. Under no circumstances should the purchase agreement be signed before the due diligence has been substantially completed, since major problems with the target company have a way of being discovered at the last moment.

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The buyer's board of directors may hire an investment banking firm to render a fairness opinion about the purchase agreement. This opinion is an analysis of the deal being offered, and is intended to short-circuit any potential lawsuits from disgruntled shareholders. It is most useful when the acquisition involves some conflict of interest, when minority shareholders are being bought out, or when there will be a significant change in the target's organizational structure. The investment bank hired for this work should be demonstrably able to render an independent opinion, and should have sufficient technical and industry-specific skills to assemble an authoritative document. The investment bank's compensation should not be contingent upon closing the acquisition, since this would be a conflict of interest. In the vast majority of acquisitions, there is no need for a fairness opinion.

If the buyer is a larger company with a substantial ability to control market prices, then acquiring another company in the same industry may subject it to government anti-trust laws. If so, it must notify the federal government of the proposed acquisition, and wait for

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government approval before proceeding. The government may deny the transaction, or require some restructuring of the combined entity, such as the divestiture of specific assets. This issue is discussed in the Government Regulation chapter.

If the buyer is acquiring a business that deals in bulk sales (the sale of merchandise from inventory, such as a furniture retailer), then it may be subject to *bulk sales laws*. Under these laws, the buyer must give at least 10 days advance notice of the acquisition to each creditor of the seller, using a creditor list that is certified by the seller. The notice must identify the buyer and seller, and state whether the seller's debts will be paid as they become due. Some state laws even require the seller to retain its acquisition proceeds in escrow in an amount sufficient to pay any disputed debts.

The final step in the acquisition process is the integration of the two companies. This process, which is described in the Acquisition Integration Process chapter, is facilitated by an integration team, but the actual integration work is conducted at the line manager level, where those directly responsible for certain operations must integrate operations.

There are two types of buyers, and they treat integration in different ways. A *financial buyer* has only completed an acquisition in order to hold the company for a period of time, hope that it appreciates in value, and eventually sell it off at a profit. A financial buyer will conduct minimal integration activities. A *strategic buyer* will pay more for a target company than a financial buyer, because it intends to keep the most valuable parts of the acquiree and discard the rest. The strategic buyer is in a position to do this, because it has a significant knowledge of the industry in question, and of the acquiree's products, intellectual property, and processes. This frequently involves merging the acquiree's operations into those of another part of the buyer's portfolio of companies. Thus, a financial buyer will conduct extensive integration efforts in order to maximize any synergies to be found.

Integration is not necessarily a one-sided, traumatic integration of the acquiree into the buyer. If the acquiree is a vibrant, well-run company, it is entirely possible that the buyer will shift some of its

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operations into those of the acquiree, sometimes to such an extent that it is subsequently difficult to ascertain who acquired whom.

This discussion has assumed that two parties consummate an acquisition. However, in the vast majority of cases, the discussions fall apart, for any number of reasons. Because of this very high risk of deal failure, both parties should always publicly downplay any deal that may be in the works, and preferably keep it secret. In the event of failure, and if the discussions have been of a public nature, then both parties should jointly state that it was caused by unspecified differences that could not be reconciled, and issue no further information. Also, there is no point in publicly blaming the other party for a failed acquisition, since there is always a possibility that the parties will later make another attempt at an acquisition, and there is no point in having hard feelings between the companies.

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Throughout this discussion, the assumption has been that the buyer is an independent third party. In reality, the target's management team may be taking an active role in the acquisition on behalf of the buyer, either to stay on with significant performance-based compensation packages, or to buy out the company themselves. If the later is the case, they usually put up a minimal amount of equity as part of the deal, accompanied by a massive amount of debt to fund the remainder of the purchase. Given the extraordinarily high leverage, the underlying business must have stable and predictable cash flows, within a secure market niche that does not require significant capital replacement costs during the loan payback period. If not, then the management team is at great risk of losing its investment, as well as its ownership of the company. A safer alternative for the management team is when a parent company wants to spin off a business unit, and it gives favorable payment terms to its management team, thereby enabling it to more safely carry out the acquisition.

In summary, the acquisition process flow involves an initial expression of interest, a valuation analysis that is likely to be repeated as more information about the target becomes available, a term sheet, due diligence, a purchase agreement, and finally the integration of the two entities. The odds of successfully completing each step decline as

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the process proceeds, so that a buyer may initially communicate with several dozen companies, issue term sheets to a quarter of them, and eventually conclude a purchase agreement with just one.

THE AUCTION PROCESS FLOW

A company's owners may elect to sell their business through an *auction* process. This may result in a higher price for their business, the commission of any brokers used to assist in the sale must be deducted from the eventual price. An auction also provides evidence that the seller's board of directors did its best to obtain the best possible price, thereby possibly averting any shareholder lawsuits claiming the contrary.

To initiate an auction, the seller's owners typically hire a broker to conduct the auction for them. Under this approach, the broker creates an *offering book* (also known as a *sales prospectus*) describing the company, but without revealing its name. The book usually contains the following information, which is designed to reveal the company's investment potential:

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- *Investment summary.* A brief overview of how the seller would be an excellent investment opportunity.
- *Company overview.* A short list and extrapolation of the key reasons why the seller is worth acquiring.
- *Market analysis.* Describes the market in which the seller operates, and the seller's niche within that market.
- *Products and services.* Describes the key products and services offered by the seller, as well as their margins. This can also include a discussion of major customers and distribution channels.
- *Management.* Notes the qualifications of those managers expected to transfer to the buyer.
- *Historical and forecasted financial statements.* Includes audited financial statements (without footnotes) for at least the past two years, and preferably more. Should also include an estimate of

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future financial performance for at least the current and following year.

- *Capitalization table.* Summarizes investor ownership by class of stock.
- *Asking price.* States the target price. If comparable sales have occurred recently, then note them in this section as justification for the asking price.
- *Concluding remarks.* Brings together all preceding sections into a one-page summary of the investment proposition.

The broker sends an auction notice to a broad array of possible buyers, and obtains an non-disclosure agreement from anyone who expresses interest. Despite the NDA, there is a strong likelihood that the seller's financial and operational information will soon find its way throughout the industry, and into the hands of competitors. Thus, anyone choosing to sell through an auction process should be ready to deal with broad distribution of potentially damaging information.

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Confidentiality is a particular problem if the seller retains a broker that indiscriminately spreads the auction notice throughout an industry. The broker may gain a few more bidders, and certainly gives its own name better brand recognition in the industry—but the seller's privacy has vanished. It is better to conduct a low-key auction with a small group of pre-qualified bidders, so that noise about the auction is minimized. However, if an activist shareholder insists on a sale by auction, then it may be necessary to publicize the auction, so that the shareholders can be assured that a broad-based auction is indeed taking place.

Once the NDA is signed, the broker issues the offering book. The broker also sends additional information to those expressing interest in exchange for a letter of intent, with the intent of quickly whittling down the list of potential bidders to a group with the interest and wherewithal to make a valid bid for the seller. The broker then issues a purchase agreement (note that this varies from the normal acquisition approach, where the buyer controls the purchase agreement).

Bidders mark up the document with their changes, leading to further dickering with the broker. The broker will attempt to keep several bidders lined up, in case the bidder offering the best price backs out of the negotiations. However, if secondary bidders are shifted into the lead position, they now know that the broker has experienced some difficulty with their predecessor, which gives them greater bargaining power.

The broker may demand a cash deposit, cash escrow, or letter of credit from the highest bidder to ensure that it completes the deal. This is sometimes necessary because other bidders are likely to lose interest in the deal once it becomes apparent that another party is in the lead position to acquire the seller. As previously noted, the price tends to decline if negotiations fall through with the highest bidder, so the broker will be keenly interested in locking in this bidder.

Negotiations may break down with multiple bidders, so that the broker finds itself dealing with the last possible bidder. If so, the broker will not reveal that other bidders have dropped out, since this gives the bidder more negotiating power. Conversely, the bidder should always suspect that there are no other bidders, and be willing to walk away if the broker will not accept the bidder's best offer.

In general, the broker should always maintain confidentiality about the identities of all interested bidders. Not only does this give the broker a better bargaining position, as just noted, but it also prevents collusion among the bidders. For example, the bidders might allow one of their number to win with a low bid, in exchange for other concessions to be granted a later date, such as access to key seller technology, or the sale of selected seller assets to them.

Many experienced buyers are unwilling to take part in an auction, because they know the price at which the seller will eventually be sold is more likely to be at the high end of the price range. Instead, they may withdraw from the process, and wait to see if the auction falls through. If so, they can re-enter the bidding, and negotiate on a one-on-one basis, usually resulting in a lower price.

The auction process can also be used when the target company has entered bankruptcy protection. In this case, a court appoints a

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bankruptcy trustee, who runs the entity on behalf of its creditors. In many cases, the sale value of a bankrupt entity is worth more than its breakup value, so the trustee conducts an open auction to sell to the highest bidder. Once a winner is established, the trustee submits the winning bid to the bankruptcy court for approval. Though there are some extra steps to complete in a bankruptcy auction, the result can be a significantly low price for the buyer. However, the buyer must be willing to make significant changes to the acquiree to improve its profitability—after all, there is a reason why the company ended up under bankruptcy protection!

The auction process tends to take more time than a normal acquisition. It requires about one month for the broker to create an offering book and derive a list of potential buyers, another month to screen those buyers, one more month to receive bids and conduct due diligence, and a final six weeks to close the deal. Thus, given the number of parties involved and extra steps involved in an auction, the seller must be prepared to wait longer than during a normal acquisition transaction to complete a sale.

In summary, the auction process is time-consuming and expensive for the seller, but can also result in a higher sale price. Given the chance of obtaining an unusually high price, it is more common to see larger firms tread the auction path; not only are they better able to afford it, but brokers are more willing to represent them, in the expectation of considerable fees.

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LOCATING AND CULLING ACQUISITION TARGETS

When a buyer decides to engage in an acquisition, it should do so in a methodical manner, and not in reaction to a sudden opportunity. This requires a long-term commitment to reviewing the range of possible acquisition opportunities, based on what it needs in an acquisition target. The first step in this process is to do a general review of the industry in which the buyer wishes to make acquisitions. The goal of this review is to determine the types of acquisition opportunities that exist,

which other companies are completing acquisitions in the same market space, and what kinds of prices are being paid.

There are a number of ways for a buyer to identify possible acquisition targets. If it wants to make acquisitions in areas closely related to its existing operations, then its *sales department* very likely already has an excellent idea of who the best prospects might be, since they compete with them constantly.

Some of the best acquisition candidates are *current business partners*. They may be customers who work closely with the buyer to develop new products, or suppliers with whom the buyer has close, long-term relationships. However, these targets generally imply either upstream or downstream acquisitions, so that the buyer becomes more vertically integrated within its industry—which needs to be a strategy decision by senior management (see the Acquisition Strategy section).

Another option is to have the acquisition team regularly accompany the sales staff to the company's regularly scheduled *trade shows*. The acquisition team can tour the various company booths for ideas. A less time-consuming alternative is to obtain trade show directories, make lists of which companies attended, and investigate each one.

Another search method is to subscribe to all of the *industry publications*, and pore through them to determine which companies regularly advertise. This is also a good way to locate subject-matter experts at other companies, since they may write articles for the trade journals.

If a target industry has a large number of public companies, then go to Yahoo Finance or Google Finance, and review the *lists of competitors* that are listed next to each company. A more labor-intensive method is to access the annual 10-K reports of public companies and see who they list as competitors.

It is also possible to uncover targets through *special industry studies*. These studies may be created gratis by university professors as part of their research, but are more commonly made available through private studies that will cost the buyer anywhere from $5,000 to $20,000 to obtain.

Another alternative is *sell-side analysts*. These individuals work for banks, brokerage houses, and investment bankers, and usually

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specialize in the public companies located within a single industry. They are experts in those industries, and may be able to provide information about the more significant players within each one.

Standard & Poor's issues lengthy lists of companies through its *Industry Surveys*. Each report covers a specific industry, and is authored by a Standard & Poor's research analyst. The reports cover a great deal more than the names of the key players. They also note industry trends, how the industry operates, key ratios, additional references, and comparative company financial analysis. The reports cover over fifty industries, ranging from advertising to transportation.

If the buyer is searching for targets with valuable intellectual property, then it can develop its own *intellectual property study* of an industry. This study shows who is working on similar technologies, which ones are publishing authoritative literature on various studies, who is being cited as a reference, and who has filed for or received patents. Such a study requires a massive amount of work, and probably the retention of an intellectual property attorney to conduct investigations. Though expensive, it can reveal the direction in which technology is moving in an industry, so that a buyer can acquire key technologies in advance of its competitors.

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Locating targets can be no trouble at all—they come to the buyer. The owners of privately-held firms may eventually want to cash out of their ownership positions, or do not have sufficient funds to keep plowing back into their businesses, or are running into regulatory problems—the reasons for sale are endless. Whatever the reason may be, company owners may make discreet inquiries among potential buyers, or through brokers.

All of the preceding methods should create a formidable list of acquisition targets; but how does a buyer winnow down the list to a qualified group of targets? The best method is to create a *fit matrix*. As shown in Exhibit 1.1, this is a matrix in which the buyer itemizes its main criteria for acquisition candidates, and how a target fulfills those needs. Common criteria are revenue size, profit size, market share, growth rate, and intellectual property. Other possible criteria are geographic location, product branding, types of distribution

Exhibit 1.1 Fit Matrix for ABC Company

Criteria	Fit	No Fit	Possible
Revenue > $10 million	√		
Revenue growth > 15%	√		
EBITDA > 15%	√		
Intellectual property			√
Growth stage		√	
Subject matter experts			√
Net cash flow positive		√	

channels, and corporate culture. The intent of this matrix is to eliminate targets from consideration, so its intent is essentially negative.

There is no scoring system involved in the fit matrix, since it is essentially subjective in nature. If a buyer were to set up a scoring system within a fit matrix, it should assign weightings to each criterion, since certain items usually outweigh the importance of others.

There is a price at which a buyer may find almost any target to be an attractive acquisition. However, it is only capable of digesting a certain number of targets per year, and it never has unlimited access to cash. Thus, the buyer must be extremely picky in determining which targets are worthy of a bid. A reason method for sorting through the list of targets is to adopt some simple cutoff criteria, below which a target will not be considered. For example, the target must have a revenue growth rate higher than that of the buyer, which ensures that the target's growth will incrementally increase that of the entire company. Similarly, the deal cannot dilute the buyer's earnings after a short acquisition integration period.

The buyer must also be extremely wary of any legal disputes in which a target is embroiled. It must evaluate each existing lawsuit for both the most likely and maximum payout possible. Of particular concern are lawsuits over the ownership of the target's intellectual property. If there is any hint of such an issue, and the buyer is basing much of the target's value on its intellectual property, then this can ruin the entire deal. Also, the due diligence team should review any lawsuits to which competing firms are being subjected, to see if the same problems could arise for the target. Given the severity of some lawsuit

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payouts, and the potential loss of control over intellectual property, litigation can be a prime reason to avoid an acquisition.

A key cutoff issue that many companies miss is the ability of the target to expand its underlying business concept. In many cases, the target is attempting to sell itself because it has completely filled its market niche, and no longer sees any way to grow further. The buyer must be very clear about its ability to expand the target's business. Otherwise, it is paying to acquire an entity with stale growth—and if a company is not growing, it only has one way to go—down.

Another cutoff issue is the proportion of sales among the target's customers. If a large proportion of sales is concentrated among a very small number of customers, then the buyer faces a high risk of major revenue declines if even one of these customers departs. This is a particular problem if there are only a handful of customers in total.

While not normally a cutoff criterion, the presence of a union shop can scare away the more skittish buyers. These buyers may have had unusually acrimonious union relations in the past, and have therefore imposed a ban on any new deals where a union is involved. Other buyers are aware that union relations *can* be managed properly, and do not consider this to be a significant issue.

One of the best cutoff criteria of all is to mention a potential price range to the target early in the discussions, and see if this meets with the approval of the target. If the target appears to have an inordinately high opinion of its value, then the buyer should allow it to obtain that price—from someone else.

By using these criteria to avoid unattractive deals, the buyer will have more resources available when the right target comes along, and can then offer a high price to obtain it.

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THE OPTIMAL TARGET SIZE

One of the acquisition screening criteria that a buyer's acquisition team uses is a revenue size range. This range is based on the target's revenue, which is a useful (though rough) method for determining the approximate complexity of the acquisition transaction. The low end of

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this range is based on the legal and administrative costs of completing an acquisition. Given just these costs, few buyers will even consider an acquisition where the target has revenues of less than $5 million—it is simply not worth their time. Also, the acquisition team must consider how to best use its time in evaluating potential acquisition targets. It takes approximately as much time to conclude an acquisition deal with a $100 million target as it does with a $5 million target. Thus, there are multiple reasons why buyers tend to ignore smaller targets. The only case where an extremely small acquisition makes sense is when the target possesses unusually valuable intellectual property that the buyer can immediately use.

There is also such a thing as acquiring too large a target. If the buyer is nearly the same size as the target, then there is a good chance that the target, once acquired, will not feel obligated to replace its own systems and organizational structure with those of the buyer. Instead, there may be a protracted power struggle over a variety of issues, resulting in an extremely long time before the two entities are fully integrated (if ever).

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The optimal acquisition size is in the general range of five to 15 percent of the size of the buyer. In this size range, the buyer can comfortably impose its will on the acquired company, resulting in rapid integration.

EVALUATE ACQUISITION TARGETS WITH ALLIANCES

Acquiring any company can be a significant risk, no matter how detailed the due diligence is. The problem is the difficulty of determining how the acquiree's employees handle themselves with customers, how they develop products, their level of ethics, and many other intangible issues that are critical to the success of an acquisition, but which are nearly impossible to measure. In addition, a buyer may pay for an acquisition based on the target's technology, only to find that the market shifts in a different direction, rendering its investment worthless.

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The solution in some cases is to first enter into a business alliance with a target. By entering into a number of alliances, a buyer can essentially keep tabs on several potential acquisitions while a new market develops, and then make offers to selected alliance partners depending on which direction the market eventually turns. This is less of an advantage in industries where there is little technological innovation, in which case the acquirer can skip the alliance approach and proceed directly to an acquisition.

In addition, if a buyer makes a substantial investment in a target as part of the alliance agreement, then it may obtain a board seat. By doing so, it has full access to the target's financial information, and will have ready access to any financial or operational issues to which the target is being subjected. Some buyers have a formal process for such investments, where they establish in-house venture capital funds with authorization to make investments within a general range of investment criteria.

If the alliance involves cross-selling of each other's products, this gives the buyer excellent information regarding sales synergies that it can enter into its valuation model. Revenue synergies are among the most difficult synergies to realize, so using an alliance to obtain realistic synergy information can be a gold mine. Also, the buyer can use cross-selling to learn how to sell the target's products, which shows it how to integrate the sales and marketing organizations of the two companies.

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The most important point in favor of the alliance approach is that the two companies have a chance over an extended period of time to examine any potential pitfalls that would interfere with an eventual acquisition, including issues with employees and a variety of communications-related topics. This approach also allows the target's employees to get to know their counterparts in the acquiring firm, which may reduce the amount of employee turnover that sometimes accompanies an acquisition.

The downside of the alliance approach is that a potential target may gain some prestige through the alliance, which can raise the price of the eventual acquisition. Also, taking additional time to work through

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an alliance arrangement gives the target time to be purchased by a competitor or at least set up a bidding war, though this danger can be mitigated by including a right of first refusal in the alliance agreement.

ACQUISITION RISKS FOR THE BUYER—VALUATION

Multiple studies have shown that, for between one-half and two-thirds of all acquisitions, the buying corporation's valuation declines to a level below that of the combined value of both the buying and selling entities before the acquisition took place. In essence, the acquisition transaction destroys value. However, this view avoids the buyer's alternative, which is to build the same expertise in-house. These endeavors are not as public as an acquisition, but may fail just as frequently. The difference is that acquisitions are conducted in the limelight, while organic growth is not. The open question, then, is whether a company really loses more value through acquisitions than through its other growth alternatives.

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A variation on this problem is the "winner's curse," where the bulk of the value derived from the acquisition ends up in the hands of the seller's shareholders. This situation arises because selling shareholders sometimes have no risk at all—they are paid in cash, which means that the entire burden of making the transaction successful rests on the buyer. If the buyer cannot execute on its plan, then the shares held by the buyer's owners lose value. The winner's curse does not arise when the buyer pays with its own stock, since this means that the seller's shareholders will share equally in the risk of properly implementing the acquisition.

A major part of the valuation reduction conundrum is that the two entities are virtually never a perfect match for each other. Some aspects of the target company are of no use to the buyer, and may be actively counter-productive. In particular, the cultures of the two companies may clash so much that it is nearly impossible to achieve a seamless merger. Instead, the two companies operate together under a single corporate identity, but they do not create value. If anything,

internal bickering shifts attention from servicing customers, resulting in lost sales and profits.

Of particular importance to valuation is factoring in the risk of acquiring an entity that is well outside the buyer's core competencies. An acquisition of this type contains a multitude of dangers, since the buyer's management has minimal experience in the target's operations. The best way to avoid this considerable valuation risk is to only acquire related businesses, where the buyer has sufficient in-house resources to deal with any problems that may arise.

The valuation reduction problem is much reduced for a serial buyer. A company that makes a practice of acquiring other entities has (presumably) learned from its mistakes through trial and error. It also has a rigorous system for evaluating and valuing targets, can identify and mitigate acquisition-related risks, and has excellent due diligence and integration systems in place. It is also much more decisive in its negotiations, being more willing to walk away from a deal if it cannot obtain a reasonable price.

In short, there is certainly a risk for the buyer of losing value from an acquisition, but perhaps no more than would be the case for an internally-funded project. If the buyer is uncertain of its ability to execute an acquisition, it can shift some of the risk to the seller, by paying with stock. The best way to mitigate valuation risk is to become a serial buyer of smaller companies, using each acquisition to gain acquisition skill.

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ACQUISITION RISKS FOR THE BUYER—LEGAL

No matter how carefully managed an acquisition may be, there is still a significant risk of lawsuits. Of particular concern is the earnout provision, where the seller has an opportunity to be paid more by the buyer if it can achieve certain financial or operational targets during the year or so following the acquisition. The problem is that the buyer's and seller's goals may conflict following the acquisition, with the seller's management being solely focused on earning the maximum

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payment under the earnout provision, while the buyer wants to integrate the two entities together. A common result is complaints by the seller that the buyer is interfering with its right to earn a larger payment, followed by a lawsuit to obtain what the seller feels is due to its shareholders. The usual solutions for the buyer are to a) never agree to an earnout provision, or b) to budget for a maximum payment under the earnout, irrespective of the results that the seller actually posts.

Directors and officers are also more likely to be sued after an acquisition, if the transaction turns out to have less than stellar results. The grounds for such suits are that the buyer did not perform sufficient due diligence on the seller prior to closing the deal (such as ensuring that an audit was completed on the seller's financial records). Maintaining excellent due diligence records will create a defensible position for the buyer, since the presence of due diligence indicates the absence of negligence.

The buyer can also be sued if the acquisition transaction itself was faulty. This usually means that a key approval was not obtained (such as a shareholder vote), or a regulatory approval of the acquisition. The larger the business, the more likely it is that some legal slipup will occur that opens the door to a lawsuit. The buyer can mitigate this risk by using a high-end law firm with considerable acquisition experience, and even by hiring a second law firm to review the work of the first one.

Another legal problem is that, if the buyer acquires the seller's legal entity, it now becomes liable for *any* problems that the seller had. This can result in lawsuits several months or years after the acquisition, for issues that the buyer knew nothing about. The buyer can mitigate this risk by requiring the seller to indemnify the buyer for any undisclosed legal problems, but the buyer is still ultimately liable for these suits.

A buyer may think that it has avoided these legal problems by acquiring only selected assets of the seller. However, under some state laws, if a buyer acquires assets, then it must also assume liability for faulty products manufactured by the seller prior to the acquisition. Also in selected states, if the buyer pays with its own stock to acquire

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a seller's assets, then the legal system may construe the transaction as a merger, so that the buyer assumes the seller's liabilities.

The buyer also faces regulatory review by the government. As explained further in the Government Regulation chapter, the buyer must notify the federal government if it is contemplating an acquisition that will give it undue influence over a market. Based on an analysis of the submitted information, the government may conclude that the acquisition gives the buyer an excessively large market share, so it either prohibits the transaction or requires the buyer to sell off some assets in order to reduce its monopoly power. While this is rarely an issue for smaller firms, it effectively prohibits larger, market-dominating entities from completing any large acquisitions in the same market space.

In summary, there are a variety of legal issues arising from an acquisition, many of which can destroy any value created by the transaction. The buyer can mitigate some of this risk, but essentially an acquisition does increase the buyer's overall legal risk.

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ACQUISITION RISKS FOR THE SELLER

While the buyer bears most of the risk in an acquisition, some also falls upon the seller—specifically, if it cannot complete an acquisition. The risk arises when a close competitor enters the bidding, and uses its due diligence investigation as a ploy to uncover the seller's competitive secrets. The competitor then backs out of the bidding, and uses the information to compete more effectively. For example, it can acquire the pay rates of the seller's key staff, and use this information to hire them away. It can also copy proprietary production or engineering information, and use it to develop competing products. Or, it can use sales information to approach key customers and offer alternative pricing or service arrangements. In short, a failed acquisition can be catastrophic for the seller.

It can use several techniques to mitigate this risk. The simplest is the standard "burn or return" provision in the confidentiality

agreement that the buyer must sign before being given access to any seller information. This requires the buyer to either destroy or return any seller information that is marked ''confidential.'' However, a less-than-ethical competitor could easily photocopy all such documents, and return the originals. A more secure alternative is to roll out information to bidders in stages. If the bidder displays continuing interest, then the buyer gives it access to increasingly proprietary information. It can also restrict copying of some documents, which are for ''eyes only'' review by the buyer.

Thus, the seller always runs the risk of having its proprietary information scattered among other companies. This is a significant problem if the seller can never seem to close a deal, so that it gains a reputation for always being for sale; this cheapens its perceived value.

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ACQUISITION FOLLOW-UP ACTIVITIES

A serial buyer should always learn from its previous acquisition activities so that it can apply them to future deals. After concluding each deal, the buyer should ask itself these questions:

- How did what we bought compare to what we thought we bought? What investigative errors caused these differences?
- What problems at the target company did we miss, and how can we locate them in the future?
- How could we have spent less time on this transaction?
- Did our cut-off criteria function properly? Did we continue with a deal that should have been eliminated early in the process? Did we drop deals that could have been winners?

A buyer may not be able to answer some of these questions until many months have passed, since problems may not become immediately apparent. To ensure that these problems are still discussed, schedule review dates for three months and a year after the closing.

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The earlier review will pick up most of the problems, while the later one can be used to address late-breaking problems.

The buyer should also create a standard list of key problems that have arisen in the past, and review this document prior to engaging in each subsequent acquisition. The intent is to look for these problems, and mitigate them wherever possible.

THE HOSTILE TAKEOVER

Most of this book assumes that the target company is interested in the buyer's offer, and is a willing participant in the acquisition process. This is not necessarily the case. The buyer may attempt a hostile acquisition, where it tries to make a purchase despite the wishes of the target's management team. This is extremely difficult to do when the target is privately held, since the management team usually owns the company, and can cheerfully spurn all offers. However, if the target is publicly held and ownership is widely dispersed, then the buyer may be able to complete a hostile takeover.

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A buyer usually conducts a hostile takeover through a *tender offer*. This means that the buyer goes around the target's management to contact the target's shareholders, and offers to buy their shares. The rules for tender offers were defined in the 1968 Williams Act, which amended the Securities Exchange Act of 1934. In essence, the buyer sends a packet of information to the target's shareholders, includes a purchase offer, a deadline, and a letter of transmittal. The letter of transmittal outlines the method for transferring shares to the buyer. The buyer has the right to reject stock if an excessive amount is tendered, or if not enough is tendered (e.g., there are not enough shares to gain control of the target). The buyer also has the right to terminate its tender offer. A shareholder can withdraw any tendered shares during the tender offer period by submitting a letter of withdrawal, along with a signature guarantee verifying that the signature of the submitting party is that of the shareholder.

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The tender offer contains a termination date, beyond which the buyer does not intend to accept additional shares of the target's stock. It can extend the tender offer, but must announce the extension no later than 9 A.M. on the business day following the date when the tender offer expires. The announcement must also state the approximate amount of securities that the buyer has already acquired, which gives everyone a good estimate of the progress of the tender offer, and the likelihood of the buyer's ultimate success.

If the buyer obtains at least 90 percent of the target company's stock, then it can adopt a merger resolution on behalf of the target company, accepting the takeover offer. Any uncommitted shareholders will receive the same compensation as all other shareholders who accepted the tender offer; however, these shareholders also retain appraisal rights, where a court can determine an objective fair value for their shares. A shareholder only exercises his appraisal rights if he feels that the tender offer undervalues his shares.

In addition, the buyer must document the tender offer in a filing with the Securities and Exchange Commission, including a term sheet summarizing the material terms of the tender offer, the buyer's identity and background, the source of funds for the acquisition, and the buyer's history with and plans for the target company.

As an alternative, the buyer may engage in a *proxy fight*, where it solicits proxies from the target's stockholders, and votes those shares at a stockholder's meeting that is called for the purpose of voting on the acquisition. The proxy solicitation must comply with federal securities laws, so it is best to hire a proxy solicitation service to handle this aspect of the acquisition on behalf of the buyer.

A hostile takeover is usually an intense and protracted affair, which fully involves the managements of both involved companies. This can be a major distraction from their conduct of daily business activities. Also, it is a reasonable assumption that the target's management will not be cooperative in the event of a takeover, so the buyer must be prepared to completely replace them, which will make subsequent integration efforts much more difficult. For these reasons, a buyer should have very good reasons for proceeding with a hostile takeover.

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DEFENDING AGAINST A HOSTILE TAKEOVER

The target of a hostile takeover can defend itself by incorporating a variety of defenses into its bylaws, articles of incorporation, and employment agreements. The more common of these ‘‘poison pills’’ are:

- *Accelerated vesting*. This provision is located in the target's option and warrant grants, and provides that the vesting periods for all options and warrants shall accelerate in the event of a change in control of the company. This creates more stock for the buyer to acquire. This provision has become less useful of late, because it has become a standard feature of nearly all option and warrant grants, and so is no longer considered a specific protection against a hostile acquirer.
- *Back-end plan*. This provision is designed to ensure a minimum acceptable price for *all* of the seller's shareholders. It does so by giving each shareholder the right to exchange each share for either convertible stock, cash, or a note that matures within a short period of time. The conversion value can be for a fixed amount, or for a percentage of the price per share offered by the bidder. It does not necessarily prevent a hostile takeover, but will ensure a reasonable value for all shareholders whose shares might not otherwise be acquired by the bidder.
- *Dead hand provision*. This provision states that only the original directors who put a poison pill provision in place can remove it. This provision keeps a buyer from attempting to stack the target's board of directors with new nominees, since they will be unable to revise the provision.
- *Fair price provision*. This provision requires a supermajority of the shareholders (usually two-thirds) to approve a proposed acquisition unless the buyer pays all minority shareholders a fair price. A fair price can be defined as a price that equals or exceeds the price the buyer paid to acquire the target company's shares prior to its formal acquisition bid, or an average of the target's stock price on the

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open market for the preceding month. The intent is to provide fairness to the shareholders in a two-tier transaction, where the buyer acquires a majority interest, and later makes an offer for the remaining outstanding shares.

- *Flip-over plan.* This provision gives current shareholders the right to purchase shares of the company upon the occurrence of a triggering event. For example, shareholders may be able to buy additional shares at half-price if there is a hostile bid for the company. This right would ''flip over'' to the surviving entity if the target were acquired, so that the buyer would face substantial dilution of its shares. Obviously, additional language in the provision should not trigger the flip-over if the transaction is approved by the board of directors—otherwise, the company would never be able to sell itself, even if it wanted to.
- *Golden parachutes.* The employment plans of key managers may state that very large payouts to those managers will automatically be triggered if the company is acquired in a hostile takeover. While this will increase the acquisition cost of the buyer, it also raises the suspicion that the management team has included the provision for its own benefit.
- *Staggered director elections.* Most companies elect their entire board of directors once a year, which makes it easier for a buyer to acquire a sufficient number of shares to force its candidates onto the board during the annual shareholders' meeting, and gain immediate control of the company. However, if the target can alter the situation to allow multi-year staggered elections, this requires much more perseverance by the buyer over several years in order to obtain a majority of the director seats. An example would be a six-director board, with two directors being elected each year to a three-year term. This would require two years for a buyer to obtain a majority of seats.
- *Supermajority provision.* This provision requires that more than a simple majority of shareholders approve a merger—usually two-thirds. A buyer can get around this provision by gaining control of

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a simple majority of the outstanding shares, and then voting these shares to eliminate the supermajority provision. To prevent this, a company must also have a provision requiring a supermajority in order to modify the supermajority voting provision.

- *Voting in person.* This provision states that a shareholder cannot submit a written consent, but rather requires a shareholder meeting in which votes must be cast in person. This is a rare provision, since a widely distributed shareholder base may make it impossible to pass any shareholder resolution, much less an acquisition approval.
- *Voting rights.* A separate class of stock can be endowed with multiple votes per share, so that a small group of shareholders effectively wields control over the entire company. This goal can also be achieved by having a class of convertible preferred stock, where each share of preferred stock can convert into multiple shares of common stock.

Before company officers attempt to adopt any of these provisions, they must realize that their shareholders may very well not want any of them. After all, the intent of most shareholders is to eventually obtain the highest possible price for their shares, and a buyer is the one most likely to give it to them. Consequently, adopting anti-takeover provisions actually *reduces* the value of their company, because it drives away bidders. Thus, many astute shareholders will vote down such proposals. Anti-takeover provisions are most likely to be found in closely-held companies, where the owners are also members of management, and are more concerned with retaining control than with the value of their shares.

The target company can also elect to switch roles and make an offer to purchase the hostile buyer; a position from which it will back down only if the hostile buyer does so as well. In some cases, the target company may actually acquire the erstwhile hostile buyer. This is generally considered counterproductive to the target's shareholders; they will receive no payout premium, since they are the owners of the surviving company.

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Another tactic is for the target to acquire a third company. By doing so, the combined entity may require so much difficult integration work that the hostile buyer now finds it to be a less attractive acquisition, and withdraws its offer. This is an especially attractive ploy if the new acquisition makes the target company so large that the hostile buyer might precipitate an anti-trust investigation if it were to follow through with its plans. However, the buyer can also sell off a sufficient amount of the newly acquired assets to bring it into compliance with anti-trust laws.

What if the target finds itself without any procedural defenses against a hostile buyer? It can bring a more suitable third party into the fray. One option is the *white knight*, which is a third party whom the target asks to make an offer for it, as an alternative to the hostile buyer. The target will still find itself owned by someone new, but presumably the white knight will be friendlier to management.

A less traumatic alternative is the *white squire*. This is a third party who agrees to buy a large block of the target's stock under a standstill agreement, whereby it cannot sell the shares to a hostile bidder. Alternatively, the target may require a right of first refusal if the white squire intends to sell the shares to another party. This tends to be a purely financial play for the white squire, under which the target essentially guarantees it a reasonable return on its invested funds in exchange for holding the stock for a certain period of time.

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An alternative to the white squire is to shift stock into the hands of company employees through an employee stock ownership plan (ESOP). If the ESOP owns a sufficiently large proportion of company stock, a buyer will have an extremely difficult time rounding up enough stock elsewhere to obtain a majority of all shares held, thereby eliminating the acquisition threat.

The target also has the option of implementing a ''scorched earth'' policy, where it sells off its most valuable assets. The target is still valuable, since it has presumably now exchanged those assets for cash, which a buyer may still want to possess. Thus, the target must take the additional step of distributing the cash to its shareholders as a one-time dividend. By doing so, a hostile bidder has no point in continuing

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with an acquisition attempt. The considerable downside to this technique is that the target is now merely a shell of its former self, with little value.

There are many defenses against a hostile acquisition, but many of them damage the value of the underlying company by making it excessively difficult for *anyone* to eventually buy the company. If a company persists in implementing anti-takeover activities, then one must assume that it is more interested in maintaining independent control of the company than in maximizing shareholder value.

SUMMARY

This chapter has noted the reasons why people buy and sell companies, and revealed the basic process flow of an acquisition. In addition, we've covered a variety of ways to locate acceptable target companies, what special acquisition risks can occur, and how to engage in and defend against a hostile acquisition.

In the remainder of this book, we delve into much greater detail about the various stages of the acquisition process. There are separate chapters on how to create a valuation analysis, write a term sheet and a purchase agreement, how to conduct a due diligence review, and the steps that are required to fully integrate an acquisition. These chapters are in the approximate order that a buyer would follow for an acquisition, but they can be read independently of each other.

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