

Stages of the M&A Process

For both the buyer and the seller, the M&A process is an exciting and stressful experience. Like any experience that is full of uncertainty, different personalities, and risk, the more realistic your expectations, the more likely you are to weather the process successfully. You might even become one of those people who are addicted to “the deal.” The intent of this chapter is to introduce you to the overall M&A process from beginning to end. The beginning of the process might not be where you expect it to be, and the end certainly extends past the final signing of agreements. Taking a few minutes to work your way through this chapter will help you to gauge your timing, activities, and expectations, and will make the entire process more productive and profitable.

The Differences between Buying and Selling

For every transaction there must be a buyer and a seller. One cannot succeed without the other, and both are dependent upon each other for a successful transaction outcome. Successful negotiators and salespeople are experts at understanding the other person’s perspective. Even though both may have opposing viewpoints with respect to the specific final process and outcome objectives, both also have a vested interest in making the process proceed to a productive and profitable conclusion. Understanding that an M&A transaction cannot be consummated without the other person’s agreement provides some motivation for your understanding of their perspective.

The basic difference between buying and selling can be summed up in this way:

- The buyer is looking for future value to be derived from the purchase. Toward this end, the buyer is looking to purchase the maximum amount of company for lowest possible price.
- The seller wants to sell for the highest possible price combined with the fewest number of future entanglements.
- Buyers and sellers in a strategic merger are looking for a lasting partnership relationship that benefits both buyer, seller, and their respective shareholders.

It is naive to assume that both parties are working toward the complete mutual satisfaction of all parties concerned, especially when the dollar amounts involved become large. But it is also naive to assume that everyone is a business mercenary out for his own particular self-interest to the exclusion or sacrifice of the other party. For example, a seller who sets too high an asking price will likely meet with a longer sale process and much frustration. And a buyer who offers too low a purchase price (low enough to be insulting to the seller) will hurt his own credibility and undermine his ability to negotiate with that seller in the future.

There is a “good faith” aspect to any large-ticket sale process that forms the foundation of any solid business transaction. If you have ever done business with someone you do not completely trust, you know that good faith is often the element that brings an otherwise stalled transaction back to life. Conversely, a lack of good faith can undermine any possibility of creating a solid transaction between parties who would otherwise be excellent buyer and seller candidates. A balance must be found between watching out for your self-interest while ensuring that the other party doesn’t feel cheated or completely insulted in a transaction.

In reality, some people succeed by being completely ruthless, but I have found that these people exist on television more than in real life. Anyone who practices business in this way is often a “one deal wonder” who might excel on a single transaction but generally cannot repeat the performance. Word gets out, and everyone now expects that person to be the shark that he has shown himself to be and to handle the negotiations accordingly. My experience has been that most people will naturally and jealously protect their own company’s best interests. Most are people of integrity who want some level of reward for both parties, but who are hoping to tip the reward factor more

in their company's favor. Approaching a negotiation within this context of integrity is almost always an excellent starting point.

Something else to consider about M&A is that the buyers and sellers are much like responsible yet divorced parents. They are happy to have made the major transition involved, but they also have an ongoing interest in the well-being of the child. A seller, especially a founder-seller, will often want a voice in the future operation of the sold entity. The buyer might well want the founder-seller involved in the future operation of the entity as it embarks on its new life. The transferred business becomes the child that both parents choose to nurture as a future project. This point may look as though it applies to only very small businesses, but many large companies are run by original founders who have created a solid internal following over previous years of success. Alienating the seller may also alienate many key employees who may transfer with the purchase, and buyers should be wary of this possibility and its ramifications.

If bad blood exists between buyer and seller, just as with two divorced parents, the final result generally will be hardest felt by the children. In the case of an acquisition, the negative impact will be borne by the sold company in the form of impeded future performance and unfulfilled objectives. If the seller has a portion of the sale price tied to future financial performance and that performance is below projections, then the seller loses. If the future financial performance does not meet initial expectations, then the buyer certainly loses. It is in the interest of both parties to have the negotiations proceed from a perspective of self-interest, but not at the expense of future cooperation. The more that you understand about the other parties in the negotiations, the more likely you are to achieve your transaction goals and create a post-purchase entity that meets or exceeds expectations.

Preparing to Sell or Buy

A common misconception is that a business manager can decide to buy or sell a company today, and simply close the deal within a few weeks. That might be the case on rare occasions, but an M&A transaction is usually complicated and may take months, or even years in some rare cases, to finalize. Large company transactions requiring regulatory or antitrust approval may not be approved at all, but may tie up both companies for extended periods of time in dealing with the involved regulatory bodies. If you are selling, you must

prepare your company to look as appealing as possible to a potential buyer. If you are buying, you must do some homework to determine the proper selection criteria for determining the optimal acquisition target company. These points may seem obvious but you will find that implementing the details associated with achieving these “obvious” points requires direction and commitment. Chapter 16, “Preparing to Buy and Sell,” outlines the details associated with presale preparations, but here are a few items to whet your appetite:

- Your legal structure should be in order so that there are no unexpected legal, tax, or litigation issues that will catch you or a prospective buyer by surprise.
- Your financial reports should be auditable with a minimal number of red flags (problems) coming to the surface.
- Your operational plans should be standardized so that another uninitiated party can understand the value intrinsic to what you do.
- Your personnel and management should be stable and experienced, because a prospective buyer will often want the management team to transfer with the company when purchased.

Just as you would put a new coat of paint on your house before selling, you should make your company look as attractive as possible. This takes time, effort, money, and foresight. Sellers might find that their company runs better with all of these value-enhancing factors in place which makes their implementation a good idea for all parties involved. Buyers will find that preparatory work enables them to recognize the right acquisition fit when it comes across their desks. Buyers are well served by giving advance consideration to a number of important aspects of the transaction, such as:

- What is the desired strategic fit between your company and the proposed acquisition target?
- What are the financial parameters within which the acquisition must conform? These parameters may include annual sales, expected purchase price, financial structure, ownership, and others.
- What are the desired personnel requirements between the acquired management and that of your company?
- Are there intrinsic economy of scale parameters that qualify or disqualify a potential acquisition target?

- What levels of technology and engineering are required to enable the acquired company to meet the buyer's technology goals?

There are many different aspects of an acquisition target that must be considered before you can determine if a proposed company is right for you. See Chapter 16, "Preparing to Buy and Sell," for a more detailed discussion of the important advance actions that optimize your likelihood of success. Of one thing you can be sure: The more that a buyer understands his or her motivations for acquiring another company, the more effective the buyer will be at separating the unlikely candidates from those that present the highest likelihood of a successful transaction.

Both buyer and seller should form an M&A team of professionals and managers who will work with you throughout the process. The team should include:

- An accountant for assistance on the financial side of the transaction.
- An M&A attorney who is experienced with transactions of your type, whether a privately held, publicly held, or nonprofit organization.
- A tax attorney (who might be the same person as the M&A attorney, but does not necessarily have to be).
- Key members of your management team who understand the business aspects of the transaction. Don't slump on selecting these people. If the deal doesn't make business sense, it is really no deal at all, even if it does make financial and legal sense. Select these personnel based on previously determined strategic business goals for the M&A transaction.
- You might want to investigate business brokers who can assist you with finding either a buyer or a seller, depending on your side of the transaction.
- Finally, you must ensure secrecy on the part of all people involved. This point cannot be too heavily stressed, especially if you are the seller. More on the need for seller secrecy is presented in Chapter 16.

In summary, buyers should not expect to find the right deal unless they have done the homework needed to recognize that deal. Sellers must make themselves as attractive as possible and must understand their most likely buyer, if they plan to get the highest possible price for their company. The more you know about what you are looking for, the more likely you are to find

it. Companies will find that time spent preparing for a transaction will better ensure a smooth and profitable transaction.

Finding the Candidate

Think back to the last time you purchased a house. Unless you were one of the lucky people who simply stumbled on the right house, you probably spent a lot of time looking at all types of houses before you found the one that was right for you. Your Realtor asked you questions about bedrooms, baths, garage size, and square footage, and so on. From this information your Realtor narrows down the field of possible houses from the unmanageable thousands available to the manageable few that present the best possible fit. The same is true for a business acquisition. There are thousands of businesses that could be potential candidates, but only a few that will ultimately meet your desired criteria. Finding them from the thousands of candidates is a tricky and usually time-consuming process.

Just as the search for a house can be narrowed down by defining basic selection criteria, so can the search for the “short list” of possible acquisition candidates. Here are a few items to consider as you start refining your initial filtering criteria:

- The maximum and minimum revenue range
- Geographic location
- Years in business
- Market share
- Reputation (either good or poor)
- Distribution channels
- Technology provided
- Corporate culture
- Specific business strengths, such as R&D, sales/marketing, or production
- Low-cost as opposed to high-price provider
- Services or products provider

- Industry
- Publicly traded or privately held
- Reputation of the management team

This list can continue to a high level of detail, which will help in refining the search. Don't be surprised if a very detailed list reveals no companies at all; at this time, you start dropping "nice-to-have" items from the list and search based on "must-have" items. Don't be fooled into thinking that a highly refined list will find exactly the right target. Much of the successful M&A process is derived from the interaction of management, owners, shareholders, and financial backers, all of which cannot be effectively quantified. All you are trying to do at this point is distill down the list of possible companies to a short list of the (roughly 10 or so) companies on which a more detailed investigation can be performed.

Some people employ the services of a business broker at this initial qualification stage. These companies take a percentage of the transaction total (usually five to fifteen percent) for assisting with the initial search and with the consummation of the final deal. Using a broker usually speeds up the filtering stage of the acquisition process, but it is not cost-free. Remember that their fees must be paid at some point and are embedded into the purchase price. The more that buyer and seller know about each other, the more accurately they can assess the likelihood of a successful future business relationship. Plan for this process to take time. Spend the required time in the due diligence stage and thoroughly understand what you are committing to with the sale or purchase.

Buying and/or selling a business is one of the most important decisions a business owner or manager will make. The seller sees the sale as a payoff for years of work. Handling the sale improperly can shortchange those years of effort and attention. Purchasing the wrong company draws valuable resources from the parent company, causing both the parent and target company to go into financial distress, seriously hurting both the buying company and often the career of the person responsible for the acquisition. The sell/buy decision is best made rationally, without haste, to best ensure a successful postsale result. Overzealous emotion and enthusiasm should be saved for the postsale environment, in which the consummated deal must perform according to expectations.

The Meetings

The M&A process usually becomes quite complicated unless the transaction value is small and the number of parties involved are few. The buyer has a team of experts, as does the seller. If there is any antitrust exposure, there will be added complexity. Even small companies may have antitrust exposure under very specific market situations. See Chapter 17, “Competitor Transactions,” for additional information on antitrust issues. Should either party be a publicly traded company, the complexity increases again. Should either party be involved in litigation of any kind, the complexity increases yet again. Be aware that unexpected and often unwelcome surprises come up during the M&A process. These surprises might stem not from deceit on anyone’s part, but simply from oversight.

The seller and buyer will have a number of internal meetings early in their respective processes that help define the various objectives of the purchase/sale. Notice that none of these meetings involve anyone outside of the immediate company. This is the planning stage for both buyer and seller. The next meetings often involve a business broker who will assist in either marketing the firm if you are the seller or finding viable acquisition targets for the buyer. Once the target companies are determined, initial meetings will be set up to investigate the willingness of the parties to either buy or sell.

After these initial meetings, a letter of intent (or letter of understanding) is often prepared stating both parties’ desires to proceed to the next step. Important items are outlined in this letter, along with the contingencies associated with each item. There are people who contend that a letter of intent is a waste of time because it is not legally binding, except with very specific conditions attached. These conditions are usually highly focused in scope and not general in nature. There are others who contend that this letter is critically important because it represents a written understanding between the parties involved. I fall into the second camp of people.

A letter of intent can be effectively used as a communication tool that ensures that both parties are working in the same direction and with the same overall intentions. Its creation forces the discussion of many important and specific items that might have been initially overlooked but would have ultimately been encountered later in the process. Assume, for example, that you

intend to purchase a company with the expressed intention of breaking it up into smaller entities which will then be resold. Assume also that the seller specifically will not allow that to happen. This discord, which is a deal-stopper, is best discovered at the early stages instead of later after the expensive due diligence stage is completed.

The seller and buyer both have a vested interest in finding deal-stoppers at an early stage. Sellers will ultimately have to reveal detailed, potentially confidential information in the later due diligence process. Buyers will invest time and money in performing this due diligence. Eliminating candidates at an early stage saves money, time, and aggravation, while also reducing risk for all involved parties.

The Due Diligence Stage

Due diligence is usually the most time-consuming, nerve-wracking, and expensive stage of the M&A process. The intent of this stage is to help the buyer understand the inner workings of the seller's company. The better the understanding, the more realistic the expectations and price. It requires that the buyer be given a high degree of access to the selling company's customers, financial records, legal records, and operations, sales, and marketing functions. Investigators are looking for items that either validate the offered price or items that diminish the company's value and its purchase price.

The seller is torn between two conflicting desires during this stage. On one hand, the seller wants the buyer to learn what is needed to feel comfortable with both the seller's asking price and quality of offering. On the other hand, the seller does not want to reveal unnecessary information to the buyer, should the deal not consummate in a final purchase. This fear of disclosure is particularly acute when the buyer is the seller's direct competitor, and for very good reason. Every company would love to know the detailed financial, marketing, and sales aspects of its competition, and due diligence requires that this information be disclosed. Should the transaction fall apart, the seller is placed at a decided disadvantage compared to the buyer, who disclosed little or no confidential information about its own internal processes during due diligence.

Once again, this is where the letter of intent comes into play. Sellers should make their secrecy boundaries clearly known in the letter of intent,

especially if those secrecy boundaries are immutable. The buyer can either accept or reject those boundaries at this earlier stage instead of being caught by surprise later. Nondisclosure agreements (NDAs) are also executed early in the process specifically with the intent of protecting the secrecy needs of the parties involved. The NDA is often executed before the parties ever meet for the first time, especially when a broker is involved.

As an alternative approach to immediate full disclosure to the buyer by the seller, an interim stage can be defined. Here, the buyer gains access to certain information with the intention of deciding on a purchase price and set of acceptance conditions. The buyer then commits to the purchase, in advance, contingent on these conditions being met. This approach provides both the seller and buyer with some level of protection.

There is risk on both sides with the revealing of confidential information. The seller who is constantly worried about giving away secret information should remember that each piece of confidential information revealed to a buyer also represents another potential area for litigation should the transaction not consummate as intended. Assume that the seller, during due diligence, reveals specific information about a major customer that is not currently a customer of the buyer. Assume also that the purchase by that buyer does not occur and that due diligence was completed. Should the buyer just happen to gain a major portion of that major customer's business within a short time after due diligence, the seller may contend that information gained during due diligence enabled the buyer to obtain that business, which will likely be in violation of the nondisclosure agreements. A buyer incensed enough about the situation might turn to litigation as a possible remedy. If the buyer had never been exposed to this confidential information in the first place, it would not have been put in the position of having to defend itself. For this reason alone, many large companies shield themselves from the confidential information of smaller companies as a standard business practice. Due diligence, by its very nature, pushes the threshold of confidential information disclosure and should be treated with the respect it deserves. Chapter 18, "Performing Due Diligence," presents the due diligence stage in great detail.

Here are a few minimum items that should be included in any due diligence effort:

- A legal structure review, including tax liabilities, employee disagreements, class action suits, or other pending litigation.

- A review of ownership and capitalization structure.
- A general breakdown of the customer base, with a more detailed analysis required to make an effective assessment. See Chapter 9, “Detailed Marketing and Sales Evaluation,” for more discussion of marketing and sales due diligence topics.
- A review of intellectual property rights, including trademarks, patents, and other areas of unique and intrinsic value. This is particularly true for technology companies.
- Outstanding liens that are guaranteed by the company and/or its owners.
- Technology evaluation that includes development tools, cycles, processes, and personnel. Key value areas should be highlighted and evaluated in light of acquisition goals.
- Financial statement review for the prior three to five years, including the minutes of board meetings and so on.
- Annual reports and required Securities and Exchange Commission (SEC) filings for any publicly traded company. This action was probably already taken during the prequalification screening stage.

Due diligence is a complicated process which should be given major emphasis. It is that stage where the buyer determines whether the target company is really everything that the seller claims it is. The buyer's acquisition team is critical at this stage. Communication within the team ensures that nothing gets overlooked and helps to consolidate the vast amounts of information collected.

Due diligence works both ways, especially if the buyer expects the seller to take stock or future promises as part of the transaction. The buyer should also be willing to open his own company records to the seller so that the seller can determine his level of risk in taking future promises in lieu of today's dollars. Sellers also get a chance to learn more about the internal workings at the buyer's company, which also enables them to determine for themselves if a cultural fit between the two exists. After all, sellers will likely become employees of the buying company once the transaction is finalized.

A willing seller is critical during due diligence. The integrity of all parties must be intact or the seller could fight the buyer's information requests at every step, making it a tough and stressful process for all concerned. For this reason alone, many buyers shy away from a hostile purchase involving an un-

willing seller or competitive situations that require extensive disclosure of confidential information that sellers are simply not comfortable providing. Due diligence is an integral and critical part of the M&A process. The way it is handled tells a lot about the buyer and seller while providing the foundation upon which a final purchase price is based.

Special Technology Comments

If you purchase a specific company with the intention of acquiring its technology or its technical personnel, the process gets more complicated. A detailed engineering analysis that assesses the reality of integrating and effectively using the technologies involved must be performed. More than one company has acquired technology assuming that their own engineers were good enough to make it work as desired, only to later discover that the reality of the situation was frustrating and expensive. Anything is possible with both time and money, and the shorter the time, the greater the money required. Unfortunately, some technology projects simply cannot be time-compressed beyond a certain point, no matter how extensive the resources thrown at them.

Integrating technology should not be assumed an easy process; unfortunately, this integration assessment is often made by nontechnical M&A managers. As with any complicated process, you are best served by first outlining a process for technology evaluation and then walking through the process one step at a time. Make sure that you include the input of engineers that are familiar with the technologies involved when performing the technology area evaluation to minimize unfortunate and expensive future surprises.

Arranging Financing

As the due diligence stage comes to an end, the buyer and seller should be closing in on a specific price for the acquisition, including associated stipulations. The capacity to fund the purchase is required of the buyer, and the seller is well advised to ensure that the buyer can come up with the required

financing. Just as a house buyer is prequalified for the required financing, so should a business buyer be prequalified. This financing will depend heavily on the financial condition of the acquired company, but the end result is the same. The buying and/or selling company must be creditworthy or the deal will simply not go through.

Buyers have usually lined up financing when the letter of intent is signed, and sellers are completely in line to ask early on about the buyer's ability to fund the purchase. A meeting to discuss methods of financing is warranted earlier in the process once a general price range is established to ensure that both parties are not wasting time. Sellers may seriously consider stalling the due diligence stage until the buyer has shown itself to be creditworthy. Chapter 6, "Deal Types and Their Funding," presents a number of different acquisition purchase funding methods.

Negotiating and Signing the Agreements

Once the due diligence stage is finished, the lawyers begin negotiating the specific terms and conditions of the deal. As a business manager, it is important that you walk that fine line between overcontrolling the negotiations and making sure that the overall business intentions are met. The detailed legal discussions are usually best left to the lawyers who negotiate these types of transactions on a regular basis.

Remember that lawyers are great at creating a legally binding agreement, but they are not always great at making sure that the agreement makes business sense. That is where the management team plays a critical role. Signing a legally binding agreement that makes little business sense is obviously counterproductive. Signing a solid business agreement that is not legally binding on the parties involved is nothing but a future breeding ground for discord and litigation. See Chapter 21, "Legal Considerations," for additional information regarding the legal aspects of M&A transactions.

Operating the Ventures

Many people think that the merger and acquisition process stops at the signing of the agreement, and these people are in for a rude awakening. The buyer must now make the acquired company perform up to its purchased expectations. If you think about it, a good marriage starts when the bride and groom say “I do” and the creation of a solid marriage happens based on what is done from that point forward. It is no different with an M&A transaction. The contract simply defines the parameters for the future relationship. Only people can make that future relationship work so that the planned expectations are met or exceeded. This is where buyers and sellers find out if all that they thought true during the due diligence stage is really true. This is when the buyers meet the employees, customers, vendors, and financial partners on a daily, operational basis. This is when the sellers get to work with the buyers on a regular basis. This is when transaction-generated agreements are met or avoided. Personalities, cultures, and technologies must merge at this stage or future performance problems (which may undermine profitability) will likely arise.

Underestimating the pitfalls associated with this stage is a serious mistake. More than one acquisition that looked great on paper has fallen apart in the postacquisition reality of personalities, cultures, and mismatched goals. Chapter 22, “After The Deal Closes,” takes a detailed look at postsale integration issues. Whatever you do, don’t ignore this important topic. All the due diligence and financial negotiating in the world won’t stand up to a poorly executed integration plan.

Moving on to the Next One

When the current transaction is finished and the postsale integration is underway, your acquisition team should be in a position to move on to the next one. Before moving on to the next transaction, it is a good idea to assess the effectiveness of your current team in light of the last transaction. What could be done to improve the next acquisition? Sellers can only sell once in a while, where buyers can buy as often as their financing and operation will support.

Chapter Summary

The M&A process is more often than not a long process full of details, personalities, and decisions. The larger the target company, the more complicated the process. If you are purchasing a company strictly as a financial venture, the M&A process is complicated enough. Adding specific personnel, technological or strategic objectives to the transaction goals simply complicates the process even more.

Buyers and sellers should understand their specific motivations and goals as they pertain to the purchase under investigation. Clearly defined goals help greatly in evaluating the impact of subsequently uncovered details. Developing these goals requires advance preparation and evaluation on the part of both buyer and seller and greatly enhances the likelihood of postacquisition success.

It is important that buyer and seller understand the perspective of the other party involved in the negotiation. The M&A process takes an extended period of time, during which the buyers and sellers are constantly learning more about each other. Maintaining an environment of trust and integrity helps greatly in dealing with numerous issues. Should trust or integrity be called into question, the entire transaction could be placed in jeopardy, even though on the surface all the operational and financial pieces seem to fit.

Care should be exercised by both buyer and seller before moving into the due diligence stage, as this stage requires extensive disclosure of confidential information and a substantial time commitment for both parties. A letter of intent should be signed prior to moving to the due diligence stage to ensure that both buyer and seller are working toward the same goals with the same set of assumptions. Make sure that both buyer and seller keep a close eye on the postacquisition environment so that future areas of enhancement or trouble can be discussed before the actual transaction is finalized. Performing the steps associated with the purchase of a company may take several months, but the combined companies have to coexist and operate into the future for years to come.