CHAPTER 1

Introduction

M&A, deals, buyouts, LBOs, MBOs, private equity, venture capital, corporate development, and a myriad of other terms are used to describe large transactions that fundamentally change the nature or course, and control, of a company. Although there are many differences among these different types of deals, a common thread runs through all of them. They are all *Strategic Transactions* that involve a change or shift in control of a company and usually a corresponding shift in strategic direction.

There are many different types of transactions done by a company during its life cycle. Companies execute agreements with suppliers, customers, partners, regulators, and financiers almost constantly. A lawyer would argue that running a business is really a long series of contractual obligations, entered into, complied with, and terminated. At any given time, most companies are entering into new agreements and consummating new transactions on a daily, even hourly, basis.

Strategic Transactions are different. They are the seismic, life-changing events that fundamentally alter a company. They usually change not only who controls the company but also the strategic direction the business will take. They sometimes take a public company private or make an independent company into a small subsidiary. While full acquisitions are the most commonly known Strategic Transactions, there are many variations on the theme. However, all Strategic Transactions have a lot in common. They all involve a substantial or total change in control and a large amount of money (or other form of payment) changing hands. They all involve a *Buyer,* who will want to learn a tremendous amount about the business and understand it deeply. They also all involve a *Seller,* who is trying to maximize the value of its business but also often has other interests, including the long-term partnership it may be entering into with the Buyer and the fate not only of its business but also of its employees.

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Over the past few decades, Strategic Transactions have played an increasingly important role in business. Companies turn to Strategic Transactions as an alternative to investment in their organic growth or when obtaining capability via strategic alliances does not provide the necessary control and/or economic value. From the growth of private equity investments in a variety of forms to the increasing use of acquisitions as a growth tool by large, and even midsized, companies, Strategic Transactions have become a standard and common part of the business landscape, fueling the growth of large and small companies. There is a long-term upward trend in both the volume and average deal size of acquisitions in the United States. Exhibit 1.1 shows that US M&A (measured in terms of dollars) remained on a substantial upward trend over the past two decades despite the downturn during the collapse of the tech bubble in 2001 and 2002, and the 2007–2009 financial crisis (aka the Great Recession). More recently, even though deal volume in 2015 was about the same as deal volume in 2005, during this 10-year time period the total dollars spent on US M&A activity grew at a compounded annual growth rate (CAGR) of 5.9 percent.

While the increased dollar spend, and hence average deal size, are partly explained by inflation, the increase in dollar volume is a clear indication that Strategic Transactions continue to be a core tool of growth for US companies. The recent trend is even stronger. Looking at the period coming out of the Great Recession, 2009–2015, both deal volume and total dollars spent on transactions increased, 3.6 percent CAGR and 18.1 percent CAGR, respectively, as the economy recovered.

Many of the largest US technology companies today received their early funding from venture capital and private equity investments, and many of the largest and most established names in business, including IBM, General Electric, and Pepsi, as well as newer stars, such as Oracle, Google, and Cisco, drove a significant part of their growth through acquisitions. (*Note:* More on corporate M&A will be discussed in Chapter 2.) For the 11-year period of 2006–2016, US venture capital raised increased from $36.4 billion (2006) to $41.6 billion (2016)—see Exhibit 1.2. However, during this period, venture capital raised declined dramatically in 2009 as a result of the impact of the Great Recession and did not again reach even 2007's level of ~$35 billion until 2014. Most recently, US venture funds secured $41.6 billion in 2016, an 18.2 percent increase over 2015's $35.2 billion. This new capital will likely be put to use over the next five years.[1]

Private equity (PE) firm investment is one form of M&A activity in that PE firms are generally buying *companies* for their own investment portfolio. In the last decade (2006–2015), despite the Great Recession of

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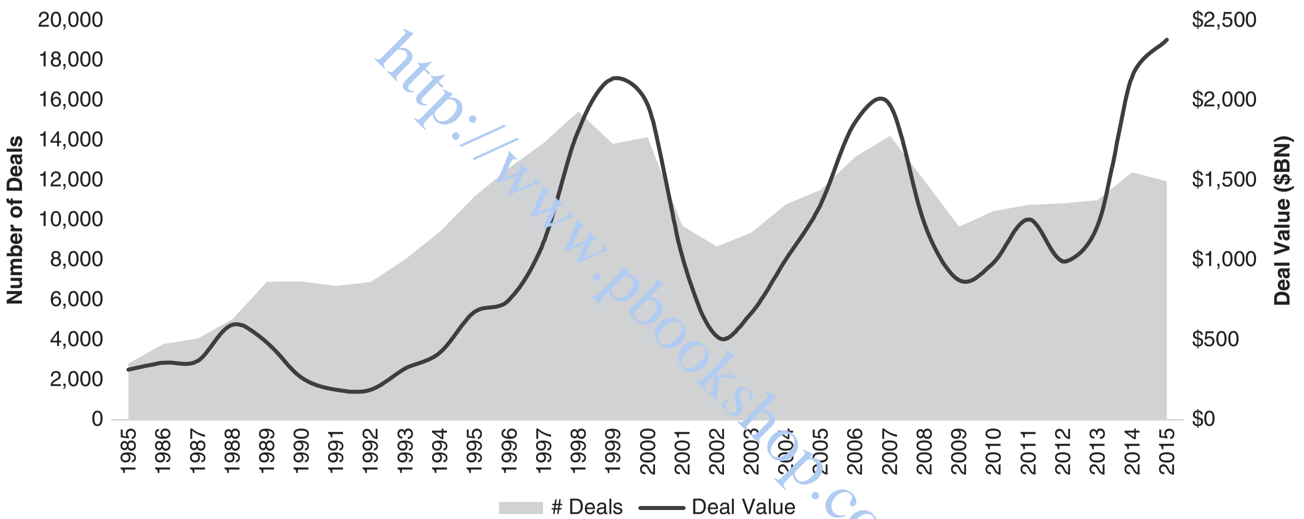

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EXHIBIT 1.1 Historical US M&A Activity
Source: https://imaa-institute.org/statistics-mergers-acquisitions/#Mergers-Acquisitions-United-States-of-America.

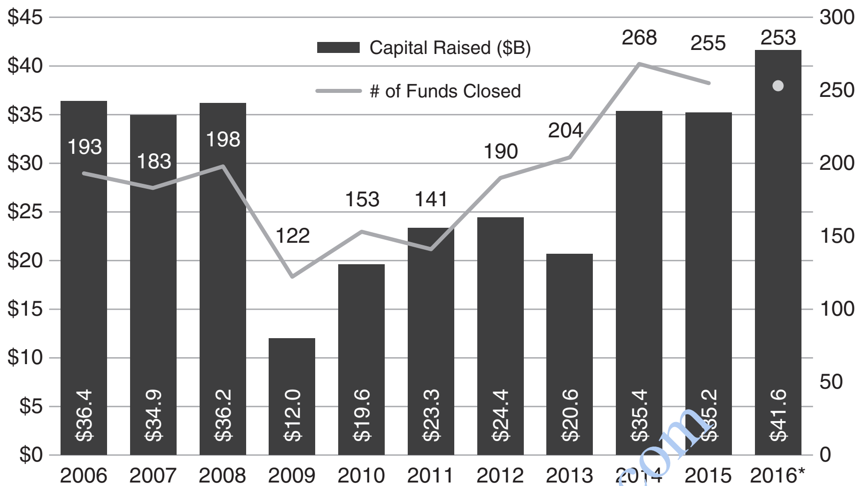

EXHIBIT 1.2 US Venture Capital Commitments
Source: NVCA 4Q 2016 US Venture Monitor, page 17, National Venture Capital Association.

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2007 to 2009, US private equity firms increased their *investment*—that is, their M&A activity—from $487 billion in 2006 to $632 billion in 2015 (see Exhibit 1.3). When you look at the money available for M&A activity globally (so-called *dry powder*), the same pattern emerges. A near record $1,307 billion was available at the end of 2015, up from $800 billion at the end of 2006 (see Exhibit 1.4). The signs are clear that M&A activity will increase as these funds are eventually put to use across all sectors of the global economy.

However, Strategic Transactions are not a riskless exercise; far from it. Although they can be a source of dramatic and quick growth when they are successful, they can be a huge drain on a business when they fail to deliver. In what is often known as the *winner's curse,* many studies find that most of the value derived from many deals ends up in the hands of the Seller rather than the Buyer.[2] Often, this failure is the result of a gap between the cost and revenue synergies expected and actually realized. In some cases, this is the result of optimistic expectations, and in others, of a failure to execute effectively on integration plans.[3] One study found 64 percent of the deals studied destroyed value for the Buyers' shareholders.[4]

This book will provide an overview of all the key steps in a Strategic Transaction and try to provide the reader with not only an overview of how

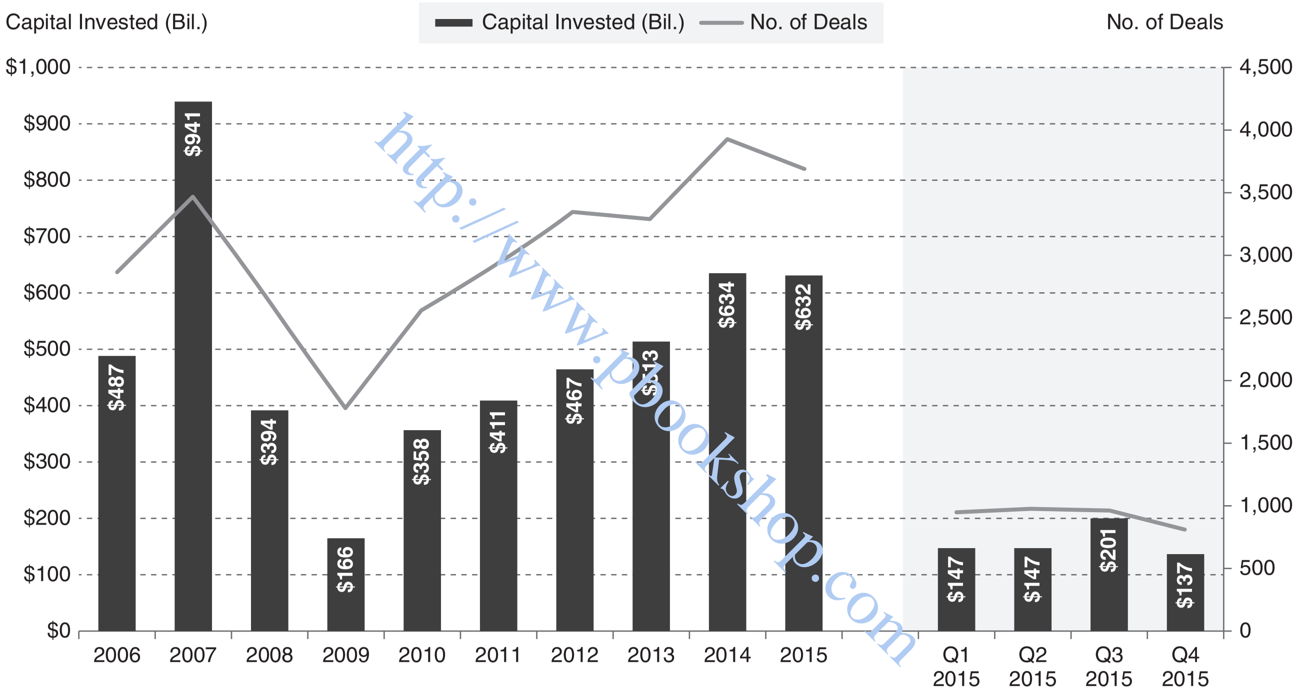

EXHIBIT 1.3 US Private Equity Investment
Source: Private Equity Growth Capital Council website (now the American Investment Council).

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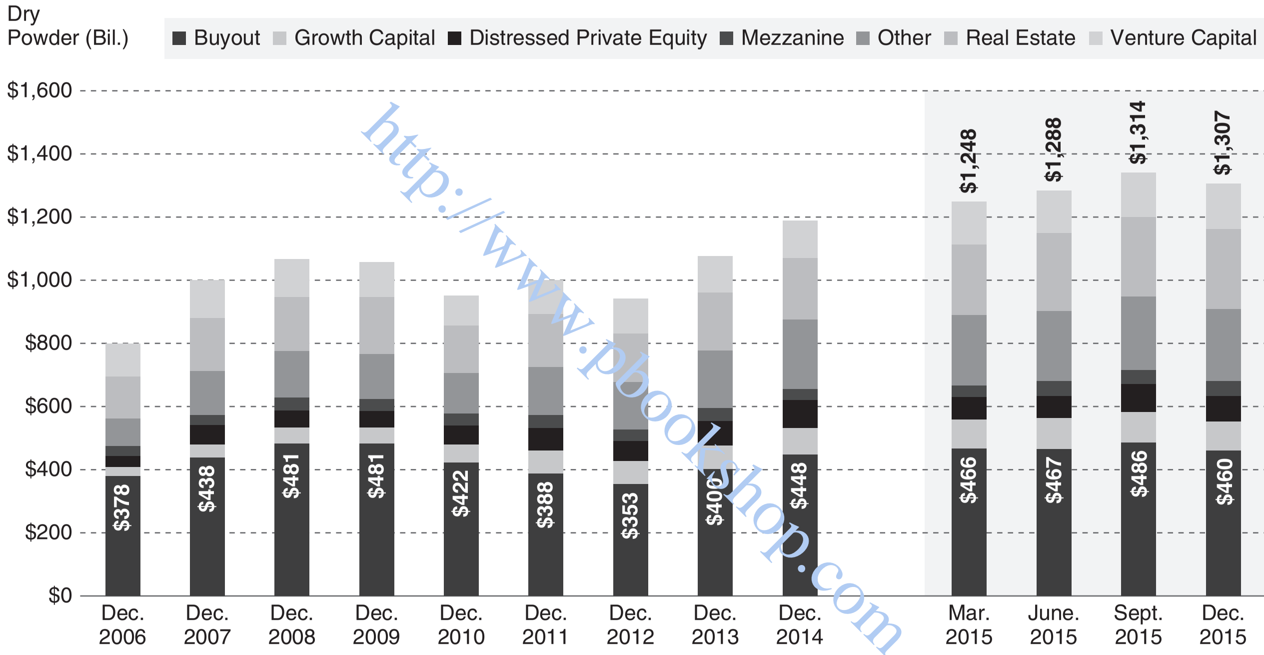

Note: Dry powder figures are global and not specific to the United States.

EXHIBIT 1.4 Global Private Equity Dry Powder
Source: Private Equity Growth Council website.

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the process works but also key lessons for how to approach and execute a deal effectively and efficiently. Many sections will discuss each side—Buyer and Seller—individually; however, it is important for any participant in a Strategic Transaction to understand both sides. Too often, a Strategic Transaction falters, or the parties do not reach the optimal terms, because one side fails to understand the other. Buyers need to understand the needs of a Seller and try to reflect them in their bid. Sellers need to understand the goals of a Buyer and manage their business to meet those goals. This can not only help to get a deal done but also, in many cases, result in a deal that is better for both sides.

One of the interesting things about a Strategic Transaction is the potential for synergy, where one plus one equals three. The combination of Buyer and Seller can create additional value to be shared. For example, a company that is undercapitalized can actually return dramatically better results once it is owned by a larger parent with more access to capital. Similarly, a small technology company with an innovative product might be worth much more when combined with the marketing power of a large, branded electronics manufacturer. In each case, the Strategic Transaction itself unlocks additional value that neither side could access individually. One of the keys to unlocking this value is a clear understanding of the other party's goals, challenges, and processes. Understanding the Buyer will make you a more effective and successful Seller, and vice versa.[5]

Chapter 2 reviews all of the key players in a Strategic Transaction. The goal here will be to discuss not only the role of these players but also their motivations and goals. This chapter will also differentiate between the goals of organizations and the individuals who run and represent them. Chapter 3 discusses the decision to buy or sell. Many of the terms, as well as the nature of the process of a transaction, will be driven by the underlying decision made by Buyer and Seller to do a deal. Chapters 4 and 5 discuss first the Buyer's preparation and then the Seller's preparation for a deal. Investing time and resources in preparing for a Strategic Transaction can yield dramatic returns. Given the large dollar amounts at stake, proper preparation is always a worthwhile investment.

Chapter 6 discusses the deal process. Given the complexity of a Strategic Transaction, how the process is crafted can actually contribute to the success of the deal. Chapter 7 will focus on the core of a Strategic Transaction—due diligence. This is the period during which the Buyer tries, in a relatively short period of time, to get a sufficiently detailed understanding of the business for sale to have comfort that its price is reasonable and its plans for growing, expanding, or otherwise improving the business are feasible. This is also an opportunity for the Seller to further pitch the value of the asset and to try

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to allay any concerns that the Buyer may have. Effective due diligence is the key to avoiding nasty surprises after a deal is done, and failure to do proper due diligence can leave a Buyer owning a business much less attractive, less profitable, or simply much different from what the Buyer thought it was buying.

Chapter 8 will discuss valuation, arguably the core of a Strategic Transaction. The fact that a valuation is expressed in terms of a single or small range of numbers belies the fact that the process, part art and part science, of reaching this number is often complex and unclear. Chapter 9 will review the often ignored issue of integration planning. For most Buyers, effective integration planning can be the difference between success and failure in a Strategic Transaction. While actual integration takes place after a deal is done, integration planning is an essential part of the transaction itself, since it both informs the other parts just mentioned (valuation, due diligence, and even the decision to buy) and helps to ensure that the actual integration can occur quickly and efficiently after the deal is closed. Chapter 8 also touches on financing issues that the Buyer may face. While some Buyers have sufficient capital on hand to do a Strategic Transaction, some large and relatively rare deals often require outside financing, and this has an impact on both the Buyer and the Seller. Chapter 10 will also discuss such financing issues.

Finally, Chapter 11 will discuss some of the mechanics of actually closing a deal and some of the "tail" issues that remain after a deal is closed. Every deal is unique and, by definition, requires a tailored set of documents. That said, some standards, forms, and checklists can be a valuable starting point. In the appendices are examples of reports, checklists, process maps, and term sheets that can help the reader flesh out the deal process.

The key steps, challenges, and processes in all Strategic Transactions are very similar. While this book will focus on the most common, the acquisition of an entire company, most of the lessons are equally applicable to transactions involving the acquisition of a strategic stake in a company as well.

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NOTES

1. NVCA 4Q 2016 US Venture Monitor, page 17, National Venture Capital Association.
2. Scott Christofferson, Robert McNish, and Diane Sias, "Where Mergers Go Wrong," *McKinsey Quarterly* 2 (May 2004), p. 2.
3. Ibid. The authors found that in 70 percent of the deals studied, the Buyer failed to achieve the expected levels of revenue synergies, and in 25 percent of the deals the Buyer substantially overestimated cost synergies.

4. "Of 277 big M&A deals in America between 1985 and 2000, 64% destroyed value for the acquirers' shareholders. Interestingly, mergers in recessions or periods of low growth from 1985–2000 did better than mergers consummated in good times." In "The Return of the Deal," *The Economist* 368, issue 8332 (July 10, 2003), p. 57.
5. For a much more detailed discussion of this topic, see Michael E. S. Frankel, *Deal Teams: The Roles and Motivations of Management Team Members, Investment Bankers, Venture Capitalists and Lawyers in Negotiations, Mergers, Acquisitions and Equity Investments* (Boston: Aspatore, 2004).

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