

The M&A Process and It's Alligators



CORPORATE FINANCE ASSOCIATES

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Introduction

This paper will describe the Merger and Acquisition (M&A) process for small to medium sized companies. It will discuss the process from the view of both the "buyer" and the "seller", based on our experience that each "side" in this process should not only understand what they need to do, but should understand what the other players in the process are doing at the same time. It is also important that each participant in the process clearly understand the goals and objectives of the other parties as well as their own. A mutual knowledge of the process, clear communications and a mutual respect will accomplish much toward completing a successful merger or acquisition.

To simplify the description of the process, we

will break it into four major sections, which usually, but not necessarily follow each other in time. Figure 1 (below) describes the flow, and potential points of backtracking.

It is also important to bear in mind that a buyer and seller do not need to be at the same stage in this process when they first enter into communication. Sellers and buyers may identify and approach target companies which are not actively pursuing the possibility of acquiring or being acquired. This difference in planning maturity means that the initiating party will occasionally have to show patience, and wait for the party to "catch up" in the process.

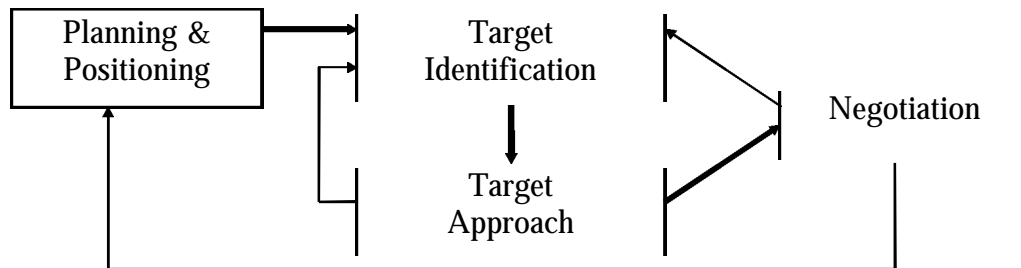


Figure 1

Strategic Planning and Organization

<u>Buyers</u>	<u>Both</u>	<u>Sellers</u>
<ul style="list-style-type: none"> ◆ Define Acquisition Strategy ◆ Define Acquisition Criteria 	<ul style="list-style-type: none"> ◆ Assemble M&A Team ◆ Define Strategic Objectives 	<ul style="list-style-type: none"> ◆ Define Selling Strategy ◆ Define Buyer Criteria ◆ Prepare Selling Memo

When a company first seriously considers M&A activity, whether as a buyer or a seller, they should put together an M&A team, which may

grow as the transaction progresses. They need to identify team members, including a senior executive with time to devote to the process,

assign responsibilities, and educate the team on their responsibilities if needed. This team will be a combination of internal staff and external team members. Some companies are able to develop and retain an internal M&A staff, but this is not the case for many companies. For sellers especially, this may be a one time transaction, and external consultants can help anticipate issues which may be the difference between a successful and an unsuccessful transaction.

Companies need to determine their strategic objectives very early, as they form the foundation for all that follows. For buyers, M&A is nearly always a strategic, as opposed to a financial, decision. They typically desire to strengthen their competitive position by acquiring products, technology, distribution or in-place customers. Sellers may desire to exit their company for financial purposes, or they may determine that they cannot continue on a desired strategic path without combining resources with an acquirer.

These strategic objectives lead directly to the next planning step. A potential buyer should develop acquisition criteria which define what kind of target company will help them meet their strategic goals. At this point they should develop a general acquisition strategy - that is a general idea of the terms they desire for any acquisition. This includes deciding if their stock will be used as part of the purchase price, and if external funding from banks or other investors will be needed. A decision should be made regarding the general size of the desired acquisition, to match available resources.

Similarly, a seller should define the characteristics of a desirable buyer, and develop a selling plan to guide them in approaching potential buyers. For larger companies which are publicly traded, and whose value is relatively well known, a one or two stage "auction" strategy may be appropriate. This strategy publicly announces that the company is "exploring opportunities" with respect to the business. Interested companies are expected to step forward and express their interest. A second stage may be added to maximize value, by reducing the number of bidders, and setting some minimal criteria. For smaller companies and for more complex technology based companies this is not a usual strategy, so the emphasis will be on a negotiated sale, preferably with more than one interested buyer.

Developing these acquisition and selling strategies requires the input of team members who have been through the process before, and who understand the wide range of deal possibilities which are not immediately obvious.

After the planning has been completed, a selling company should create a Selling Memorandum, which presents their company's value in it's most favorable light, as viewed by the type of buyer the selling company hopes to attract. The memo is not a Business Plan, but needs to have such a plan behind it. It is a selling document, and cannot be well focused without a definition of it's target audience. The selling company or its agent must put themselves in the mind of an acquiring company in creating this Selling Memorandum.

<u>Buyers</u>	<u>Both</u>	<u>Sellers</u>
♦Distribute Acquisition Criteria	♦Identify Potential targets	♦Distribute Selling Memo
♦Accomplish Initial Acquisition Screen	♦Evaluate Strategic Fit	♦Accomplish Initial Buyer Screen
	♦Prioritize Targets	

Identifying the Targets

At this point in the process both the buyer and seller will distribute their respective acquisition criteria or Selling Memorandum through their contacts or those of their agents. Depending on the strategies chosen, this initial distribution may be very widespread, or limited, pending identification of high priority targets. It is important for both buyers and sellers to require binding (on themselves and any outside advisors) confidentiality agreements concerning any data which is released, both now and later in the process.

Both the buyer and seller, as well as their agents, will then go through the process of identifying potential buyer or seller “targets”, using established networks, as well as searching through the vast mountain of available information which modern technology has created. At this point, having acquisition or buyer criteria is absolutely essential to prevent wasting significant amounts of time and money. As potential targets are identified, these screens are applied, to assure the original strategic

objectives would be met by a deal with that target company.

The priority of both buyers and sellers at this point should be to find targets which are good strategic fits with their objectives. Sellers should be assessing the probable ability of their target buyer to successfully complete a transaction, by looking at the targets financial resources and acquisition track record. Buyers should consider the operational feasibility of an acquisition or merger, and specifically how their strategic needs will be met.

At the completion of this phase, companies should have a prioritized list of target companies to contact. Often this will be in the form of an “A” list and a “B” list, which will guide them through the following contact process. They should also be open and responsive to unsolicited opportunities as a result of having distributed their acquisition criteria or Selling Memorandum.

Approaching Potential Targets

<u>Buyers</u>	<u>Both</u>	<u>Sellers</u>
<ul style="list-style-type: none"> ◆ Accomplish Due Diligence ◆ Prepare Letter of Intent (LOI) 	<ul style="list-style-type: none"> ◆ Make Initial Target Contact ◆ Negotiate LOI 	<ul style="list-style-type: none"> ◆ Support Due Diligence ◆ Respond to LOI Intent

Executives of buying and selling companies may contact the identified priority targets directly or through an agent, which may have several benefits. For a selling company, using an agent has the obvious advantage of maintaining the confidentiality of their company’s availability on the market, thus maintaining the internal morale of the company through some of the early exploratory discussions. An agent can also screen out serious and qualified inquiries from “kick-the-tires” responses.

An acquiring company may also find advantages to remaining anonymous, as they can maintain

the confidentiality of their strategic plans, and perhaps get initial information from potential acquisition targets more easily. At some point during this phase of an acquisition, the principals of both parties will need to meet and develop a trusting working relationship. Third parties and outside team members can help orchestrate this.

Selling companies may also have to respond to potential buyers’ requests for information either directly or through an agent. Initial due diligence investigations will take place during this phase. At some point the selling company will have to make some of their employees and staff aware of the potential company sale, which can have a disruptive impact on daily operations.

Buyers will be gathering available public information on any companies they wish to approach, as well as analyzing the available selling material from their target. Typically a buyer will want more information on a target company than the seller wants to release, resulting in early negotiations and discussions centered on access to information. The buyer will need to gather enough financial and market information to make an initial valuation of the target company, and will need enough operational information to determine how the companies might be able to combine.

After the buying company feels they have adequate input, they will prepare an initial Letter of Intent (LOI) if the target company still is an attractive match with their acquisition criteria. They will also need to revisit their acquisition strategy, given what they will now know about the target company. The LOI should contain not only the price they are willing to pay, but should discuss acceptable financial terms and possibly

early operational integration considerations. This initiates a negotiation process. Although LOI's are usually considered not to be legally binding, they certainly do set the direction for the Definitive Agreement, and legal counsel will need to review the LOI after the business objectives and issues are documented.

The seller will review the LOI and usually will develop some counter proposals for various aspects of the offer. The buyer and seller will often have several meetings during this phase, with team members providing support. Primary issues should be at the business level, rather than detailed legal issues. The purpose of a negotiated LOI is to capture the guidelines set by the respective parties, and to set the framework for negotiating a Definitive Agreement. The LOI will usually set forth conditions prohibiting the selling company from negotiating with other potential buyers while Definitive Agreement negotiations are underway. Agreeing to an LOI is one of the major go/no-go points in the process for both buyer and seller.

Negotiating a Definitive Agreement

Once an LOI has been accepted by a potential seller, a detailed investigation, or due diligence,

should attempt to minimize this disruption by clearly defining their information needs, and by coordinating through specified channels. If the

<u>Buyers</u>	<u>Both</u>	<u>Sellers</u>
♦Accomplish In-Depth Due Diligence		♦Support In-Depth Due Diligence
♦Prepare Detailed Valuation	♦Plan Operational Integration	
	♦Address Legal & Tax Issues	
	♦Negotiate Definitive Agreement	
	♦Close	

phase will follow. The buyer will take the initiative in requesting and analyzing data from the selling company. The data will cover issues of products, markets, facilities, people, accounting processes, and other legal issues such as contingent liabilities. The seller should anticipate spending a great deal of time

responding to buyer requests, while the buyer

buyer is successful in acquiring the target company, they will benefit by having minimized the negative impact of the due diligence phase.

It is important for operating level management of both buyer and seller to meet and develop an initial concept of operational integration as part of the process of developing a Definitive Agreement. This operational level coordination

will inevitably surface issues which will need to be negotiated. The seeds of many unsuccessful, or at least disappointing, acquisitions have been sown by incomplete or half-hearted attempts at planning for life after the acquisition. Obviously the buyer wants a successful integrated operation after the deal, and the seller will also typically have a vested interest if the terms of the deal include a pay-out over time related to the success of the combined operation. In some acquisitions the seller may remain with the acquired company, and will be part of the operational integration.

To support the negotiation of the Definitive Agreement, the buyer will take all the information obtained during the detailed due diligence, together with the proposed operational integration concepts to accomplish a detailed valuation of the target company, as they plan on operating it. This valuation is important, in that it helps the buying company determine their “push back” position, and helps prevent getting caught up in the emotion of a negotiation. Several funding structures will need to be considered, and third-party sources of funding, such as banks, may need to become involved during these negotiations. The buyer’s full acquisition team will be involved in these negotiations, with legal counsel taking a more active role as the deal moves closer to final agreement.

While the buyer is developing their negotiating position, the selling company should be developing their own position by anticipating the issues and values as seen by the buyer. It is very easy for a selling company to fixate on what they think their company is worth, rather than looking at the acquisition through the eyes of the buyer. Often an outside team member is the best source of this objective view, and their input should be considered in developing the seller’s negotiating position.

Negotiation of a Definitive Agreement can be time consuming, and will typically divert senior management attention from the running of their respective businesses, which should remain their highest priority. It is helpful for both buyers and sellers to have a “quarterback” for this phase,

who can handle team coordination, and can optimize the time use of senior executives, who must remain involved. This “quarterback” (who may be internal or external) can also facilitate negotiations by proposing “straw-man” options and positions which might not be appropriate for the respective company principals.

When a definitive agreement has finally been negotiated to the satisfaction of the buyer and seller, a formal “closing” will normally be held. Often the final financial terms will not be known exactly at that time, and the agreement will specify how the settlement will be affected by a strict accounting taken as of that date. Deals have been broken at the closing table, so the teams should be prepared to respond to issues even at this point. After closing is complete, and the signatures are dry, the acquiring company must then build on the foundation of the Definitive Agreement to build a healthy and profitable new or expanded operation.

Summary

The acquisition or merger of businesses is a complex process which should be understood by all parties involved. It is essential to have a qualified team in place, working with company owners and managers to develop the objectives and strategy for that company. These strategic objectives provide a “touchstone”, to which all later activities should be tied. Another key is to accomplish adequate due diligence, both as buyer and seller, in order to understand the value of the company being acquired, as it is planned to be operated by the acquiring company. This allows both buyers and sellers to not only anticipate the other party’s positions, but to understand the reasoning behind them. This mutual understanding of value will underlie the negotiation of a successful acquisition, and lays the foundation for a successful company after the transaction is completed.

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