

Buy-Side M&A: Qualifying Your Seller & Uncovering Hidden Value

Firmex Webinar Series
M&A Master Class

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Mr. Sherman is a partner in the Washington, D.C. office of Jones Day with over 2,500 lawyers worldwide.

He is the author of 23 books on business growth, capital formation and the leveraging of intellectual property, including **Mergers & Acquisitions from A to Z** and **The AMA Handbook of Due Diligence**.

He has appeared as a guest and a commentator on all of the major television networks as well as CNBC's "Power Lunch," CNN's "Day Watch," CNNfn's "For Entrepreneurs Only," USA Network's "First Business," and Bloomberg's "Small Business Weekly." He has appeared on numerous regional and local television broadcasts as well as national and local radio interviews for National Public Radio (NPR), Business News Network (BNN), Bloomberg Radio, AP Radio Network, Voice of America, Talk America Radio Network and the USA Radio Network, as a resource on capital formation, entrepreneurship and technology development.

He has served as a top-rated Adjunct Professor in the Masters of Business Administration (MBA) programs at the University of Maryland for 23 years and at Georgetown University for 15 years where he teaches courses on business growth strategy.

He has served as General Counsel to the Young Entrepreneurs' Organization (YEO) since 1987. In 2003, *Fortune* magazine named him one of the Top Ten Minds in Entrepreneurship and in February of 2006, *Inc.* magazine named him one of the all-time champions and supporters of entrepreneurship.



Trends Specific To Buyers For 2012

- Be selective – it is still a buyer's market
- Be strategic – acquire based on specific acquisition objectives
- Be efficient (and competitive) – at some point, the \$2.5 trillion will start flowing back into the markets
- Be inquisitive – look for hidden strategic values

Trends Specific To Buyers For 2012 (Cont' d)

- Be persistent – dig both deep and wide on due diligence concerns and gut instincts
- Be prepared – revisit financial models, capital costs and investment thesis (test and re-test)
- Be a visionary – think through integration challenges and post-closing hurdles

Buy vs. Build Analysis

Buy vs. Build Analysis

At what point is it better to buy capabilities than it is to develop them organically? Factors to consider include:

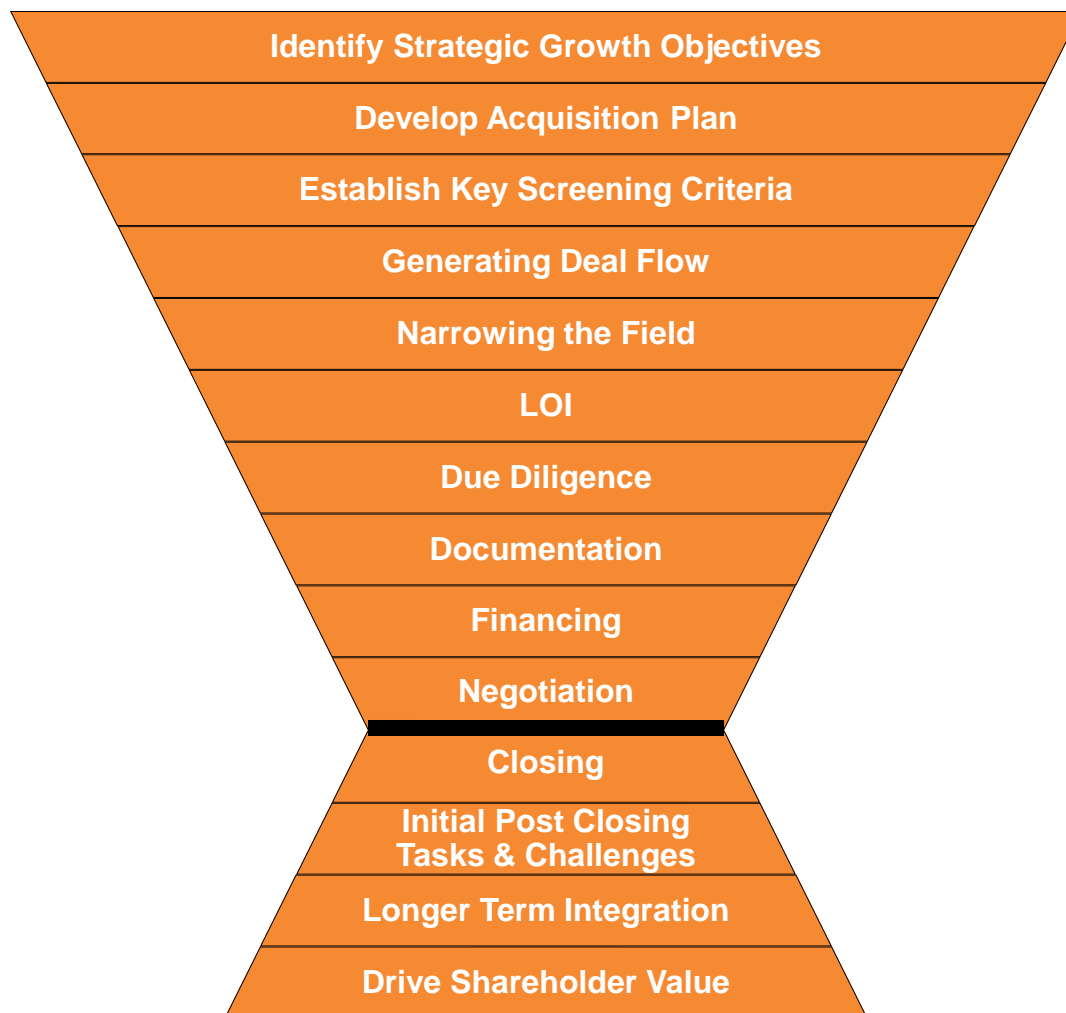
- Costs (tangible and intangible)
- Speed to market
- Quality/expertise
- Degree of competition in market
- Speed and difficulty/access to building a distribution channel
- Market fragmentation
- Regulation
- Access to financing/cost of reports

Buy vs. Build Analysis (Cont'd)

- Governance issues
- Customer acquisition costs/timeframe/loyalty
- Supplier acquisition costs/timeframe/loyalty
- R&D capabilities/new product profile
- Human capital
- IP rights of competitors (as a blocking factor)

Overview of the Buyer's Preparatory Process

The Buyer's Process – Overview



Developing An Acquisition Plan

Acquisition Planning Is Critical To Avoid Post-Closing Failures

- McKinsey & Co: 61% of recent M&A deals failed to earn cost of capital or better on funds invested
- Booz Allen & Hamilton: 50% of merged companies' Total Shareholder Return (TSR) under-performed relative to industry peers 2 years after deal close
- Mercer Management Consulting: 48% of merged companies had a TSR that was lower than their industry average 3 years after deal consummation

Question: If the Fortune 500 can't get it right, what can we learn from their mistakes?

The Buyer's Mantra: Develop an Acquisition Plan

- Mergers and acquisitions are used by entrepreneurs and middle-market companies when it is more efficient to acquire assets and resources from outside rather than expand internally (“cheaper to buy than to build” mentality). The process should begin with an **Acquisition Plan**, which identifies the specific objectives of the transaction and the criteria to be applied in analyzing a potential target company.
- The Acquisition Plan will also be presented to various sources of acquisition financing to provide the capital needed. Although the reasons for considering growth by acquisition will vary from industry to industry and from company to company, the most common strategic advantages from the perspective of a buyer include:

The Buyer's Mantra: Develop an Acquisition Plan (Cont'd)

- You can achieve operating and financial synergies and economics of scale with respect to production and manufacturing, research and development, management or marketing, and distribution.
- Your company may be able to develop the full potential of the target company's proprietary products or services that are suffering from lack of capital to move projects forward.
- The target company may stand to lose its management team due to the lack of career growth potential unless it is acquired by a business that offers higher salaries, increased employee benefits and greater opportunity for advancement. Conversely, you may have a surplus of strong managers who are likely to leave unless your company acquires other businesses that they can operate and develop.
- You may want to stabilize your company's earnings stream and mitigate its risk of business failure by diversifying your products and services and/or customer base through acquisition rather than internal development.

The Buyer's Mantra:

Develop an Acquisition Plan (Cont'd)

- Your company may need to deploy excess cash into a tax-efficient project (because both distribution of dividends and stock redemptions are generally taxable events to its shareholders).
- Your company may want to achieve certain production and distribution economies of scale through vertical integration, which would involve the acquisition of a key supplier or customer.
- The target company's management team may be ready for retirement or a key manager may have recently died (leaving the business with residual assets that can be utilized by your company).
- You may wish to increase your market power by acquiring competitors, which may be a less costly alternative for growth than internal expansion.

The Buyer's Mantra:

Develop an Acquisition Plan (Cont'd)

- You may be weak in certain key business areas, such as in the recruitment and retention of skilled technical workers or systems, research and development or marketing, and it may be more efficient to fill these gaps through an acquisition rather than to build these departments internally.
- Your company may have superior products and services but lack the consumer loyalty or protected trademarks needed to gain recognition in the marketplace. The acquisition of an older, more established firm can be a more efficient method of developing goodwill.
- Your company may want to penetrate new geographic markets and conclude that it is cheaper to acquire firms already doing business in those areas than to establish market diversification from scratch.
- Your company may provide the technical expertise or capital the target company needs to grow to the next stage in its development.

The Buyer's Mantra: Develop an Acquisition Plan (Cont'd)

- In today's marketplace and with recent trends toward consolidation strategies, it is particularly important that the seller (especially when the buyer's stock is a large component of the consideration) understand, accept, and respect the buyer's acquisition strategy and growth plans for the consolidated company.
- The well-prepared acquisition plan can be a valuable negotiation tool in dealing with seller's concerns with the value and continued growth of the buyer's stock.

The Buyer's Mantra: Develop an Acquisition Plan (Cont'd)

The Acquisition Plan will also identify:

- The targeted *size* of the acquisition candidates.
- The *source* of acquisition financing and amount available.
- The *method* for finding candidates (e.g., internal search or use of intermediaries).
- The *desired financial returns* and/or *operating synergies* to be achieved as a result of the acquisition.
- The minimum and maximum ranges and rates of acceptable *revenues*, *growth*, *earnings*, and *net worth* of the seller.

The Buyer's Mantra:

Develop an Acquisition Plan (Cont'd)

- The *impact* of the acquisition on existing shareholders of your company.
- The likely *competing bidders* for qualified candidates.
- The members of the *acquisition team* and each of their roles.
- The nature and types of *risks* the buyer is willing to assume (versus those that are unacceptable).
- The desired *geographic location* of the target company.
- The desired *demographics* and *buying habits* of the seller's customers.
- The plans to retain or replace the *management team* of the target company, even though this policy may vary by candidate; include a section addressing at least your preliminary plans.

The Buyer's Mantra: Develop an Acquisition Plan (Cont'd)

- Your willingness to consider *turnaround or troubled companies*. Each buyer will have a different tolerance level; some want and prefer the cost savings of buying a fixer-upper company while others prefer the company to be pretty much intact.
- Your tax and financial preferences for *asset vs. stock transactions*.
- Your openness to *full versus partial ownership* of the seller's entity, or your willingness to consider a spin-off sale, such as purchase of the assets of an operating division or the stock of a subsidiary.
- Your interest or willingness to launch an *unfriendly takeover* of a publicly held company or buy the debt from the largest creditor of a privately held company.

Applying the Criteria: How to Narrow the Field

Once all of the pertinent issues listed above have been addressed in the Acquisition Plan, it should be relatively easy to define the selection criteria and screen the candidates.

The more typical criteria include some of the following:

- A history of stable financial and growth performance over different market cycles and under different conditions.
- A market leader in its industry niche and in its geographic region.

Applying the Criteria: How to Narrow the Field (Cont'd)

- A company with a recognized brand name and established market share.
- Products not susceptible to obsolescence or rapid technological change.
- A strong management team with research and development capability.
- Stable and economically favorable relationships with customers, vendors, creditors, and debtors.
- Room for growth or excess capacity in manufacturing or production.
- A minimum and maximum range of revenue (i.e., from \$15 to \$25 million).

Applying the Criteria: How to Narrow the Field (Cont'd)

- A range of cash flow or earnings before interest, taxes, depreciation and amortization (EBITDA).
- A defined range for purchase price.
- A range for purchase price consideration addressing a preferred ratio of stock, cash and earn-out.
- Geographical location.
- An existing management team that agrees to remain in place for up to _____ years.

The Buyer's Reality

- Naturally, unless it's your birthday, you're not likely to find all of these qualifications in every candidate; if you do, there will likely be multiple bidders. ***Market conditions may affect the degree of compromise that you may need to accept.*** Rather, the buyer must be ready to mix and match--accept compromise in some areas. But be careful not to overlook too many warts, lest you end up with a deal that you will regret later.
- Again, the goal is to compare the acquisition objectives to the strengths and weaknesses of each seller. The acquisition team must have a clear idea as to *how* each targeted company will complement the buyer's strengths and/or mitigate its weaknesses.
- The qualitative and quantitative screening criteria will help the buying team ensure that the right candidates are selected. They are intended to filter out the wrong deals and mitigate the chances of post-closing regrets and problems.

Buyer Rationale Determination (SAMPLE)

Technology Sector	Fit With Sarbanes Oxley Compliance / Enterprise Governance	Business Process Adjacency	Business Buyer Fit
Category 1	Implement Sarbanes Oxley; provide audit workflow and accelerated process; manage information workflow and reporting to audit committee and executive staff	High	High
Category 2	Reporting processes and analysis as required by Sarbanes Oxley "What if" and forecasting compliance risk scenarios: Sarbanes Oxley, Basel II	High	High
Category 3	Data integration and analysis in support of Sarbanes Oxley/Basel II	Medium	Medium
Category 4	Address the documentation and process management of compliance Manage critical documents through a controlled life cycle, including content authoring, review, editing, approval, and distribution	High	Medium
Category 5	Ensure key controls and security parameters are in place and are monitored effectively Provide the foundation for financial compliance	Medium	Medium
Category 6	Ensure that human resources are deployed, monitored, and managed effectively Manage and implement human resource policies consistent with governance program	Low	Low
...	Ensure that systems are secure and can be audited Manage access rights and secures the use of electronic communications	Low	Low
...	Ensure reliability of data coming from multiple platforms that must be correlated to support compliance processes	Low	Low
...	Protect information from IT faults, power outages, or other disasters Act as the platform for the retention of electronic records and digital information	Low	Low

Competitors

Most Strategic Fit

Less Likely Buyers

Buyer Rationale Determination (SAMPLE)

Top Category 1

- Expand business process infrastructure to address specific, higher valued added, business processes (e.g., Governance)
- Offer Governance and Compliance solutions to installed base, increasing value and utility of BPM solutions
- Increase ASP through solutions focus

Top Category 2

- Integrate data capture, reporting, and policy enforcement objectives with the high perceived value of financial governance and audit reporting
- Leverage data analysis and data integrity positioning to specific process of financial and risk compliance

Top Category 3

- Tightly integrate ERP transaction management and accounting with audit, compliance, and SarbOx compliance processes
- Accelerate market adoption through installed base

Top Category 4

- Leverage portal, document management, and workflow capabilities into a high value-added compliance and risk management practice;
- Tools and applications similar to BPM and thus benefit from the same points of leverage
- Gain credibility and market positioning allowing greater access to the large and growing compliance market

Target Evaluation (SAMPLE)

Acquirer	Total Score	Strategic Fit 60%	Buyer Acquisitiveness 20%	Market Capitalization 10%	Cash Available 10%	Market Capitalization (\$ millions)	Cash and STI (\$ millions)	LTM Acquisitions (Count)
VeriSign Inc.	5.0	5.0	5.0	5.0	5.0	\$ 4,663.5	\$ 683.5	11
Symantec Corp.	5.0	5.0	5.0	5.0	5.0	18,013.1	4,099.4	4
Digital River Inc.	4.8	5.0	4.0	5.0	5.0	1,935.7	537.2	3
eBay Inc.	4.2	4.0	4.0	5.0	5.0	37,847.6	3,354.5	3
First Data Corp.	4.2	4.0	4.0	5.0	5.0	31,685.4	1,705.1	3
Google Inc.	3.8	3.0	5.0	5.0	5.0	114,835.3	9,821.6	6
Transaction Systems Architects	3.5	4.0	2.0	5.0	2.0	1,290.3	176.1	1
GSI Commerce Inc.	3.3	4.0	2.0	3.0	2.0	536.7	128.6	1
Yahoo! Inc.	3.2	2.0	5.0	5.0	5.0	39,916.0	2,688.6	9
Microsoft Corp.	3.2	2.0	5.0	5.0	5.0	262,819.4	31,096.0	17
Amazon.com Inc.	3.2	3.0	2.0	5.0	5.0	11,784.9	1,419.0	1
Intuit Inc.	3.2	3.0	2.0	5.0	5.0	10,626.7	1,282.2	1
CyberSource Corp.	3.2	4.0	2.0	3.0	1.0	387.4	50.6	1
Fair Isaac Corp.	3.1	3.0	2.0	5.0	4.0	2,137.2	316.1	1
Lightbridge Inc.	3.0	4.0	1.0	2.0	2.0	289.4	98.2	0
Heartland Payment Systems Inc	2.6	2.0	4.0	5.0	1.0	1,006.7	23.4	3
Optimal Group Inc.	2.4	3.0	1.0	2.0	2.0	330.2	187.2	0
Art Technology Group Inc.	2.3	3.0	1.0	2.0	1.0	308.6	37.4	0
IAC/InterActiveCorp	2.2	1.0	3.0	5.0	5.0	8,387.9	2,152.2	2
Global Payments Inc.	2.2	2.0	1.0	5.0	3.0	3,177.1	218.5	0
Rainmaker Systems Inc.	2.2	3.0	1.0	1.0	1.0	79.8	15.0	0
Bottomline Technologies Inc.	2.0	2.0	2.0	2.0	2.0	203.6	77.3	1
Morgan Stanley	2.0	0.0	5.0	5.0	5.0	72,035.6	836,446.0	5
Mastercard Incorporated	1.8	1.0	1.0	5.0	5.0	7,323.4	2,081.3	0
American Express Co.	1.8	1.0	1.0	5.0	5.0	64,751.9	6,798.0	0
Citigroup Inc.	1.4	0.0	2.0	5.0	5.0	239,731.9	622,459.0	1

Tier 1 Acquirers

Questions & Answers

Thank You

Next M&A Master Class is Nov 17th, 1pm Eastern

Art or Science? Due Diligence Best Practices & Pitfalls



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