

GET THE DEAL DONE: The Four Keys to Successful Mergers and Acquisitions

By Marilyn J. Holt, CMC

The most important aspect of any merger or acquisition is: "What is the value when the two become one?"

Few people quarrel with success. That is why mergers and acquisitions remain the hottest topic in the business world. Mid-sized companies face continued struggles with increasing market share, market position, and financing. Mergers and acquisitions can facilitate explosive expansion and predictable profitability. Industries where mergers and acquisitions have been extremely profitable and popular past five years are:

- component and subassembly manufacturing;
- computer software and hardware;
- high-technology companies of all types;
- defense contractors;
- telecommunications;
- utilities;

- entertainment, including TV and radio broadcasters;
- financial institutions, including banks, brokerages, and insurance companies.

Making the Merger and Acquisition Decision

A merger or acquisition gives you measurable results. It can easily double the size of your company without the stresses of high, uncontrolled growth. Mergers and acquisitions let you expand your market overnight. You instantly gain a customer base with brand loyalty and capture a significant share of a new market with established name recognition.

Since the companies being acquired have performance records, funding the acquisition has advantages for

sophisticated debt and equity financiers. They have historically done well financing mergers and acquisitions. They realize the value of the two individual companies plus their composite value and potential become the basis for the acquisition financing. The most important aspect of any merger or acquisition is: "What is the value when the two become one?"

For successful a merger and acquisition, the owner, CEO, or chairman of the board of the initiating company must be the lead and visionary. The leaders of the most powerful companies personally work on their mergers and acquisitions. Michael Eisner, Chairman and Chief Executive Officer of the Disney corporation stated, on national television, that he spent two years refining his dream of buying Capital Cities/ABC, Inc. In the evening, Eisner built spreadsheets and visualized the market advantages the combined companies would have in the worldwide market. He worked closely with his business brokers or investment bankers, and his transaction team to make his dream a reality.

For you, merging or acquiring another company can be easier than Eisner's experience. You do not have to identify a specific company to acquire. Business brokers or investment bankers can help identify an appropriate candidates for acquisition. The investment banker helps you understand the value, both tangible and intangible, of your company after an acquisition, to a potential buyer, or to a potential partner company if you seek a merger. Your investment banker can structure the business portion of the deal to

maximize your profitability, and construct a deal that it is beneficial, win-win deal, for both parties.

After you have found the right business to buy, there are many things you need to do to get the deal done.

The Four Key Issues of the Deal

Throughout the buy-sell process four crucial issues cause deals to get done or disintegrate:

- motivation;
- pricing;
- due diligence; and
- closing requirements.

The Motivation of the Deal

The greatest deal motivation is money. The buyer wants to make an investment that reaps financial rewards. The seller wants payment for his existing business. He wants to move on to something else.

This basic truth needs to be kept in mind during all phases of the deal. If you drive too hard a bargain, are too demanding, or erect impossible barriers, the other party will go to someone else.

Figure 1 illustrates the personal motivations of a deal. As you negotiate your deal, you need to understand these motivations and how they affect your specific deal.

Motivation

Buyer	Seller
Investment	Stress or boredom
Strategic acquisition	Strategic divestiture
Job	death, dissolution, or retirement (cashing in on the investment)

Figure 1 The Motives

The emotional deal killers are shown in Figure 2. All revolve around fear. They may grip you, your corporate board, or others you entrust with the deal. Fear can be paralyzing.

Confront fear, before you begin the buy-sell process. Visualize your new life, your new financial and strategic position. Moving toward positive results is more beneficial than looking at negatives.

Emotional issues that kill the deal

Buyer	Seller
Fear of Failure	Fear of Parting
Fear of Change	Fear of Change
Fear of Regret	Fear of Regret

Figure 2 The Emotional Deal Killers

Positive, energetic buyers envision a successful future.

Positive sellers look forward to their new life. They present their businesses in a positive light to attract quality and motivated buyers.

The Buy-Sell Process

Most people buy or sell any business only once. The buy-sell process remains undefined in their minds. There are ten steps in the buy-sell process, shown in Figure 3.

The most effective way to sell your business or to find a business for merger or acquisition is through an investment banker. A reputable investment banker will be able to explain the process, the paperwork, and the costs.

A qualified investment banker creates value in your transaction. The investment banker



can help you analyze and position your company for maximized financial value. (A discussion of business brokers and investment bankers is found in the section “How Your Investment Banker Helps You.”)

Steps of the Basic Deal

Buyer & Seller	Decide to do the buy-sell transaction and select an investment banker
Buyer & Seller	Locate a qualified target
Buyer & Seller	Sign reciprocal confidentiality agreements
Buyer	Make an offer
Seller	Accept, reject, or counteroffer
Buyer & Seller	Negotiate a buy-sell agreement
Buyer & Seller	Retain independent escrow attorney for closing and complete closing
Buyer & Seller	Perform the due diligence
Buyer & Seller	Sign off on contingencies, if possible
Buyer & Seller	Transfer property, honor additional agreements.

Figure 3 Buy Sell Process

Whether you intend to buy or sell, you should complete a professional valuation of your company. A business valuation can be conducted by an American Institute of Certified Public Accountants (AICPA) or American Society of Appraisers, (ASA) a certified or affiliated valuation service. Qualified appraisers use a minimum of three valuation techniques (there are over a dozen techniques currently used) that results in a range of values. This valuation does not value the company strategically,

however it provides a documented basis for value that serves as the foundation for determining the strategic value.

Do not necessarily go with the investment banker who says he or she can get you the most money. You should be able to understand where the value of the business is to be realized, the type of buyer who would be interested, and how long the process will take. If you cannot understand the price, probably a buyer or merger partner will not understand it either. An overpriced business will not sell at the inflated price, and by the time the price has been reduced, the most qualified buyers will have seen the company and no longer be interested. The result may be that your business sells for less. A qualified investment banker will carefully assess your company for growth and strategic potential, and return on investment.

Business brokers and investment bankers also provide you with sample and actual documents for the sale, and true intermediary negotiation services.

Business brokers and investment bankers work on either an hourly fee, or on a commission or success fee basis. With a commission or success fee, you know the amount you pay for the service before it is



rendered. The time of the broker and staff devote to a transaction makes the hourly basis potentially more expensive.

Some investment bankers, associated with stock brokerage firms, do initial public offerings and private stock placement. The most common way these business brokers and investment bankers are compensated is by a fee based on a percentage of the transaction value. There are also "up front" consulting fees for valuations, marketing, and consulting.

The Contact Process

Your investment banker will search for potential acquirers or merger and acquisition target companies either nationwide or within the region that you specify.

Confidentiality is of prime concern to both parties in a merger and acquisition. Most buyers want confidentiality to avoid receiving unsolicited offers. Most sellers want confidentiality to preserve the company's on-going business relations and preserve the value of the company. The investment banker has become the conduit by which parties make contact.

Initial contact is done anonymously. Both parties sign blanket confidentiality agreements the investment banker keeps them on file. The investment banker keeps the confidentiality of both sides during the initial stage.

From the buyer, the investment banker will have sworn statements of financial ability to

purchase a business. From the seller, the investment banker will have an acquisition memorandum and other pertinent documents about the five risks acquirers want disclosed: management, product, operations, market, and financial risk.

The Transaction Process

Your investment banker manages the transaction process. He/she works with your attorney and accountant.

In the case of an acquisition, the buyer selects a company and reviews an anonymous acquisition memorandum summary about the company for sale. When an acquirer expresses an interest in moving forward, the investment banker identifies each party to the other, provides the buyer with the full acquisition memorandum, and provides the seller with the buyer's statement of financial ability.

The potential buyer reviews the full acquisition memorandum, based on the compatibility the business and chooses to move forward or not. A potential acquirer has the right to review the business. He may end the consideration process without any obligation to the seller. For this reason, multiple potential buyers are informed, on an anonymous basis, of the opportunity.

A serious potential buyer will be given an initial introduction that reveals the name of the business, more specific information, and may include a tour of the business

facilitates. After an initial introduction to the business, the buyer makes an offer using a letter of intent. The seller then grants the buyer the right to examine the business for a limited amount of time.

In the case of a merger, the process follows the acquisition process. However, both parties examine the documents of the other as though each were the acquirer. A merger is a mutual process, and therefore more considerations must be answered.

The Letter of Intent (LOI) is a document drawn up by the buyer, his/her representative, or lawyer. In an acquisition, the LOI expresses the intent of the buyer to acquire the business, and makes a monetary offer. In a merger, the LOI, the result of a negotiation process, states the intent of both parties to merge, and makes a monetary or equivalent (such as a stock swap) offer. The LOI requires a satisfactory due diligence investigation (discussed in detail in the section "Due Diligence of the Deal,") as a condition of closing. Dates for acceptance, usually seven to ten days in the future, are set. In some cases the LOI may request negotiation of the price, again, with the closing based on the acceptability of the findings of due diligence. For an acquisition, there should be provisions to permit the seller to examine the financial worthiness of the buyer.

The LOI process may cause a series of offers and counter offers to be made. The agreement must be accepted and signed by both parties. If the seller wants part of the agreement changed, he or she makes a counteroffer. The whole process begins

anew. The seller makes changes to this "new" agreement. This constitutes another counteroffer. The easiest way to make changes on the letter of intent and initial them. Both sides are free to accept or reject the counteroffer.

The most effective way to manage the offer-counteroffer process is to have your investment banker negotiate the changes, and reach an acceptable LOI. This moves the merger and acquisition process along in an orderly and timely manner. The LOI includes specific dates and times of completion of each part of the due diligence process. The LOI does not specify the exact conditions of closing. The purpose of the LOI is to make the intent of the buyer and seller explicit, and secure the property for a limited amount of time while the Purchase Agreement is being drafted. These are normally done in a sequence agreed upon by the parties. Usually there are penalties specified if either side decides to nullify the agreement outside of the stated contingencies.

The LOI is accepted when an offer is agreed upon and the document is signed by both parties, which is commonly called "signed all around." At this time, earnest money, either in cash or equivalent, or in the form of a promissory note is presented by the acquirer. In a merger, earnest money from both parties is required. The earnest money is held in an escrow account often by the escrow attorney. The amount of the earnest money varies, although approximately 5% to 10% of the selling price is common. The next step is a purchase and sale agreement.

The Purchase Agreement details what is being acquired, the circumstances of acceptance, called contingencies, based on the due diligence findings, and the exact conditions of closing. The most effective way to reach an acceptable understanding is to have your investment banker negotiate the purchase agreement. The purchase agreement is usually drafted by the buyer's attorney, and reviewed by the intermediary and the seller's attorney.

The purchase agreement specifies the selling price, although the parties may specify the conditions for adjustment of the closing price. Adjustments are commonly made for inventory, accounts payable and accounts receivable, and any other fluctuating financial activity.

The contingencies upon which consummation of the deal rests, are specified. Their satisfaction and removal are staged according to a mutually agreed schedule. The due diligence process may require remediation of problems discovered, or the production of additional documents. Common contingencies include a more detailed examination of books and records, financing, assignment of lease, and passing any government regulations that may affect the transfer of ownership of that particular type of business. If key personnel are important for the merger or acquisition, successful completion of new contracts with each party may be included. For a particular business, there may be other contingencies. Continuation of the business as usual is also a common requirement.

The purchase agreement specifies the date, time, and place of closing. If the conditions for closing cannot be met by that date, the deal may fall through. Allowances for changes in the time table set by the purchase agreement are the result of the level of mutual trust the parties build during the merger or acquisition process.

The Pricing and Structuring the Deal

This maxim holds: "No matter how good or bad a business is, if priced right, it will sell."

The primary issue of the *right price* for the buyer is how long it takes the business to earn its purchase price back. When large investors and companies expect a merger or acquisition candidate to earn itself out in about five years.

When you buy a business, you need to compute the expected return on investment.

If buying a company for investment reasons, a higher capitalization rate is required to keep pace with other investment opportunities, and a capitalization rate between 25% and 30% is sought.

If making a strategic acquisition or merger, a lower capitalization rate may be acceptable as long as the acquisition or merger meets other income needs.

A strategic acquisition can be purchased for a higher price than a company

purchased as an investment. Both considerations are important, and both parties need to weigh various the factors.

The *value* of a business is its cash price at a given time. The *price* is usually an amount of money paid over time. Since the time-value of money must be included in the price, the opportunity costs to the seller holding the note must be included. The interest on the moneys owned must be at identified market rates, and interest rate volatility may be hedged against with interest adjustment terms.

The final deal price includes working capital (usually left in the business), contracts, work in progress, inventory, materials, accounts receivable, accounts payable, equipment, patents, processes, trademarks, trade names, and customer lists. Each of these affects the price whether it is based on the sale of assets or the sale of stock.

The Due Diligence of the Deal

Due diligence is the process by which the buyer and the seller investigate facts of a person's good faith, standing, and reputation and authentic credentials.

The due diligence process for the seller involves determining the financial capabilities of the buyer. This investigation includes credit checks, background checks, and verification of funds.

The due diligence process for the buyer or for those doing a merger requires an investigation of the company being purchased. The buyer of the company must be concerned about issues of buying and owning the business. Every legal, managerial, financial, and regulatory issue must be examined and the facts verified.

The seller must provide full disclosure. The owner of the acquisition or merger candidate reveals all facts known about the company to the buyer or merger partner.. The seller of the business may face lawsuits charging a fraudulent transfer if full disclosure is not made. This can mean that the courts reverse the deal ("unwind it"), and the buyer must be made whole, which may include penalties or interest. However, the buyer is solely responsible for the soundness of the information, except in cases of fraud, which must be proven in court.

To ensure the due diligence process is properly and efficiently done, the buyer should engage professionals, including: lawyers, accountants, and environmental assessment engineers. A due diligence checklist serves as a guide for the process.

The Due Diligence Checklist for both asset and stock based transactions

General Corporate Materials

- Articles of incorporation
- Business licenses
- Other corporate or business documents
- List of regions in which the company is operating (e.g. list of locations of warehouses and sales offices by region)

Management structure

- Officer and director lists
- Potential litigation
- Non compete agreements with current and prior employers
- Shareholder lists and stock transfer records
- Compliance with Laws
- Compliance with government regulations
- Liens, suits and judgments

Personnel

- Consulting contracts

- Contracts with unions
- Employee benefit plans, pension, profit sharing, stock purchase, stock ownership and stock option plans, or other defined contribution plans whether voluntary or involuntary
- Employment contracts and severance arrangements
- Loans and guarantees to directors, officers or employees (recourse vs. non-recourse, collateral pledged, and other transactions with stockholders, directors)

Real Property

- Deeds
- Leases of real property
- Liens and other encumbrances
- Other Property
- Equipment leases
- Patents, trademarks, and other intangible assets registered and unregistered
- Financing
- Credit agreements, indentures, loans and guarantees of third-party obligations
- Commission, brokerage, and agency agreements

All other contracts

Financial information

- Accounts receivable analysis and aging
- Reviewed or audited financial statements
- Back orders
- Capital expenditure plans
- Cash flow and working capital analysis
- Correspondence with independent public accountant
- Inventory valuation and pricing policies
- Interim financial statements

Tax Issues

- Federal, state and local tax returns
- Sales, use, and all other business tax reports

This list cannot include every type of liability and contingency imaginable. A particular deal may require additional issues that need to be investigated.

If the purchase is financed by a bank or other lender, both the buyer and the company will be scrutinized by the lender. The following is a checklist of basic documents that all small business owners must provide when applying for a loan from various sources.

The Loan Application Checklist

- Current personal financial statements of the buyers
- Last 3 years tax returns (1040s) of buyers and business (if exists) including all schedules
- Last 3 (or as above) year-end business financial statements
- Any interim business financial statements
- Any agreements or letters of intent to purchase products
- Most recent month end accounts receivable and accounts payable aging of equal date.
- List of collateral, with statement of current encumbrances and debt position a new lender would have to take
- Background of principals
- Any projections of cash flow, etc.

The Closing of the Deal

The term close refers to the end, conclusion, or finish of the deal; that is the reaching of an agreement, coming to terms, and transferring property. Closing is the process

where the ownership of the business changes hands.

There are a number of documents that legally signal the close of the deal. The letter of intent (LOI) and the purchase agreement represent the process by which buyer and seller reach an agreement. The purchase agreement also states the date, time, place, and escrow attorney for closing. The purchase agreement is binding when the document is signed all around.

Closing usually takes place through an escrow attorney. The escrow attorney should be involved at the time of the signing of the LOI. The escrow attorney usually determines the place, date, and time of closing. The escrow attorney handles significant issues prior to closing. The four tasks primary tasks the escrow attorney performs are:

seek clear title to the business;

- record necessary security documents;
- notify state and county governmental entities of the sale; and
- establish a trust account to hold earnest money, full payment, and disburse funds.

Establishing clear title to the business is the most time consuming. An experienced escrow attorney will provide you with an estimate of how long this will take. The time varies based on the speed of specific jurisdictions. The escrow attorney look for all claims against the business assets or property, including debt, judgments, lawsuits pending, taxes, and penalties due.

Prior to closing, these things must be completed:

- all adjustments need to be calculated so that the parties can determine pro rata payments;
- a third party should be completed and accepted by both parties; and
- contingencies signed off.

The escrow attorney prepares final documents required for transfer of the property. The investment banker or escrow attorney usually present the parties with a written agenda for the proceedings, clearly stating precisely what each party must bring to closing.

The day before closing a cash disbursement sheet should go to all parties for examination and comment. The cash disbursement sheet lists all the obligations the seller will pay at the time of closing. This way there will be no surprises. Any last minute adjustments, need to be disclosed at least the day before closing.

The principals, or their legal representatives, for each side must attend closing. Your investment banker attends closing and presents a full set of documents showing that all the conditions of the sale have been met.

The seller brings the following to the closing: all certificates, titles, and other documents required to transfer the property. The buyer brings a certified check in the amount specified by the escrow attorney payable to the trust account.

The parties sign the required documents. The escrow attorney writes checks to pay off all the seller's obligations concerning the business, including pro rated taxes, debts and obligations not assumed by the buyer, the investment banker's fees, attorney and accounting fees, and fees owed to the escrow attorney. The escrow attorney writes a check to the seller or transfers money to the seller's private account. Some moneys may be held in reserve, to pay obligations that have been estimated, such as taxes, but do not have a

specific amount yet attached. The escrow attorney pays the remainder to the seller within a specified number of days.

The 11th Hour Deal Killers

After all your hard work, a deal can fall apart. This is expensive whether you are buyer or seller, so you need to be aware of

The 11th Hour Deal Killers

Seller	Failure to disclose claims and other liabilities such as: unpaid taxes and penalties, unpaid debts, toxic and hazardous materials.
Seller & Buyer	Failure to disclose lawsuits.
Seller	Changing the balance sheet to keep the assets that rightfully belong with the company, such as payments for uncompleted work in progress or working capital.
Buyer	Misrepresentation of financial ability to pay, or lack of disclosure of financing arrangements.
Seller	Misrepresentation of inventory.
Buyer	Changing priorities, or internal misunderstandings of the buying team.
Time	The longer it takes to close, the less likely it will close. One month to closing after purchase agreement reduces the chance of closing by 25%.

Figure 4 The Deal Killers

the 11th hour deal killers. First, you need to be sure you, as the principal, are clear about your motives, that you have reached a fair price, that you have completed the due diligence process, and that all the closing requirements can be met. Second, you need to make sure that all the people working with you, associates, employees, advisors, and lenders are completely signed off on all parts of the process. Last minute surprises are very costly. A broken deal leaves both parties worse off. Time, money and energy are all spent with no gain.

The Deal Killers

When the deal is done properly, both the parties achieve their goals.

How Your Investment Banker Helps You

Working with your investment banking firm insures you get the deal done quickly, economically, and properly. Your investment banker understands the intricacies of your deal. Take advantage of their substantial experience in helping clients make informed decisions regarding the merger and acquisition. Your success is enhanced by your investment banker identifying the best prospective buyers and potential targets. Your investment banker will help you initiate, value, structure,

negotiate, finance, and implement this your transaction.

Good business brokers or investment bankers should use a structured approach to capital formation that combines the rigors of a strong marketing discipline with the clearly defined performance requirements of sophisticated investors. Your investment banker helps secure financing from the most appropriate sources, on the best available terms. They also oversee the transition of the acquisition.

Your investment banker should help in non-financial ways, such as providing a clear understanding the marketing issues, and lending their experience with the transition issues such as work force stabilization, operational changes, promotion or reassignment of management, and the development and implementation of a new exit strategy.

Mid-sized companies can be strong contenders in the national and worldwide marketplace by effectively used the powerful tool of mergers and acquisitions. One of these companies could be yours. Acquiring or merging with another company could be the most intelligent financial decision that you ever make.

Copyright © 2001 Marilyn J. Holt. All rights reserved. No part of this work may be reproduced or distributed in any form or by any means, or stored in any database or retrieval system without prior and express written permission of the author and publisher. Contact Holt Capital for reprint permission. This work is the accompanying material to the seminar, "Get the Deal Done." To have this seminar presented before your management team, group or trade show, call Holt Capital.