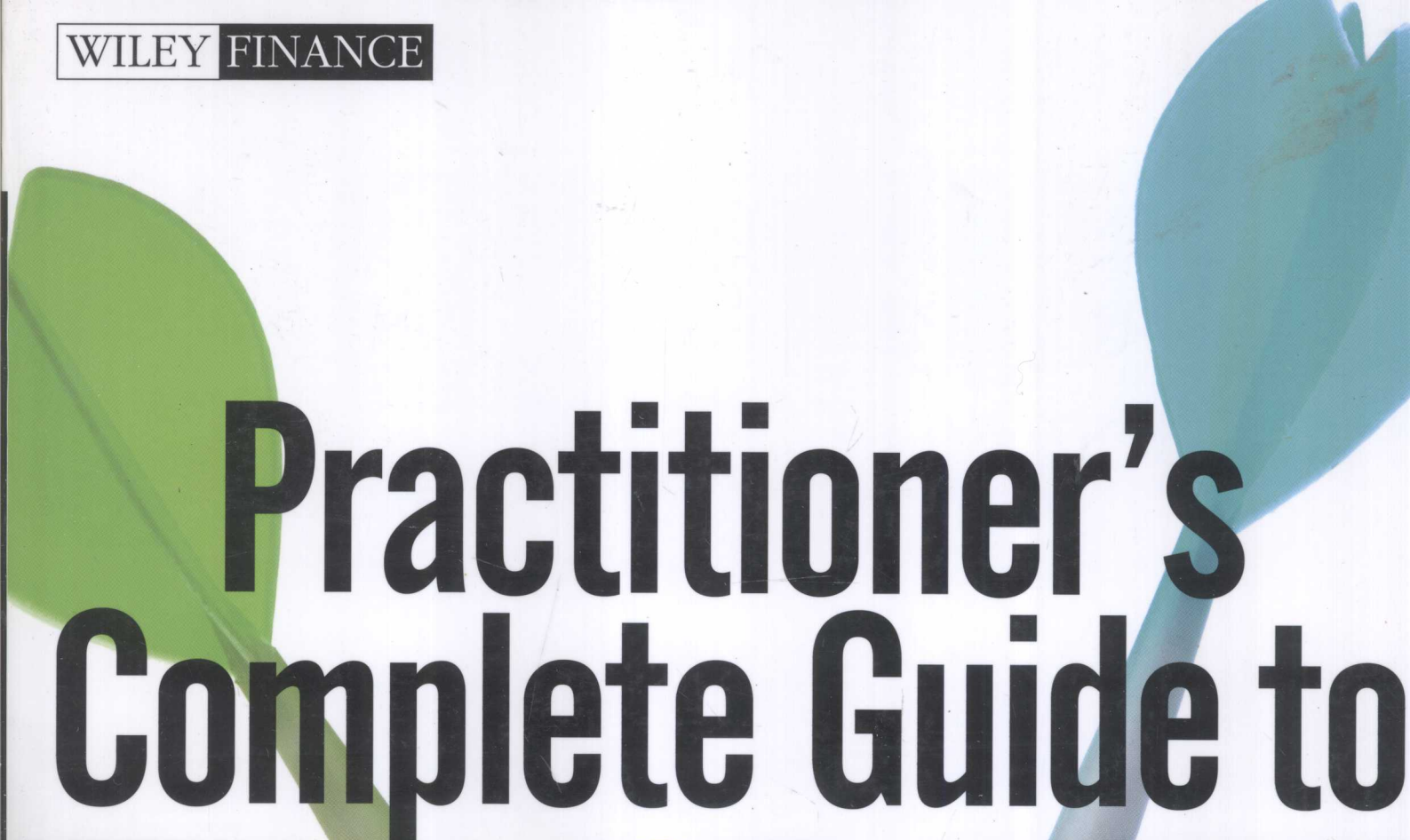


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Practitioner's Complete Guide to M&A

An All-Inclusive Reference



David T. Emott



with **WEBSITE**

Practitioner's Complete Guide to M&As

An All-Inclusive Reference

DAVID T. EMOTT

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Preface

This book is a hands-on, practical guide and reference to the key topics, issues, and methodologies buyers and sellers face and employ in doing M&A (business mergers, acquisitions, divestitures, stock buybacks, equity investments, and joint venture transactions). It is a quick, easy-to-use reference for those new to the process of M&A (private business owners, students, associates, trainees). In addition, it will refresh and reacquaint those already familiar with deal making (CEOs, CFOs, lawyers, accountants, tax and finance, and insurance and deal professionals) with what happens, when, who is doing it, and why, and answer the question: What do we need to know and do at this phase of the process?

The book is written as a quick-read reference of ideas, approaches, and don't-forgets for use during live transactions and as a self-study guide to enable fast transfer of essential M&A knowledge.

The topics in the book are laid out sequentially to enable the reader to build the highly relevant knowledge base necessary for pursuing and understanding corporate development via M&A. Topics covered including strategy development, acquisition criteria, deal sources, deal fee arrangements, due diligence, conducting auctions, lean enterprise, cost of capital, risk premiums, size premiums, leveraged and unleveraged beta, systematic and unsystematic risk, discount rate construction, valuation, pricing leveraged buyouts, the real deal about using debt, terminal values, real options in valuation, platform value, joint venture valuation and structuring, values, offers and deal pricing, discounts and premiums, venture capital valuation, growth, comparable pricing multiples, transferring pension obligations, deal integration, negotiation, risk and entropy, taxable and tax deferred deal structures, warrant- and economic value added- (EVA) based incentive plans, contracts and papering the deal, earn-outs, valuing synergies and tax step-ups, tax treatment of deal fees, escrows, caps, baskets, indemnity duration, why deals go bad, and much more.

Although some of the topics are longer than others, they all provide a succinct, pragmatic, and understandable view of each topic. The appendices referred to in each topic provide illustrations and visual guides that will prompt the reader to ask: How can this be adapted to work for us?

One of my goals when writing this book was to demonstrate the application of pertinent academic theory to the practical process of getting deals done. Sources in the footnotes and in the reference list direct the reader to additional information on the subjects discussed. It is my hope that the reader will view the book as a key reference when preparing for and undertaking the heady challenge of doing M&A. My aim is for the reader to finish a topic or the entire text with the feeling of "I get it."

DAVID T. EMOTT

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D. T. E.

Contents

Preface	xi
Acknowledgments	xiii
TOPIC 1 Strategy Development, Then M&A	1
TOPIC 2 M&A Process: Front to Back	13
TOPIC 3 Why M&A?	17
TOPIC 4 Deal Criteria	19
TOPIC 5 Deal Sourcing	26
TOPIC 6 Fees for Services	29
TOPIC 7 Financial and Strategic Buyers	36
TOPIC 8 How Long Will It Take to Complete the Deal?	38
TOPIC 9 Confidentiality Agreements	39
TOPIC 10 "Concern Capture" Due Diligence	44
TOPIC 11 Keep Deal Conversations Quiet	53
TOPIC 12 Auctions	54
TOPIC 13 Seller's Prospectus	62

TOPIC 14	65
Pay for Inherent Capabilities Only	
TOPIC 15	68
Platform Value	
TOPIC 16	70
Buyer and Seller Value Perspectives	
TOPIC 17	73
Integration Initiatives Will Determine Deal Value	
TOPIC 18	75
Unlock Hidden Value: The Lean Enterprise	
TOPIC 19	78
The Real Deal: Lean	
TOPIC 20	82
Valuation: An Introduction	
TOPIC 21	86
Discounted Cash Flow: An Introduction	
TOPIC 22	90
Free Cash Flow	
TOPIC 23	95
Fair Return on a Deal	
TOPIC 24	104
Risk-Free Rates	
TOPIC 25	105
Equity Risk Premiums	
TOPIC 26	106
What Is Business Risk?	
TOPIC 27	110
Entropy: Tendency toward Negative Variation	
TOPIC 28	112
Equity Investor Risk	
TOPIC 29	113
Beta	
TOPIC 30	116
Systematic Risk	
TOPIC 31	118
Unsystematic Risk	

TOPIC 32	
Beta with or without Debt	119
TOPIC 33	
Beta: Levered or Unlevered	120
TOPIC 34	
Beta Application in Determination of C_u	123
TOPIC 35	
Levered Beta Moves as Debt to Equity Moves	125
TOPIC 36	
Size Premium	127
TOPIC 37	
Weighted Average Cost of Capital	130
TOPIC 38	
Terminal Values, Terminal Value Multiples, and Terminal Value DCFs	137
TOPIC 39	
Discounted Cash Flow Valuation Illustrated	142
TOPIC 40	
Leverage: The Real Deal	147
TOPIC 41	
Debt Limits	149
TOPIC 42	
Debt Adds Value: Derivation of D_t	151
TOPIC 43	
The Leveraged Buyout; Definition and Valuation	155
TOPIC 44	
Valuing the Leveraged Buyout	160
TOPIC 45	
Real Option Valuation: An Introduction	169
TOPIC 46	
Real Option Valuation: Application and Illustration	173
TOPIC 47	
M&A Values Are Not All the Same	179
TOPIC 48	
Discounts and Premiums	183
TOPIC 49	
Discounted Cash Flow Valuations: Minority or Control	192

TOPIC 50	
Inflation in DCF Valuations	194
TOPIC 51	
Integration, Alignment, and Synergy Benefits: Plan It Out	195
TOPIC 52	
Integration, Alignment, and Valuing Synergy Benefits	197
TOPIC 53	
Venture Capital Valuation	208
TOPIC 54	
Discount Rates and Valuing Free Cash Flow	211
TOPIC 55	
Growth, C^*, and Return: The Engine to Increased Valuations and Deferred Tax Advantage	222
TOPIC 56	
How Fast Can the Target Grow?	225
TOPIC 57	
Cash Flow Multiples, Growth Rates, and Discount Rates	227
TOPIC 58	
Comparable Multiples	239
TOPIC 59	
Converting FCF_M to P/Es and Other Valuation Multiples and Deriving Slot Multiples for Public Companies	247
TOPIC 60	
EBITDA Valuation Engine	264
TOPIC 61	
Free Cash Flow Equivalent Impacts for Arbitrary Adjustments to Discount Rates	276
TOPIC 62	
Transferring Defined Benefit Pension Plan Liability Issues	278
TOPIC 63	
Environmental Remediation Expenses	282
TOPIC 64	
Environmental Insurance	283
TOPIC 65	
Management Warrant Incentive Plans	285
TOPIC 66	
Negotiation: Introduction and Overview	290

TOPIC 67	
Negotiation: Values, Offers, Prices, and Risk Assumption	292
TOPIC 68	
Negotiation: Offer Content	296
TOPIC 69	
Negotiation: Create Space in Your Ideas	298
TOPIC 70	
Negotiation: Beware of the Emotions of Private Sellers	299
TOPIC 71	
Negotiation: Imprint; Do Not Lecture	301
TOPIC 72	
Negotiation: Handling Tight Spots	303
TOPIC 73	
Negotiation: Closing the Bid-Ask Negotiating Gap	305
TOPIC 74	
Negotiation: Be Aware of Leverage and Deal Momentum Shift	308
TOPIC 75	
Negotiation in the Final Stages	311
TOPIC 76	
Negotiation: Use Earn-Outs or Noncompete Agreements to Close a Bid-Ask Gap	313
TOPIC 77	
Negotiation: After the Deal Is Agreed	318
TOPIC 78	
Negotiation: Bluffing and How to Handle It	321
TOPIC 79	
Negotiation: When Do You Step Away?	324
TOPIC 80	
Negotiation: When Do You Proceed?	326
TOPIC 81	
Negotiation: Do a Time Capsule	328
TOPIC 82	
Negotiation: Build Trust to Get Closed	329
TOPIC 83	
Exits under Duress: Have a Plan if the Deal Does Not Work	333
TOPIC 84	
Structuring the Deal: An Overview	334

TOPIC 85	
Structuring the Deal: Asset Step-Ups, Noncompete, and Synergy Valuation Engines	341
TOPIC 86	
Total Shareholder Return	346
TOPIC 87	
Stakeholder Value Creation	349
TOPIC 88	
EVAquity: Align Shareholder and Management Interests	353
TOPIC 89	
Letter of Intent	358
TOPIC 90	
Purchase and Sale Agreement	359
TOPIC 91	
Purchase and Sale Agreement: Explanation by Section	361
TOPIC 92	
Purchase Price Adjustments for Working Capital	370
TOPIC 93	
Indemnification and Survival Provisions	374
TOPIC 94	
Escrows	379
TOPIC 95	
Joint Venture Transaction: Valuation and Structuring Overview	381
TOPIC 96	
Why Deals Go Bad	389
TOPIC 97	
After the Deal: Do a Deal Bible	391
TOPIC 98	
Do the Audits of the Integration and Deal Value Creation Plan	393
About the Web Site	395
Index	397

Strategy Development, Then M&A

Topic 1 presents an overview of the fundamental elements typically addressed in the strategic planning process; explores a number of work activities, approaches, and ideas pertinent to the process of developing strategy; and explores where mergers and acquisitions (M&A) fit in the strategy development and execution process.

The reader is encouraged to take the time to read through the Appendices referenced in the text of this and all remaining Topics in conjunction with the narrative to gain the appropriate level of understanding of the subject matter discussed. Appendices are either presented at the end of this and each remaining Topic or are available for review and download on this book's companion Web site (see the About the Web Site page for login information).

M&A IS ONE OF MANY BUSINESS DEVELOPMENT OPTIONS

- M&A in an operating business is one of a number of means to accomplish a strategic goal and generally results from a strategic planning and strategy development process.
- M&A activity is the strategic activity of investor groups (equity funds, venture capital funds, etc.).
- The work involved in strategy development in manufacturing or service firms is often found to be frustrating and difficult.
- The questions, introspective search, dialog, and answers often are time consuming and unclear, particularly to the operating executives doing this work who are used to dealing with issues and process refinements of running a business and making decisions.
- The operating executives include chief executive officers, chief financial officers, chief operating officers, operations directors, plant managers, manufacturing managers, chief marketing executives, or sales officers.
- The operating executives, however, are the source of the knowledge gained over years in the business that matters most in developing strategy.

- The work agenda must acknowledge early on that strategy development deals with issues and questions that do not have great clarity. The answers to these questions usually surrender not to analysis but to participants' best thinking and judgment.
- The strategy development team should move along as fast as the pace of capturing and quantifying judgment allows and determine where complementary off-line research and analysis by the team and or team analysts is needed to enhance the judgment.
- Avoid a heavily research-driven process.

STAGES INVOLVED IN THE STRATEGIC PLANNING PROCESS

- *This section provides a general overview of the key elements of the strategic planning process* usually employed in an operating company and indicates where M&A fits in. The information is presented in the Strategy Planning Process Engine in Appendix 1.1.
- *Corporate vision* embodies a brief, understandable, timeless statement of the rationale for why the firm exists (not what it does or wants to be) and the core principles that govern how the firm and its employees will conduct business and themselves during its existence.
- *Corporate mission* embodies a brief, understandable, realistic statement of what the firm wants to be (and be seen as) in the medium term, say 15 to 20 years.
- *Corporate strategies* are brief, understandable, achievable action statements of intent, direction, and desired result that are necessary to achieve and that, if achieved, will move the firm toward its mission (if not achieved, they will prevent achievement of the mission). These strategies are intended to create sustainable competitive advantage in the organization's market space. These strategies emanate from the strategy development process discussed later in this topic.
- *Initiatives* are big, achievable activities and programs that individuals and teams rally around and participate and take ownership in. Initiatives are necessary to complete and, if completed, will move the firm toward realization of the desired results embodied in each strategy. They are usually multiyear in duration. M&A is potentially one of a number of business development initiatives.
- *Key performance indicators (KPIs)* are descriptions of relevant, timeless indicators of performance in operating and functional support processes and initiative realization.
- *Metrics* are relevant, preferably quantitative measures by which to gauge performance toward and achievement of initiatives and of KPIs.
- *Goals* are brief statements of this year's (perhaps part of a multiyear goal) expected achievements and related metrics of achievement for each initiative or KPI. Goals are owned by individuals and teams and provide a clear measure of personal and team performance.

- *Results* are measurement based, integrate with incentive plan design and rewards, and provide the basis for measuring goal achievement and making cyclical, periodic adjustments to strategy, initiatives, metric targets, and goals.

STRATEGY DEVELOPMENT—WHERE AND HOW TO CREATE VALUE

- *The essential thrust of strategy development* is identifying *where to create value* (attractive market spaces to enter or maintain and defend) and *how to create value* in the spaces selected. (What are the enabling capabilities and strategies required to close the capability gaps that exist for the firm to compete in the identified spaces and create enduring stakeholder value?)
- M&A is one of a number of means of closing the capability gaps. Other methods include organic development, in-house start-up, licensing, joint ventures, and other contractual arrangements.
- The process involved in detail strategy development usually includes the two steps noted above, which are shown in the Strategy Development and Gap Closure Engine in Appendix 1.2.
- Many of the process steps presented on Appendix 1.2 may not be carried out explicitly in reaching strategy conclusions in businesses that prefer a more intuitive strategy development approach, but they probably reflect the thought processes and trade-offs made by intuitive strategy developers.
- Do not underestimate what a highly skilled and experienced strategy development consultant can offer to drive the strategy development process. Experienced experts will, at the very least, provide a voice of reason, contrast, and clarity to the process. More often they will provide the results of external research and insights, options, points of focus, and direction, which are all of timeless value to the user.
- There is also great benefit to focus the due diligence process (normally applied to acquisition targets as discussed in Topic 10) internally (the firm's due diligence self-assessment) as part of the firm's strategic planning process. Doing so captures much of the knowledge of the firm's capabilities discussed later in this topic, as well as the business and valuation drivers discussed in Topic 10 and attractive market criteria discussed in Topic 4.

WHERE—IDENTIFY CUSTOMER'S INITIATIVES AND ATTRACTIVE MARKET SPACES

- *Identify your customer's (and your customer's customers) strategic initiatives* in the market spaces you are now engaged in (See Appendix 1.2). Also identify their current and future product and service needs and requirements that will fulfill their initiatives (B, Appendix 1.2):

- By doing so, you can identify where are they going, what will they need to get there, and what is most important to them to enable them to succeed. You will also identify what capabilities will be necessary for vendors to excel at to meet their customers' product and service requirements (B1, Appendix 1.2). Consider the following:
 - Closely follow industry trends.
 - Hold "customer futures" conferences for your industry and its future.
 - Talk to your customers: How can you be in their future?
 - Attend customer industry conferences and trade shows.
- *Identify new attractive market spaces* (B2, B3, Appendix 1.2) and the future product and service requirements of those spaces worthy of developing, entering, and defending (B, Appendix 1.2). Identify the capabilities necessary to meet those product and service requirements (B1, Appendix 1.2).
- *Use brainstorming techniques* to identify adjacent and new market space ideas. Cross-reference them to the results from these idea-generating methods:
 - Search Web databases for ideas on where others are placing investments.
 - Interview pension advisors and venture capital and equity investors for investment trends and developing sectors.
 - Interview "blue sky" thinkers for megatrends and implications on business sectors.
 - Perform top-down growth segment identification methods using macro, segment-oriented databases. Where is growth and investment occurring?
 - Examine the value chains in growth sectors to identify the key value-creating enablers and inputs to the identified attractive macro sectors: What is the key ingredient, enabler, or activity in the value chain that adds the critical function to the end products and services within the sector?
 - Identify the key value-added ingredient sector of the value chain that becomes the target market space in the attractive sector.
 - Question industry experts to identify the value chain and enhance the analysis.
 - Cross-correlate the findings from each method.
 - Perform activity and capability extension analysis as discussed later in this topic.

HOW—IDENTIFY YOUR ACTIVITIES AND CAPABILITIES—EXTEND THEM

- *Identify your business's internal activity and capability strengths* (Activities, Capabilities, and possibly Competencies) (C, Appendix 1.2).¹
 - Activities and capabilities are all the relevant things done in the business to serve customers in one way or another.

¹ This activity and capability extension analysis is grounded in the excellent work of John Stempeck, of Avalon Associates, Boston, MA, a strategy development consulting firm.

- Activities and capabilities as illustrated in Appendix 1.3 are evaluated in terms of how well they are done and the relative state of evolution of the activity within the company versus the requirements in targeted market spaces and as practiced by principal competitors. They are described as follows:

How Well the Activity Is Practiced in the Company

- Leader or cutting edge; equal to or just okay; follower or lagging behind

State of Evolution of the Activity as Practiced in the Marketplace and as Required to Meet Future Market Requirements

- Emerging, recently developed, gaining traction
- Required and undergoing change
- Mature, subject to competitive replacement

Activities and Capabilities Might Include, for Example

- Conceiving, designing, assembling, fabricating, engineering
- Proposal preparation, selling, order taking, chemical synthesis
- Milling, cutting, folding, drawing, welding, bending, preparing, polishing
- Field service, customer inventory management, distributing, delivering
- Some activities may be competencies (see below)

Competencies Are the Reason(s) Customers Come Back

- Competencies are the conjoint result of excellent business process execution (combinations of activities performed at a cutting-edge level) and deep capabilities described in terms of years of know-how, education, and unique learned and applied skills that are utilized in work activities.
- Competencies are observable and identifiable by customers as activities performed that they rely on most heavily and are not easily replicated by the competition.
- Bain & Company defines a core competency as a deep proficiency that enables a company to deliver unique value to customers. It embodies an organization's collective learning, particularly of how to coordinate diverse production skills and integrate multiple technologies.²
- Customer interviews asking why customers rely on you, buy from you, and keep coming back rather than going to the competition are often the most productive way to identify competence. Customers may say:
 - "They always deliver on time in full quantities needed."
 - "Their product always functions to spec under the harshest use conditions."
 - "They can solve any technical design and application problem we throw at them and do it quickly."
 - "Their technical and delivery proposals to our conceptual requirements leave no questions unanswered—we know what we are going to get."

² www.bain.com/management_tools/tools_competencies.asp?groupcode=2.