

ANDREW J. SHERMAN
MILLEDGE A. HART



S E C O N D E D I T I O N

MERGERS & ACQUISITIONS FROM A TO Z

Latest trends and best practices for structuring profitable deals

New due diligence rules and strategies in the age of Sarbanes-Oxley

Guidelines for keeping deals on track and managing post-closing challenges

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Andrew J. Sherman
and Milledge A. Hart

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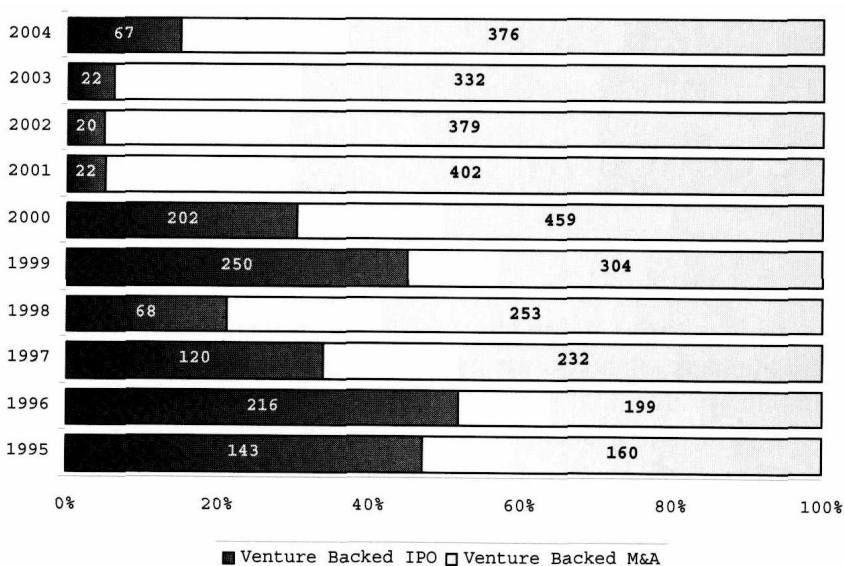
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Introduction

In business there is one simple rule: grow or die. Companies on a growth path will take away market share from competitors, create economic profits, and provide returns to shareholders. Those that do not grow tend to stagnate, lose customers and market share, and destroy shareholder value. Mergers and acquisitions (M&A) play a critical role in both sides of this cycle—enabling strong companies to grow faster than competition and providing entrepreneurs rewards for their efforts, and ensuring weaker companies are more quickly swallowed, or worse, made irrelevant through exclusion and ongoing share erosion.

Mergers and acquisitions are a vital part of any healthy economy and importantly, the primary way that companies are able to provide returns to owners and investors. This fact, combined with the potential for large returns, make acquisition a highly attractive way for entrepreneurs and owners to capitalize on the value created in a company. Exhibit I-1 illustrates this point from the perspective of the venture-backed company. In the past five years, 92 percent of liquidity events from venture capital funded firms were realized via merger and acquisitions, with only 8 percent of these companies achieving liquidity through an initial public offering (IPO).

Starting a company and selling it can be the fastest way to create substantive wealth. While it is difficult to start a successful company, the economic rewards are tremendous. The authors of this book have enabled transactions that created enormous value for shareholders. In one case, a two-year-old technology company had only \$150,000 of invested capital and zero revenue, yet was able to obtain a \$13 million sale price. Another transaction involved a 30-year-old, second-generation, family-run business that provided nearly \$30 million to the family shareholders. A merger or acquisi-

Exhibit I-1. Mergers and acquisitions vs. IPOs: 1995–2004.

SOURCE: *VentureOne*.

tion is frequently the happy ending to the tales written by productive and fortunate entrepreneurs.

Mergers and acquisitions have played a variety of roles in corporate history, ranging from the “greed is good” corporate raiders buying companies in a hostile manner and breaking them apart, to today’s trend to use mergers and acquisitions for external growth and industry consolidation.

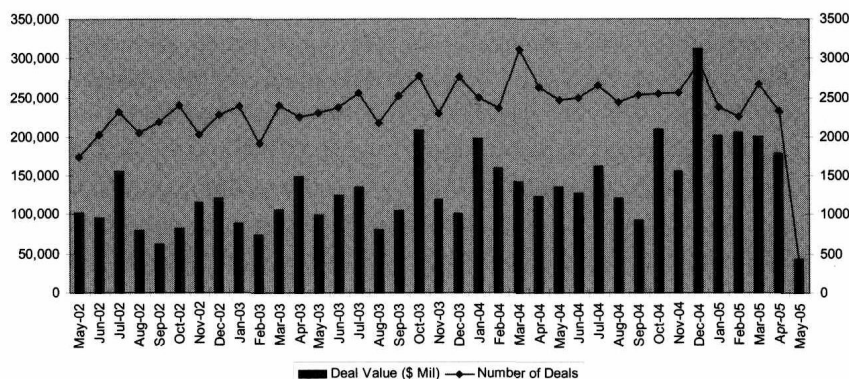
During the 1980s, nearly half of all U.S. companies were restructured, over 80,000 were acquired or merged, and over 700,000 sought bankruptcy protection in order to reorganize and continue operations. The 1980s featured swashbucklers and aggressive tactics to gain control over targets. The 1990s were equally dynamic in terms of companies evolving through upsizing and growth, downsizing, roll-ups, divestitures, and consolidation, but with a different focus on operational synergies, scale efficiencies, increases in customer bases, strategic alliances, market share, and access to new technologies. This period, however, came to a crashing end with the bursting of the tech bubble and the global recession that followed.

The more recent wave of M&A activity seen since mid-2004 has been driven by the more general macroeconomic recovery and several key trends. First, many companies have exhausted cost cutting and operational efficiencies as a means to increase profitability, and are looking to top-line growth as a primary enabler of shareholder return. The increased pressure to grow highlights the opportunity to achieve growth through acquisition. Second, the M&A market has been supported by the return of corporate profits and with it, improved stock price valuation. The improved valuations have enabled corporations to leverage their internal currencies to acquire target companies who are willing to swap their illiquid private stock for valuable public company shares. Third, interest rates have hovered at historical lows, enabling firms to cost-effectively utilize debt to finance acquisition-based growth.

In 2004, 31,233 deals transactions were announced worldwide, a 9 percent increase over the 28,702 announcements in 2003. These transactions were valued at \$1.9 trillion, a 39 percent increase over the \$1.4 trillion worth of transactions in 2003 (see Exhibit I-2). The U.S. marketplace saw 8,504 of these 28,702 transactions, valued at \$841 billion.

In addition to the aforementioned macroeconomic forces, many large industries have seen strong consolidation trends, with energy and power, financial services, and telecommunications leading the way by deal value, and high technology leading in terms of the total number of deals (see Exhibit I-3).

Exhibit I-2. Worldwide transactions: May 2002–May 2005.



SOURCE: Thomson Financial.

Exhibit I-3. Last twelve-months' deal activity by industry sector (as of May 2005).

Target Macro Industry	Deal Value (\$ Mil)	Mkt. Share	Number of Deals	Average Deal Size (\$ Mil)
Energy and Power	327,947	15.6	2188	\$150
Financials	305,841	14.6	3835	\$80
Telecommunications	209,831	10.0	957	\$219
Real Estate	178,132	8.5	1382	\$129
Media and Entertainment	165,446	7.9	2363	\$70
Industrials	157,365	7.5	3892	\$40
Materials	145,673	6.9	3131	\$47
Healthcare	141,880	6.8	1699	\$84
Retail	128,631	6.1	1467	\$88
High Technology	123,727	5.9	4348	\$28
Consumer Products and Services	123,163	5.9	2930	\$42
Consumer Staples	92,676	4.4	2022	\$46
Government and Agencies	903	0.0	34	\$27
Industry Total	2,101,215	100.0	30,250	\$69

SOURCE: Thomson Financial.

The telecommunications industry, in particular, has been transformed by merger activity in the last 18 months. After nearly \$100 billion in deal making, Verizon Communications and SBC Communications have emerged as two giants set to dominate the industry. These two companies control end-to-end connections from copper to the home to mobile telephony—a power position not seen since the days before the 1982 Justice Department ordered the breakup of AT&T. With Verizon's acquisition of MCI in response to SBC's purchase of AT&T, these telephony giants will own nearly 87 percent of the business market for telephony and data communications. Companies like BellSouth and Qwest were left out of the merger frenzy, and as such, are in substantially inferior competitive positions.

Finally, this decade is decidedly marked by the return of the mega-deal. It seems that nearly every week a large, industry redefining transaction is announced. Whether it is the oil and gas industry continuing to consolidate or the telecommunications sector returning to the structure before AT&T's breakup, today's headlines are riddled with news about massive structural change. Listed in Exhibit I-4 are the largest ten deals announced in the six months prior to May 2005.

Exhibit I-4. Ten largest deals: October 2004–April 2005.

Date Announced	Target Name	Acquirer Name	Value (\$mil)
10/28/2004	Shell Transport & Trading Co	Royal Dutch Petroleum Co	80,088.37
1/28/2005	Gillette Co	Procter & Gamble Co	57,226.81
12/15/2004	Nextel Communications Inc	Sprint Corp	46,513.70
2/18/2005	UFJ Holdings Inc	Mitsubishi Tokyo Financial Grp	41,431.03
12/7/2004	Telecom Italia Mobile SpA	Telecom Italia SpA	28,820.69
12/20/2004	Public Svc Enterprise Grp Inc	Exelon Corp	27,356.59
12/15/2004	Guidant Corp	Johnson & Johnson Inc	25,020.48
1/31/2005	AT&T Corp	SBC Communications Inc	22,076.11
12/23/2004	Almanij NV	KBC Bank & Insurance Holding	20,891.21
4/4/2005	Unocal Corp	ChevronTexaco Corp	18,919.22

SOURCE: Thomson Financial.

In addition to the substantial activity from large industry players, financial buyers have increased the scale, scope, and visibility of their transactions. While these companies no longer employ the junk-debt style leveraged buyouts that were popular in the 1980s, they now compete for large deals via large buyout funds and consortium behavior. The Carlyle Group, a premier private equity firm run by former IBM CEO Louis Gerstner, illustrates this scale phenomenon precisely. In 2004, The Carlyle Group returned \$5.3 billion to investors, invested \$2.7 billion, and raised another \$7.8 billion in capital for acquisition purposes. In addition, many of these large private equity firms are starting to collectively compete for large deals. In March of 2005, a consortium of financial buyers took Sungard Data Systems private in a transaction valued at \$11.3 billion dollars. Leading private equity firms Silver Lake Partners, Bain Capital, The Blackstone Group, Goldman Sachs Capital Partners, Kohlberg Kravis Roberts & Co. L.P., Providence Equity Partners and Texas Pacific Group worked collaboratively to complete the buyout. This transaction is particularly noteworthy in that it is the largest leveraged buyout since KKR bought RJR Nabisco for \$25 billion in 1988, and it is the largest buyout of a technology company.

Yet with so many dollars changing hands, there remains a very limited number of readily available resources for business executives and professional advisors to turn to for strategic and legal guidance. This book is intended to be such a resource.

There is no more complicated transaction than a merger or acquisition. The various issues raised are broad and complex, from valuation and deal structure, to tax and securities laws. The industries affected by this rapid activity are also diverse, from banking and computer software companies, to retailers and healthcare organizations. It seems that virtually every executive of every major industry faces a buy or sell decision at some point during his or her tenure as leader of the company. In fact, it is estimated that some executives spend as much as one third of their time considering merger and acquisition opportunities and other structural business decisions. As we will see in the chapters to follow, the strategic reasons for considering such transactions are also numerous, from achieving economies of scale, to mitigating cash flow risk via diversification, to satisfying shareholder hunger for steady growth and dividends.

The federal government's degree of intervention in these transactions varies from administration to administration, depending on the issues and concerns of the day. During the Reagan-Bush years, the government took a passive role, generally allowing market forces to determine whether a given transaction would have an anti-competitive effect. During the Clinton years, regulatory bodies took a more proactive approach, with more intervention by the U.S. Department of Justice and the Federal Trade Commission, such as a refusal to provide the necessary approval for the proposed merger of Staples and Office Depot in mid-1997. The current Bush administration, however, has taken a more *laissez-faire* approach only to have the European Union take a more aggressive role in preventing potentially anti-competitive mergers. The European Competition Commission's landmark rejection of GE's 2001 proposed acquisition of Honeywell signified a shift in the role that the EU played in the global M&A marketplace.

This book will *not* focus on the mechanics of the mega-mergers of recent years, such as the private equity consortium purchase of Sungard for \$11.3 billion, the Shell Transport & Trading Co acquisition by Royal Dutch Petroleum Co valued at \$80 billion, or the

\$46 billion Nextel-Sprint merger. Nor will it address the recent trend by overseas companies to buy in to the U.S. market via acquisitions in the banking, computer, and telecommunications industries. When the value of a transaction is \$1 billion or more, there is a team of skilled investment bankers and professional advisors quarterbacking the transaction, and in such cases the importance of this book will be less.

But what about the thousands and thousands of transactions each year that range from \$1 million at the low end to \$100 million at the high end? Where do these small- and middle-market company executives turn for guidance? For many of these executives, mergers and acquisitions represent a digestible and manageable strategy for business growth. Buying an additional \$2.5 million, or even \$25 million, in sales or profits may be easier, faster, and more profitable than building it from scratch.

Recent years have seen a significant increase in merger and acquisition activity within industries that are growing rapidly and evolving overall, such as in health care, information technology, communications, and software development, as well as in traditional industries such as manufacturing, consumer products, and food services. Many developments reflect an increase in strategic buyers and a decrease in the amount of leverage, implying that these deals were being done because they made sense for both parties, which is different from the highly leveraged, financially driven deals of the late 1980s.

The middle-market transaction is the clear focus of this book. Fortunately for that audience, middle-market transactions continue to attract compelling valuations. In the twelve-month period ending in April 2005, deals in the \$25 million to \$100 million transaction value had an $8.5 \times$ EBITDA multiple (EBITDA, also known as earnings before interest tax depreciation and amortization, is considered a decent approximation of pre-tax cash flow). See Exhibit I-5.

Companies in this segment need to understand the key drivers of valuation since they are often able to focus their operating goals in order to maximize the potential valuation range. Therefore it is important to know that the multiple a company achieves for its business directly correlates with the following seven characteristics:

1. Strong revenue growth
2. Significant market share or strong niche position

3. A market with barriers to entry by competitors
4. A strong management team
5. Strong, stable cash flow
6. No significant concentration in customers, products, suppliers, or geographic markets
7. Low risk of technological obsolescence or product substitution

Exhibit I-5. Last twelve-months' transaction multiples (as of April 27, 2005).

By Size (\$ in millions)	EBIT	EBITDA
Less than \$25	5.9×	4.7×
\$25 to \$100	11.7×	8.5×
\$100 to \$250	11.8×	8.4×
\$250 to \$1,000	16.7×	10.8×
Over \$1,000	16.3×	12.7×

SOURCE: Thomson Financial Securities Data Corporation. Based on multiples between 0× and 25×; excluding media and telecom.

Successful mergers and acquisitions are neither an art nor a science but a *process*. In fact, regression analysis demonstrates that the number one determinant of deal multiples is the growth rate of the business. The higher the growth rate, the higher the multiple of cash flow the business is worth.

A study of deals that close with both buyer and seller satisfied show that the deal followed a sequence, a pattern, a series of steps that have been tried and tested. This book focuses on conveying this process to the reader, as we learn to understand the objectives of both buyer and seller in Chapters 2 and 3, through the process of negotiations and closing in Chapters 4 through 10, to closing and beyond in Chapters 11, 12, and 13.

For example, when a deal is improperly valued, one side wins big while the other loses big. By definition, a transaction is a failure if it does not create value for shareholders and the easiest way to fail, therefore, is to pay too high a price. To be successful, a transaction must be fair and balanced, reflecting the economic needs of both buyer and seller, and convey real and durable value to the shareholders of both companies. Achieving this involves a review and analysis of financial statements, a genuine understanding of how the proposed transaction meets the economic objectives of each

party, and a recognition of the tax, accounting, and legal implications of the deal.

A transaction as complex as a merger or acquisition is fraught with potential problems and pitfalls. Many of these problems arise either in the preliminary stages, such as forcing a deal that shouldn't really be done (i.e., some couples were just never meant to be married); as a result of mistakes, errors, or omissions owing to inadequate, rushed, or misleading due diligence; in not properly allocating risks during the negotiation of definitive documents; or because it became a nightmare to integrate the companies after closing. These pitfalls can lead to expensive and protracted litigation unless an alternative method of dispute resolution is negotiated and included in the definitive documents. This book is designed to share the pitfalls of such transactions, with the hope that buyers and sellers and their advisors can avoid these problems in their future transactions.

Finally, with merger and acquisition activity continuing to grow at rapid rates, entrepreneurs and venture capitalists continuing to form new entities and pursue new market opportunities, it is critical to have a firm grasp on the key drivers and inhibitors of any potential deal. With so much money on the line, it is essential to understand how to maximize price and valuation goals while ensuring the transaction is successfully consummated.



The Basics of Mergers and Acquisitions

Over the past decade, we have seen countless examples of companies, such as General Electric, Citigroup and Cisco, that have grown dramatically and built revenues through an aggressive acquisition program. After a pause in the early part of the twenty-first century, the wave of consolidations, mergers, and acquisitions is once again moving to record heights in the United States and is sweeping through the small- and middle-market company sector of our economy. After several years of downsizing, cost cutting, and slow growth, seasoned executives and entrepreneurs are searching for efficient and profitable ways to increase revenues and win market share. The growth options are as follows: organic, inorganic, or by external means. Examples of *organic* growth are hiring additional salespeople, developing new products, or expanding geographically. The best example of *inorganic* growth is an acquisition of another firm, often done to gain access to a new product line, customer segment, or geography. Finally, *external* revenue growth opportunities are franchising, licensing, joint ventures, strategic alliances, and the appointment of overseas distributors, which are available to growing companies as an alternative to mergers and acquisitions as a growth engine. This book focuses primarily on mergers and acquisitions as a means to grow, although toward the end of the book we explore certain external opportunities as well.