Merger & Acquisition Focus

October/November 2009

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Ask the Advisor

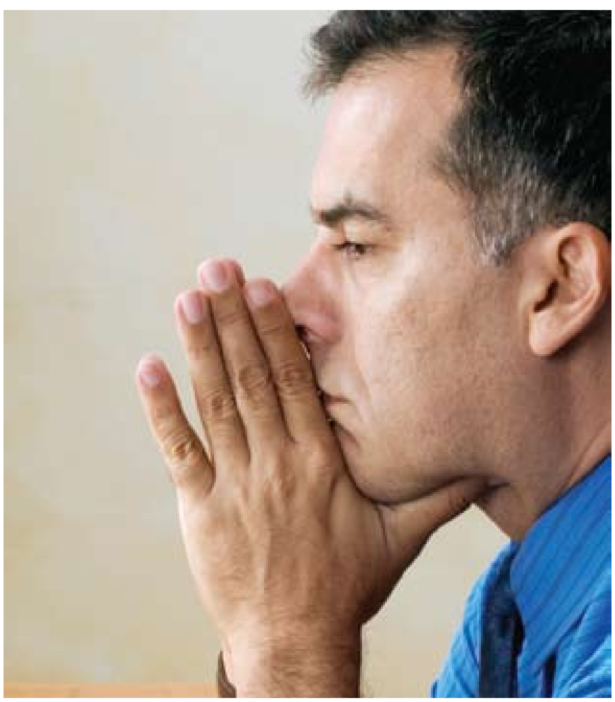
Manage risk the right way

Risk management has, understandably, become a big concern for both business buyers and sellers during the recent economic downturn. More than ever, companies pursuing an M&A transaction need to adequately account for the possibility that their deal will fall through before it's complete or fail to meet their postmerger objectives.

The many faces of risk

Risk takes several forms during an M&A transaction, from the potential for fraud and misrepresentations to risk in the process itself. A deal might fall apart during the negotiation stage due to personality conflicts or inadequate financing, wasting considerable time and expense for both parties. Being left at the altar can be particularly harmful for selling companies because they risk gaining a reputation as damaged goods.

It's also possible that an acquisition has hidden costs a buyer won't discover for years, such as environmental liabilities. Buyers need to worry



that their potential target will simply fail to live up to its projected profitability, or even fall victim to a maelstrom of lost customers, uncooperative vendors, alienated employees and a hostile market.

Prevent catastrophe

Of course there's no guarantee that an acquisition will generate a specific amount of revenue or meet other measures of success. But buyers can limit the risk of major catastrophe. The due diligence stage — when buyers review and scrutinize the seller's financial statements, legal documents, facilities and tangible and intangible assets — is critical. During this period, buyers may want to consult a risk management specialist who's familiar with signs that something's amiss.

Buyers should pay particular attention to anything that could be a legal liability, from waste disposal methods to intellectual property ownership to employee disability claims. Talking with employees can provide insight into potential problems that don't show up in financial reports. Buyers also need to assess whether insurance and cash reserves are adequate for potential claims and indemnification. If they decide that recognized liabilities or certain assets are likely to cause trouble, they should negotiate to remove them from the balance sheet before the deal is completed.

Some strategies buyers might consider to reduce the risk of underperformance (and loss of revenue) after the deal closes include earnouts (see "Performance anxiety? Earnouts can help" on the next page) and contingent value rights (CVRs). CVRs include stock and warrants and are designed to encourage the selling company's shareholders to either retain or sell their ownership positions — depending on the buyer's wishes. For example, to retain selling shareholders, a buyer might award them additional payments if the merged company's stock price falls below a certain floor.

How sellers mitigate risk

Although buyers bear most of the responsibility during the due diligence period, sellers should also try to mitigate risk. It's a good idea to perform background checks on the buyer's principals to rule out fraud and seek reassurances that the buyer has lined up adequate financing.

Sellers that are financing part of the deal themselves need to dig even deeper until they're comfortable that management will be capable of running the company successfully.

Paper vs. reality

History shows that intriguing deals on paper don't always deliver in the real world. Still, aggressive risk management can reduce the possibility that unforeseen factors will damage the long-term value of a merged company.

Quality risk management comes at a price, however. Due diligence, for example, can be extremely time-consuming, so both buyers and sellers need to determine in advance its scope and who will incur transaction costs. And to avoid paying too much for the acquisition, buyers need to incorporate the cost of risk management — including the expense of outside experts — into their bid price. ■

Hedging your bets

Among the many M&A-related risks is that of fluctuating markets. To prevent stock market volatility from destroying a deal between public companies, the parties could consider one of two offers:

Fixed-collar. Both parties agree that either can cancel the deal without penalties if a share price (buyer's, seller's or both) moves below or above specific numbers. The upper "trigger" prevents the buyer's shareholders from paying too much for an overvalued company, and the lower trigger allows a seller receiving payment in the form of buyer stock to walk away when the buyer's shares are worth substantially less than at the start of the negotiations.

Floating-collar. Here, the buyer and seller can alter their share exchange ratio if share prices go above or below specified limits. The agreed-upon sale price, however, remains the same, regardless of share price fluctuations — only the number of shares exchanged varies.

Performance anxiety? Earnouts can help

Given the current state of the U.S. economy, it's not surprising that both business buyers and sellers are entering M&A transactions with increased trepidation. Buyers, in particular, are putting a greater emphasis on risk control, seeking to acquire targets as cheaply as possible and, in many cases, using earnouts to limit potential losses. These tools can also benefit sellers motivated to complete a deal now, instead of waiting for market conditions to improve.

Bridging the gap

An earnout sets a company's purchase price according to how well it performs after it's sold. The buyer generally makes a down payment and several staggered payments over time based on the acquired

Buyers, on the other hand, commonly favor net earnings because it better reflects economic value. The number of variables involved in determining the bottom line, however, can lead to future disagreements. Operational metrics often offer a good compromise for both sides.

business's performance. Originally, earnouts were developed to retain key employees after a merger. These days, however, they're more commonly used to bridge valuation gaps or overcome negotiation stalemates in which buyers and sellers disagree about the company's future profitability.

Buyers generally like earnouts because they ensure seller involvement during the transition period and require less money up front, thus reducing risk should the acquisition fail to meet expectations. Sellers like them because earnouts allow succession in phases while the seller participates in the sold company's future profitability.

3 factors

Typically, earnouts base their price on one of three factors:

1. Gross revenue,
2. Net earnings, or
3. An operational metric common in the industry, such as customer base size or sales numbers.

Sellers typically prefer gross revenue as a price basis because the expense management that's associated with net earnings is likely to be beyond their control.

Minding the details

Whichever price basis you and the other party agree on, pay attention to what products and services are included when calculating the price. These can be the items that exist at the deal's closing and those that may be developed in the future based on the seller's current offerings.

Earnout periods generally span between two and five years. Longer durations mean more information is available to compute the earnout. But as time passes, results may be more attributable to the acquirer's business practices, rather than the original owner's. Results also can be skewed by a temporary event — such as a natural disaster or lawsuit — that doesn't necessarily affect the operation's long-term value.

These days earnouts are commonly used to bridge valuation gaps or overcome negotiation stalemates.

Anticipating trouble

The last thing either party wants is for their earnout to trigger a dispute down the road. Earnout discussions, therefore, should include potentially sticky post-transaction situations. For example, what if the buyer has products or services that compete with the selling company's, or if the buyer later acquires a competitor? Sellers should seek assurance that resources won't be channeled to other operations to artificially deflate the acquisition's performance.

Or what happens if the buyer wants to bundle acquired products and services with its existing offerings? This can make distinguishing revenues and earnings problematic, particularly if there are differences in marketing, price, production and distribution. Often, the best solution is to base the earnout on the combined business's performance rather than that of the acquired company's.

M&A parties also should discuss what might occur if the buyer decides to sell certain assets that drive growth before the earnout period ends. In this situation, the seller typically asks the buyer to purchase the earnout at a mutually accepted price. Intellectual property ownership can be another source of contention if the seller continues to develop new products and ideas.

Finally, decide which accounting practices will be used to calculate the earnout price — Generally Accepted Accounting Principles (GAAP) or another method — and ensure the newly merged company's accounting system is set up to track this. Agree upon periodic reports, as well as the seller's right to inspect or audit the calculations.

Know your buyer (or seller)

Before agreeing to an earnout, both M&A parties need to ensure the agreement protects their interests and anticipates potential conflict. Earnouts typically shift some of the transaction's risk to the seller, so sellers should fully investigate their buyers and may want to consider staying on in some capacity after the deal closes. ■

How to sell your sale to employees

Just because you're thrilled to have found a good buyer for your company doesn't mean your employees will greet the news with the same enthusiasm. You may, in fact, encounter negative reactions and even strong resistance from them. Left unchecked, employee dissatisfaction can depress a deal's ultimate value — and in extreme cases even cause its collapse. So before you announce your deal (or news of it leaks), plan how you're going to sell the sale of your company to these critical stakeholders.

Breaking news

Once you begin the M&A process — likely as soon as you start preparing your company's financials and facilities for the market — news that major change is in the works is likely to filter down to employees. Unconfirmed rumors (often worst-case scenarios) and employee feelings of powerlessness over the future of their jobs can cause considerable morale problems, particularly if management remains mum.

Obviously, deal negotiation details need to be kept confidential for legal and strategic reasons. But you and other executives should be in regular contact with your human resources staff and midlevel managers to get a sense of what employees are hearing and whether they're spreading misinformation. If rumors are circulating, hold a company meeting to let employees know that a sale is being considered and to dispel untrue information. If you aren't in a position to reveal details of a possible deal, simply tell them that.

Don't sugarcoat facts

Once you've hammered out the details of your M&A and signed a sale agreement, work with the buyer to get employees up to speed. They should be briefed on their new owner's business, culture and strategic objectives. Consider holding informal "meet and greet" sessions with small groups of employees and the buyer's management.

You don't want to create a sense of panic, but don't sidestep hard facts, either. If layoffs or relocations are in the new owner's plans, employees should know as soon as possible. At this time, you and the buyer may also want to discuss compensation, buyouts or retraining opportunities the merged company plans to offer.

Employee investment is key

Employees will naturally be worried about the new owner's corporate culture and how they'll fit into it. A good employee who's been working hard for a promotion, for example, is likely to be concerned about unfamiliar management and the need to start over proving him- or herself to the new boss.

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To prevent this kind of anxiety and help ensure that the best employees stay on, ask your managers to identify valuable and high-performing staff. Then, introduce these individuals to their new managers so they can initiate a working relationship before your company is absorbed by the buyer's.

One of the most common ways companies breed employee resentment during a merger is by reducing compensation or taking away benefits. The airline industry — in which employee seniority ranking determines who gets promoted and paid accordingly — offers a classic case.

When America West and US Airways merged in 2005, conflict soon erupted between the two companies' groups of pilots. Pilots in each demanded higher seniority rankings over comparably experienced pilots in the other — leading to litigation. Although this is an extreme example, all merging companies need to be aware of such potential conflicts and try to structure their deal to avoid them.

Open and honest

Change is always difficult for employees, particularly long-timers. But as long as you're proactive — heading off rumors at the pass, communicating the facts as soon as possible and easing the transition for key employees — you should be able to sell most of your employees on your sale. ■

Ask the Advisor

Q. Should I sell my company in an auction?

A: If you expect substantial buyer interest when you put your business up for sale, you might want to consider an auction. This competitive sale process is designed to get the best possible price and most attractive terms for sellers.

What are the advantages?

A successful M&A auction can provide such benefits to sellers as:

Higher prices. Competitive bidding means that the winning bidder often pays more than the selling company's initial valuation. For example, General Dynamics won a recent M&A auction for Axsys Technologies, paying $643 million, or 12.5 times Axsys' earnings before interest, taxes, depreciation and amortization (EBITDA).

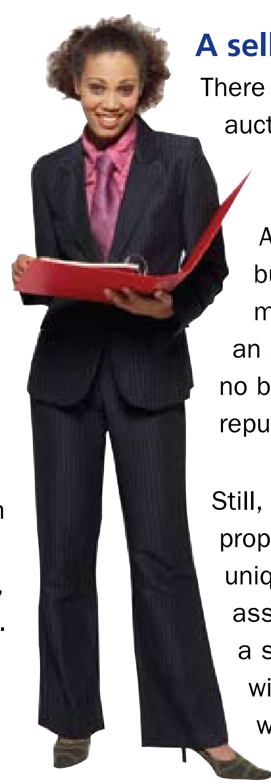
Speed. Auctions create a clear timetable for prospective buyers, establishing how long they have to conduct due diligence and make their bids.

Protection. The presence of several backup bidders puts pressure on the winning bidder to reduce the scope of final negotiations and complete the deal.

How does it work?

The auction process deviates slightly from a standard business sale. Generally, the seller draws up a list of buyer candidates, such as competitors and large customers. The seller also prepares a confidential memorandum (known as "the book") outlining the business, its assets and liabilities, and growth projections and distributes it to all potential bidders. Bidders generally must sign a nonbinding indication of interest and a confidentiality agreement before receiving the book. Bidders also receive a list of auction rules and a prospective sale agreement.

After this first round of interest, the seller typically winnows down the pool of buyers based on bid price and strategic factors. Remaining bidders can make specific due diligence requests and must submit more detailed bids, including financing information. The process usually ends when the buyer chooses one bidder from this second round and the parties conduct quick one-on-one negotiations to complete the sale.



A seller's strong bet

There are some possible drawbacks to an M&A auction. Some buyers will refuse to participate, depriving a seller of potentially strong candidates and affecting the sales price. Auctions tend to favor and attract strategic buyers. (Financial buyers may have trouble meeting their goals if they pay too much for an acquisition.) Also, if the auction fails and no bidders complete the sale, the seller risks a reputation as damaged goods.

Still, if you own a company with, for example, proprietary products, technologies or other unique or valuable tangible and intangible assets, the process can be a boon — even in a sluggish market. Discuss the auction option with your M&A advisor, who can help you weigh it against other selling strategies. ■

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