Merger & Acquisition Focus

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Ready, set, test!
Before you sell,
consider a practice run

So you've bought a troubled company: Now what?

Getting the most value out of your IP

Ask the Advisor

Ready, set, test!

BEFORE YOU SELL, CONSIDER A PRACTICE RUN

If you're planning to sell your company, you might improve your odds of success by performing a test run, or mock acquisition, first. A test run allows you to see your company as potential buyers see it, warts and all. Instead of waiting for actual buyers to find your company's weaknesses during face-to-face meetings or the due diligence stage — when there's probably little you can do to fix them — find and address possible problems now.

Go through the motions

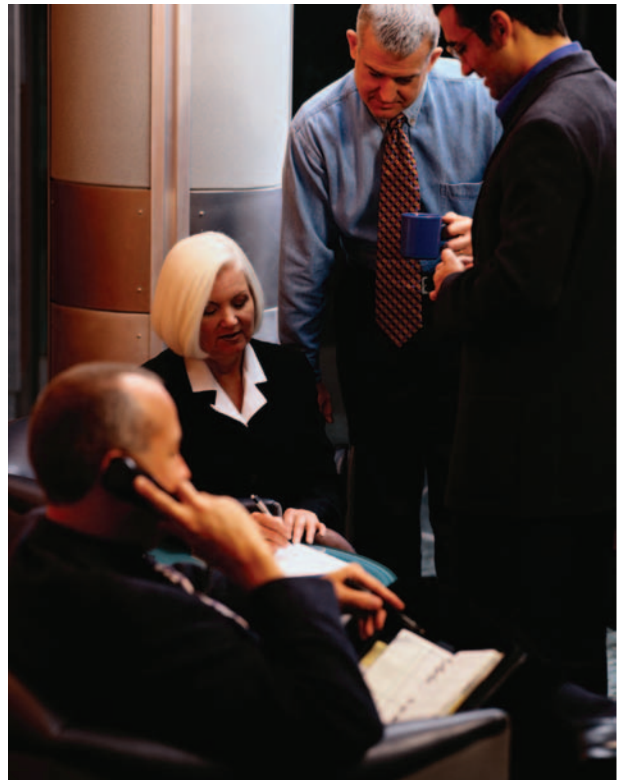
There's no one way to perform a test run, nor does the process need to be conducted according to a strict timeline. After all, you still have a business to run and it must be in peak shape when you put it up for sale.

If your work days are packed, you and your senior managers could conduct an informal mock deal during nonbusiness hours. Doing it yourself can take anywhere from three months to a year — depending on the extent of your test run and how soon you hope to begin the sale process.

If you can't spare the time or personnel to conduct the entire process in-house, consider hiring a third-party consultant. M&A advisors can plan the test run and manage time-consuming tasks such as mock financial due diligence.

There are many advantages associated with working with such professionals. For example, you're likely to:

- Complete the test run faster,
- See the process run more smoothly,
- Improve the quality of information gathered, and
- Be able to compare data to that of similar companies.



Also, if you're concerned about rank-and-file employees catching wind of a possible sale, consultants can conduct test run activities off-site or during nonbusiness hours.

Role playing

Even if you bring in outside assistance, you and your senior managers can help the process by participating in mock acquisition scenarios. For example, you might conduct meetings in which some managers represent buyers and others represent your company.

In this exercise, mock buyers could draw up a list of important questions for those playing the role of sellers on such issues as revenues, assets, projected growth, company culture and customer relationships. This can help your company prepare for initial meetings with potential buyers so you aren't caught off guard with questions you can't answer. Your mock sellers also should draft a sales prospectus, which your role-playing buyers can rigorously examine for gaps or red flags.

Going over the numbers

Financial and legal due diligence is probably the most important part of any test run. Ensure legal records are complete and financial statements are thorough, accurate and up-to-date, and then use them to identify issues that are likely to ring caution bells with buyers. You won't necessarily be able to fix every financial weakness or potential legal liability, but you can decide how you'll frame the discussion about them during sale negotiations.

During your test run, focus on these areas in particular:

Capital. Review the amount of cash flow and maturity levels of your company debt, and compare them to that of other companies in your industry. Buyers won't consider cash flow and debt in a vacuum — they'll compare these line items to those of other companies they're considering buying.

Legal liabilities and assets. Consider not only your company's outstanding legal issues, but also their potential cost — what it would take to settle cases out of court or pay trial costs and adverse judgments. Also ensure your intellectual property (IP) holdings are documented and your ownership is established. (See "Getting the most value out of your IP" on page 5.)

20/20 vision

Buyers' eyes typically aren't clouded by personal associations and relationships that can sometimes develop as you manage your company's daily business. Although a thorough test run is best, any mock acquisition is helpful because it provides you with the valuable perspective of a potential buyer and gives you the opportunity to address potential concerns before you try to sell. ■

So you've bought a troubled company: Now what?

If there's a silver lining to a weak economy, it's that the M&A market is brimming with bargains for buyers with the cash to acquire them. Financially distressed companies, in particular, can look inexpensive relative to their growth potential. But getting a good price is only part of a successful deal: You also must be able to turn that troubled acquisition around.

Opportunities vs. risks

Before you buy a bargain, ensure it actually has potential. Issues such as weak cash flow or poor leadership can be relatively simple to fix, but it's much harder to turn around a company with obsolete product lines or pending lawsuits.

Examine your distressed target for hidden values and ensure you understand its profit drivers and roadblocks. Without a clear understanding of these, you may misread the company's financial statements, misjudge its financial condition and, ultimately, devise an ineffective course of rehabilitative action.

While due diligence is an important part of any acquisition, it's probably the most critical stage in a turnaround deal. You need to pinpoint the source of your target's distress (such as maturing products or overwhelming debt) to determine what, if any, corrective measures can be taken.

Research market trends and determine if your target's products and services are becoming obsolete, or if the company is strategically positioned to introduce new products. Also determine if the business harbors significant liabilities, such as product claims or dissatisfied customers.

Due diligence also may unearth potential sources of value, such as tax breaks, underutilized assets or proprietary technologies. Benchmarking the company's performance with its industry peers can help reveal where opportunity lies. Once you have a good picture of your target's opportunities and risks, you can decide whether it's a good turnaround prospect.

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Get off on the right foot

Generally, the first post-transaction step is for new owners to determine what products drive revenue growth and which costs hinder profitability. This is the time to divest the business of unprofitable products, services, subsidiaries, divisions or real estate. Staff cuts and management restructuring also may be in order.

Implementing a longer-term cash-management plan and forecast based on receipts and disbursements is critical. You'll want to manage each line item of your acquisition's weekly or daily receipts and disbursements in accordance with profit and loss projections, changes in working capital, and major debt and capital expenditures.

Your cash-management plan should enable you to identify lost revenue opportunities, such as unbilled services, longer-than-necessary billing terms and poor inventory management. This plan can also help you determine where you might be able to cut costs.

Measuring success

Tracking your turnaround's progress is essential. Ensure that accounting and reporting systems are producing the data necessary to run effective management reports. Without systems that list all assets and liabilities, you won't be able to fully pursue opportunities or respond to potential problems.

Because the task can seem overwhelming, you may be tempted to focus only on your acquisition's day-to-day operations. But a strategic plan and short- and long-term timelines that map the path toward revenue growth and improved cash flow are necessary.

You may find, for example, that the company's best revenue-producing assets aren't reaching customers and that their potential could be realized with a more sophisticated marketing campaign. Macro- and micro-level planning are equally important.

Don't abandon reason

Deeply discounted targets can tempt even the most disciplined business buyer to abandon its acquisition criteria and long-term objectives. Before you snap up a "bargain," discuss your plans with an M&A professional, who can help you determine if that troubled company really is a turnaround opportunity — or simply a dead end. ■

Getting the most value out of your IP

In an M&A marketplace currently dominated by strategic buyers, intellectual property (IP) can be a seller's most valuable asset. If you're considering selling your business, it's critical that you assess the value of your IP and ensure that you — and not employees or contractors — own it. Also, you should prepare a marketing plan for your IP that matches your buyer's objectives.

Considering that the IP category includes far more than copyrights, trademarks and patents these days, cataloging and appraising intangible assets can be time consuming. So be sure to get an early start on the task.

People for the project

First, consider the scope of your IP documentation and appraisal task and the time and personnel it will require. Keep in mind that IP currently in use isn't the only property that requires inventorying and valuing. You also need to include IP without formal documentation and in development.

If your company doesn't have the time or expertise to conduct the project, consider hiring outside experts to do it. At the very least, engage advisors such as patent attorneys and professional valuators to appraise your assets. Accurate valuations are essential if your company is to receive the fairest sale price.

Cataloging your holdings

Once you have the people in place, begin cataloging your IP. Keep in mind that not all intangible assets are as easy to identify as trademarks and proprietary software programs. For example, "hidden" IP can include internal company standards, such as employee rulebooks or training manuals, or it can be trade-related items, such as a packaging design or client sales lists.

Also look out for unpatented technology and developments. IT department employees, for example, may be working on a database project that's only in the early stages. But their research materials might be valuable to potential business buyers.

What's it worth?

When you've finished cataloging IP, you'll need to put a price on it. The greatest risk at this stage is that you'll undervalue your IP assets and allow a buyer to grab them for much less than they're worth. Of course, you also need to be aware of the opposite: Overvaluing IP can scare away buyers.

IP valuation is primarily concerned with the lifespan of the assets, since their value typically deteriorates as they grow older and the market changes. This is particularly true of technology IP, such as software programs.

How to verify IP ownership

Intellectual property (IP) will increase your sale price only if you own it. So before you dangle IP assets in front of potential buyers, verify that the property is yours and that you have documentation to prove it.

For copyrights and trademarks, the most critical determination is the "range" of ownership. For example, is your trademark valid only in North America, or is it also valid in the European Union and major Asian countries?

Determine the range of protection for patents, too, and decide whether any are provisional — an informal, temporary patent status. If so, try to finalize the patent before selling, and if that's not possible, you'll need to disclose the situation to your buyer. Also ask whether the value of your patents is reliant on other patents. For example, is the patent an improvement on another company's patent? If so, determine whether you'll need to pay a license to that third party.

Pay particular attention to time-sensitive assets and ensure a valuator reviews them before you begin the sale process and again when you're close to the due diligence stage. If you don't, your buyer might discover, for example, that the fair market value of what you had considered an important asset has fallen below book value.

Potential conflict

Parties to M&A deals often clash over asset values — particularly if the buyer or seller makes an aggressive case for over- or undervaluing intangible holdings. To reduce the chance of conflict, consider these assets from a potential buyer's perspective. You may be surprised to find that some of your IP assets would be of little practical use to other companies.

Also run through some questions that buyers generally ask when reviewing a target's IP:

Is this an exclusive copyright or trademark? If you've only registered a trademark in a particular country or for only one specific product, your trademark may be less valuable.

What's the legal status of this asset? If any patent applications have yet to be filed, or are set to expire after a certain period, it will likely reduce the asset's worth. For more information, see "How to verify IP ownership" at left.

How does this advance my strategic goals? A buyer may think that an IP asset you consider valuable is unlikely to advance its objective of, for example, increasing market share. Thus, your asset will be of less — and possibly no — worth to the buyer.

Strategic reasoning

Buyers with the resources to make M&A deals can afford to be picky, and they're likely to have solid strategic reasons for making an acquisition. Your IP holdings may represent such a reason for a buyer, so be careful how you handle it. ■

Ask the Advisor

Q. Do I need to handle promotion issues before I sell my business?

A. The M&A process requires sellers to juggle many competing obligations and responsibilities. Even if your top priorities are to ensure that the transaction goes smoothly and you receive a fair price for your business, you can't afford to ignore issues such as employee promotions and leadership succession. Moreover, if you neglect employees at this critical time, these issues are likely to rear their ugly heads later on.

Don't procrastinate

Selling owners often are tempted to put outstanding promotions and successions on hold, assuming the company's buyer will deal with them later. Avoidance can backfire, however. If employees are frustrated and disgruntled, they may leave for greener pastures. And the departure of key employees can, in turn, reduce the value of a business or discourage buyer interest entirely.

To avoid that scenario, conduct an extensive personnel review before putting your business on the market. Interview managers to learn which employees are due for promotions and to determine who's critical to your company's bottom line — whether they're salespeople, product developers, production managers or your CFO. Next, consult your HR department about current pay rates, employee longevity and employment agreements with key people.

Weighing interests

Once you've collected the relevant information, evaluate it and attempt to strike the best and fairest balance between your interests and those of employees. Among other criteria, consider which employees:

- You need to incentivize because their continued employment is critical to your company's value,
- Deserve — on the basis of performance, tenure or verbal promises — a promotion or raise, and
- Have contracts that guarantee specific compensation or positions.

Don't forget to factor in the financial cost of increased salaries, benefits and perks. Potential buyers will carefully scrutinize your balance sheet, including the amount that goes to payroll and benefits.

For succession issues, take any tacit agreements — say, your verbal promise that after a certain period your second-in-command will assume greater responsibilities — and formalize them. Most buyers prefer that management succession issues be in writing so they don't have to fulfill vague promises or face potential lawsuits after they assume ownership.

Taking the initiative

Above all, remember that employees are some of your company's most valuable assets. By resolving promotion and succession issues now, you'll help shore up the foundations of your business and preserve its value. ■