Merger & Acquisition Focus

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Shrinking to grow
Why a strategic divestiture might help your business flower

Now may be the time to sell your tech company

Ask the Advisor

Blueprint for your company's future
Attract investors with your business plan

Shrinking to grow

Why a strategic divestiture might help your business flower

Companies usually have some vision of how they want to grow and maximize long-term shareholder value. All too often, however, they fail to realize how strategic divestitures can play a key role in achieving that vision.

Selling a poorer performing or noncore unit can, in fact, enhance the value of remaining operations. Underperforming business lines or divisions often overwhelm management, diverting it from more profitable pursuits. And in many cases, other companies are better suited to pursue the line of business and are willing to pay for the opportunity. So maximizing your company's value may mean that it's prudent to divest the unit and redeploy the proceeds into other lines with greater long-term prospects.

Financial impact

The cash flow impact of selling a product line or division may not be obvious. Financial models that evaluate the future impact of the sale on your company's revenue, product mix, gross profit margins, selling costs and overhead can be helpful in this regard.

Consider that, while it's easy to identify the forgone sales and direct cost reductions that will result from the divestiture, it may be more difficult to fully calculate the amount of overhead the unit has been absorbing. The sale of the business line may affect other business units by increasing overhead if you don't plan to simultaneously reduce it commensurately. Your financial model must also consider contingent receipts such as earnout payments — deferred payments that are contingent on the company achieving certain milestones.

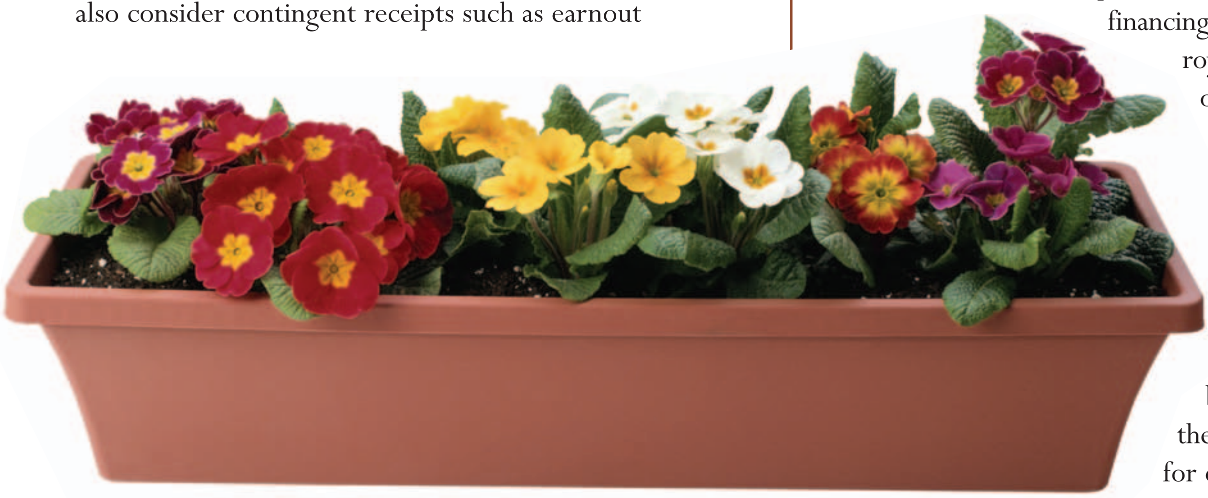
Other considerations

If you're selling a troubled division or business line, you need to contend with additional challenges. To mitigate risk, a buyer may stipulate as part of the deal that you retain an equity stake in the line or provide financing for the deal. There's an upside to this: If your underperforming operation produces better results for a more efficient owner, you get to participate in its success.

It's also important to understand the supply chain and sales channel of your ongoing business and the division being sold. If the divested operation is a significant link to your supply or distribution chain — either because you continue to use it as a source or because it remains a distribution channel for other products — it is more likely to create conflict after the transaction is complete. Finally, if important intellectual property is used in the divested business, you may need to negotiate complicated licensing arrangements to close the deal.

Post-transaction involvement

Typically, sellers have no significant continuing involvement with the business line being sold once the transaction closes. However, in many cases, sellers can retain some involvement in the divested business — whether it's routine administrative functions during the post-deal transition or more complex sublease arrangements, seller financing, retained equity stakes, royalties due from licensing or service commitments.



Post-transaction seller involvement often depends on the type of buyer (financial or strategic) acquiring the business line. Financial buyers may plan to use the acquisition as a platform for entering a new industry and may require a service contract from the seller to perform certain administrative activities for a time.

Strategic buyers, on the other hand, may be less likely to require transitional support or ongoing service arrangements. These buyers typically try to integrate the target's operations with theirs as quickly as possible to capture business synergies.

Maximize value

Selling a division or business line may help you to grow your core business. By carefully considering the financial issues likely to arise against your other strategic goals, you can increase the probability that a sale will maximize value for your company down the road.

Creating carve-out statements

One of the most difficult problems when selling a product line is creating a carve-out statement — a discrete set of financial statements for the division you are divesting when that division has no separate historical financial statements. While identifying sales and direct costs is usually easy, allocating shared costs that involve marketing, accounting, information services and human resources means making some judgment calls. This process is usually necessary, however, because buyers require carve-out statements to value the entity.

Now may be the time to sell your tech company

Selling a company is never easy — and that can be doubly true of selling a technology company. Your principal assets walk out the door each evening and you can only hope that they come back the following day, making valuing your business challenging. What's more, the sector has spent the last few years trying to recover from the Internet bubble implosion and turn-of-the-millennium economic slowdown that has drastically affected corporate IT spending.

But the market for tech company mergers and acquisitions appears to be on the mend. In 2004, almost 1,300 deals involving computer software, supply and service companies were announced in the United States, according to Mergerstat. That's the sector's best showing in several years. Many industry experts anticipate even more widespread consolidation to take place in coming years as technologies mature and companies seek ways to increase their scope and cut costs. Now, in fact, might be a good time to consider selling your tech business.

Industry consolidation

Mergers and acquisitions enable markets to deal with overcapacity by reducing competition in a particular industry. The economic rationale for consolidation in the technology industry is particularly compelling. Several industries, such as PCs, have matured, forcing the market leaders to create economies of scale and protect their position from challengers while seizing opportunities to extend their dominance.

Acquisitions, therefore, can serve both offensive and defensive objectives. They allow larger companies to defend their customer bases, gain particular technologies or talent and create size advantages. Size offers efficiencies in spreading large fixed costs, such as those for research and development, over high product volumes.

This strategy is especially critical for tech companies because they usually require large initial capital investments. Once developed, however, manufacturing costs tend to be relatively low. Size also offers psychological comfort to customers that their tech vendor will be available to provide long-term support services.

In certain software and hardware sectors where technology is relatively mature, incentives for consolidation are high. In fact, consolidation has already occurred on a large scale among midrange computer and mainframe manufacturers. These industries found scale-driven mergers to be effective

in reducing fixed costs over greater volumes and satisfying the demand for bigger and more stable suppliers.

Preparation for sale

If you decide you want to sell your tech company, you will need to obtain an up-to-date valuation. Valuing technology companies involves several difficult valuation issues. Tech companies generally have significant investments in intellectual property such as patents, trade secrets, proprietary processes, coding and technological know-how. While valuation techniques can fairly easily calculate the value of tangible assets of traditional companies, the value of tech companies' intangible assets is harder to quantify.

Another challenge is to determine the company's "path to profitability," an assessment of the time it will take for the company to generate positive cash flow, the milestones necessary to reach it and any attendant risks.

Tech companies in the developmental stage present even greater valuation challenges because they have extensive in-process research and development. A developmental stage company will likely experience operating losses, have no or few products in the market and low revenue. In addition, there may be uncertainty as to its ability to achieve future financial milestones.

Options besides selling

Selling your company outright isn't your only option as technology sectors consolidate. Many companies are finding that joint ventures and other forms of strategic alliances can minimize costs and maximize shareholder value.

Alliances such as outsourcing and offshoring arrangements enable the sharing of knowledge, capital and other resources, without necessarily committing companies to permanent or even long-term relationships. Strategic alliances can be used to provide a transition out of a business when an outright sale isn't feasible.

Another option is to sell a specific product line or division. Shedding noncore assets can free up financial and human resources to concentrate on your company's more strategic initiatives and strengthen your market position. (See "Shrinking to grow" on page 2.)

Or you might want to consider selling or recapitalizing your company with private equity. Many private equity firms are experienced in growing tech companies and better positioning them for a larger exit strategy — which may or may not include a public offering. Private equity firms can also offer you the chance to take some money off the table yet still remain involved in the day-to-day management of your business.

> *Acquisitions allow larger companies to defend their customer bases, gain particular technologies or talent and create size advantages.*

Making the choice

Ultimately, the decision to sell or pursue a strategic alliance depends on such factors as your particular technology niche, your competitive position and your strategic goals. If you decide to pursue one of these options, be sure to engage advisors who understand the fast-changing environment, intense competition and valuation challenges tech companies face.

Q. What is the best way to acquire a distressed company?

A. Despite the increased risks, investing in distressed companies is a legitimate acquisition strategy. But buying a distressed company involves different issues than you would normally encounter when buying a relatively healthy company.

Buying bank debt

There are several ways to acquire a company in distress. If the distressed company is large enough, you may be able to buy debt from existing lenders instead of purchasing equity.

One advantage of buying debt is that it will likely trade at significant discounts because banks are often required by regulators to write down their bad loans to approximate economic value. For example, if a bank has written down a loan to 70 cents on the dollar, it can later sell the debt at just 71 cents on the dollar and still record a short-term profit, as well as free up reserves.

Buying distressed debt also gives you a negotiating position with the company and access to information you might not otherwise have, such as financial statements and reports on financial covenant performance. Finally, this strategy potentially allows you to influence the restructuring process. You may even have the option of converting your debt to equity ownership during the restructuring and gain control over the troubled firm.

The risk of this strategy is that you may get stuck with poorly performing debt. Therefore, significant due diligence must be performed before purchasing a distressed company's loans. You also must contend with the demands of other stakeholders, including lenders, creditors and equity holders.

Bankruptcy sales

Another strategy for acquiring a troubled company is to buy it out of bankruptcy according to a Section 363 sale. The bankruptcy code provides buyers with benefits that are unavailable in an out-of-court acquisition, including:

- Obtaining the assets free and clear of all liens, claims and encumbrances,
- The ability to choose which of the target's existing leases and contracts to assume,
- Greatly limited exposure to potential successor liability and other claims, and
- Protection from fraudulent transfer claims.

But there are several disadvantages associated with buying a company out of bankruptcy. To obtain the best price, bankruptcy courts usually require a distressed company's assets to be sold at auction. The auction process can delay the completion of a transaction and potentially allows other bidders to compete for the assets. What's more, sales in bankruptcy are often sold "as is," with limited time provided for due diligence.

Bankruptcy also may hurt the underlying value of the business being bought. A negative stigma attached to bankruptcy can affect a company's relationships with customers, creditors and stakeholders. Further, many of the company's strategic, financial and operational decisions are subject to increased scrutiny and publicity during bankruptcy. This may inadvertently help its competitors. Finally, buying a bankrupt business is a complicated process involving many parties including the court, secured and unsecured creditors, unions and employees. This typically increases transaction costs.

If despite the potential downsides you think you want to purchase a company in bankruptcy, decide whether you'd rather participate in the auction as a bidder or negotiate a purchase agreement with the debtor before the auction. If you take the latter position (known as a stalking horse bid), you risk getting outbid by another party.

But several factors improve a stalking horse bidder's odds of emerging successful. You may negotiate a purchase agreement before the auction under an exclusivity agreement, limiting the input of future bidders. This agreement may state that you will receive reimbursement of expenses if you are outbid. You can also request that a successful bidder pay you a breakup fee. Note, however, that each of these provisions must be approved by the bankruptcy court.

Important decisions

There are plenty of economic incentives to reorganize and restructure a distressed company. But you should approach the decision recognizing the many challenges involved and be prepared to make important decisions along the way.

Blueprint for your company's future

Attract investors with your business plan

Just as the strength and stability of a building depends, in large part, on an initial blueprint, the success of your business and its ability to generate value for its shareholders relies on your business plan. A business plan isn't just the foundation of a new business; it's a tool for monitoring an established company's progress, determining the need for future financing and making major strategic decisions.

In addition, your plan is a communication tool — defining the business's purpose, profitability, industry, competition, management and personnel for lenders and new investors. How effectively you communicate these details can determine your ability to grow the company.

What's in the plan

A good business plan will provide a realistic perspective of all aspects of the business. It should include a description of your business, including details about how it operates, a discussion on market factors and strategies, an evaluation of your main competitors, an assessment of your business risks and what might mitigate them, an overview of your business and financial goals, and both historical financials and a financial forecast.

While the purpose of your plan may dictate its length and level of detail, the best business plans generally are concise and targeted to their specific audience. For example, lenders are concerned about your ability to repay loans. Therefore, a business plan targeting lenders should focus on financials — showing adequate collateral, a history of steady cash flows and an ability to reach future financial goals. The plan should also specify loan requirements, how the business intends to use the funds and how it plans to repay them.

What investors look for

When addressing potential investors, your plan should specify how much equity you are offering for what amount of money (under "source of funds"), how the business will use the money ("use of funds") and the return on equity investors can expect.

Investors typically want to know as much as possible about how your business operates. They often put a high premium on the experience and quality of a company's management team, looking for individuals with a history of successfully implementing a business plan in the specific market. Your plan must, therefore, communicate your capabilities in obtaining your company's objectives.

Investors will also be interested in your market research and analysis of business opportunities. This means you should discuss potential barriers to bringing your products to market, such as government regulations, competing products and high product development costs.

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The information conveyed in your plan is crucial for an investor's valuation of your company and the terms and conditions necessary to attract additional funding. Often, the most valuable asset of an early-stage business is its intellectual property. Therefore, you need to convincingly convey the value of patents, licenses, trade secrets and other forms of intellectual property you own.

Why financial forecasts are critical

A plan's quantitative business forecast is a critical component of all business plans. Projecting your business finances can show that you understand how

your ideas and objectives translate into tangible financial results. While a certain amount of detail is important in substantiating the projections, it is important not to add too much detail in the business plan. The finer details are often best discussed during face-to-face meetings. These personal interactions between management and investors will showcase your understanding of the business.

If your business is relatively new, preparing an accurate income statement and cash flow projections can be challenging. Even if you draft your basic business plan internally, you may want to engage outside advisors to prepare financial statements. (On the other hand, it's never a good idea for a business to allow outside advisors to write the entire business plan without significant input from management.)

Time well spent

It will likely take you four to eight weeks to complete a detailed business plan. But this should be time well spent. A business plan can serve as an ongoing business tool you can use to set up realistic milestones and monitor your progress. And by forecasting where your business will be in the near and intermediate term, you can communicate your plans to potential investors.