Merger & Acquisition Focus

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Keeping key players on board with incentives

For many business buyers, their target's executives and other key employees are a large part of the company's appeal. An exodus of top talent after an M&A is announced can reduce the selling company's value significantly. So sellers need to ensure that personnel remain on board during and after a merger. An excellent way to do that is by providing financial and other incentives.

Making the list

As soon as initial deal negotiations with a buyer begin, sellers must identify their most valuable employees — for example, executives who will be responsible for integrating the company, top salespeople, product developers, and managers responsible for a significant percentage of revenues. Such employees typically represent 5% to 10% of a business's current workforce.

It's important to keep these staff members in the loop. (See "Emotional ownership is critical" at right.) Almost nothing can damage the morale of a valuable employee faster than learning about the sale through the grapevine.

Some employees may be motivated by the offer of more-flexible work hours or the ability to telecommute from home.

Show me the money

Along with the need to feel like they have a role in your company's future, key employees are likely to respond to various financial incentives. You may want to consider:

Stock options. Stock options in the newly merged company typically are offered to executives and top managers and can be an excellent way to motivate their performance during integration and beyond.

Stay bonuses. This type of incentive rewards employees who agree to stay for a specified period, such as two years, with a lump-sum payment — usually a percentage of their current salary.

Deferred compensation. As an alternative to stay bonuses, some companies offer key employees a deferred bonus, with interest, due to be paid at some specified time in the future.

Beefed-up benefits. These could include anything from extra vacation time to an improved health care package to supplemental insurance policies such as disability or long-term care.

Some of these incentives have the potential to become costly over the long term. But there are alternatives, such as task-specific rewards. You might, for example, promise a completion bonus for projects essential to your M&A deal, such as successfully conducting layoffs of redundant staff or integrating your IT network with your buyer's. You also could offer "management-by-objectives" bonuses which reward employees for completing tasks which might otherwise be neglected during the course of a merger.

Other postmerger perks

There's a limit, of course, to the amount of financial incentives you can offer employees to stay on board. To supplement financial incentive plans or engage employees who aren't necessarily motivated to stay by the offer of more money, work with your buyer to come up with some *nonfinancial* perks that you can selectively offer to holdout employees.

Often, these are relatively easy to provide, such as the guarantee of a new job title or responsibility for particular client accounts. Some employees may be more likely to remain loyal if they can take a trusted executive assistant or IT technician with them to the new company. Others may be motivated by the offer of more-flexible work hours or the ability to telecommute from home.

Don't wait and see

When human capital is central to a company's acquisition value, sellers can't afford to wait and see how their key employees will react to news of an impending merger — because they may very well respond with their feet. Whether you offer financial compensation or other perks, you give them a reason to stay and see your business through a challenging stage in its life. ■

Emotional ownership is critical

Financial bonuses are almost always welcome. But most employees require something else if they're to remain loyal to a company being bought and be willing to transfer their allegiance to its buyers: an emotional stake. One way to ensure key employees feel this sense of loyalty is to offer them a place on your M&A deal team.

Deal teams are made up of professional M&A advisors and company leaders who are tasked with planning and providing support for every aspect of the merger — from internal communications to due diligence; transaction negotiations to integration. Depending on team members' areas of expertise, they may be asked to help vet potential buyers, review existing contracts or lead the company's media relations campaign. With so many issues involved and details to attend to in an M&A deal, there should be plenty of work to go around.

Torn between two buyers

HOW TO HANDLE AN ENVIABLE DILEMMA

Receiving serious interest from two buyers may seem like a business seller's dream scenario. Competing buyers are more likely to bid up a company's selling price and enable it to ask for — and get — favorable deal terms. But this situation also can be dangerous. If sellers don't play their hands right, they could potentially alienate both interested parties.

Facilitate interest

In a persistently fragile economic environment, it's still a buyer's market. So the chance of a seller getting caught in the middle of a bidding war right now isn't high. But when the economy improves and cash-rich buyers return to the M&A marketplace, a seller could wind up in this intriguing but delicate situation. Healthy companies with low debt and unique products and intellectual property assets are likely to be in greatest demand.

One buyer may be committed to retaining long-term employees, and the other plans to replace these employees with its own staff.

Sellers can help facilitate a two-bidder scenario by seeking two strong candidates during their presale research. Be sure you understand the buyers' long-term strategies and what they're likely to need — and be willing to pay for — to achieve them. When you find strong potential buyers, draft customized proposals for each, emphasizing your compatibility (for example, complementary products or geographic location).

One way to improve the odds that at least one buyer will make an offer is to target two buyers with different market philosophies. One might be a strategic buyer — say, a company in your industry that has indicated it wants to expand. The other might be a financial buyer, such as a private equity fund, that has the cash and is willing to pay a premium for fast-growing, high-quality businesses.

Avoid playing coy

What do you do when your company garners serious interest from two buyers, and both are interested in conducting preliminary due diligence? Strive to be as honest and open in your dealings as permissible. Unless serious privacy issues exist, inform each buyer that you're in negotiations with a rival. Don't run the risk of them learning such information second-hand.

There's always a chance that the existence of another candidate will cause a buyer to reassess its interest in your company. One or both buyers could drop out of the running, or they could double down on their efforts, with each seeking to make a more attractive offer than its rival.

Watch out

Another possible risk for sellers is realizing during negotiations that one buyer is much more attractive than the other. For example, one buyer may be committed to retaining long-term employees, and the other plans to replace these employees with its own staff members. This could lead to a worst-case scenario in which you reject an offer in favor of the other, only to have the spurned suitor launch a hostile bid by going directly to shareholders.

There's only so much you can do to avoid that situation, though you can lessen any awkwardness and possible headaches by doing extensive research on the buyers you're targeting *before* you reach out to them. Another option is to structure your deal as a private auction for a limited pool of buyers, in which all interested parties perform due diligence and make their final bids simultaneously.

When two's better than one

Although it can be risky, courting two serious buyers can pay off handsomely. The key is to ensure you'll be comfortable selling to either buyer so that the one that comes up with the highest price and best terms is the clear winner. ■

$1 doesn't always equal $1

CASH FLOW VALUE IS SUBJECTIVE

Strange as it may sound, different appraisers valuing the same company's cash flow — a key component of business value — can come up with different numbers. This doesn't mean that one expert is wrong, but instead that the process of valuing cash flow requires valuators to make highly subjective decisions. Not only might a buyer's valuator disagree with a seller's valuator, but experts working for different prospective buyers can arrive at different conclusions.

What buyers want

Cash flow commonly is thought of as a company's net income (sales minus expenses and income taxes), plus noncash expenses (primarily depreciation and amortization) minus principal liabilities, working capital, and capital expenditures, such as new equipment. The resulting free cash flow is the amount a business's owner could remove each year without compromising the company's ability to function and grow.

Most buyers hope to realize cash flow equal to their original investment, plus interest, within five years of making an acquisition. By forecasting five years' cash flow and reducing that amount by the interest the buyer expects to receive, you can determine a company's present cash value or the amount the buyer is likely willing to pay.

To calculate the value of a company from the cash flow it generates, a valuator performs a discounted cash flow analysis (DCFA). This expert estimates future cash flow over a period of years, and then discounts the combined cash to determine the present value. The "discounted" portion reflects the risk of actually receiving the full amount at a later date.

Choosing a time period

In theory, a DCFA consists of two seemingly simple steps, but in reality it can be a complicated calculation. First, valuators decide the number of years to include — typically five and no more than 10 or fewer than three. The further out experts project, the more work they're required to do and the less accurate the results are likely to be.

Experts factor in assumptions about future sales, operating expenses, tax rates and capital expenditures for each year included in the analysis. To the sum of these cash flows, some valuators add an estimated value of the company's net assets at the end of the period being analyzed.

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But estimating future results can be tricky, because company-specific, industry and other factors can cause results to differ from assumptions. A DCFA is only a tool or basis for valuation, and minor changes in input can significantly affect projected outcomes.

Applying discounts

The second major step in a DCFA — choosing the appropriate discount rate to apply against estimated future cash flows — is how valuators try to account for the uncertainty of projected results. While cash flow estimates attempt to quantify *returns*, discount rates try to quantify *risk*. If the discount rate is set too high, a valuation is likely to undervalue the business. Conversely, if it's set too low, the resulting market value will be too high.

Some discount rates are based on complex mathematical models, while others rely on industry averages that have been tracked over time. Frequently, buyers analyzing a business for potential acquisition use a "weighted" discount rate, which factors the buyer's average borrowing cost into the calculation to determine the minimum required return to satisfy providers of capital. Two prospective buyers with similar cash flow assumptions about a business could, in fact, arrive at different valuations because they borrowed differently.

Because so many variables enter into DCFA calculations, valuators often perform "stress tests" to assess the validity of their conclusions. By varying assumptions — say, the assumed growth rate of sales or expenses, or the discount rate — they can generate a range of values.

Negotiation advantage

Arriving at the negotiation table with a range of values in hand will help you evaluate your buyer's or seller's offer. Keep in mind, however, that many variables determine a company's ultimate sale price, including the state of the general economy and M&A marketplace, and a business's unique offerings, such as trademarks or unique products. ■

Ask the Advisor

Q. How do I ensure I actually get paid for selling my company?

A. When an M&A deal closes, it isn't necessarily the end of a business seller's relationship with its buyer. Most acquisitions involve future payment obligations, such as installments paid by the buyer to the seller. To mitigate the risk that the buyer will default on its obligations, the seller must ensure it has a form of security.

Generally, security is discussed during transaction negotiations. Once a seller agrees to finance part of the deal and receive future payments from the buyer, the parties must determine an acceptable type and level of security. This isn't the kind of agreement you want to seal on a handshake. On the other hand, extensive haggling over the form and amount of security could threaten the deal, so try to be both prudent and flexible.

What and how?

The first step in security negotiations is for the parties to decide which of the buyer's obligations will be secured. For example, buyers should establish security for any fees they'll owe the seller for postdeal activities — such as promissory notes, lease payments, consulting fees or noncompete agreement compensation.

Once they agree on a list of buyer obligations, the parties must determine how best to provide security. Depending on the companies involved and the amount in question, security could take the form of:

- A term life insurance policy on the buyer that extends over the period of payment obligations,
- Shares of stock in the company being sold or in the newly merged company,
- A clause in the sale agreement that limits the buyer's ability to take on new debt or increase management compensation while it still owes the seller,
- A lien on the buyer's corporate assets, including accounts receivable, inventory, real estate and machinery, and
- Event triggers that oblige the buyer to pay the seller in full — for example, the buyer failing to meet specified revenue targets or defaulting on a loan.

If a buyer defaults on the agreement, it typically has a period of time in which to cure the default. After that, the seller can obtain a court judgment and possibly repossess assets.

Safe and secure

While establishing security on buyer obligations may seem to be a relatively minor detail in the complicated merger process, don't neglect it. The last thing you want is to spend all your time negotiating a fair price only to receive a percentage of it. ■