Merger & Acquisition Focus

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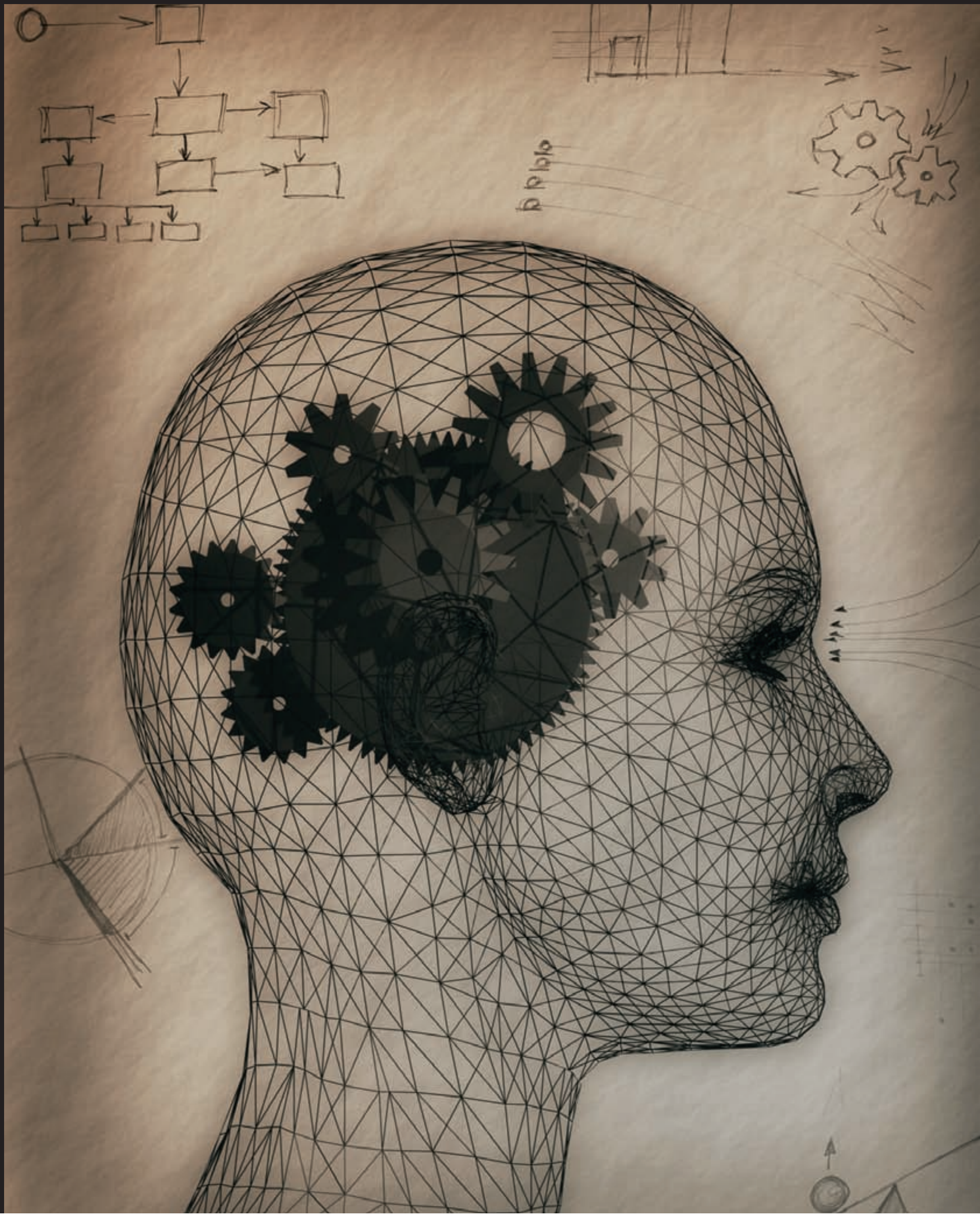
Ask the Advisor



Intellectual property and due diligence

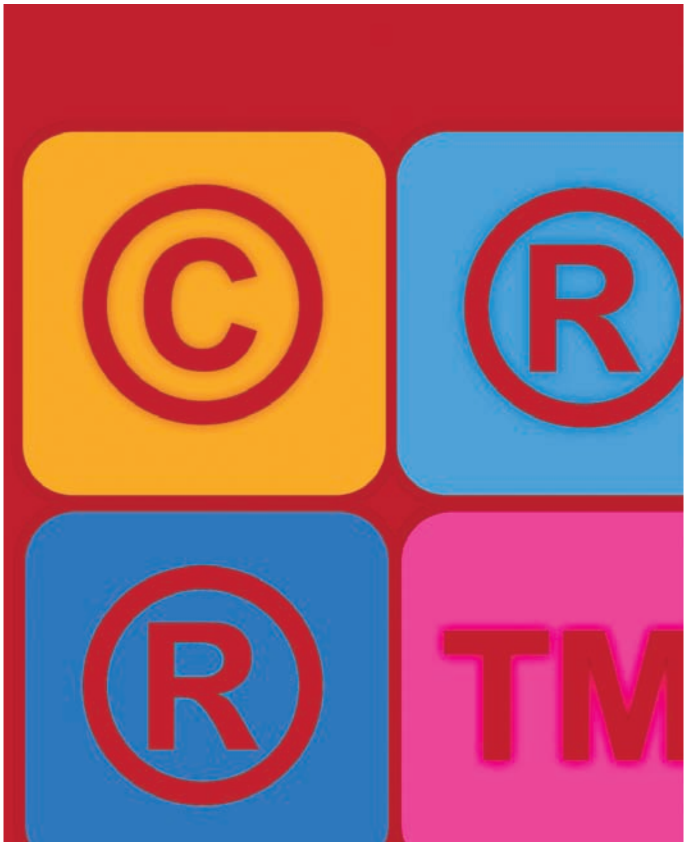
How buyers and sellers should prepare

Increasingly, M&A transactions involve intellectual property such as patents and proprietary industrial designs. Because many deals are made to gain access to the seller's intellectual property, these intangible assets have become as significant as physical assets — if not more — when determining value.

Buyers must be meticulous when performing due diligence on intangible assets so that they avoid potential infringement suits or becoming vulnerable because of weak patent or trademark rights. And sellers should be prepared to demonstrate the high value and safety of their company's intellectual property.

Be an early bird

It's never too soon for sellers to begin preparing their company's intellectual property for scrutiny. Start by identifying and cataloging physical evidence of intangible assets. In some cases it may be necessary to seek out potential licensable intellectual property from employees and consultants. Interview employees about potential proprietary information that's being used but has never been documented formally and create a record, including the names of authors or inventors, dates of first use, and supporting communications documentation.



By beginning sale preparations early, sellers will be able to accommodate serious buyers when they request a preliminary report of the company's assets. Early preparation also offsets the likelihood that a potential buyer will uncover unpleasant surprises late in the process — surprises that could delay a deal's closing or derail it altogether.

Be prepared

Potential buyers will want answers to a host of questions related to a company's ability to control its intellectual property assets, the various protections that have been implemented and the availability of key supporting documents such as trade name license agreements and patent assignments. Sellers should be prepared to answer buyers' questions, including:

- Has the seller secured intellectual property protection in the United States and in appropriate foreign countries by filing the necessary legal documents or registrations?
- Has a properly prepared and recorded chain of title from each prior owner been established?
- Have any patents or trademarks been challenged or disputed, and are they likely to be infringing on any third-party rights?
- How strong is the company's overall intellectual property portfolio — are patent or trademark claims likely to stand up to legal challenge?
- Have patent and trademark protection processes been performed by legal counsel with a positive, value-driving reputation?

- What steps have been taken to protect the company's portfolio of, for example, noncompete agreements, enforcement actions, product labeling and security of trade secrets?
- What intellectual property licenses are relied on to run the business?
- What portions of the intellectual property portfolio have been licensed to others?
- What complementary patents and trademarks can be developed for the portfolio?
- What are the prospective untapped markets for the intellectual property?

While buyers won't consider all of the selling company's intellectual property rights equally valuable, the more important the rights, the more closely buyers will scrutinize the assets.

Expect challenges

When potential buyers conduct intellectual property due diligence, several issues are likely to arise. Sellers may, for example, have to explain or establish who actually owns a particular intellectual property right associated with the company. It's not uncommon for businesses to use separate intellectual property holding companies for tax purposes or rely on rights and licenses obtained by subsidiaries in other states or countries — both of which could camouflage ownership.

Is your house in order?

If you're preparing to sell a company with significant intellectual property assets, you can put potential buyers' minds at ease by ensuring the following is ready for scrutiny:

- Policies and procedures for identifying, evaluating and obtaining protection for new inventions and caring for key secrets,
- Properly filed patent applications,
- Thorough inventor notes and communications,
- Policies regarding assignments and nondisclosure agreements,
- Procedures for clearance searches on newly developed or improved products or services prior to their launch, and
- Research on the intellectual property of competitors.

Sellers may find that some of their most valuable assets aren't properly documented at all. For example, if a company has used a particular piece of proprietary information for many years, it may have become part of the company's historic knowledge but not necessarily be recorded that way.

Sellers also may disagree with buyers about the value of a piece of intellectual property. A seller may, for example, believe one of its registered patents is easily enforceable and, therefore, valuable. A buyer, however, may place little value on the patent because it was obtained based on only a small improvement to a particular technology that isn't of much use to the buyer.

Although there's no standard formula for valuing a patent, trademark or copyright, professional valuators typically evaluate the market in which the asset is being used, project the income and revenue that the asset is likely to generate, and calculate a fair market value of the property by discounting the expected benefits by an appropriate rate of return. How intellectual property is appraised can significantly affect the overall value of the company, so it's essential that an experienced and objective professional perform the valuation.

Reap the benefits

Even the most comprehensive intellectual property preparation can't guarantee that issues won't arise during the due diligence stage. But it's an essential step sellers should consider to help potential buyers assess the value of a company and increase the chances of a fair and satisfactory price.

Use your acquisition as a tool for growth

Acquisitions can be risky when used as a primary strategy for growing a company. Failed integration, in particular, can thwart the long-term success of many transactions. But when used as a strategic tool — a component of a larger corporate strategy — an acquisition can be a highly successful way to grow your business.

Know your goals

Often, companies leap into an acquisition merely to eliminate a competitor or acquire an attractive product. But for acquisitions to fuel a company's future growth, they can't be approached thoughtlessly or viewed as an isolated event. Instead, M&As should be considered as much a part of business operations as marketing, finance and other mission-critical functions.

Before contemplating an acquisition, you must define your company's strategic goals. Do you want to diversify assets, reduce costs, increase brand awareness or expand into new markets? Whatever your goals, an acquisition should further them and complement other strategic plans. You should also compare consolidation with other options, such as organic growth, restructuring, strategic alliances or even the sale of an underperforming asset.

Businesses with more attuned products, customers and technologies are likely to enjoy a smoother integration process.

Take, for example, a company that decides its major strategic goals are to reduce costs and position itself as the market niche leader. It may initially consider acquiring a producer of complementary products but after further consideration conclude that's likely to result in only a fraction of the desired increased profitability.

The company then might examine the possibility of cutting costs and growing market share through organic means but ultimately determine it's impossible to accomplish both with current resources. After examining all of its options, the company finally decides that an acquisition is indeed the answer, if it can find a target that can provide it with greater exposure as well as cost efficiencies.

The right fit

Once you decide an acquisition is the best, or only, way to reach your corporate goals, focus on finding the best target. Fit is important: If you're considering an acquisition based solely on opportunity, the deal is likely to result in disappointment.

Instead, ask how the target company will specifically support your strategic vision. Will new products, for example, be well received by your existing customers? And will your current lineup of products meet the target company's customers' needs? Are the cultures of the merging companies compatible? Depending on your goals, you might also consider the target's market reach, competitive landscape and customer satisfaction levels.

Your M&A advisors can help you structure your due diligence plan so that you spend the bulk of your time and effort scrutinizing only the target company's assets and financial details that are most relevant to your goals. For example, if you're acquiring a competitor to gain access to its research and development staff, it's unlikely that you'll want to devote excessive due diligence to its real estate holdings.

All components of an acquisition may carry future liability, however, so a thorough investigation is critical to accurately assess potential risks. Your business unit managers should assist in due diligence to ensure the review process includes the items they feel are most important.

Get an early start on integration

Even if your target seems to be the perfect fit, you may still encounter difficulties in integrating the two organizations. Businesses with more attuned products, customers and technologies are likely to enjoy a smoother integration process.

To assist integration between less similar companies, begin planning the merger early. Managers in each company should develop integration plans and a checklist of integration challenges, such as the possible replication of organizational processes and functions, cultural mismatches and staff redundancies.

Concentrate on your value drivers. If, for example, one of your strategic goals is to increase top-line revenue, focus on merging sales forces and communicating new product and pricing structures to customers. Also consider financial risks. For example, will increased sales compensate for the cost of the acquisition and additional debt load?

Look at the big picture

Using M&As as a component of your larger corporate strategy can help fuel your company's long-term growth more effectively than one-event deals that are made for immediate gains. Focus on broader goals to refine your acquisition criteria and identify the right deal, and then devise an integration plan that can be executed quickly and efficiently so that you can enjoy the benefits of the transaction.

Dream team

Let professionals guide your M&A deal

A knowledgeable and experienced M&A deal team can help facilitate and streamline the business sale process — from due diligence to negotiations to the execution of agreements and other postdeal transactions. Whether you're buying or selling a company, consider the following to help ensure your team will be a winning one.

Choose members wisely

Some of the most important decisions you'll make in the process concern selecting professionals to help with your merger or acquisition. A deal team may consist of financial and legal experts or you may need to expand the team to include — depending on the size and scope of the deal and your industry — specialists from fields such as government and environmental regulation, human resources, risk management, information technology, and operations. Often, a business broker or intermediary will lead the team, helping to organize and package information from all certifiable sources and further negotiate the deal.

Your current legal and accounting advisors may be able to serve on your deal team and recommend M&A experts to work with you. When evaluating potential advisors, consider such factors as their:

- Experience with transactions similar to yours in terms of size and industry,
- Success rate with previous clients,
- Number of engagements handled per year, and
- Professional affiliations.

Also investigate potential complaints of inappropriate or unprofessional behavior, which can be ascertained by contacting relevant regulatory agencies.

And be sure these are individuals you can talk with honestly and who, in turn, take your concerns seriously. Once you've assembled your team, open communication and efficient information sharing will be essential to its success.

Guide your team

Because of increased concerns about fraud, financial misrepresentations and the profitability of consolidation, many buyers have intensified their due diligence and are demanding a more qualitative analysis of a target's assets and legal issues. They should be ready to devote time to the information-gathering and negotiation process.

As sellers come under such intense scrutiny, they should put a deal team in place as early in the process as possible to enhance the value of their assets and prepare to prove their credibility. Any significant surprises uncovered by a buyer during the due diligence phase will almost certainly lead to a reduced offer.

Ensuring that team members understand the goals of a deal is critical. Buyers need to articulate their consolidation objectives — for example, whether theirs is a financial or strategic acquisition — and which of the target's assets are of greatest interest. Sellers need to communicate their selling price goals and unique value drivers and outline other issues, such as those related to timing and the protection of intellectual property and financial information.

Without clear guidance, conflicting views and opinions among the deal team could hamper its productivity and efficiency. You can avoid this by assigning tasks to specific individuals, based on their areas of expertise.

Moreover, both sellers and buyers should consider forming due diligence committees. Comprising company executives and select deal team advisors, the committee should meet regularly to review the status and progress of the due diligence process. It's the committee that will determine areas requiring further probing, such as quantifying synergies and integration costs, as well as issues that may affect provisions in the purchase agreement, such as risk allocation, representations and warranties.

Know your purchase agreement

Buyer and seller deal teams also will be instrumental during the negotiation process. The teams can help outline the structure of the deal, purchase price, financial terms, integration and any potential "deal killers."

> *The deal team can help ensure that the terms of the transaction are carried out and work with business unit leaders to direct integration and keep it on track.*

Once the parties have come to an agreement, the deal team will prepare and review the purchase agreement's terms and conditions. For example, the team may work through actual conditions that may arise and run model purchase price adjustments using anticipated inputs, such as how current assets and current liabilities are defined.

The deal team must be prepared to include additional stipulations into the purchase agreement to solve issues that will affect the final purchase price, such as a valuation of a piece of intellectual property. Once the purchase agreement is signed, the team will continue to work together through any regulatory consent processes and assist, as necessary, with the process of merging finances, operations and other systems. The deal team also can help ensure that the terms of the transaction are carried out and work with business unit leaders to direct integration and keep it on track.

Start building yours

The process of buying or selling a business can easily distract owners and executives from important day-to-day operations. An efficient deal team can help by focusing your transaction goals at every phase — from prenegotiation to integration.

Q. What should I consider when choosing a lending partner for my acquisition?

A. Your lender will be critical both to the initial and long-term success of your M&A deal. Partnering with the wrong lender could result in a loss of funding at an inopportune time, such as just before the deal is scheduled to close or during the delicate integration stage.

Before you approach a lender, consider the type of deal you're undertaking. For example, a riskier transaction that relies on less traditional collateral, such as machinery, equipment and inventory with limited liquidity markets, may suggest you'd be better off partnering with a private investor or a more flexible lender, such as a commercial finance company, rather than a bank. Understand, however, that these kinds of lenders typically charge a higher interest rate to offset the additional risk they assume.

A bank lender, on the other hand, may enhance your company's reputation and provide a range of loans as well as other financial services. Additionally, you might use trusted business contacts and the Internet to search for and identify lenders that specialize in your industry and company size.

You'll also want to evaluate potential lenders on their:

Experience. A lender should have experience working with companies in your industry and even your market niche. It also should have experience providing M&A financing and understand the need for flexibility with these types of transactions.

Credit decisions. Your lender must have an in-depth understanding of your business and its distinctive characteristics. When making lending decisions, a bank should take into account a company's total financial picture — including its current assets and potential for growth — and not simply focus on economic conditions, business cycle fluctuations and regulatory guidelines.

Range of capabilities. A lender should be able to offer customized financing services to accommodate rapid growth, changes in strategic direction or unexpected occurrences, such as an urgent need to expand a manufacturing facility or acquire additional real estate.

Lending capacity. Not all lenders will be able to meet your financing needs. Consider the lender's typical loan amounts and loan limits.

Flexibility. An ideal lender won't offer you a one-size-fits-all program that could hinder your progress, but rather accommodate the amortization terms, prepayment and re-borrowing conditions, rates, range of usage, and loan configurations you need.

Risk and commitment. A lender that's willing to accept a reasonable amount of risk should be able to weather any mild storms your company may experience — particularly during the integration stage of a merger or acquisition.

Long-term relationship. A good lender looks beyond the one-time transaction. You must determine if a lender is committed to serving as a strategic partner and supporting your business for the long haul.

It's likely that no lender will be able to meet all of your needs. But careful research and assessment can help you choose one that will help further your strategic goals and commit to your business's long-term success.