M&A Seminar Series, Session Two

Business Development Executive's View

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Summary of Discussion Points

Panel

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How do you identify targets?

› Key is to tie in to overall long-term strategic plan. The plan should take into account normal competitive issues such as areas where your product suite needs to be filled out and customer input on new products, technologies and features needed. A deal may be attractive for both strategic reasons (in terms of fit with technology vision) and tactical reasons, such as meeting a competitor's advantage, or addressing an expressed customer need.

› A target may have a position in a particular market segment where the buyer does not currently participate, or may have technology that is more robust than that of the acquirer, or may be in an adjacent market that is a natural path for expansion. The acquirer must target acquisitions that let it build on the acquirer's core competencies to take advantage of new opportunities in the marketplace.

› Analyze the relevant market to identify key opportunities. Collect information about technology and customer trends.

› Do a make vs. buy decision in evaluating whether buying or developing a product is best, with speed being one of the factors that favors acquisition, since internal development takes longer.

› Once you decide to move forward with discussions with a target, engage your organization in a highly disciplined fashion to take the next steps in the review, analysis and diligence process.

How do you ensure strategic and cultural fit?

› Cultural fit is mostly a people issue. The key is often the compatibility of the R&D teams. You can assess that by having the teams interface during negotiations and the diligence process. You can get a strong sense of the target's culture from observing how target's representatives conduct themselves during negotiations.

› Important factors in cultural fit include work ethic, "start up" vs. "big company" mentality, comfort with new roles, complementary strengths, past R&D achievements, and similar views of business priorities.

› When large companies buy small start ups, there will be culture shock, so key is not to overwhelm the target with process that hurts morale or stifles creativity.

› Strategic fit goes to whether the target's technology is complementary and adds new products, addresses customer needs and so forth. To determine strategic fit, you need to determine whether you have a common view about what is best for the business.

Negotiating and valuation tactics

Valuation methodologies utilized?

› DCF, accretion/dilution, and ROI. One key metric is when will deal become accretive. Accretion less an issue if deal is highly strategic.

› Analysis will include revenue synergies from buyer's channel. Larger companies with a large channel are in a better position to run a meaningful DCF calculation.

› If the target is pre-revenue, look to buyer's own revenue ramp experience, then discount that.

› In running a ROI analysis, a buyer may use its own cost of capital and look for a return on our assets similar to its own.

Should the benefit of synergies be shared in computing valuation?

› Negative synergies (cost savings) may include a substantial amount of the target's G&A expenses. It makes some sense to share these.

› Most positive synergies relate to the benefit of the buyer's channel and of combining products, technology and people.

› Buyers generally believe that they, as buyer, are bringing these synergies to the table, so they should not be shared, but it is a negotiating point.

› Revenue synergies from selling target products through the buyer's sales channel can be incorporated into a DCF analysis.

› Buyers must be cautious about how the target positions its projections. Sometimes, the target will exaggerate projections to maximize the value of a fixed deal, or, for earnouts, the target might even understate its projections so the earnouts milestones (e.g., a "minimum bookings threshold" above which the earnout applies) are set at a lower level.

› Determining deal value is, of necessity, an iterative process. The more you know, the better position you are in to determine a fair value. The key is, always tie your valuations to specific revenue and expense projections, and always test those, to make sure they are conservative and sustainable. Only add in the benefit of synergies if you can quantify them in terms of near term benefit. Also, adjust your valuations based on your deal history.

Earnouts that work—why do technology companies use earnouts so often to bridge valuation gaps and what are some of the issues involved?

› Earnouts allow you to bridge the valuation gap between what the buyer is willing to pay and what the target is looking for, which is often a function of what the target perceives to be its other liquidity alternatives, and its ability to remain independent without additional financing.

› Earnouts also serve as a valuable retention mechanism, since employees know that unless they remain aboard to help the acquired target business unit achieve the technology and product release milestones, the earnout is not likely to be earned.

› Earnouts also help smaller acquirors compete with larger acquirors that can offer higher fixed cash amounts.

› Earnouts can work well when there is a small group of target stockholders, and the milestones are based on technology or product release milestones.

› Bookings, revenues or net income based earnouts are more complex, difficult and hard to define without ambiguity, as there are difficult issues as to the target's desire to retain some level of independence and control over its operations so it can maximize the earnout.

› If the buyer does agree to give some control to the target employees (such as a commitment to an operating budget or allowing the target product to remain an independent offering for a set period), that hampers the buyer's ability to run the combined business as it sees fit, so it raises difficult integration issues, and sometimes, disputes that are hard to resolve.

› Drafting issues in a bookings earnout may include how to handle product discounts, "all you can eat deals", service deals where products are used for the customer's benefit but not separately invoiced, and whether the out years of a long term contract count as a "booking".

› If an earnout is used, former employees of the target will be harder to integrate into the buyer's teams, as they may have side agendas driven by the earnout milestones,

amd they may be de-motivated, resentful and distracted if it appears the earnout milestones will not be met.

Risk reduction mechanisms (indemnity and escrow provisions)

> *For a public-private deal, what is "market" for escrow percentage, escrow duration, escrow exclusivity, where escrow is not the exclusive remedy, survival of indemnity beyond the escrow as to all or special representations only, maximum indemnity cap absent fraud, and basket size?*

› What is market depends on relative bargaining leverage, the results of diligence, the complexity of the target and the deal value

› Arguably, "generic" market terms are: an escrow of 12-15% of deal size that survives for at least 18-24 months and that is the sole remedy as to "normal" claims but a non-exclusive source of recovery for special claims like those related to IP, capitalization, due authorization and basis for litigation, and as to those special representations, the right to seek indemnity for at least 3-5 years by recovering some meaningful percentage of the deal price, which may ramp down over time.

› Typically, where there is an earnout, the buyer will also reserve the right to recover on indemnity claims by making set offs against some percentage of the earnout, which percentage may ramp down over time.

› The indemnity basket is usually 1/2 to 1% of deal size, with full recovery of claims once the basket is exceeded.

› Much of the negotiating time is spent on these issues and there is often compromise.

› It is important to do what is fair and necessary to reasonably protect from the normal risks presented (or if there are special circumstances, to protect for the special risks presented). That creates an atmosphere of trust and mutual respect.

> *Why are collars used to reduce the risk of price movement?*

› Collars can restrict the exchange ratio, by capping or setting a floor on the number of shares, or capping or setting a floor on the dollar value of the deal.

› The key issue is what happens when you reach the cap—can a party walk or is the deal value subject to formulaic adjustment up to another outside "band".

› A target that is worried about a declining share value of the buyer may want a dollar minimum, whereas a buyer that has that concern may want to cap the number of shares issuable so that the number of shares issuable under a deal will never exceed the 20% threshold that triggers a requirement for buyer stockholder approval of a deal. A buyer concerned about rapid upward movement in its stock price may want to cap the dollar value of a deal.

Walk-away rights. How critical are walk away rights, given that targets seek deal certainty?

› The buyer's board needs the right to walk if the target has a true "melt down" before closing that bears on the key issues that impact deal value, such as sudden attrition pre-closing of the target's customers or employees.

› The objective of these provisions is not to walk but to insist that a particular issue be corrected pre-closing or an ability to re-negotiate so the target bears the cost or risk of a new liability or litigation matter that arises.

› As a practical matter, the buyer rarely will walk from an announced deal, as it may impair the buyer's future M&A activity.

Diligence process: describe your typical diligence process in terms of length of time, number of participants and so forth. What are the key things you look for? What have you found that made you walk?

› Diligence usually takes a minimum of 2-5 weeks

› The number of people involved will vary based on the size and complexity of the target's operations. It may help to have all the key players at the buyer and the target involved in the diligence process, so they will not be surprised by the deal's announcement—this may help in the integration process.

› Key diligence issues include unclear IP ownership (such as jointly developed IP or IP developed with government funds), financial matters, product issues, legal diligence, and customer diligence.

› It is critical to evaluate how robust and supportable the product is, the level of customer satisfaction, the ability of the product to scale, the excellence of product support and QA, and competitive threats.

› IP ownership, product issues and pending litigation will kill deals.

Dealbreakers

› Deal breakers from diligence or negotiations could include: IP ownership and product issues, the target's insistence that escrow be the exclusive remedy, a private target that refuses to deliver a "locked" vote, the target's insistence on an unsupportable valuation, and pending litigation (particularly involving core products).

Deal process issues — comment on your deal process, team coordination issues, and integration issues.

› Process typically starts with initial discussions at BD then higher executive level to determine fit and mutual interest and related preliminary diligence.

› Next stage is negotiating an LOI, then submitting it to the board for approval.

› Next is heavy diligence and the negotiation of definitive documents, then final board approval and signing. More senior executives must become involved if negotiations are at an impasse. GMs need to get involved to ensure that they have resolved the product, customer, employee, and support issues that will impact integration of the target.

› It is critical to keep communication open with your executives and GMs so all involved in the acquisition and integration effort are on the same page, especially in terms of timing and as to a consensus that the deal is worth the effort.

› It is critical to have all of the internal groups well coordinated, including R&D, HR, legal, tax, finance, and sales. Frequent meetings are critical. The key is to bring all the important parties together very quickly after merger is completed and to prioritize the high level integration plan. Don't get lost in logistics details.

› The best acquirors have a very detailed and organized deal process, where all internal team members know their part and can move quickly.

› Any RIFs should be done only once, at or just prior to closing, so target employees know where they stand and stay incentivized.

How do you go about persuading the target CEO/Board to sell?

› The key in persuading the target CEO and Board to sell is to convince them that the two business have the synergies to succeed, and give an upside that is better than the stand-alone scenario.

› It is important for the buyer to persuade the target that the buyer is committed to treating customers, employees and shareholders right and that the parties share a common vision.

› VC's primary concern is valuation and liquidity and opportunity cost. If the common is underwater, it may be critical to persuade the preferred holders (VCs) to back off their liquidation preference to incentivize employees.

› In any negotiation, it is critical to look at who has the negotiating leverage at the target and focus your energies there.

› Given the less than robust IPO market, most founders and VCs of private companies plan for an M&A exit and don't need much persuading, if an agreeable valuation can be reached, and earnouts can help bridge any gap.

› As to public targets, if their market cap is modest, or an additional cash infusion is required for them to ramp, they will often find that an acquisition with a 30-40% premium is a highly attractive alternative.

Board management

› As to board management, it is critical to get the board involved early and often and keep the CEO updated to enable the CEO to brief the board.

› Having board members help on deal process helps executives sell the rest of the board on the vision and need for the deal.

› Pre-selling board on all potential targets can speed the approval process.

› The Board needs to understand the strategic rationale, the basis for the valuation, what the tough negotiating issues are and how the resolution of those issues might impact the deal terms and upside.

› The board package should start with a high level summary, then add increasing levels of detail so directors can dive in as little or as much as they desire.

› Post deal, it is important to advise the buyer's board how each acquisition has performed.

› Target boards need to be protected from M&A litigation, by ensuring that a good record has been set, the target has been duly shopped, due care has been exercised, and there are no "bad optics" that suggest that parties acted other than in stockholders' best interests.

Impact of new SOX/Wall Street/litigation environment on deals

In selling deal to Wall Street analysts as a buyer, what are the critical factors on how to position the deal and set expectations?

› Wall Street wants to be persuaded that the buyer has a compelling strategic vision as to how the merger will help build shareholder value over time.

› In technology deals, you must help the analysts understand what the target's technology is, why the technology is important and why the valuation is justified, and keep the market up to date on developments so analysts can evaluate how the deal is panning out financially.

› The presentation must be supported by solid financial analysis that is sufficiently conservative and well thought out to give analysts comfort that management has thought the whole deal through.

› The key is to under-promise and over-deliver. However, larger, more dilutive deals may require the use of less conservative, and more realistic, guidance to help persuade analysts that the deal made sense.

What is impact of SOX on M&A?

› SOX compliance burden has distracted some acquirors.

› SOX is forcing directors of public companies to take a much more active role in the M&A process.

› Deals may be deferred to a subsequent quarter to delay the need to certify the target financials and ensure the deal will not adversely impact previously tested and certified controls.

› SOX may make it more difficult to buy companies that do not have audited financials.

› The burden and cost of SOX is pushing many small cap public companies and pre-public companies to consider being acquired to push off to buyers the burden and cost of complying with SOX.

Comments on the recent increase in M&A litigation claiming the deal value was not maximized and the process was not designed to maximize price?

› The board of a public target should assume that "strike suit" litigation will be filed, regardless of how much the company was shopped.

› These suits can often be settled rather inexpensively if the target has established a good record of having shopped the company, and openly and fairly considered all strategic alternatives, and avoided any self dealing.

› A buyer of a public company will want to have the ability to walk if a public target has litigation filed against it that might result in material damages, and the ability to veto a settlement pay off that is material to the deal, even though those requirements make the deal less certain for the target.

› There is tension between this type of litigation, which forces shopping to be maximized, and the buyer's unwillingness to spend money negotiating a deal that is still being shopped to others and unwillingness to acquire a target at an unreasonable valuation.

Lessons Learned:

What are “red flags” that will put you off from doing a deal?

› lack of clear rights to IP; open source issues

› a poor reputation for technology excellence or delivery

› lack of candor from target management

› pending litigation

› an unduly high target preferred liquidation preference that leaves little deal value for common holders and employees, leaving them unmotivated

Is it better to use a more or less detailed term sheet, and what are the critical issues to have covered?

› Generally, buyers prefer to obtain a more detailed LOI, as it reduces the risk of disputes over key terms and reduces later negotiating time and cost.

› Key issues to address in the LOI aside from deal economics are escrow and survival terms, limits on indemnification, earnout calculation mechanics and issues relating to deal certainty.

› Public targets should try to get more details into the deal summary, particularly as to deal certainty, since that’s when its leverage is maximized.

› Private targets should seek to have the LOI include favorable provisions as to indemnity matters (e.g., that escrow is the exclusive remedy), as it is unlikely to have the leverage to win such points later.

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