M&A Seminar Series, Session Three

CFO View Summary

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Summary of Discussion Points

Panel

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Comment on valuation methodologies used in evaluating potential deals.

Before an acquirer starts merger negotiations, it is critical that it determine what it believes the target is worth on a stand alone basis as well as on an as-merged with cost and revenue synergies basis. The buyer is then armed for the target's later push to share the benefit of synergies.

One common valuation methodology is a DCF analysis. This model requires the use of various assumptions as to product life, how fast revenues will ramp, terminal value and so forth. These assumptions are tested through sensitivity analysis.

A DCF analysis is far more subject to variances based on assumptions than is a straight revenue projections analysis, where you model what you think the target's revenue stream will be, then run different appropriate multipliers of revenue and EPS off that incremental revenue stream to achieve various valuation ranges, and then do an accretion-dilution analysis on a GAAP and a pro forma basis.

A buyer's board may set a valuation threshold, such as that deals must generally be accretive within 2 quarters, at least on a pro forma basis, to be approved, which will in turn drive the valuation negotiations. For very large buyers, only very large deals will be material enough to meaningfully dilute EPS.

Buyers will sometimes do deals that are initially dilutive, if they are strategically important and they can be explained to the street in a way that makes sense. Where deals are projected to be dilutive on a GAAP basis solely due to a technical accounting reason, like deferred compensation or variable award charges or a write-down of deferred revenues, the analysts will usually be supportive of the deal (even if the buyer has a policy of only using a GAAP presentation (i.e., and not eliminating such non-operating charges in a pro forma presentation)).

It is important to use a comparable companies' analysis to understand how the market is valuing a public target, then determine what assumptions are built in to that analysis and how that compares to the buyer's internal analysis.

The key is to understand what assumptions as to projections and synergies must be true to achieve each level of deal value, and understand what the buyer has to do to achieve and deliver those projections and synergies and what the execution risks are.

When buying a small R&D stage company without revenues and where the key asset is the R&D team, DCF analysis may not be effective a valuation methodology. In that case, the deal can be analyzed more in terms of a make vs. buy and time to market analysis.

Comment on tactics used in negotiations as to deal value.

From a public seller's viewpoint, the shopping and evaluation of strategic alternatives that the board is often forced to do with the help of its bankers and counsel, and the inability of the public seller to truly lock up a deal in advance, will often serve it well in valuation negotiations. It is critical for any potential seller to have evaluated and mapped out a viable strategy for staying independent (so that it can walk from any merger negotiations that are not promising). When the seller has other bidders as well as a viable stand-alone option, it is well positioned to maximize valuation.

A long term strategy of staying close to key executives at competitors and other potential buyers can help you implement a rapid market check by evaluating the interest of various bidders and possibly playing them off against each other.

A target CFO can help the buyer's management team converge on the target's desired valuation by helping the buyer's team to build a mutually agreed go-forward financial model and to quantify and risk-adjust the synergies. But the target needs to be careful not to over-promise in its projections, because they become the operating plan for the target post-closing.

In summary, some important steps for a target in arguing for a higher valuation are:

1. Have other interested parties;
2. Be willing to walk; and
3. Put an aggressive but achievable model together, realizing that it will become the target's operating plan.

In the case of the EMC's purchase of Documentum for $1.7 billion (representing just under 6X trailing 12 month revenues and a 30% premium to 30/60 day trading averages), for example, the keys to valuation were:

1. Multiple interested parties;
2. Strategic value of the deal to the buyer;
3. No product overlap; and
4. Deal was a financial win/win.

From the viewpoint of a buyer, it is often productive to ensure that multiple issues are on the table, instead of just price. For example, deal certainty, upside through an earnout, the upside in the buyer's stock, and the value of the buyer as a platform for the target founder's careers and the target's technology, can be important in persuading the founders to accept one bid over another one that is nominally more valuable. Another approach is for the buyer to ensure that the target understands that a public buyer needs to have a valuation that makes sense in terms of applicable market revenue and EPS multiples, not just as a multiple over the last VC round valuation. Of course, using an earnout is often an effective means of overcoming a disagreement about valuation.

Where the parties have a disconnect on valuation based on the target's perception of its future projections, the first step has to be to make sure that the buyer understands how the target is estimating its projections, and what the assumptions were, and make sure they understand in detail how the buyer views the target's projections. This usually results in the parties coming much closer to a mutual understanding as to future target projections, which usually narrows the differing views about valuation. For example, a buyer can point out that the target's IPO comparable valuation is invalid because it ignores both the risk and cost of an IPO, or that the buyer's projections understate the costs of building out its sales channels.

In the end, how much the parties are willing to compromise on valuation is often a function of the specific negotiations, the target's and the buyer's "next best alternative" to the deal, whether the buyer views the deal as defensive or offensive, and whether the bulk of the consideration is going to the key R&D team members thus incentivizing them to perform.

Where the buyer is pushed on valuation to the top of its range, it has to evaluate what assumptions must be true to achieve that negotiated valuation viewed from a bottom's up analysis, and then ask the tough questions as to achievability of those assumptions.

As to the process of negotiations, as a general rule it is critical to have multiple negotiating channels and to have an identified means of addressing issues that are negotiating roadblocks. Negotiating valuation is an iterative process, and it usually cannot be done in one session. It helps to

have bankers and savvy finance and legal teams on both sides of the table, to reach a fair compromise.

Comment on your use of accretion/dilution analysis and the various assumptions used in that analysis.

In evaluating whether and when a deal will become EPS accretive, you start by assessing the anticipated cost and revenue synergies. Cost synergies are easiest to identify, and there are fairly good rules of thumb as to what cost synergies are typical, but you do need to understand exactly how you will achieve those cost synergies (that is, what headcount cuts you will make and whether those cuts will impair your ability to achieve the anticipated revenue synergies). As to revenue synergies, it is important to understand how channel synergies will work and what is required to achieve those. This results in a determination of the ranges for accretion or dilution at various valuation points (and when the deal turns accretive), which can then be used in the deal negotiations and deal analysis.

This analysis can be done on both a GAAP basis and on a non-GAAP basis (i.e., excluding items like deferred compensation charges and write downs of deferred revenue). One approach for the buyer is to argue for a lower valuation based on when the deal will become EPS accretive on a GAAP or "fully loaded" basis, but justify the deal internally on the basis of it becoming EPS accretive earlier on an incremental pro forma basis.

The issue of when a deal will become accretive is normally more a question for the Board and in dealing with analysts rather than an express topic in the negations, but the target's bankers will compute the maximum valuation that the buyer can pay and still have the deal be accretive immediately or within a specified number of quarters.

Most buyers have rules of thumb as to when an acquisition must become EPS accretive (at least on an on an incremental, pro forma basis), but they will often stray from such benchmarks for strategic deals.

As noted above, the target CFO may be able to help shape the buyer's view as to when the deal will become EPS accretive by helping the buyer build the go-forward financial model and persuading the buyer that the assumptions in the projections are reasonable and supportable.

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

As with the CFO's dealings with the Board of Directors, it is often useful to lay the groundwork with analysts well in advance of any particular deal as to the buyer's M&A strategy, so when a particular deal comes up, less education is required as to strategic fit. Sometimes the strategic benefits of a deal are not immediately obvious (as was the case in the EMC-Documentum deal), so the parties need to be very proactive in persuading the street as to the strategic rationale.

Analysts will want to understand when the buyer believes the deal will become accretive, and what the underlying assumptions of that analysis are (e.g., as to revenue and cost synergies), and why those are reasonable. (In this regard, it is critical to demonstrate the buyer's ability to sell the target's products through its sales channel.) It is also important to help analysts plug your analysis into their own models, so they can support your financial analysis.

On smaller deals that effectively constitute the purchase of an R&D team, the analysts may also want to understand the pedigree and track record of the target's R&D team, and why and how the target's R&D team will fit in.

As noted, on deals that are initially dilutive due to technical accounting issues, you need to explain those issues thoroughly to the analysts. Once you do, those types of issues are usually not an impediment.

Rather than outlining specific expected projections for a private target, you can discuss relative contributions within the type of matters as to which you give guidance to the street (say, annual revenue and bookings growth), and for a public target you can speak in terms of the valuation as a multiple of consensus estimates of anticipated revenues, to get analysts comfortable that you paid a reasonable multiple.

At a high level, the buyer should try to set expectations such that it can either hit or exceed the street's estimates.

What are the critical elements in dealing with the Board?

Key aspects of board process management on the buyer side include:

1. Educate the board well in advance as to the buyer's strategic product roadmap, so board members are pre-sold on the need for acquisitions in certain key technology areas.

2. Show the board how a particular deal fits into the long term strategy.

3. In terms of financial analysis, lay out the assumptions so the board understands how management views valuation, what the assumptions are and why management believes those assumptions are reasonable. This let's the board better understand the deal value, cost and revenue synergies, the action plan to achieve those synergies and projections and associated risks.

4. Follow a consistent deal process and presentation format, so the board can focus on the key issues. This might include a summary of deal terms, strategic analysis, financial and valuation analysis, major assumptions and a summary of deal risks.

5. Help the board understand the post-closing assumptions and integration steps critical to achieving the expected value of the deal to the buyer.

6. Prior to the final board meeting approving the deal, have a series of one on one conversations with board members to solicit their input and reflect that input in the analysis and presentation of the deal and the deal negotiations so the board's concerns are addressed in advance.

7. Anticipate detailed board questions, and have detailed backup as to anticipated questions.

8. Keep the board updated on negotiations, and where possible have board members meet key target founders and executives.

9. Make clear to the board who the executive sponsor of the deal is.

10. Give the board a report on a regular basis as to how past acquisitions have performed on a financial and operational basis, with suggestions for improvements in how to handle future deals.

Key elements of dealing with the board on the sell side, where the burden of showing "due care" is greater and the risk of litigation against directors is greater, include:

1. Plan for multiple board meetings to evaluate the deal and alternatives to the deal.

2. Know how to quickly reach each director; it may be fatal to a deal if the target can't achieve a unanimous board vote at a critical juncture.

3. As on the buy side, have frequent one-on-one discussions with board members to pre-sell them and get their informal input.

4. Create multiple viable alternatives, and have materials and a process that help the board fully evaluate each alternative (including that of staying independent).

Comment on key accounting and tax issues.

Obviously, it is critical to be sure through diligence and perhaps an audit that there are no misstatements in the target's financials.

Since pooling accounting (which required fixed stock for fixed stock exchange) is abolished, buyers can use a wide mix of consideration, stock, cash and earnouts, to get deals done more creatively, and are being much more aggressive that pooling rules allowed (10% escrow for one year) in demanding remedies that protect the buyer.

One key accounting issue is how to incentivize retention of key employees without triggering variable accounting or a deferred compensation charges (e.g., if receipt of an earnout is subject to vesting, it will be viewed as tied to employment and generate a compensation charge). One approach could be to use technical milestones that focus the R&D team, but allow team members to receive the earnout even if they quit, on the hope that team members will realize that they all need to stay employed with the buyer post-closing in order to maximize the chances of achieving the technical milestone. There still a possible free rider problem, but it is perhaps preferable to variable award treatment. As companies start to expense options, there may be additional leeway as to deferred compensation charges, and parties may move to different approaches in this regard, such as increased use of restricted stock.

Another key accounting issue is estimating the write down of deferred revenues.

Tax issues include: (1) being sure you don't have so much cash or other "boot" as to "blow" tax-free reorganization treatment; (2) ensuring through diligence that there are no unexpected tax liabilities; (3) understanding the impact of the deal on complex international tax structures and the sales process that is required by such structures; and (4) if a buyer does a series of material acquisitions, it must monitor whether there will be a change of control that would limit utilization of its net operating losses (NOLs).

How has SOX impacted M&A practice?

SOX often helps buyers, because targets are much more incentivized to be acquired, and a target's "threat" to effect an IPO as an M&A alternative is less credible.

Through diligence the buyer and the buyer's auditors must carefully evaluate the target's controls and processes, so there is no impact on the buyer's ability to give all required SOX certifications.

Generally, SOX is less of a concern if the target is either immaterial or it will be quickly absorbed into the buyer's systems and processes.

In EMC's acquisition of Documentum, EMC had Documentum complete the SOX work for QTC (quote to cash) (invoicing, fulfillment, AR, collections) and IT, but not other controls work as it was not deemed material to EMC. Documentum was sufficiently material overall that substantial SOX issues would have impacted EMC's 404 certification.

How do you try to make sure that the target employees remain adequately incentivized?

It is critical to structure the deal to provide a mix of liquidity to shareholders and retention of key employees. An ideal mix of consideration for this purpose might be some cash and some stock, as investors usually want to maximize cash, but founders are willing to take a mix of cash and stock if the deal is tax-deferred. It is critical that there be enough deal value allocated to the common stock (i.e., the R&D team) to provide a meaningful incentive and that may require asking preferred holders to reduce their liquidation preference.

Another way to incentivize retention is to make sure the overall compensation package of the target employees is fair and well structured, enter into employment agreements with top key employees, ensure that employees have meaningful jobs with clear duties, ensure that the HR integration process is very smooth and fast (e.g. badges work, email works) so employees don't get frustrated and can be creative and productive immediately.

To avoid internal resentment where there is an earnout, it may be advisable to adjust internal salaries of existing buyer employees who need to help the target employees achieve the earnout.

In some cases (e.g., EMC-Documentum), a specific cash bonus plan to help ensure retention can be highly effective. In that case, each key employee was paid a multiple of on target earnings over a specified (6, 15, or 30 month) retention period, and attrition was minimized.

Comment on lessons learned from evaluating past deals

Generally speaking, deals are more likely to be successful where:

- there is a clear reason for doing the deal and a clear fit with the buyer's long term strategy;
- the integration process was managed in a manner that fit with that strategy and rationale;
- the deal had an executive sponsor within the buyer who was accountable for the achievement of the anticipated benefits of the deal;
- the tough operational decisions after closing (like RIFs and other cost savings measures and terminating overlapping products) are made quickly but in a manner that does not disrupt the business;
- any earnout is structured in a manner that is consistent with the buyer's long term business objectives; and
- the buyer actively monitors performance of its deals, to help it learn from past mistakes and adjust terms accordingly.

What are the benefits of using earnouts?

The benefits of earnouts include:

- it helps bridge a valuation gap when the negotiations get bogged down, which can accelerate negotiations, although trying to anticipate all future earnout issues can slow the negotiations;

- it puts the burden on the target team to timely deliver the promised products and bookings, which incentivizes and focuses the target's R&D and sales teams in particular;

- earnouts are often easier to analyze and present to the board and analysts, because there is less risk of overpaying when the earnouts are tied to future bookings; and

- of necessity, earnouts require that the parties trust each other and reach a shared understanding that if unanticipated issues come up, they will be dealt with fairly and by an agreed resolution process—so the earnout discussions can be a good means of determining when that trust and cooperative working relationship is there, and when it isn't (in which case, the deal is often not worth pursuing).

What are the disadvantages of using, and issues that come up in structuring, earnouts?

Disadvantages of earnouts can include:

- it is difficult to anticipate every issue as to which there will be a future ambiguity, resulting in disputes or difficult future negotiations;

- earnouts are difficult to negotiate and administer;

- frequently, earnouts leave the target employees incentivized to take actions that turn out to be inconsistent with the buyer's long-term company-wide goals;

- products tend to blur over time, making measurement difficult, especially for software. For example, it may be unclear how to fairly allocate revenue and development costs over time;

- the target will often seek to blame any failure to achieve earnout milestones on budget or synergy shortfalls;
- new hires into the target's business unit can be difficult, as they come to resent the differences in overall compensation between otherwise similarly situated employees. The same issue arises with existing buyer employees whose cooperation is needed to achieve earnout milestones;

- revenue-based milestones can be much more complicated than bookings-based milestones due to the complexities of revenue recognition, and operating income based milestones present even greater complexities and opportunities for being "gamed" by either party; and
- provisions designed to let the target operate independently post closing, or that give firm assurances to target executives as to continued employment, can result in a lack of operational flexibility that can result in a misalignment of goals.

Any other comments on negotiating tactics as to matters other than deal value?

On the sell side, it is critical to build relationships with top executives at potential buyers, to know who the executive sponsor for your deal is at the buyer, to have alternatives to the deal and to let the bankers and lawyers work the issues up front.

It is critical to have multiple negotiating channels, but to have a back-channel means of resolving negotiating logjams, usually CEO to CEO or CTO to CTO, because it is usually easier to compromise in back channel discussions than in open negotiations.

It is critical for the buyer to understand the cap structure of the target, and to determine the deal value at which the key target employees will meaningfully participate in the deal proceeds, which is usually the minimum price for opening deal negotiations.

Any other comments on other process or timing issues?

On the sell side, sell when you are doing well but concerned about the future. For example:

- DCTM was on a two-year roll in a tough environment;

- It had an acquisition path laid out and begun;

- It was, however, concerned that various larger companies would become competitors in the near future;

- It saw the world moving from best of breed to best stack:
  - Consolidation was the norm;

- Growing from $300M to $1B on its own was risky.

On the buy side, it is critical to have a standard methodology for looking at deals and for evaluating the financial model, valuation, strategic fit, and synergies, and for tracking the performance of each M&A deal post-closing (and holding the executive sponsor accountable if there is a failure to achieve the expected performance). If you don't have a standard approach, you can often have a valuation disconnect, i.e., you overpay.

As a general rule, the more companies you buy, the more you learn to spend more time, up front and over the months following a deal, focusing on integration.

Comments on bankers?

Buyers benefit from using bankers on public-public deals, for the full services they can provide: fairness option, board materials, board relations and deal negotiations. When representing the target, bankers are good at playing the "bad cop" in negotiations, which is helpful because it is difficult for target officers to assume that role, since they often will start working for the buyer post-closing. It is less critical for a public buyer to use a banker in an acquisition of a private target that will not require buyer's stockholders' approval. However, the buyer may be better off if the target has a banker to educate the target as to valuation norms and smooth out the deal process.

Any other lessons learned?

- On the buy side, be sure to have an executive sponsor.

- On the sell side:

1. Keep the team involved in the deal very, very small.
    - The distraction level is unimaginable.

2. Quickly set up a comprehensive due diligence war room.
    - That will save countless hours of work later.

3. Know how to reach key people, such as board members.

4. Plan retention carefully:
    - Expect that revenue synergies will always fall short and take longer than expected.
    - Remember, your projected business case will become your financial plan

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