# M&A Seminar Series, Session One

## Investment Banker View

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Fenwick
FENWICK & WEST LLP

### Summary of Discussion Points

**Panel**


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**What is the right time for a target to sell?**

Sell while it is still opportunistic rather than an imperative. Optimum timing for a private company may be where it does not have a near-term financing need and it is far enough away from the previous valuation that it has had the time to create more momentum. Sell when you actually have something to sell. If you are approached by one of the dominant players in your market segment, consider that bid carefully, as if you spurn the inquiry, you can expect that the inquiring company will soon become a competitor. A "dual-track" M&A processes makes far more sense when the "second-track" is an IPO (and the company is a realistic IPO candidate) than when the second track is another private (down value) round.

**Valuation Methodologies.**

Bankers typically use comparable public companies analysis (multiple of revenue, EBITDA, net income), comparable transactions analysis (multiples of last twelve months and next twelve months revenues), accretion/dilution analysis and discounted cash flow (DCF) analysis.

**Negotiating Valuation.**

The target will seek credit for negative (cost) and positive (product, technology, customer) synergies, and buyer will initially refuse as it is typically "bringing those to the table"; end result is often a compromise, particularly in a competitive situation.

**When do you make (and evaluate) your "best and final" offer?**

Certainly, if you think another bidder will emerge or an auction is involved or you expect that the target will shop the deal, it makes sense to leave room to move the price up. A record of upward price movement through negotiations is critical for the target board to demonstrate it satisfied its duty of due care, so the buyer will want to accommodate that. Also, the optimum record for the target board may be to give up some negotiating demands, such as for a "fiduciary out", in order to obtain a more certain deal at a higher valuation. A target must realize that the bidder that appears to have the highest bid may in fact lower that bid later after diligence, so sorting bids pre-diligence is dangerous. From this perspective, targets are well advised to do e-rooms of all diligence materials, let various interested parties all do their diligence at once, and then compare their offers.

**Shopping The Deal.**

The key is to identify likely buyers, their ability to pay, their strategic interest, their acquisitiveness, any timing concerns (such as where a potential buyer is distracted integrating a recent acquisition), sort them into Tier 1 and Tier 2 categories based on these factors, then get the Board's buy in on which potential buyers to approach, and what the specific "pitch" is to each potential buyer. The shopping process will vary significantly depending on whether the target is public or private, pre-revenue or profitable and/or in need of funding. Shopping is most effective when at least two bidders engage. Unless the company has a relatively sizable revenue base and cash-flow (and is a candidate for a financial sponsor take-out), there are usually relatively few logical strategic buyers for any particular business. If you've struck out with the Tier 1 list, it generally doesn't make sense to widen the net and extend the process, as that can be perceived as a sign of weakness. Extensive shopping can strain relations with customers and employees, and embolden competitors, leaving the target with no choice but to sell.

**What is required for you to advise the board that it has obtained the best price reasonably available?**

To determine whether you have identified all the potentially interested buyers for a target, evaluate which companies have made acquisitions in the market segment, as outsiders will rarely come in to a new market segment. Also, look at the proclivity to buy and the strategic interest of each potential buyer, and ask, is this the right time for a particular buyer to look at the target (e.g., is buyer distracted integrating another recent acquisition). For technology companies, often the "best price" reasonably available can be the only price reasonably available because the number of logical and likely strategic partners is relatively low, so the Board really needs to evaluate not only whether there is likely to be another buyer either now or in the future, but also what are the company's prospects "stand-alone" in the absence of the deal at hand and how might that impact future appetite for the company.

**Can you lock in a public target?**

Generally, no, as the target board will need to retain a fiduciary out for unsolicited superior bids and the Omnicare case makes clear that effectively locking a deal with voting agreements is impermissible. However, it is typical to require the target board to bring the deal to a vote even if there is an intervening bid. Use of a cash tender offer structure can reduce the time for another bidder to emerge. Requesting an option to acquire 19.9% of the target may dissuade another bidder, although such options are infrequent now that pooling accounting has been eliminated. Other tactics could include asking for a higher than normal break-up fee. All of these devices can create fiduciary duty problems for target board, which could backfire on the buyer if a court invalidates the provision.

**Is the threat of doing an IPO a credible alternative to an M&A deal for a venture-backed company?**

Generally, no. M&A remains a far more common exit strategy than IPOs, among other reasons because IPOs take 1-2 years longer to incubate and it takes 50% more investment to prepare for an IPO than to be acquired. The IPO market is just not that viable and robust to be a credible alternative to an M&A deal. To make IPOs more viable, we would really need to rebuild the IPO infrastructure. The threshold for IPO candidacy will remain very high, and the market and execution risk for public companies will continue to make it a far more expensive and risky alternative to M&A. Also, Sarbanes is making IPOs even less attractive as an M&A alternative, since the cost of being public has risen dramatically. Companies that truly are IPO candidates will have the luxury of choosing between an IPO or being acquired at a public market valuation, while less robust companies will have a difficult time arguing for it credibly for the reasons noted.

**Comments on collars?**

Collars are very complex. There are a wide variety of collars, such as those assuring a minimum equity percentage to the target stockholders, a minimum dollar value of the deal, or that a set a dollar value or ownership percentage that will not be exceeded. Whether a collar make sense depends on the parties' expectations as to movement in the price of the target. A collar should be flexible enough to anticipate that the buyer's stock frequently will trade down when market first hears about a deal then will trade up as the market learns about the synergies in the deal. A major concern with collars is that they encourage arbitrageurs to game the stock.

**Comments on Earnouts?**

It is challenging to construct an earn-out structure that is equitable to both parties. Earnout milestones tend to be centered either on product availability or technical milestones (which are better) or financial performance targets (which are worse). Financial targets (particularly sales or bookings) are difficult because the acquired management team usually doesn't control resources and pricing policies that drive product pricing and revenue. If parties wish to use an earnout, they should try to anticipate all the interpretation "issues" that will come up later, such as how to handle bundled deals, derivative product deals, inordinately discounted sales, and so forth. The target will also seek to impose some "operating parameters" on the acquirer to help ensure, for example, that the acquirer will fund the operating budget, and continue to offer and support the product, during the earnout out period.

**Is it better to use a more or less detailed term sheet?**

In general, the private target's leverage declines after it signs a no shop, so the target will often be best served by having a more detailed term sheet that covers the key economics, deal certainty, escrow percentage and term and indemnity cap. Buyers can also benefit from winning key points (such as that escrow is a non-exclusive remedy) in a term sheet, as that will likely reduce subsequent negotiating time, but buyers often have more leverage at the agreement stage. Public-public deals usually have a generalized deal summary (with some key terms left open), not a letter of intent, to minimize the need for disclosure. If a target knows that some issues may surface in diligence, such as a potential IP claim, or a third party consent that will be hard to obtain, it is often best to disclose that point before the term sheet, and resolve that matter in the term sheet, so it is not used later as an excuse to lower the deal value.

Use of Cash vs. Stock. Buyers that have excess cash, or that perceive their stock to be undervalued, favor cash deals. Targets seeking a tax-free exchange (or the upside from deal synergies pushing up the value of the acquiror's stock post-closing) will favor a stock deal. Another factor currently favoring cash is the relative opportunity cost (interest rates are low while stock valuations are fairly rational). Cash deals can be completed more quickly and with lower deal costs. However, by offering cash, the buyer may put the target into "Revlon" mode where it is forced to shop the deal heavily to get the best price reasonably available.

**Views on the current M&A environment?**

M&A volume is expected to increase in 2005 relative to 2004, as it did in 2004 relative to 2003. M&A drivers include excess cash on balance sheets, industry consolidation (e.g. in telecom), increased CEO confidence, activity driven by hedge funds and private equity players, increases in hostile deals, a strong economy, availability of cheap financing, strengthening stock prices and the continuing moderate trend of deal premiums. Conditions are ripe for consolidation in almost every sector, including software, e-commerce, media, semiconductor and EDA. The poor market reception to the HP/Compaq and AOL/Time Warner deals may slow down large deals in favor of smaller, strategic deals that add markets, products and customers. Expect increasing M&A activity in Asia, particularly in India and China, as companies map out M&A strategies that will help them better compete in the global market place. The predominant M&A trend in 2005 may be deals that are "tactical" in terms of technology and product footprint, more "strategic" in terms of acquiring captive customers where footprint matters, and sustainable.

**Observations on the recent spate of hostile deals?**

The increased interest in M&A generally is contributing to the increased amount of hostile activity. Expect more hostile activity, particularly in industries that are consolidating, as companies are looking for R&D, products and customers in particular market segments. Other factors driving increased hostile activity include the large number of mid-sized companies with "orphaned" market capitalizations and the increased aggressiveness and clout of buyout funds. Where the target is in a hot market segment, it may generate multiple bids, both friendly and hostile. The old view that hostiles don't work since the people are the asset (and they can walk out the door if they don't like the hostile acquirer) may be true in "hot" market segments where many new start ups are being funded, but is much less true in less favored segments, such as the capital equipment and enterprise software segments, where few start ups are being funded, growth is poor and the segment is ripe for consolidation, so there is really no place for the employees to go.

**Comments on the trend towards increased M&A litigation claiming the deal process was not designed to maximize price?**

The plaintiff's bar has noticed that the results of Delaware appraisal cases have been that the courts hold that the acquired companies are worth 1.5 to 2 times the negotiated M&A deal value, and much of that results from DCF analysis, which can produce a different result than other analyses and "reality based" deal negotiations. Given the increased M&A

litigation risk, is critical for the public target to establish a strong record of having shopped the company and ensure that the Board's discussions are vigorous and extensive and that potential conflicts of interest are carefully scrutinized and disclosed. Use of special committees of disinterested board members, with their own counsel and banker, can help provide added protection, but no approach can prevent a strike suit. Unfortunately, M&A litigation fails to recognize the reality that most technology companies don't lend themselves to "a process designed to maximize price." At most, the process is really designed to find a logical, willing buyer with the financial wherewithal to pay a premium for the company. Price maximization and "auctions" are a luxury for sellers of reasonably "interchangeable, commodity" properties that throw off large amounts of cash. Those kinds of companies lend themselves to a meaningful DCF exercise. DCFs are not as useful in valuing high-growth industries, since so much of the resulting DCF value comes from the terminal multiple, so the DCF is actually more representative of a future assumed "take-out" of the business. Still, Plaintiffs will often claim that a DCF is "more reality-based" than an implied multiple of forward earnings or trailing EBITDA because it is a bottoms up representation of the company, but the numerous inputs imply a false sense of precision. Large companies like IBM, MSFT and AOL all emphasize a DCF approach to valuing acquisitions, but they factor in numerous internal synergies and product position/distribution plans that they alone are in a position to model.

**How do you manage down the risk of director liability in M&A deals in light of the recent case law (Disney and Emerging Communications) finding potential liability where directors [allegedly] knew that they were making material decisions without adequate information and deliberation?**

Directors are being, and should be, much more rigorous in light of these cases. Even pre-LOI, boards are requiring bankers to work harder to prepare the board, requiring more to justify the strategy of a deal and requiring more data about the risks of a deal. Boards are much more likely to kill a deal. M&A is, and should now be, more of a "working committee" process at the board level. A banker should meet with the Board "often and early." It is critical that the board has good materials, adequately in advance and that meeting record shows that directors understood and dug in on the issues. "Follow-up" Board meetings should be encouraged. Bankers should try to illustrate for the Board potential shareholder reaction and encourage a discussion as to what needs to be true from shareholders' viewpoint for a deal to have created value.

**Comment on proposed NASD fairness opinion rules?**

NASD has solicited comment on whether to propose new rules that would require specific procedures and impose specific disclosure requirements where a banker issues a fairness opinion in situations that arguably involve a conflict of interest. The panelists' view was that banks are already very cautious in issuing fairness opinions given the related liabilities, and that these rules would be counterproductive.